Redemptions Under Section 303

Emeric Fischer

William & Mary Law School
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by

EMERIC FISCHER

I. INTRODUCTION

The point of departure in reference to corporate distributions is section 301, under which, generally, all distributions (unless specifically otherwise provided) are considered to be dividends taxable as ordinary income. Under these provisions a stockholder whose stock is redeemed by the corporation would have to report ordinary income, whereas if he sold it to others he would have capital gains under section 1221. Congress recognized the inequity of this result and in section 302 made provision for certain situations in which a corporate distribution would be considered to be in the nature of a sale subject to capital gains treatment. Thus a substantially disproportionate distribution in redemption of stock would qualify for such treatment. Such a distribution, in order to qualify, must meet the so-called 80 percent—50 percent rule. The 80 percent rule requires that after the redemption the voting stock owned by the shareholder be less than 80 percent of the voting stock he owned prior to the redemption and the 50 percent rule requires that after the redemption he own less than 50% of the total voting power of all classes of voting stock. Both percentage rules must be met, it is not an “either, or” test. Furthermore, the 80 percent test is based on the total outstanding shares after the redemption and not on the pre-redemption number of shares.

2 I.R.C. §§ 301(a) and 316(a).
3 I.R.C. § 301(c)(1).
* It is not merely the capital gains deduction (60% of the gain) that makes capital gains attractive, but the fact that the basis of the stock is deducted from the proceeds received for it, whereas in a dividend situation the whole proceeds are subject to the tax!
It is to be noted that under State corporation laws a dividend can be paid only if there is surplus to cover it (capital be not impaired). Redemptions are similarly restricted, lest a dividend be paid in the guise of a redemption. To illustrate: Corporation X has 100 shares outstanding, 50 owned by A, 50 by B. X has a large cash balance, but since it has no surplus, A and B cannot draw a dividend. They decide to each 'redeem' 10 shares and thus "bail-out" the cash. After the 'redemption' they each still own 50% of X (40 shares each out of 80 outstanding). Obviously the 'redemption' was a disguised dividend.
4 I.R.C. § 1221.
5 I.R.C. § 302.
6 I.R.C. § 302(b)(2).
7 I.R.C. § 302(b)(2)(C).
10 A common error is to compute the percentages on the basis of previously outstanding shares. Assume Corporation X has 100 shares outstanding, of which
One of the greatest difficulties in meeting the substantially disproportionate rule is the problem posed by the attribution rules. In general terms, section 318 provides, *inter alia*, that an individual owns not only the stock he owns outright, but also the stock owned by his spouse, his children, grandchildren, parents, and proportionately the stock owned by a partnership of which he is a partner, or an estate or trust of which he is a beneficiary, or a corporation of which he is a controlling shareholder. The effect of the attribution rules is that a stockholder in a family owned corporation would not be able to redeem under section 302(b)(2).

In order to give relief to this situation the complete termination rule provides that if a shareholder redeems all his shares capital gains treatment will apply and the *family* attribution rules will not apply. stockholder A owns 60 shares, i.e. 60 percent of the outstanding shares. If he redeems 20 shares he will own 40 shares out of 80 outstanding. To own less than 80 percent of what he owned prior to the redemption, he would have to own less than 48% of the outstanding stock (80 percent of 60 percent). However he now owns 50 percent (40 shares out of 80), thus not meeting either the less than 80% rule nor the less than 50% rule. A formula has been devised whereby the required number of shares to be redeemed to meet the substantially disproportionate rule can be determined:

\[ X = \frac{NT}{4T-4N}, \]

where \( N \) represents the number of shares owned by the stockholder prior to redemption and \( T \) represents the total shares outstanding prior to redemption. Applying the formula to the foregoing illustration we find

\[ X = \frac{6000}{500-240} = 23.08 \]

shares.

11 *I.R.C.* § 318.
13 *I.R.C.* § 318(a)(2)(A), (B), (C).
14 *I.R.C.* § 302(b)(3).
15 *I.R.C.* § 318(a)(1).
16 *I.R.C.* § 302(c)(2)(A). This provision, that only the family attribution rules shall not apply, is specific and unambiguous. Nevertheless in *Rickey v. U.S.*, 427 F. Supp. 484 (W.D. La. 1977) the court, relying on *Crawford v. Commr.*, 59 T.C. 830 (1973), held that the estate-beneficiary attribution rules can be waived. In *Crawford* the stock was owned by the decedent, his wife, and their sons. The wife was a beneficiary of the estate, the sons were not. The corporation redeemed all the stock of the estate and the wife, the total amount being in excess of the amount eligible for § 303 protection. To qualify this excess for § 302(b)(3) treatment (complete termination of interest) the estate and the wife filed the agreement required by § 302(c)(2)(A) so as to waive attribution from the sons to the wife (which would then have been reattributed from the wife to the estate). The IRS, relying on Rev. Rul. 59-233, 1959-2 C.B. 106, maintained that the estate could not waive the family attribution rules and that although the wife's filing of the agreement did prevent attribution of the sons' stock to her for purposes of the complete termination-of-interest as to her, nevertheless for purposes of determining the reattribution from her to the estate, the waiver was not effective. The Tax Court did not accept this illogical reasoning and held that the estate could waive the family attribution rules so as to completely terminate its interest in the corporation even though other members of
To meet this safe harbor rule, the shareholder must not only divest himself of all the stock, but must not be an officer, director or employee of the corporation, nor acquire any shares, or such status, within 10 years of the distribution, and must file a waiver agreement to notify the Commissioner of any such prohibited acquisition within 30 days of such acquisition.

the family, who are not estate beneficiaries, (here the sons) own stock in the corporation.

