CHAPTER 42

SECTION 303 STOCK REDEMPTION

INTRODUCTION

Internal Revenue Code Section 303 allows the purchase of a portion of a decedent shareholder's stock by his/her corporation to be treated as a sale or exchange rather than as a dividend. A Section 303 partial redemption can provide cash and/or other property from the decedent shareholder's corporation to provide liquidity for the decedent shareholder’s executor to use to pay death taxes and other death-related expenses.

WHEN IS USE OF SUCH A DEVICE INDICATED?

1. When there is a desire to keep control of a closely-held or family corporation within the decedent-shareholder’s family after death.

2. When the corporation’s stock is a major estate asset and a forced sale or liquidation of the business in order to pay death taxes and other costs is a threat.

3. Where a tax-favored withdrawal of funds from the corporation at the death of the stockholder would be useful.

4. When a redemption of IRC Section 306 stock is desirable.

WHAT ARE THE REQUIREMENTS?

1. The stock to be redeemed by the corporation must have been included in the decedent’s gross estate for federal estate tax purposes.[[1]](#endnote-1)

2. The value for federal estate tax purposes of all stock of the corporation that is included in determining the value of the decedent’s gross estate must comprise *more than* 35% of the excess of (1) the value of the gross estate over (2) the sum allowable as a deduction under IRC Sections 2053 (estate expenses, indebtedness, and taxes) and 2054 (losses).[[2]](#endnote-2) Essentially, that means the stock includible in the gross estate must be worth more than 35 percent of the adjusted gross estate. In a hypothetical situation, assume the gross estate is $12,250,000; administrative and funeral costs are $250,000, and there are no other deductible expenses. To qualify for a Section 303 redemption, the value of the stock in question must *exceed* $4,200,000 (i.e., must be more than 35% of ($12,250,000 – $250,000)).

3. The amount that can be safely redeemed under IRC Section 303 is limited; Section 303 limits the "safe" redemption amount to the sum of

(a) all estate, inheritance, legacy, and succession taxes (including generation-skipping transfer taxes) and interest thereon imposed by reason of decedent’s death, and

(b) funeral and administration expenses (whether or not claimed as a deduction on the federal estate tax return) can be redeemed and receive favorable income tax treatment (i.e., avoid dividend treatment).

Any excess will be taxed under the rules of Code Section 302.[[3]](#endnote-3) This means any balance may be taxed as a dividend to the “seller,” the estate or heir from whom the stock is being redeemed, or it may qualify for favorable tax treatment (no realization of taxable gain due to the stepped-up basis of the stock upon the decedent’s death) if the tests of IRC Section 302 are met.

4. A redemption under Section 303 will qualify for favorable tax treatment only to the extent that the interest of a shareholder whose stock is redeemed is reduced either directly or indirectly through a binding obligation to contribute toward the payment of the decedent’s death taxes and/or administration expenses.[[4]](#endnote-4)

See Figure 42.1 for illustrations of the Section 303 Stock Redemption qualifications and favorable tax treatments.

**Figure 42.1**

|  |
| --- |
| **DETERMINATION OF WHETHER ESTATE QUALIFIES FOR**  **SECTION 303 STOCK REDEMPTION** |
|  |
| Federal Estate Tax Value Of Corporate Stock In Gross Estate (1) $4,200,000 |
|  |
| Gross Estate Less Allowable Deductions (2) $6,500,000 |
|  |
| 35% of Gross Estate Less Allowable Deductions (3) $2,275,000 |
|  |
| Qualifies If (1) Is Greater Than (3) |
|  |
| **REDEMPTION UNDER SECTION 303 PROTECTED TO EXTENT OF** |
|  |
| Funeral And Administration Expenses $90,000 |
|  |
| Federal Estate And Generation-Skipping Taxes $400,000 |
|  |
| State Death Taxes $250,000 |
|  |
| Generation-Skipping Transfer Taxes $0 |
|  |
| Interest Collected As Part Of Above Taxes $0 |
|  |
| Maximum Allowable Section 303 Redemption $7440,000 |
| Computations Courtesy – NumberCruncher Software: http://Leimberg.com |

HOW IT IS DONE – AN EXAMPLE

The process of a Section 303 stock redemption is relatively simple. The corporation redeems (buys back) stock from the party who receives it at the death of the decedent-stockholder in question. Usually, the recipient of the decedent's stock will be the decedent-shareholder’s personal representative, that is, the decedent’s executor or administrator. Sometimes the seller will be a direct heir, surviving spouse, or trustee of an irrevocable trust created by the decedent. The redemption is protected (i.e. is treated as a sale or exchange and any gain receives capital gains treatment rather than as a dividend entirely taxable at ordinary income rates to the extent of corporate earnings and profits) under Section 303, however, only if it is purchased from a stockholder who is obligated to pay death taxes, funeral, or administration expenses or whose share of the decedent’s estate is reduced by these expenses.

