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Planning Buy-Sell Agreements In The Hospitality Industry

Abstract

In the article - Planning Buy-Sell Agreements In The Hospitality Industry - by John M. Tarras, Assistant Professor, School of Hotel, Restaurant and Institutional Management at Michigan State University, the author initially observes: "The vast majority of hospitality firms (restaurants, hotels, etc.) would be considered closely-held corporations. As such, they have unique planning problems compared to large, publicly-traded hospitality firms. One area of special concern to the closely-held hospitality firm is the planning and adoption of a buy-sell agreement."

The above thesis statement outlines the heart of the article; the buy-sell agreement in regard to smaller [closely held, as Tarras calls them] corporations.

The theory is narrow and pro-active, spanning the gap between personal-to-corporate stock manipulations.

"The primary purpose of a buy-sell agreement is to contribute to the orderly transfer of a shareholder's stock in a hospitality firm upon some future incident [typically retirement, withdrawal of a shareholder, disability, or death], as Tarras defines the concept.

"The hospitality firm or the other shareholders would be committed to purchase the departing shareholder's stock at an agreed upon price and method, and to ensure that ample cash will be obtainable for such an impending sale. The buy-sell agreement provides a market for the shareholder or the shareholder's estate for the sale of otherwise illiquid stock," the author further provides as canons of buy-sell agreements.

In defining the buy-sell agreement with restrictive clauses, Tarras demonstrates, "... many closely-held hospitality firms desire to limit ownership to those individuals, either family or principal corporate employees, who are essential to the well-being of the firm."

Tarras says, another element of the buy-sell agreement is to furnish the departing shareholder with liquidity. "... there typically is some form of cash down payment with the remainder denoted by an interest-bearing promissory note [usually 5 to 15 years]," he informs. "The departing shareholders may require that the hospitality firm pledge the assets of the firm and that the remaining shareholders personally guarantee the promissory note."

"... the most frequent reason for establishing buy-sell agreements is for estate planning purposes," Tarras says.

There are tax advantages and liabilities for both the seller and buyer of stock via the buy-sell agreement, and the author enumerates many of these.

One, big advantage of the buy-sell agreement is that it provides for the running of the company with a minimum of disruption through the stock-cash transition process, Tarras offers.

Keywords

John M. Tarras, Planning Buy-Sell Agreements In The Hospitality Industry, Shareholders, Stock purchase [s], Estate planning, Liquidity

Planning Buy-Sell Agreements In The Hospitality Industry

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The vast majority of hospitality firms (restaurants, hotels, etc.) would be considered closely-held corporations. As such, they have unique planning problems compared to large, publicly-traded hospitality firms. One area of special concern to the closely-held hospitality firm is the planning and adoption of a buy-sell agreement.

The primary purpose of a buy-sell agreement is to contribute to the orderly transfer of a shareholder's stock in a hospitality firm upon some future incident (typically retirement, withdrawal of a shareholder, disability, or death). The hospitality firm or the other shareholders would be committed to purchase the departing shareholder's stock at an agreed upon price and method, and to ensure that ample cash will be obtainable for such an impending sale. The buy-sell agreement provides a market for the shareholder or the shareholder's estate for the sale of otherwise illiquid stock. Partnership interests can also be the aim of such agreements.

In addition, a well written buy-sell agreement can give shareholders control over who will receive the stock prior to the event that initiates the buy-sell obligation. For instance, many closely-held hospitality firms desire to limit ownership to those individuals, either family or principal corporate employees, who are essential to the well-being of the firm. The closely-held hospitality firm typically has shareholders who have some relationship to each other, either familial or business, with an inordinate wish to thwart outside interests from becoming included in the firm's operations. The buy-sell agreement with a restrictive clause incorporated within it is most effective in this type of situation.

Buy-sell agreements are most useful when there is a desire to assure continuity of the hospitality firm. Major shareholders may wish to assure family members with a desire for running the firm that they will be given control through the buy-sell agreement. Also, key employees may be given an incentive to stay if the buy-sell agreement provides for assurance that the firm will continue, even if events occur which require the existing shareholders to dispose of their stock (i.e., death).