The facts in Rickey are different. There the decedent and his children owned 92% of the stock, outsiders owned the balance. The corporation redeemed the stock of the estate, as required by the Articles of Incorporation as well as the will of the decedent. This left the children owning 82% of the post redemption outstanding stock, which according to § 318(a)(3)(A) is attributed to the estate. However the estate filed the waiver agreement and reported the amount in excess of that which is eligible for § 303 protection as a § 302(b)(3) transaction. The IRS rejected this conclusion and characterized the redemption (the excess of the § 303 amount) as essentially equivalent to a dividend. When the matter came in front of the district court, it held for the taxpayer. The court said:

Thus a literal reading of Sec. 302(c)(2)(A) appears to limit the waiver to the family-member attribution rules. If this were correct, the estate would not be a proper entity to file a 10 year agreement, timely or otherwise.

In the case of Estate of Crawford, 59 T.C. 830 (1973), the Tax Court was faced with this identical issue and found that an estate is a proper entity to file the agreement. The Court noted that where a literal application of the language of a statute would lead to absurd results, that language would not be slavishly applied.

Rickey, supra at 489.

Upon appeal, the Fifth Circuit Court in Rickey v. U.S. 592 F.2d 1251 (1979) recognized the error made by the district court in concluding that Rickey and Crawford were identical, but nevertheless affirmed the lower court on the basis that

The harsh results which are obtained from mechanical application of the attribution rules, coupled with a vigilant eye on the Congressional purpose in enacting the attribution rules, has led some courts to the conclusion that a slavish application of the attribution rules is improper. Rickey, supra at 1257.

The Court explained that the Congressional purpose in enacting § 318 (the attribution rules) was to eliminate abuses where "certain relationships bespeak an identity of interest and common control." Id. at 1256. No such abuse occurred here:

It cannot be argued that the estate's motivation in allowing this redemption was one of benefitting the beneficiaries. Rather the estate was merely carrying out provisions of the decedent's will—selling the shares back to the Corporation and distributing the proceeds to the beneficiaries, thereby terminating its control over the corporation. We will not find that decedent's death was a device to bleed out corporate profits at capital gains rates.

The affirming of the lower court by the Fifth Circuit caught most commentators by surprise. Everyone expected a reversal. The decision runs counter to the words of the statute. Crawford merely held that an estate may waive the family attribution rules. Rickey says that the entity attribution rules may be waived. It would not be prudent to do any tax planning in reliance on the Rickey case.
A third provision\textsuperscript{21} provides the final exception to the general rule that distributions are dividends. This exception states that if the distribution is not essentially equivalent to a dividend then the redemption shall be considered a sale. The criteria for this exception have been inexact\textsuperscript{22} and therefore unreliable. \textit{U.S. v. Davis}\textsuperscript{23} further curtailed the usefulness of this provision, at the same time reaffirming the view that the attribution rules apply thereto, thereby making the exception almost useless in family held corporation situations. Although several Revenue Rulings\textsuperscript{24} have set forth some guidelines as to when section 302(b)(1) would apply, it is a most hazardous exception to rely on and it is recommended only as a last resort.

Congress recognized that the complex requirements of section 302, coupled with the attribution rules, would make it nigh impossible for an estate to redeem stock under favorable capital gains treatment.\textsuperscript{25} Thus an estate, a substantial portion of which consists of closely held stock, would be illiquid and would have difficulty in paying taxes and expenses. If redemption of the stock would be considered a dividend (because of nonqualification under section 302) then the estate would not only have death taxes to pay but a substantial income tax as well. The only other alternative the estate would have is to sell the stock to outsiders.\textsuperscript{26} However, it is well known that closely held corporate stock does not have a market\textsuperscript{27} and therefore the most likely buyers would be the large competitors of the family owned enterprise, resulting in the eventual disappearance of small businesses from the American economy.\textsuperscript{28} To alleviate the situation Congress enacted section 303\textsuperscript{29} which generally

\textsuperscript{20} Treas. Reg. § 1.302-4(a)(1).
\textsuperscript{21} I.R.C. § 302(b)(1).
\textsuperscript{23} 397 U.S. 301 (1970).
\textsuperscript{25} Actually very seldom would an estate have any gain on a redemption since (absent the carryover basis rules) the redemption price is equal to the stepped up basis. Thus for practical purposes, a redemption by an estate is usually tax free.
\textsuperscript{26} The estate would have no gain, for the reason stated in note 25, \textit{supra}.
\textsuperscript{27} Rev. Rul. 59-60, § 2.03, 1959-1 C.B. 237.
\textsuperscript{28} S. Rep. No. 2375, 81st Cong., 2d Sess., 1950-2 C.B. 483, 522-23. From the standpoint of the surviving stockholders and members of the family of the decedent, there may be additional reasons for the need to redeem all or part of the stock: 1. The financial needs of the beneficiaries may be inconsistent with the retention of the stock, as for example, the widow may prefer having a source of steady and assured income rather than the non guaranteed dividends that common stock would bring; 2. members of the decedent's family may not have any interest in participating in the business or managerial ability to do so and therefore the welfare of the business would mandate redemption of their stock; 3. non-family members among the surviving stockholders may not get along with members of the family, resulting in eventual deterioration in the business.
\textsuperscript{29} I.R.C. § 303.
provides that if its requirements are met, a redemption "shall be treated as a distribution in full payment in exchange for the stock so redeemed", and the attribution rules, to the extent section 303 applies, would not apply.