Stock may not be redeemed from any stockholder who acquired his stock by purchase or gift (if the donor was not the decedent).[[5]](#endnote-5) For example, if a father wills stock to his son and his son later sells or gives the stock to his brother, the brother’s stock is not eligible for a Section 303 stock redemption in the father’s estate. Also, Section 303 is not applicable where stock is redeemed from a stockholder who has acquired the stock from the executor in satisfaction of a specific monetary bequest.[[6]](#endnote-6)

Without adequate prior planning, there may be insufficient funds in the corporation to effect a Section 303 redemption. Generally speaking, cash will be needed by the corporation if the main purpose of a Section 303 redemption is to provide estate liquidity. Although the corporation could borrow the money to pay for the stock, the ability of the business to obtain large amounts of cash may be uncertain and the terms and conditions of the loan may be prohibitive. A method of funding that will guarantee the necessary cash on the insured’s death is the purchase of life insurance on the stockholder by the corporation.

The life insurance used to fund the Section 303 redemption should be a typical key person policy. The corporation should be the applicant, owner, premium payor, and beneficiary. (In the case of an uninsurable stockholder, a sinking fund can be established by using fixed or variable annuities, mutual funds, or other securities.)

*Example.* Assume Aaron Sterling, a widower who dies in 2013, owns 75% of a corporation. His son Joshua owns the remaining 25%. Aaron’s portion of the stock is valued at $6,000,000. The value of his estate, after subtracting allowable deductions under IRC Sections 2053 and 2054, is $10,000,000. Assume there was little cash in Aaron's estate. Assuming Aaron's estate and inheritance taxes and other death-related expenses are projected to be about $4,000,000. The corporation would purchase $4,000,000 of life insurance on Aaron’s life. (This assumes Aaron’s estate and inheritance taxes and other death related expenses will approximate $4,000,000.)

*Step 1:* At Aaron’s death, his stock will pass to his estate. *Step 2:* The corporation then receives the insurance proceeds on Aaron’s life. *Step 3:* The corporation uses the life insurance proceeds to pay Aaron’s estate for stock qualifying for the Section 303 redemption. *Step 4:* The estate transfers stock with a value equal to the money it receives to the corporation. *Step 5:* Aaron’s estate uses the cash to pay federal and state death taxes and administrative and funeral expenses.

TAX IMPLICATIONS

1. The amount paid to the estate should not be treated as a dividend distribution. Instead, it will be treated as the “exchange price” for the stock and will generally result in little or no gain recognized by the estate if the basis for the stock was “stepped-up” by reason of being included in the shareholder’s estate. (Note: if the stock was a gift to the decedent and that gift was made within one year of his death and it then passes from the donee-decedent back to the donor or the donor’s spouse, it will not receive a step up in basis!).[[7]](#endnote-7) However, to the extent the price paid by the corporation to the estate exceeds the estate’s basis, the estate will pay a tax at capital gains rates on any such gain.

Under the current law step-up-in-basis rules, a Section 303 redemption typically results in no adverse income tax consequences to the shareholder from whom the corporation made the redemption (generally the executor of the estate).

The favorable treatment occurs because the basis of the stock in the executor’s hands (say $10 a share) is “stepped up” to the stock’s fair market value for federal estate tax purposes (say $26 a share) and the $26 a share price paid to the executor by the corporation to redeem the stock is generally equal to the stock’s basis, i.e., the $26 a share fair market value for federal estate tax purposes. Thus, the amount realized on the “sale” is exactly equal to the seller’s basis and there is no taxable gain for income tax purposes. In some cases the value per share paid by the corporation is greater than the value of the stock per share for federal estate tax purposes; when that happens, a capital gain results.