Another aim of a buy-sell agreement is to furnish the selling shareholders with liquidity. This does not mean that a buy-sell agree-

ment should furnish an all-cash remuneration to a shareholder whose stock is redeemed or purchased. Instead, there typically is some form of cash down payment with the remainder denoted by an interest-bearing promissory note (usually 5 to 15 years). The departing shareholders may require that the hospitality firm pledge the assets of the firm and that the remaining shareholders personally guarantee the promissory note. In many cases the departing shareholders will also demand that restrictions be placed on dividends, salaries, and transferability of the firm's common stock until the note is paid off.

Lastly, the most frequent reason for establishing buy-sell agreements is for estate planning purposes. The buy-sell agreement is especially valuable as it can establish estate valuation of the shareholder's stock well in advance and provide the administrator of the estate with the liquidity to pay cash payments to the heirs. It also allows the other owners to continue running the hospitality firm with the minimum of disruption. Anyone who has tried to establish value for a closely-held hospitality firm will appreciate the benefit of a well written buy-sell agreement. Many a business associate has been shocked to discover that the deceased business associate's wife with no business experience is expecting to help run the business, or the estate of a major shareholder is illiquid and is forced to sell the decedent's stock to outsiders in order to pay the estate taxes. A well-written and funded buy-sell agreement will eliminate the problems cited above and help eliminate costly legal infighting between family members and the remaining shareholders.

The best time to consider the advisability of entering into a buy-sell agreement is when the firm is organized. Such an agreement may be entered into between the shareholders and the corporation (redemption plan), or it may be entered into among the several shareholders without the involvement of the corporation (cross-purchase plan). Normally, it is preferable to involve the corporation since this enables corporate funds to be utilized in the acquisition of stock of a withdrawing shareholder.

To formulate an agreement to the wishes of a hospitality firm and its shareholders, buy-sell agreements can blend the attributes of both redemption and cross-purchase plans. Covered by a "hybrid" plan, remaining shareholders may be required to acquire a definite number of shares from the departing shareholder, for example, an amount that will equalize ownership holdings, and the firm may be obliged to redeem the remaining shares.

Types Of Buy-Sell Agreements Vary

The buy-sell agreement can be exclusive with the firm or among the shareholders, even though most buy-sell agreements provide for both, maintaining the right to obtain a selling shareholder's stock before a sale can be made to anyone not currently associated with the firm. However, elements external to the business must be initially considered before choosing the appropriate type of buy-sell agreement. For example, if the hospitality firm is a franchisee, there may be restrictions on the transferability of the franchise which may require separate release forms being obtained from the franchisor prior to implementing the buy-sell agreement.

However, very critical planning considerations involve the needs of the individual shareholders and include the type of ownership, ages, insurability, and financial circumstances for each of the individual shareholders. All these factors interrelate and must be evaluated in order to arrive at the optimal buy-sell agreement.

Liquidity is usually provided to the departing shareholder through a cash down payment and promissory note. Most buy-sell agreements covering the death of a shareholder are funded with life insurance. The shareholders need then to ascertain whether all the parties to the buy-sell agreement are insurable. If any of the shareholders are uninsurable, then the hospitality firm may have to resort to some alternative form of providing for the potential buy-out of those shareholders (i.e., a special cash savings account). In addition, if the cross-purchase method is used for redeeming the stock of a decedent shareholder, then each shareholder must purchase, own, and pay the premiums on life insurance of the other shareholders. This can become burdensome to the younger shareholders who must purchase insurance on older shareholders, who most likely own the largest portion of the firm's stock. If the inequities are too great, then use of a cross-purchase agreement may need to be aborted and a redemption agreement will need to be substituted in its place. However, one advantage of the cross-purchase agreement is that the shareholders who purchase the stock of the other shareholders will increase their tax basis in the stock acquired, while the firm's purchase of the stock through a redemption clause will not necessarily increase either the firm's basis or its assets or the shareholders' basis for their stock.

On the other hand, a redemption agreement is easier to fund by life insurance than a cross-purchase agreement. A redemption agreement centralizes the purchase of a shareholder's stock because the hospitality firm will own and pay for the life insurance for each of the shareholders. Another advantage of the redemption method is that once the agreement is written, it does not need to be amended for each addition or subtraction from the shareholder group.