II. ANALYSIS OF SECTION 303

A. Inclusion of Stock in Gross Estate

The stock to be redeemed must be included in the gross estate. This is not to say that it must be owned by the estate, but merely be counted among the assets thereof. Stock given away within three years of the date of death of the decedent is included in the gross estate, even though ownership is in the donee. Similarly, stock that was held by the decedent in joint tenancy with another person would be stock owned by the survivor, but included in the gross estate. Stock over which decedent held a general power of appointment which remained unexercised at the time of his death, is included in the gross estate, but ownership would be in the person acquiring it in default of the exercise of the power. Finally, stock acquired by a legatee, heir, surviving spouse, or a trustee of a testamentary trust qualifies for section 303 treatment (subject to meeting other requirements) since the stock has been included in the gross estate.

In addition, section 303 provides for redemption of stock which came into the hands of a shareholder after the death of the decedent (and thus was not originally included in the gross estate) so long as the basis of the "new stock" is determined by reference to the basis of the "old stock", the old stock was included in the gross estate and the old stock would have qualified for section 303 treatment. The new stock is referred to as substituted stock, examples of which include stock acquired in a section 305(a) distribution, stock acquired in a section 355 spin-off or exchange, stock acquired in a section 368 reorganization or stock acquired in a section 1036 exchange.

A decedent owned, at the date of death, stock in two corporations, neither of which met the required percentage tests. The executor elected the alternate valuation date. Between date of death and the alternate valuation date.

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30 I.R.C. § 303(a) flush phrase.
31 I.R.C. § 303(a).
32 I.R.C. § 2035(a); Treas. Reg. 1.303-2(f).
33 I.R.C. § 2040(a); Treas. Reg. 1.303-2(f).
34 I.R.C. § 2041(a) (2); Treas. Reg. 1.303-2(f).
35 Treas. Reg. 1.303-2(f).
36 I.R.C. § 303(c).
37 I.R.C. § 303(c) (1); "new stock" and "old stock" are terms used in the cited paragraph.
38 I.R.C. § 303(c) (2).
39 I.R.C. § 303(c) (3).
valuation date the two corporations merged in a tax free merger and thus the new stock issued to the executor had a basis by reference to the old stock, and it also met the percentage test requirements. The Service held that the new stock did not qualify since the old stock was not included in the gross estate (as of the alternate valuation date, which became the relevant date) nor would the old stock have qualified for section 303 treatment. On the other hand, where a holding company stock was included in the gross estate and qualified for section 303 treatment, a later distribution of its holdings in a section 355 split-up qualified such distributed stock for section 303 redemption.

The character of the stock is irrelevant: voting common or non-voting common, cumulative preferred or non-cumulative preferred, all qualify. However, stock which is acquired by purchase, even though previously included in the gross estate, does not qualify for section 303 protection. "Purchase" includes satisfaction of a specific monetary bequest with stock, which stock then could not be redeemed under the safe harbor rules of section 303. But where the executor has discretion under the will to distribute assets in kind for the satisfaction of the pecuniary bequests, the stock so distributed will qualify for section 303 treatment.

B. Relationship of Shareholder to Death Taxes

Prior to the Tax Reform Act of 1976 any shareholder who received the stock from the decedent was entitled to the favorable treatment of section 303 (subject to its requirements). However, the T.R.A. added a provision which limited the availability of the section to those shareholders who bore their share of burden of death taxes and ad-

41 As per requirement of § 303(c)(2).
42 As per requirement of § 303(c)(3).
44 Prior to the 1976 Tax Reform Act, section 306 stock lost its "taint" at the death of the shareholder since the basis of the stock in the hands of the successors (i.e. the estate or beneficiaries) was not determined by reference to decedent's basis (see section 306(c)(1)(C)), but rather by reference to the market value at date of death. When the carryover basis rules came into effect under the Tax Reform Act of 1976, there was concern that redemption of section 306 stock will not obtain the shelter of section 303, that is, the redemption would give rise to ordinary income. Section 306(b)(5), added by the Revenue Act of 1978, dispelled these fears by providing that redemption of section 306 stock, to the extent that section 303 applies, will not be subject to the ordinary income rules of section 306(a).
46 Id.
47 e.g. the estate, any beneficiary, a joint survivor, a donee who received the stock within three years of date of death, etc.
47a Tax Reform Act of 1976.
administration expenses.\textsuperscript{48} Since the marital deduction trust usually is not subject to reduction by taxes and expenses, stock intended to be redeemed should not be left to the marital trust. The fractional share formula should not be used, unless such stock is specifically allocated to the income trust or other non marital portion of the estate. Prior to the 1976 Act the widow could, by exercising her general power of appointment over the assets of the marital trust, withdraw all or part of the stock from the marital trust, redeem the needed amount and thus help the executor pay the taxes and expenses. Commentators have now raised the question whether the use of proceeds of a section 303 redemption to fund the marital trust, would disqualify the prior redemption. No regulations have been issued as to this question of tracing the proceeds of a redemption to their destination.\textsuperscript{49}

If stock is to be made the subject of specific bequests and it is desired that the beneficiaries thereof be able to redeem the stock under section 303 protection, then the specific bequests should by the terms of the will be made subject to their pro rata share of taxes and administration expenses.