2. The insurance premiums paid on the life of the insured stockholder are not income tax deductible by the corporation.[[8]](#endnote-8)

3. When the proceeds of the key person life insurance are paid to the corporation at the death of the stockholder, they will be received free of federal income taxes (with the possible exception of any corporate level alternative minimum tax).[[9]](#endnote-9)

4. Section 303 redemptions are specifically exempt from the income tax law's "attribution" (constructive ownership) rules which artificially attribute stock actually owned by one party to another party. These attribution rules make it more difficult (and sometimes impossible) to qualify for a complete or substantially disproportionate stock redemption under IRC Section 302. Section 303's exemption from these complex and tricky rules are of great help in making redemptions from family corporations possible without the threat of dividend treatment.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

In order to qualify (aggregate) an ownership interest in two or more corporations for purposes of meeting the “more than 35% of adjusted gross estate” test, there must be at least 20% in value of each corporation included in the decedent’s estate. In determining the 20% stock ownership by decedent, the surviving spouse’s half of stock constituting community property may be included by treating it as if it had been included in determining the value of the gross estate of the decedent.

FREQUENTLY ASKED QUESTIONS

**Question** – Is cash the only property that may be distributed by the corporation?

*Answer* – No. If the need for liquidity exists, cash is generally the most practical type of property. However, Section 303 does not require that the corporation make its purchase of the decedent’s stock in cash. The corporation can distribute property “in kind.” For instance, the corporation might distribute income-producing assets such as rental property (e.g., an apartment house, office building, or parking lot) in return for the stock it receives. Unfortunately, the corporation would recognize gain on the distribution of any appreciated property. The corporation could also have taxable income in the event of a recapture of depreciation,[[10]](#endnote-10) liability in excess of basis,[[11]](#endnote-11) and the excess of the fair market value distributed over the adjusted basis.[[12]](#endnote-12)

The corporation can also issue notes to pay for the stock. The redemption rules are tested when the notes are delivered, not when they are paid. However, the notes should have a fairly short maturity (5 years or less).

Stock of the corporation making the distribution does not qualify as “property” and therefore may not be used to buy back the decedent's stock.[[13]](#endnote-13)

**Question** – Do the funds received in the redemption have to be used to pay estate settlement costs?

*Answer* – No, the funds received in the redemption do not *have* to be used directly to pay estate settlement costs. Sometimes, an estate will already have sufficient cash. The estate’s settlement costs (exclusive of debts) only serve as a measure of the amount which can be redeemed. As long as the requirements for Section 303 are met, the corporation can redeem the permitted number of shares regardless of whether or not the executor actually needs the cash for liquidity purposes. Similarly, money or property received by the seller does not actually have to be used to pay estate settlement costs.

**Question** – Is an agreement necessary for Section 303 redemptions?

*Answer* – Generally, an agreement is unnecessary in the case where the executor will acquire the controlling interest in the corporation. However, an agreement would be advantageous to a minority stockholder. This would provide assurance that the corporation will go through with and his estate will benefit from a Section 303 redemption. (Quite often, however, a complete redemption is preferable to a partial redemption. This is particularly true in the case of the death of a minority shareholder because of the relatively weak voting control position the survivors of such a shareholder will have.) Specific permission should be granted by the stockholder in his will allowing his or her executor to effect the redemption.

**Question** – Can a Section 303 stock redemption be done without a majority stockholder’s losing control?

*Answer* – It is possible to complete a Section 303 stock redemption without losing corporate control or diluting stock interest. Where there is a nonvoting class of stock outstanding, it is permissible for the corporation to redeem only the nonvoting stock.[[14]](#endnote-14)

Generally, only one class of stock (common) is outstanding. There are two or perhaps three ways to accomplish the 303 redemption without creating voting or control problems. Recapitalization is the first method. If a corporation has only one class of stock outstanding, a shareholder may exchange a portion of his or her voting common stock for nonvoting preferred stock of equal value. The new preferred stock is then redeemed under Section 303. This creates no adverse effect on the voting control of the corporation.

A second method of overcoming voting and control problems is the issuance of a preferred stock dividend prior to the death of a decedent-stockholder. A preferred stock dividend is declared on the common stock. This entails no recapitalization and, normally, the dividend is tax free. Then the preferred stock is redeemed pursuant to Section 303.

A third possible means of taking money out of a closely held corporation through Section 303 without a relative loss of control was suggested by a ruling that allowed the company to issue a stock dividend of nonvoting stock and to redeem the newly issued stock from the estate without creating a taxable distribution. The approval for such a stock dividend followed by a redemption should be obtained from corporate shareholders.[[15]](#endnote-15)

**Question** – How is it possible to improve the chances of meeting Section 303 tests?

*Answer* – Lifetime gifts of personally owned life insurance or other property (except the stock in question) to the surviving shareholder’s family may reduce the gross estate of the stockholder (but only to the extent such gifts are not made within three years of the stockholder’s death. Gifts of assets within three years of death are brought back into the gross estate under IRC Section 2035 for purposes of Section 303 and its tests).