When contemplating a buy-sell agreement for the hospitality firm, the shareholders need to contemplate whether to adopt a mandatory or optional purchase terminology within the buy-sell agreement. The decision to adopt a mandatory or optional buy-sell agreement will depend upon the circumstances and desires of each of the shareholders. However, if the desire of the firm is to provide liquidity or the continuity of the firm, then the mandatory purchase method would be preferable. Governed by the terms of a mandatory buy-sell agreement, either the firm or other shareholders consent to buy the stock of the departing shareholder at a specific price recorded in the agreement, upon a definite occurrence (usually death). In addition, terminology of such an agreement often restrains or prevents lifetime transfers. In establishing value for estate planning purposes, the mandatory method has proved the easiest to apply.

Frequently a buy-sell agreement will be designed so that a stockholder will be restricted as to who may purchase his stock during

his life, while at death either the hospitality firm or other shareholders will have the option to purchase the stock at a specified price and the estate of the shareholder will be obliged to sell at that price. Although the option method is less desirable for the shareholder who wishes liquidity, it is a valid planning tool for the firm which may not have the present means to guarantee a buy-out price for shareholder's stock.

Valuing The Hospitality Firm Varies Widely

Techniques for establishing a value for the disposal of any hospitality firm in a buy-sell agreement deviate widely and will be mandated essentially by what the shareholders deem fitting for valuation of the hospitality firm. Accordingly, the pricing formula may be predominately based on book value, earnings, appraisal by an outside party, or an annual establishment of an agreed price.

Book value is a simplified valuation method, and it usually ignores the vitality of a hospitality firm. Book value is net worth as shown on the balance sheet divided by the number of outstanding shares. The deficiency with this method is that it portrays a value at a certain date. Assets are carried at their original cost less depreciation, and growth potential, geographic domain, and competence of personnel are not specifically valued under this method. Despite the inherent drawbacks of the book value method, the majority of buy-sell agreements utilize this method for assessing the firm's value.¹ The ease of use apparently outweighs the overly simplistic application for assigning value.

The capitalization of earnings method substantiates a firm's value by multiplying the firm's earnings capacity by a capitalization rate. However, the capitalized earnings method of valuing a hospitality firm is merely as reliable as the capitalization rate chosen. The pitfalls with a capitalization of earnings valuation are complicated due to a firm's earnings capacity which may not correctly reflect income, and a key shareholder's death may negatively influence earnings capacity. Despite these obstacles, the capitalization of earnings is a good method for assessing a hospitality firm and is a valuable tool when shareholders can agree upon the capitalization rate to be used.

A buy-sell agreement can provide for a hospitality firm's value to be agreed upon by outside appraisers. The acquisition price could be determined by independent appraiser(s), with shareholders agreeing by majority vote to abide by the appraisal accepted. However, the price of appraisals is costly and since precise appraisals are recurring, this method can be economically impractical. If this method is used, the agreement should define the formula for the appraisal and the capitalization rate distinctive to the particular hospitality business being measured.

Lastly, an easy method of valuing a hospitality firm, although not necessarily the most accurate method, is merely to agree by majority vote to a price per share of stock at each annual corporate meeting. Periodic updating is essential because continued operations may make a previously agreed to value unrealistic.

Buy-Sell Agreement Can Benefit Estate Planning

The more common use of the buy-sell agreement is for the purpose

of estate planning.² A correctly drafted buy-sell agreement can establish the estate tax value of a deceased shareholder's stock at the value that the agreement requires the shareholder's estate to sell the stock. The estate tax advantage of determining the stock's value can be considerable since the agreement can set the buy-sell value at a modest fraction of the value which the stock would have had if there were no requirement to sell at the buy-sell price. However, in order for the stock's estate tax value to be established at the buy-sell price, regulations³ and case law state that an agreement must fulfill four requirements.

The first requirement is that the buy-sell agreement must arrive at either a fixed or determinable value according to a formula method or a fixed value method which was reasonable at the time the buy-sell agreement was entered.⁴

The second requirement is that the deceased shareholder's estate be required to sell his stock according to the buy-sell agreement and that the other shareholders or the hospitality firm be obligated to purchase the deceased shareholder's stock (mandatory method). An option (optional method) to purchase the decedent's stock by the remaining shareholders or the hospitality firm has generally been held to be controlling to determine the value of the stock.⁵ The primary question becomes whether or not the estate is required to sell under the buy-sell agreement. Thus it has been held that a mere right of first refusal by either the selling estate or buying shareholders or firm will not control for determining value.⁶

The third requirement states that the deceased shareholder must have been required to offer his stock during his lifetime to the other shareholders or to the firm before considering outside offers.⁷ The reason for this requirement is simply that if the decedent had been free during his lifetime to sell his stock, he may have been able to procure a higher price for the stock.