The phrase "interest of the stockholder is reduced directly by any payment"\textsuperscript{50} indicates that the person who actually bears the burden of taxes and expenses is entitled to redemption under section 303 as distinguished from persons who merely have the legal obligation under local law. The parenthetical expression in the cited\textsuperscript{51} statute "through a binding obligation to contribute" raises the question whether such obligation could be entered into after the death of the decedent and need not be an obligation created under the will or by local law. If this were the case, it could be a powerful post mortem tool: defects in the will in reference to payment of death taxes and administration expenses could be cured by the affected beneficiary by entering into a binding agreement with the executor to pay his or her portion of taxes and expenses.

Interestingly enough the 1976 Act did not modify the rule that the proceeds of redemption need not be applied to the payment of taxes and expenses. The symmetry of the section 303 amendments would have been more perfect had this requirement been inserted alongside the requirement that only those shareholders who bear the burden of

\textsuperscript{48} I.R.C. § 303(b)(3); the provision is as follows: "Subsection (a) shall apply to a distribution by a corporation only to the extent that the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by any payment of an amount described in paragraph (1) or (2) of subsection (a)."

\textsuperscript{49} The rule is that proceeds of a redemption need not be used to pay taxes and expenses.

\textsuperscript{50} See n. 48 supra.

\textsuperscript{51} Id.
paying the taxes and expenses are privileged to take advantage of section 303.

C. Relationship of Stock to Decedent's Estate

In order to qualify for section 303 treatment the value of all the stock of a single corporation included in the gross estate must exceed 50 percent of the gross estate reduced by the allowable administration expenses, funeral expenses, claims against the estate, and losses of the estate. All classes of stock of the corporation may be aggregated for this test. It is noteworthy that the statute uses the word "allowable" and not the word "deducted", thus indicating that the administration expenses, etc., need not be deducted on the estate tax return to qualify them for inclusion for the 50 percent test. This gives flexibility to the personal representative to do some post mortem planning to determine whether to deduct these items on the estate tax return or the income tax return of the estate.

Suppose the decedent owned stock in two or more closely held corporations, none of which meet the 50 percent test. Is the estate to be penalized because the decedent did not put all his eggs in one basket? Fortunately relief is provided: Where stock of two or more corporations are included in the gross estate and each represents more than 75 percent of the value of the outstanding stock of such corporation, then such stock may be aggregated for purposes of the 50 percent test.

Suppose an estate holds a controlling interest in two corporations, Corp. A and Corp. B. The executor wants to redeem stock of Corp. A but Corp. A is unable to do so, either because of lack of cash, or because of the legal impediment of insufficient surplus, or because of debt instruments outstanding which prohibit dividends or any distributions to stockholders until a future time. However, Corp. B does have the ability to buy the stock of Corp. A from the executor. Could such a transaction qualify under section 303? Happily there is a provision which permits such brother-sister corporation redemptions and characterizes the transaction as a redemption of the stock of the acquiring corporation (herein Corp. B). Similarly, an estate holding controlling

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52 As to decedents dying before 12/31/76 the ratio was more than 35 percent of the gross estate or more than 50 percent of the taxable estate.
53 I.R.C. § 2053.
54 I.R.C. § 2054.
57 At least 50 percent of the voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of all classes of stock. Section 304(c)(1).
58 I.R.C. § 304(a)(1).
59 Therefore it is the acquiring corporation's stock that must meet the requirements of section 303, e.g. the 50 percent inclusion test.
shares of a parent corporation and a subsidiary corporation, can cause the subsidiary to redeem the shares of the parent and the transaction is treated as a redemption of the stock of the parent.60

D. Limitation on Amount Sheltered

The amount of the distribution protected by section 303 is limited to the sum of all death taxes “imposed because of such decedent’s death”61 and allowable administration and funeral expenses under section 2053.62 It is noteworthy that administration expenses need to be determined for two separate purposes: first, for the ‘more than 50 percent test’, the amount of stock required to be included in the estate in order that section 303 apply, and second for the purpose of determining that limit of the amount of sheltered redemption. Thus it is important to be able to identify the expenditures which qualify as an administration expense.63

In a jurisdiction where the expenses of a wife’s last illness and funeral expenses are obligations of the husband, and her will does not expressly relieve him of such obligation, such expenses are not allowable as administration expenses.61

If the executor does not wish to redeem the full amount in a single transaction or if the corporation cannot distribute the full amount, the redemption can take place in several steps, limited cumulatively to the amount mentioned hereinbefore.65 If the redemption is made from two or more stockholders then section 303 protection extends only to that portion of the distribution to each which is equal to that shareholder’s payment, or obligation to pay, the death taxes and allowable expenses. In either case, when multiple redemptions are made, each redemption will be deemed made under section 303 until the limits of that section have been reached, and this is so even though non dividend treatment could have been obtained under some other provision, such as section 302.66 Assume four redemptions of $30,000 each with a maximum section 303 limitation of $80,000 (the amount of total death taxes and allowable expenses). The first two redemptions and $20,000 of the

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60 I.R.C. § 304(a)(2). The parent’s stock must meet the requirements of § 303. Cf. n. 59.
61 I.R.C. § 303(a)(1).
62 I.R.C. § 303(a)(2).
63 The Service has maintained until recently that interest on installment payments of estate taxes is part of the tax and not an allowable administration expense and so declared in Rev. Rul. 75-239, 1975-1 C.B. 304. The Tax Court in Estate of Bahr, 68 T.C. 74 (1977), disagreed with the Service and declared the aforementioned ruling incorrect. The Commissioner acquiesced in the decision in 1978-2 C.B. 1 and revoked Rev. Rul. 75-239, supra, in Rev. Rul. 78-125, 1978-1 C.B. 292.
66 Treas. Reg. § 1.303-2(g).
third redemption are deemed to be redemptions under section 303 even though these early redemptions could have qualified under section 302. However, the $10,000 balance of the third redemption and the full amount of the fourth redemption will be considered section 301 redemptions unless they could qualify under section 302.