A sale by the stockholder to the corporation of a personally owned life insurance policy on the stockholder’s life or a contribution to the capital of the corporation should make qualification for a Section 303 redemption easier. This is because the stockholder’s gross estate may not be significantly changed. But, the value of his business interest relative to his personal estate should be increased. (This may also make it easier to qualify for a 6166 installment payout of estate taxes attributable to the business.) Another technique to accomplish the same result is the purchase by the corporation of new key person insurance coverage. This would increase the value of the business at the insured's death relative to the value of the adjusted gross estate.

**Question** – What are the timing requirements for a Section 303 redemption?

*Answer* – The proceeds from the redemption must be received after the decedent’s death and no later than: (1) three years and 90 days from the due date of the federal estate tax return; or (2) 60 days after a tax court decision in a contest of estate tax liability has become final; or (3) the time permitted for the payment of estate tax installments where the executor has elected and the estate qualifies for a deferred payment of estate taxes attributable to the business under IRC Section 6166 (up to 14 years).

However, where a distribution is made *more* than four years after the decedent’s death, the amount of protected distributions is limited to the lesser of: (a) the amount of taxes, funeral, and administrative expenses remaining unpaid at that time, or (b) the taxes and expenses that are actually paid within one year of the Section 303 payment to the stockholder.

**Question** – If there is more than one class of stock outstanding, can the aggregate value of all classes be taken into account in meeting the “more than 35%” test?

*Answer* – Yes, all classes of stock can be added together in meeting the “more than 35%” test regardless of which class of stock is being redeemed.[[16]](#endnote-16)

**Question** – May stock of two or more corporations be aggregated for purposes of meeting the “more than 35% of adjusted gross estate” tests?

*Answer* – Only if 20% or more in value of the outstanding stock of *each* corporation is included in the decedent’s gross estate.[[17]](#endnote-17)

**Question** – Are the constructive ownership (attribution) rules a problem?

*Answer* – No. As noted above, to the extent that stock is redeemed under IRC Section 303, these rules can be ignored.

**Question** – Assume the executor needs cash quickly. Before an IRS audit, a Section 303 redemption takes place. Upon an audit of the estate tax return: (a) the IRS increases the valuation on the stock; (b) the IRS decreases the valuation; or (c) for some other reason the redemption does not qualify under Section 303. How can dividend treatment be avoided?

*Answer* – Arrange for the first contingency by providing that the purchase price and the number of shares redeemed will be adjusted so that the corporation will pay no more, and no less, than the value of the stock as finally determined for federal estate tax purposes. Alternatively, a contingency agreement that voids the purchase and sale could be arranged in the event that the “more than 35%” test is not met.

**Question** – Can the corporation redeem stock other than that held by the executor at the time of the stockholder’s death?

*Answer* – Yes, subject to the limitations discussed directly above; if for any reason stock was included in the decedent-stockholder’s gross estate, it can be redeemed even if it is in the hands of someone other than the estate’s executor at the time of the redemption.[[18]](#endnote-18) For example, if a mother purchased stock with her own funds and held it jointly with her daughter when she died, the entire value of the stock would be in the mother’s estate but the daughter would become the owner of the stock. A Section 303 redemption would be permissible to the extent the daughter’s interest had to bear a portion of her mother’s estate’s taxes and estate settlement costs, which should be considered when drafting the tax clause in the documents. The corporation could purchase (redeem) the stock directly from the daughter.

Likewise (subject to the limitation discussed above regarding an obligation for taxes and expenses), where the stock transferred is considered included in the decedent’s estate because of a transfer with a retained life estate, a transfer taking effect at death or a revocable transfer,[[19]](#endnote-19) the corporation could purchase the stock under Section 303 from the new owner. The same result occurs where the stock is placed into a revocable trust by a shareholder. Because the stock would be included in the decedent-stockholder’s estate, a redemption from the trustee would be allowed (again, assuming the share of the estate going into the trust bears a direct or indirect burden to pay death taxes or administration costs or is reduced by such amounts).

**Question** – Will life insurance owned by the corporation to fund the Section 303 redemption cause or aggravate an accumulated earnings tax problem?

