**8813. What is an IRC Section 303 stock redemption? How is a Section 303 redemption useful in the context of a closely-held corporation?**

IRC Section 303 was enacted expressly to help solve the liquidity problems frequently faced by estates that are comprised largely of stock in a closely-held corporation, and to protect small businesses from forced liquidations or mergers due to the impact of estate taxes. Within the limits of IRC Section 303, surplus can be withdrawn from the corporation income tax-free.

In certain instances, stock of a public corporation also may be redeemed under IRC Section 303.

Any payments by a corporation to a shareholder generally are treated as dividends (see Q 8811). Despite this, under certain circumstances IRC Section 303 allows a corporation to redeem part of a deceased stockholder’s shares without the redemption being treated as a dividend. Instead, the redemption price will be treated as payment in exchange for the stock in a capital transaction.

**Planning Point:** This is significant because the estate will receive an adjustment to the basis of the stock under IRC Section 1014. Therefore, when the stock is redeemed, the gain or loss shall be based upon changes in value subsequent to the date of the deceased shareholder’s death.

An IRC Section 303 redemption can safely be used in connection with the stock of a family-owned corporation because the constructive ownership rules (see Q 8812) are not applied in an IRC Section 303 redemption.[[1]](#footnote-1)

The following conditions must be met if a stock redemption is to qualify under IRC Section 303 for non-dividend treatment:

(1) The stock that is to be redeemed must be includable in the decedent’s gross estate for federal estate tax purposes;

(2) The value for federal estate tax purposes of all stock of a redeeming corporation that is includable in a decedent’s gross estate must comprise more than 35 percent of the value of the decedent’s adjusted gross estate.[[2]](#footnote-2) The “adjusted gross estate” for this purpose is the gross estate less deductions for estate expenses, indebtedness and taxes[[3]](#footnote-3) and for unreimbursed casualty and theft losses.[[4]](#footnote-4) The total value of all classes of stock includable in a gross estate is taken into account to determine whether this 35 percent test is met, regardless of which class of stock is to be redeemed.[[5]](#footnote-5)

IRC Section 303(b) provides that a corporate distribution in redemption of stock will qualify as IRC Section 303 redemption if all the stock of the corporation that is included in determining the value of a gross estate exceeds 35 percent of the adjusted gross estate. Although most gifts made by a donor within three years of death are not brought back into the donor’s gross estate under IRC Section 2035, certain kinds of gifts are brought back. These are the “first kind of exception” gifts. Gifts of corporate stock that fall within this classification are part of a gross estate for purposes of computing the 35 percent requirement (or the 20 percent requirement discussed below) and a corporation’s redemption of this stock will qualify as a sale or exchange if all other requirements of IRC Section 303 are satisfied. IRC Section 2035(c)(1)(A) states generally that the three year rule will apply for the purposes of IRC Section 303(b). This is generally interpreted as follows: If a decedent makes a gift of any kind of property within three years of his or her death, the value of the property given will be included in the decedent’s gross estate for purposes of determining whether the value of the corporate stock in question exceeds 35 percent of the value of the gross estate, but a distribution in redemption of that stock will not qualify as an IRC Section 303 redemption unless the stock redeemed actually is a part of the decedent’s gross estate.[[6]](#footnote-6)

The stock of two or more corporations will be treated as that of a single corporation, provided that 20 percent or more of the value of all of the outstanding stock of each corporation is includable in a decedent’s gross estate.[[7]](#footnote-7) Only stock directly owned is taken into account in determining whether the 20 percent test has been met; constructive ownership rules do not apply even when they would benefit a taxpayer.[[8]](#footnote-8) Stock that, at a decedent’s death, represents the surviving spouse’s interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is considered to be includable in a decedent’s gross estate for the purpose of meeting the 20 percent requirement.[[9]](#footnote-9) The 20 percent test is not an elective provision, meaning that if a distribution in redemption of stock qualifies under IRC Section 303 only by reason of the application of the 20 percent test and also qualifies for sale treatment under another section of the IRC, the executor may not elect to have only the latter section of the IRC apply and thus retain the undiminished IRC Section 303 limits for later use. All distributions that qualify under IRC Section 303 are treated as IRC Section 303 redemptions in the order they are made;[[10]](#footnote-10)

(3) The dollar amount that can be paid out by a corporation under protection of IRC Section 303 is limited to an amount equal to the sum of (x) all estate taxes, including the generation-skipping transfer tax imposed by reason of the decedent’s death, and federal and state inheritance taxes attributable to a decedent’s death, plus interest, if any, collected on these taxes, and (y) funeral and administration expenses allowable as estate deductions under IRC Section 2053.[[11]](#footnote-11)

(4) The stock must be redeemed not later than (x) three years and ninety days after the estate tax return is filed (the return must be filed within nine months after a decedent’s death), (y) sixty days after a Tax Court decision on an estate tax deficiency becomes final, or (z) if an extension of time for payment of tax is elected under IRC Section 6166, the time determined under the applicable section for payment of the installments. For any redemption made more than four years after a decedent’s death, however, capital gains treatment is available only for a distribution in an amount that is the lesser of the amount of the qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution, or the aggregate of these amounts that are paid within one year after the distribution;[[12]](#footnote-12)

(5) The shareholder from whom stock is redeemed must be one whose interest is reduced directly, or through a binding obligation to contribute, by payment of qualifying death taxes and funeral and administration expenses, and the redemption will qualify for capital gains treatment only to the extent of that reduction.[[13]](#footnote-13) That is, “the party whose shares are redeemed [must actually have] a liability for estate taxes, state death taxes, or funeral and administration expenses in an amount at least equal to the amount of the redemption.”[[14]](#footnote-14)

The stock of any corporation, including an S corporation, may qualify for IRC Section 303 redemption. Moreover, any class of stock may be redeemed under IRC Section 303. Thus, a nonvoting stock, common or preferred, issued as a stock dividend or issued in a lifetime or post-death recapitalization can qualify for the redemption.[[15]](#footnote-15)

1. . IRC Secs. 318(a)-(b). [↑](#footnote-ref-1)
2. . IRC Sec. 303(b)(2)(A). [↑](#footnote-ref-2)
3. . IRC Sec. 2053. [↑](#footnote-ref-3)
4. . IRC Sec. 2054. [↑](#footnote-ref-4)
5. . Treas. Reg. §1.303-2(c)(1). [↑](#footnote-ref-5)
6. . Rev. Rul. 84-76, 1984-1 CB 91. [↑](#footnote-ref-6)
7. . IRC Sec. 303(b)(2)(B). [↑](#footnote-ref-7)
8. . *Est. of Byrd v. Comm.*, 21 AFTR 2d 313 (5th Cir. 1967). [↑](#footnote-ref-8)
9. . IRC Sec. 303(b)(2)(B). [↑](#footnote-ref-9)
10. . Treas. Reg. §1.303-2(g); Rev. Rul. 79-401, 1979-2 CB 128. [↑](#footnote-ref-10)
11. . IRC Secs. 303(a), 303(d). [↑](#footnote-ref-11)
12. . IRC Secs. 303(b)(1), 303(b)(4). [↑](#footnote-ref-12)
13. . IRC Sec. 303(b)(3). [↑](#footnote-ref-13)
14. . H.R. Rep. No. 94-1380 at 35 (Estate and Gift Tax Reform Act of 1976), *reprinted in* 1976-3 CB (Vol. 3) 735 at 769. [↑](#footnote-ref-14)
15. . Treas. Reg. §1.303-2(d). [↑](#footnote-ref-15)