E. Limitation on Period for Distribution

There are three periods of limitation provided for in section 303(b):

(a). The period of limitation for assessment of the estate tax plus 90 days thereafter. Since the period of limitation for assessment is three years from the due date of the tax return, and the tax return is due nine months from the date of death, the period amounts to four years (3 years plus 90 days plus 9 months). If a late return is filed the three year period of assessment starts running from the date of actual filing.

On the other hand if the return is filed before the due date, then it is the due date and not the actual filing date which controls. Thus a redemption can be made within four years of the date of death even though an early return was filed. (b). If a petition has been filed in the Tax Court, challenging a deficiency assessment, then the period of limitation is extended to within 60 days after the decision of the Tax Court becomes final. (c). If an election has been made under section 6166 or 6166A to pay the tax in installments, then the period of limitation is the period provided in those sections (15 years and 10 years) respectively. Under any of the aforementioned limitations, if a redemption takes place more than four years after the date of death, the amount distributed by the corporation is limited to the lesser of (1) the aggregate of the death taxes and expenses which are unpaid at the time of redemption, or (2) the aggregate of such taxes and expenses actually paid during the year beginning on the date of distribution. Where such delayed redemptions are contemplated, careful advance planning is indicated to coordinate payments of taxes and expenses with redemptions. If a payment has to be made to meet an expense or tax payment and the corporation is unable to make a cash distribution within the time required under the aforementioned rules, the corporation could distribute a note thereby fixing the date of distribution and bring it under the shelter of section 303 even though the note will be paid off (in installments or in total) at a time which shall have been after the expiration of the time limitation for the redemption.

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69 I.R.C. § 303(b)(1)(B). In no event is the four year period shortened (by an early Tax Court decision).
70 I.R.C. § 303(b)(1)(C).
F. Generation Skipping Transfers

The scope of this paper does not embrace a discussion of generation skipping transfers. However, mention needs be made of section 303(d) added by the Tax Reform Act of 1976, which provides that stock included in a generation skipping transfer can be redeemed under section 303 rules conditioned on two requirements: (1) the generation skipping transfer must occur at or after the death of the deemed transferor and (2) the stock constitutes more than 50 percent of the generation skipping transfer. Each generation skipping transfer is applied separately for the 50 percent test and the time limitations for the redemption begin on the date of the transfer rather than the date of the deemed transferor's death.

III. Deferred Payments of Estate Taxes


The provisions of the Code pertaining to deferred payments of estate taxes are found in sections 6166 and 6166A. These provisions are wholly independent of section 303, however, they could be used in connection with redemptions made under section 303. Section 6166 applies to estates of decedents dying after December 31, 1976. It provides for the payment of the tax in ten installments, the first installment being deferrable up to five years after the due date of the estate tax return. The amount of the tax deferrable is the portion attributable to the closely held business interest included in the estate. A closely held business interest is defined as a trade or business, 20 percent or more of the value of its voting stock being included in the estate, or it is a corporation with 15 or less stockholders. To
qualify for section 6166 treatment the value of the stock included in the
gross estate must exceed 65 percent of the adjusted gross estate.\textsuperscript{2}

Section 6166A (which was section 6166 before the Tax Reform
Act of 1976) applies to estates of decedents dying before or after
December 31, 1976 and provides for payment of the tax in ten in-
stallments,\textsuperscript{3} the first being due at the due date of the tax return.\textsuperscript{4} The
amount deferrable is the portion of the tax attributable to the closely
held business interest included in the gross estate.\textsuperscript{5} A closely held
business interest is defined as a trade or business\textsuperscript{6} 20 percent or more
of the value of its voting stock being included in the gross estate\textsuperscript{7} or
a corporation with ten or less stockholders.\textsuperscript{8} To qualify for section
6166A treatment such stock must exceed 35 percent of the value of
the gross estate\textsuperscript{9} or 50 percent of the taxable estate.\textsuperscript{10}

B. Use of Section 303 in Connection with Deferred Payment Provisions

Even a cursory reading of the qualification requirements of Sections
303, 6166 and 6166A reveals a great disparity among them.\textsuperscript{11} To be
able to use section 303 in tandem with either of the other two\textsuperscript{12} the

\textsuperscript{82} I.R.C. § 6166(a)(1). The decedent has to be a citizen or resident of the
United States.

\textsuperscript{83} I.R.C. § 6166A(a).

\textsuperscript{84} I.R.C. § 6166A(e).

\textsuperscript{85} I.R.C. § 6166A(b). The amount so attributable is "an amount which bears
the same ratio to the tax . . . as the value of the interest in a closely held business
which qualifies under subsection (a) bears to the value of the gross estate."
(Emphasis added. Cf. to ratio applicable to section 6166, note 78.)