*Answer* – In general, if in any tax year the corporation’s taxable income is retained for the purpose of paying insurance premiums (or for any other purpose) in excess of the amount of the $250,000 accumulated earnings credit ($150,000 in the case of certain personal service corporations), the corporation should be prepared to show that such excess retentions are necessary to meet the “reasonable needs of the business”; such excess retentions that are beyond reasonable business needs may attract the tax. Where an uncommitted key individual life insurance policy (of the appropriate amount and type) is used to shift the risk of the loss of a key person’s services, it will generally not cause or aggravate an accumulated earnings tax problem.

Likewise, even though death proceeds do increase earnings and profits (to the extent they exceed premiums paid), they should not, per se, cause or aggravate an accumulated earnings tax problem. Term, whole life, or a similar low cash value policy should be used. Furthermore, the redemption should be affected, wherever possible, in the same fiscal year that death occurs.

*Note:* The statute provides that “the reasonable needs of the business” include the “Section 303 redemption needs of the business.” However, the Internal Revenue Service’s position is that this provision applies only to amounts accumulated in the year of death and thereafter.

Consider having a third party – such as an irrevocable trust for family members – own the life insurance. At the shareholder’s death, the proceeds would be paid to the policyowner trust which could then make a fully secured loan at a reasonable (market) rate of interest to the corporation. The corporation could then redeem the stock under Section 303. The three advantages of this technique are: (1) the insurance proceeds don’t “swell” the value of the corporation for estate tax purposes; (2) cash values cannot trigger an accumulated earnings tax problem; and (3) neither cash values nor death proceeds can trigger an alternative minimum tax problem. Furthermore, the interest paid by the corporation to the trust enhances the financial security of the beneficiaries of the trust.

**Question** – If closely held stock is left to a specific legatee under the terms of a deceased stockholder’s will, and there is a provision in the will that states that estate and inheritance taxes will be paid out of the residue of the estate, can there be a Section 303 redemption?

*Answer* – No. There cannot be a Section 303 redemption because the specific legatee will not bear any portion of paying the taxes. The redemption will qualify under Section 303 only to the extent that the interest of the redeemed shareholder is reduced directly or through a binding obligation to contribute to the payment of death taxes or funeral or administration costs.

**Question** – Can stock of an S corporation qualify for Section 303?

*Answer* – Yes. Stock of *any* corporation, including an S corporation, may qualify under Section 303.[[20]](#endnote-20) In addition, any class of stock, common, preferred, voting or non-voting may be redeemed if otherwise qualifying for a Section 303 redemption.

**Question** – If the executor elects to take an income tax deduction on the estate’s income tax return for funeral and administration expenses, rather than deduct such expenses on the estate tax return, does this have any impact on the amount qualifying for redemption under Section 303?

*Answer* – No. The fact that the executor deducts funeral and administrative expenses on the income tax return of the estate will not reduce the amount of stock that can be redeemed.

CHAPTER ENDNOTES

1. . IRC Sec. 303(a). [↑](#endnote-ref-1)
2. . IRC Sec. 303(b)(2)(A). [↑](#endnote-ref-2)
3. . IRC Sec. 303(a). [↑](#endnote-ref-3)
4. . IRC Sec. 303(b)(3). [↑](#endnote-ref-4)
5. . Treas. Reg. §1.303-2(f). [↑](#endnote-ref-5)
6. . Treas. Reg. §1.303-2(f). [↑](#endnote-ref-6)
7. . Treas. Reg. §1.303-1; IRC Sec. 1014(e). [↑](#endnote-ref-7)
8. . IRC Sec. 264(a)(1). [↑](#endnote-ref-8)
9. . IRC Sec. 101(a)(1). [↑](#endnote-ref-9)
10. . IRC Secs. 1245, 1250. [↑](#endnote-ref-10)
11. . IRC Sec. 311(b)(2). [↑](#endnote-ref-11)
12. . IRC Sec. 311(b)(1)(B). [↑](#endnote-ref-12)
13. . Rev. Rul. 65-289, 1965-2 CB 86; IRC Secs. 303(a), 317. [↑](#endnote-ref-13)
14. . Treas. Reg. §1.303-2(c)(1). [↑](#endnote-ref-14)
15. . Rev. Rul. 87-132, 1987-2 CB 82. [↑](#endnote-ref-15)
16. . Treas. Reg. §1.303-2(c)(1). [↑](#endnote-ref-16)
17. . IRC Sec. 303(b)(2)(B). [↑](#endnote-ref-17)
18. . Treas. Reg. §1.303-1. [↑](#endnote-ref-18)
19. . IRC Secs. 2036-2038. [↑](#endnote-ref-19)
20. . Let. Rul. 9009041. [↑](#endnote-ref-20)