The fourth requirement states that the buy-sell agreement must be a bona fide business arrangement and must contain adequate consideration when the parties enter into the agreement. Buy-sell agreements have been held to constitute valid bona fide business purposes which are set up to preserve continuity of management, to maintain family control, and to arrange affairs in the best interest of the hospitality firm.⁸

The buy-sell agreement, however, must not be a tax avoidance device for passing a decedent's shares to the natural objects of his bounty for less than adequate consideration.⁹ Adequate consideration for determining the value of the stock has generally been resolved to mean at the time that the buy-sell agreement has been entered.¹⁰ However, if at the time of the buy-sell agreement adequate consideration was provided for, the courts have generally held that subsequent appreciation in value of the business would not invalidate the value established in the buy-sell agreement.¹¹

Nevertheless, mere compliance with the requirements enumerated above will not necessarily result in fixing the estate value of the decedent's stock according to the buy-sell agreement. If the decedent was not in good health when he entered into a buy-sell agreement, the courts

will look closely at the facts to determine if the buy-sell agreement is actually a testamentary tax avoidance device.¹² Furthermore, in *St. Louis County Bank*,¹³ the Eighth Circuit created uncertainty whether a buy-sell agreement will fix the value of a decedent's stock when the facts infer a testamentary device for passing stock to one's heirs.

In this case, a buy-sell agreement was entered into between shareholders of a family corporation. Originally the company was in the moving and storage business (an operating company); it later changed into a rental of real estate (investment company). The decedent, who controlled the firm, had entered into the buy-sell agreement when his health was poor but while the company was still an operating entity. Losses incurred in the rental of real estate caused the value of the decedent's stock to reflect a zero value when applying the formula in the buy-sell agreement. Upon the death of the decedent the agreement was not enforced by the corporation as was its right under the buy-sell.

The court found that the fact that the corporation did not invoke the provisions of the buy-sell agreement when it was economically feasible to do so (value would have been zero to the corporation) and the ill health of the shareholder when the buy-sell agreement was entered into provided a basis for inference that the agreement was a device for passing the decedent's share to his family members without incurring estate taxes.

Therefore, shareholders when planning a buy-sell agreement need to consider not only the four requirements discussed above but also avoid any inference in the agreement that would make it a testamentary device for transferring stock to the younger family shareholders. Shareholders can contradict the inference by ensuring that if a formula is used, it establishes a reasonable value for the hospitality firm; or if a fixed price is used for establishing the value, it reasonably reflects the value of the firm. Also, as previously mentioned, the buy-sell agreement should be entered into at the time the firm is organized or at least while the principal shareholders are in good health.

Tax Consequences For Purchasers Are Simple

If the cross-purchase method is used to fund a buy-sell agreement, the tax consequences for the purchasing shareholder are quite straightforward. The shareholders will receive a stepped-up basis in the stock they purchase.¹⁴ If the shareholders have purchased insurance upon the life of a decedent shareholder, the insurance premiums will not be deductible;¹⁵ however, the insurance proceeds will be tax-free to the shareholders.¹⁶

When the redemption method is used, generally the hospitality firm will not recognize taxable gain upon its redemption of a shareholder's stock if only cash is distributed.¹⁷ However, if the hospitality firm distributed property other than cash to the departing shareholder, the firm will recognize taxable gain to the extent that the fair market value of the distributed property exceeds its adjusted basis.¹⁸

If life insurance is purchased by the firm, the proceeds will be received tax free;¹⁹ however, the premiums paid for the insurance will not be deductible.²⁰ Generally, the remaining shareholders do not receive an

increase in basis for the stock redeemed by the firm as in the case of the cross-purchase method.