\textsuperscript{86} See note 79.

\textsuperscript{87} I.R.C. § 6166A(3)(c)(A).

\textsuperscript{88} I.R.C. § 6166A(3)(c)(B).

\textsuperscript{89} I.R.C. § 6166A(a)(1).

\textsuperscript{90} I.R.C. § 6166A(a)(2).

\textsuperscript{91} The comparative table below focuses more sharply these differences:

\begin{tabular}{|c|c|c|c|}
\hline
$\textsuperscript{\text{§ 303}}$ & $\textsuperscript{\text{§ 6166}}$ & $\textsuperscript{\text{§ 6166A}}$ \\
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Nature of eligible stock & All outstanding stock & Voting stock & Voting stock \\
Closely held interest requirement & No specification & 20\% of value of above & 20\% of value of above \\
Inclusion in gross estate & More than 50\% of adjusted gross estate & More than 65\% of adjusted gross estate & More than 35\% of gross estate \\
Stockholder's burden of paying taxes & Required & 75\% of outstanding stock \text{ of each must } & Applies to executor only \\
& & be included in gross estate & \\
Aggregation of two or more corporations for inclusion test & 75\% of outstanding stock of each must be included in gross estate & 20\% of value of voting stock must be included in gross estate & \\
Citizenship or residency & Not required & Required & \\
Nature of corporation & Trade or business only & \\
\hline
\end{tabular}

\textsuperscript{92} See § 6166(a)(4).
more stringent requirements of each would have to be met.\textsuperscript{93} Even if these requirements are met, the rule in relation to redemptions made four years after the death of the decedent (the amount of qualifying redemption may not exceed the amount of installment to be paid within a year of the date of redemption) requires careful advance planning in timing redemptions.\textsuperscript{94} Furthermore, since the amount of the redemption must be used to pay the Federal Estate tax, no other use could be made of the proceeds.\textsuperscript{95} A plan to redeem the maximum amount allowable under section 303\textsuperscript{96} within four years of the date of death of the decedent, and electing either of the installment payment sections (to thus be able to put the excess proceeds of the redemption to some investment or other use), may run afoul of the acceleration provisions of these sections.\textsuperscript{97} These provisions provide that if a third or more of the value (in the case of section 6166)\textsuperscript{98} or half or more of the value (in the case of section 6166A)\textsuperscript{99} of the closely held business interest is withdrawn from the business, then payment of the balance owed is due immediately. However, in the case of a redemption to which section 303 applies, such withdrawals will not accelerate payment if the aggregate amount of all federal estate taxes (including the non deferred portion) that shall have been paid on or before the installment date following redemption (or one year after the date of redemption, if earlier) shall at least equal the aggregate amount of all redemptions theretofore made.\textsuperscript{100} In other words, the one third or one half rules do not apply if the proceeds of the redemptions were used to pay federal taxes. This of course eliminates the use of section 303 in tandem with either of the deferral sections for purposes of utilizing part of the redemption money for investment purposes (over the period of deferred payments). However, if the total amount of section 303 redemptions is less than one third or one half of the closely held business interest that shall have been paid on or before the installment date following redemption (or one year after the date of redemption, if earlier) shall at least equal the aggregate amount of all redemptions theretofore made.\textsuperscript{100} In other words, the one third or one half rules do not apply if the proceeds of the redemptions were used to pay federal taxes. This of course eliminates the use of section 303 in tandem with either of the deferral sections for purposes of utilizing part of the redemption money for investment purposes (over the period of deferred payments). However, if the total amount of section 303 redemptions is less than one third or one half of the closely held business interest

\textsuperscript{93} Thus, to use section 303 in accordance with section 6166 the gross estate will have to include more than 20\% of the value of the voting stock of the corporation, (unless it has 15 or less stockholders), which value must exceed 65\% of the adjusted gross estate. The stockholder must be a citizen or resident of the U.S. and must share in the burden of payment of death taxes and expenses. If aggregation of the stock of two or more corporations is necessary to meet the inclusion requirements, the stock must represent more than 75\% of the outstanding stock of each, including 20\% of the voting stock of each (unless the corporation has 15 or less stockholders), and must meet the 65\% test. A similar analogy may be made for the combined use of sections 303 and 6166A.

\textsuperscript{94} The corporation may be unable (or unwilling) to adhere to such a schedule of redemptions.

\textsuperscript{95} Except short term investments for less than one year's duration.

\textsuperscript{96} The sum of death taxes and funeral and administration expenses.

\textsuperscript{97} I.R.C. §§ 6166(g) and 6166A(h).

\textsuperscript{98} I.R.C. § 6166(g)(1)(A)(i).


\textsuperscript{100} I.R.C. § 6166(g)(1) flush paragraph after subparagraph (B) and § 6166A(h)(1) flush paragraph after subparagraph (B).
(depending on which section the executor elected) no acceleration problem arises. Moreover, if the non deferred portion of the tax is greater than the deferred portion and the executor was able to pay such non deferred portion without a section 303 redemption, then the aggregate section 303 redemptions will always be less than the total Federal Estates taxes paid and therefore the acceleration rules will not be triggered.

IV. PLANNING FOR A SECTION 303 REDEMPTION

A. To Meet the 50 Percent Inclusion Requirement

It is apparent from the foregoing analysis of sections 302, 303, 304, 6166 and 6166A that pre-death planning for section 303 redemptions is strongly indicated. A threshold matter to be determined is whether the closely held stock to be included in the potential estate will meet the inclusion ratio requirements qualifying the stock for section 303 redemption.\textsuperscript{101} If doubt exists that the minimum ratio will be met there are several steps that can be taken to tilt the weight of the to be included stock in the proper direction:

1. Instituting an inter vivos gift program in which assets other than the closely held stock are given away, thereby reducing the value of the portion of the estate representing other assets and relatively increasing the value of the portion of the estate comprised of the closely held stock.

2. To reduce the problem of valuation of the stock (which necessarily has a direct effect on the 50 percent inclusion issue) several methods are available:

   a. Recapitalization of the corporation, exchanging the common stock of the (older) stockholder for preferred stock. The value of preferred stock is fairly easy to establish since its value is determined in the same manner as that of an interest bearing security, namely its yield relative to the market interest rate. In addition, there are incidental benefits in exchanging the common for preferred stock: (1) control of the corporation is shifted to the younger members of the family (they are now the holders of voting stock) and (2) the senior or retiring stockholder(s) would be assured of a fixed income rather than unpredictable common stock dividends.

\textsuperscript{101} The more stringent inclusion requirement of § 6166 (65% of adjusted gross estate) needs to be considered as well, if installment payment of the estate tax is contemplated. Since the adjusted gross estate is never less than the taxable estate, the 50% adjusted gross estate requirement of § 303 will always meet the 50% taxable estate requirement of § 6166A and therefore no separate planning needs be done for use of that section, to the extent of the inclusion requirement. In light of the preceding sentence, the 35% gross estate (alternate) requirement can be disregarded.
b. If a shift in control is not desired, then instead of recapitalization, a distribution of a preferred stock dividend on all outstanding common stock should be used, so that to the extent the preferred stock is included in the gross estate a predetermination of what its value might be at time of death, and what portion of the value of the estate it would represent, could more easily be made.  

c. Where a stockholder owns stock in two or more corporations, none of which are expected to comprise more than 50 percent of the value of the potential adjusted gross estate, nor do they represent more than 75 percent of the outstanding stock of each, a merger or consolidation ought to be considered so that the resulting stock will potentially amount to more than 50 percent of the value of the adjusted gross estate.

d. A better known and more frequently used method of fixing the price of the stock (and thereby enable a more conducive method of calculating the value of the stock as a percentage of the potential estate) is the restrictive agreement. A properly drafted, binding agreement, will make the price fixed therein (by formula or otherwise) conclusive on the Service. There are two types of such agreements:

(1) The buy and sell agreement between the corporation and all the stockholders, the corporation being the primary obligor and the surviving stockholders being secondarily liable in case the corporation

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103 The preferred stock distributed under either of these methods (recapitalization or dividends) will be "section 306" ("tainted") stock. See § 306(c)(B) and § 305(a). After the passage of the Tax Reform Act of 1976 and before the 1978 Revenue Act many commentators expressed the belief that "section 306" stock will not lose its taint at the death of the holder and therefore would not qualify for the privileged treatment under § 303. They based this conclusion on the carryover basis rules of the TRA (§ 1023). It was argued that prior to the TRA the taint disappeared at the death of the holder since the stock acquired a new basis (§ 1014) and with the new basis there was no taint; with the carryover basis however the taint is carried over as well. The Revenue Act of 1978 laid to rest these fears through enactment of § 306(b)(5) which provides that to the extent § 306 stock is redeemed in a § 303 redemption, the provisions of § 306 do not apply.

104 See § 303(b)(2)(A).

105 For purposes of this paper, the phrase "adjusted gross estate" when used in reference to § 303, means "the excess of the value of the gross estate over the sum of the amounts allowable as a deduction under section 2053 or 2054." See text at note 55.


107 In order to eliminate the possibility that the redemption of the stock by the corporation is not attributed as a dividend to the surviving stockholders (under the argument that the corporation was discharging an obligation of the stockholders) the agreement must be clear that the surviving stockholders are bound to buy the stock only if the corporation cannot. See Holsey v. Comr. 258 F.2d 865 (3d Cir. 1958); Rev. Rul. 58-614, 1958-2 C.B. 920; Rev. Rul. 69-608, 1969-2 C.B. 42.
cannot perform. The agreement provides that the corporation (or surviving stockholders) shall buy and the estate of decedent stockholder shall sell at a fixed or determinable price.

(2) The corporation, and the stockholders secondarily, to have the option to buy and the estate be obligated to sell at the option price.

To be binding, the option or contract must be (1) to purchase all the stock owned by the decedent at death, (2) decedent cannot dispose of the stock during lifetime at a price which is different from the option or contract price, and (3) the agreement must be a "bona fide business agreement and not a device to pass the decedent's share to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth". A mere option to sell is not sufficient to fix the value of the stock and could have disastrous results in that it sets a minimum value for valuation (at which price the executor may have to sell) but does not establish a maximum value (on which valuation the estate tax may have to be paid). Neither does a mere right of first refusal by the corporation or surviving stockholders fix the value, but it has a depressing effect thereon.

The price at which the stock is to be redeemed is to be fixed by a formula which takes in consideration prior years' per share earnings over a period of at least five years and book value, thus the price would reflect both asset and income values.

Funding such an agreement could be accomplished through purchase of life insurance. The corporation would buy a policy on the life of each stockholder upon whose death the proceeds, which are tax free to the corporation, would be used to redeem the stock of the deceased stockholder.