Another potential tax planning problem for the firm occurs when a redemption is funded on earnings set aside by the firm. In such cases, the firm may become liable for the accumulated earnings tax which is imposed where corporate surplus exceeds the reasonable needs of the business.²¹

Generally, if the redemption under a buy-sell agreement is motivated by maintaining harmony in the firm by buying out a minority shareholder's interest, then the courts have held this to be a reasonable need of the firm.²² However, accumulating funds merely to redeem a majority shareholder's stock has been held not to have been for the reasonable needs of the business.²³

Tax Consequences For Sellers Are More Complicated

For years prior to 1987, a seller of stock under a buy-sell agreement desired to obtain capital gain treatment upon the redemption of his stock. If the cross-purchase method was used, the selling shareholder had no trouble obtaining capital gain treatment. However, things were more complicated if the stock was purchased using the redemption method. Here the departing shareholder and corporation would need to plan carefully to fall within one of the safe harbors of IRC Section 302²⁴ in order to obtain favorable capital gain treatment and to avoid dividend income treatment. Generally, any shareholder who terminated his entire interest in the firm and planned carefully would have been able to obtain capital gain treatment upon the redemption of his interest.

Under the Tax Reform Act of 1986, the favorable 60 percent capital gains deduction for individuals is eliminated. However, the highest tax rate that can be imposed on capital gains is 28 percent. When fully phased in, the effective top individual rate can be as high as 33 percent for certain high income individuals. The Tax Reform Act of 1986 provides a formula for ensuring that the top rate paid on net capital gains remains at the 28 percent level for all qualified transactions after 1986. Therefore, most shareholders will still find the need to plan the buy-out so as to qualify for the capital gain and thus avoid the higher rate phase in for high income individuals.

Notwithstanding that preferential rate treatment for capital gains has been eliminated, the Tax Reform Act of 1986 did not eliminate the code provisions concerning the characterization of income as ordinary or capital. Under the new law capital losses not offset against capital gains will be allowed to offset ordinary income up to \$3,000 annually; the excess is to be carried over to future years until it is used. Therefore, planning is important for the departing shareholder, especially if the shareholder has capital losses to offset against the capital gain from the sale of stock in a buy-sell agreement.

Many buy-sell agreements were established as cross-purchase types because of the inability to qualify for one of the exceptions in IRC Section 302. These buy-sell agreements should be reviewed in light of the Tax Reform Act of 1986 to determine if the often awkward cross-purchase type is still needed.

Under current federal income tax, a deceased shareholder's stock receives a step-up in adjusted basis equal to the fair market value of the stock on the date of the shareholder's death. Since, the fair market value of the stock has been included in the decedent's estate, the beneficiaries realize no taxable gain on the sale of stock because their basis will equal the selling price.

A buy-sell agreement can accomplish several important business, tax, and estate planning objectives. By thoroughly analyzing the needs of a hospitality firm and its shareholders, a carefully drafted, individually tailored buy-sell agreement achieves the shareholders' objectives and helps assure their firm's survival.

References

¹*Buy-Sell Agreements for Privately Held Corporations*, Stanley B. Block, *Journal of Accountancy*, (September 1985), p. 110.

²*Ibid.*

³Reg # 20.2031-2(h) provides:

“(h) Securities subject to an option or contract to purchase. Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.”

See also, Rev. Rul. 59-60, 1959-1 CB 237.

⁴*May v. McGowan*, 194 F2d 1207 (2d Cir 1952).

⁵*Helvering v. Salvage*, 297 US 106 (1936).

⁶*Worcester County Trust Co v. Commissioner*, 134 F2d 587 (1st Cir 1943).

⁷*Estate of Caplan v. Commissioner*, TCM 1974-39.

⁸*Estate of Bischoff v. Commissioner*, 69 TC 32 (1977).

⁹Reg #20.2031.2 (h).

¹⁰*Estate of Bischoff v. Commissioner*.

¹¹*Brodrick v. Gore*, 225 F2d 892 (10th Cir 1955).

¹²*Slocum v. Commissioner*, 256 F. Supp. 753 (DC N.Y., 1966).

¹³674 F2d 1207 (8th Cir 1982).

¹⁴IRC #1012.

¹⁵IRC #264(a) (1).

¹⁶IRC #101(a) (1).

¹⁷IRC #311(a).

¹⁸IRC #311(d) (1).

¹⁹IRC #101(a).

²⁰IRC 264(a) (1).

²¹IRC #531.

²²*Mountain State Steel Foundaries, Inc. v. Commissioner*, 284 F2d 737 (4th Cir 1960).

²³*Wilcox Manufacturing Co., Inc. v. Commissioner*, TCM 1979-92.

²⁴IRC #302(b).