B. To Meet the Requirement that Stockholder Bear Burden of Tax

The will should be thoughtfully drafted to eliminate bequests of stock to beneficiaries who are not to be subject to payment of taxes and

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108 Some reasons for such inability are lack of cash, or legal obstacles such as a lack of surplus (local law prohibiting distributions under such conditions), or the existence of outstanding debt instruments prohibiting dividends or redemptions, etc.


110 See Estate of Salt, 17 T.C. 92 (1951) acq. 1952-1 C.B. 4; May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932).


112 Worcester County Trust Co. v. Comr., 134 F.2d 578 (1st Cir. 1943).

administration expenses. Conversely, if the testator wishes to leave stock to particular beneficiaries whom he desires to be active in the corporation's management and affairs, then, in order to eliminate the possibility of redemption on their part, the dispositive provision should expressly exempt such bequests from taxes and expenses.

C. To Meet Other Contingencies

The will should have provisions giving flexibility to the executor to use section 303 (and the deferred payment sections) for the best interests of the estate. He should be empowered to use his discretion to decide whether to make a single lump sum redemption or several redemptions, whether to accept property other than cash, whether to accept new stock for old, whether to use the alternate valuation date, whether to pay taxes in installments under the deferral provisions, and to distribute assets in kind in satisfaction of a pecuniary bequest.

V. Collateral Matters

A. Accumulated Earnings Tax

Section 531 imposes a penalty tax on corporations for unreasonable accumulations of earnings. This matter gave concern to planners in relation to accumulations of cash for redemption of stock. As a partial relief measure section 537 provides that the amount needed to redeem stock of a decedent under section 303 shall be considered a reasonable business need in the year of death or any year thereafter, limited to the maximum amount allowed under section 303. The amount referred to includes any amount to discharge any obligations incurred in the redemption. Thus paying off a note given in payment for the stock would qualify under this provision. This gives flexibility in planning the corporate pay out (for the redemption). An accumula-

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114 The marital trust is not usually subject to such taxes and expenses. If the maximum marital deduction is desired and it is also desired that the marital trust have stock and the possibility exists that some of it will need to be redeemed, then a formula need be created which will provide an amount that will equal the sum of the maximum deduction and its prorata share of taxes and expenses. Such a formula may be extremely difficult to devise.

115 See text at note 65 and text between note 95 and end of III B.

116 See text at note 72.

117 See text between note 36 and end of paragraph.

118 See text of paragraph following the paragraph mentioned in note 117.

119 See text at notes 45 to 46.

120 I.R.C. § 531.

121 I.R.C. § 537.

122 I.R.C. § 537(b)(1). For maximum allowed see text at notes 61 and 62.

123 I.R.C. § 537(b)(3).
tion prior to the year of death might be considered an unreasonable accumulation but the need for such accumulation is eliminated under the aforementioned provision. The corporation can distribute a note in payment for the stock and then pay off the note over a period of years. If the executor needs the cash he could discount the note with a common creditor (e.g. the bank) of the corporation. Thus the need to have a large amount of cash or liquid securities on hand for the contingency of a redemption is reduced by this provision.

B. Distribution of Appreciated Property

Section 303 redemptions offer a once in a lifetime (read death time) opportunity to bail out certain appreciated property held by the corporation, without the incurrence of tax either on the part of the corporation or on the part of the stockholder receiving the property. Section 311 provides that if a corporation distributes property in redemption of stock it generally will have to recognize gain. However, one of the exceptions to this rule is a section 303 redemption, to the extent that section 303 applies. Here is a situation where a section 303 redemption could be used as an ideal vehicle to distribute appreciated securities without any gain being recognized. However, appreciated property subject to depreciation would not fare as well upon a distribution thereof, the depreciation recapture rules taking precedence over section 311, and therefore such property should not be distributed. Similarly, LIFO inventory and property subject to debt in excess of tax basis are not subject to the exception. Installment paper (owned by the corporation) should also not be distributed in a redemption, since such disposition would immediately accelerate the maturity of the tax that was reportable on the installment basis.

124 Life insurance funding would eliminate such need. The discussion assumes no such funding plan.
125 See also text at note 72.
126 I.R.C. § 311.
127 I.R.C. § 311(d)(1).
129 No gain is recognized to the corporation on account of § 311(d)(2)(D) and no gain is recognized to the redeeming stockholder because his tax basis is the fair market value on the date of distribution, and upon immediate resale the gain would be zero.
130 Any depreciation taken on tangible personal property since January 1, 1963, and varying percentages of “additional” depreciation (the difference between accelerated and straight line depreciation) taken since January 1, 1964 on real property, to the extent of any gain on such property (the difference between fair market value on date of distribution and tax basis of property), is to be reported by the transferor as ordinary income. See §§ 1245 and 1250.
131 I.R.C. §§ 1245(d) and 1250(i).
132 I.R.C. § 311(b)(1).
133 I.R.C. § 311(c).
134 I.R.C. § 453(d).
VI. Conclusion

Although the Tax Reform Act of 1976 has restricted somewhat the benefits available under section 303, it is still a very useful vehicle to make available to the estate tax free funds with which to pay death taxes and expenses. Careful pre-death planning could make section 303 available where without planning its potential use might be lost. Possible use of the deferral payment sections in tandem with section 303 would make the benefits of the latter even more beneficial.