Protective

BUSINESS CONCEPTS

Section 303 Redemption

The Problem...

Unique estate liquidity problems arise when an owner of a family corporation dies. As a result, there may be:

- A need to sell off part of the business to generate cash for estate needs.
- A possibility that outsiders join the business as a result of the sale.
- An issue when a stock redemption is considered a dividend distribution rather than the sale of a capital asset, thus subjecting the redemption to a potential 23.8% tax (up to 20% tax on dividends plus the 3.8% Medicare surtax on investment income).

The Section 303 Solution...

- Under Section 303 of the Internal Revenue Code, a deceased shareholder's estate or heirs may sell enough stock back to a closely held corporation to pay federal and state estate taxes and other expenses without the IRS treating the transaction as a dividend distribution.
- Section 303 allows heirs with liquidity needs to get cash from the corporation with little or no federal income tax consequences.
- Any gain that arises from a Section 303 redemption is taxed favorably as a long-term capital gain.
- Unlike dividend income, capital gains can be offset by the shareholder's basis in the stock—including a step-up in basis that occurs at death.

Requirements...

Under Section 303, when a shareholder dies, a partial stock redemption may be treated as a sale eligible for long-term capital gains treatment when the redemption meets four tests:

1. The stock must be included in the decedent's gross estate—but may be held by a surviving joint tenant as well as by the executor of the estate.
2. The stock's value must exceed 35% of the value of the adjusted gross estate.
3. The stock must be held by someone whose interest in the estate would be reduced by the payment of estate costs.
4. The redemption must occur within four years of the shareholder's death, with certain exceptions.

Limitations...

- Section 303 limits the amount of stock that may be redeemed to an amount equal to the total of state and federal estate taxes, estate administration costs and funeral expenses.
- If more than one heir wants to redeem stock, a "first-come, first-served" rule applies. Once the maximum is reached, Section 303 is no longer available to the decedent's estate or any other heirs.

Funding the Redemption...

- When a small corporation does not have enough cash to redeem a deceased owner's shares under Section 303, the business can use life insurance proceeds to provide the necessary funds.
- The shareholder agrees in writing to allow the business to purchase a specified amount of life insurance. The business is the owner and beneficiary of the policy on the shareholder's life. When the shareholder dies, the business uses the policy proceeds to purchase stock from the deceased shareholder's heirs or estate.
- If the notice and consent requirements have been met, life insurance proceeds are usually free of federal income tax.

The Advantages...

- In addition to providing adequate liquidity for estate settlement, life insurance can ensure adequate income for the deceased owner's spouse or family and equalize inheritances among the owner's children.
- Ownership of the business remains in the family.
- Heirs are assured of having funds to help pay estate settlement costs.
- Corporate dollars can be used to make a tax-favored partial redemption.
- Income taxes on the sale can be minimized or avoided.
- There's no requirement that a Section 303 redemption can be used only if the estate needs cash to pay death costs. It may be used even if other cash is available.

After the Redemption...

- Like any stock redemption, a Section 303 redemption alters the surviving shareholders' ownership percentages.

- **Example:** Tom, Dick and Harry own 40%, 40% and 20%, respectively, of their small corporation. Dick dies and half of his stock—or 20%—is redeemed. The ownership percentages now shift to 50% for Tom (a 10% increase), 25% for Harry (a 5% increase), and 25% for Dick's heirs (a 5% increase added to their remaining 20%).
- Whereas Dick's interest was formerly twice as great as Harry's, the redemption of half of Dick's stock means that Harry's interest now equals the interest of Dick's heirs.

The Bottom Line...

A Section 303 stock redemption funded by life insurance gives close corporation owners a way to create needed estate liquidity at an owner's death without incurring needless taxation, and ensures that a business that is often a major family asset will remain in the hands of the surviving stockholders.

SUMMARY

What Is a Section 303 Stock Redemption?

Section 303 of the Internal Revenue Code gives a close corporation shareholder's estate or heirs a tax-advantaged way to generate cash to pay the costs of estate settlement when the estate owner dies.

The law recognizes that, when a full or partial owner of a small, closely held corporation dies, his or her estate may need immediate liquidity to pay settlement costs at death. If the only source available for cash is to sell corporate stock, at least two problems can arise.

First, the need to sell creates the potential for outsiders to join the business. Second, a stock redemption by the estate or heirs could be treated as a dividend distribution rather than the sale of a capital asset, which could subject the corporate distribution to tax, with no offset for basis.

How Does a Section 303 Redemption Work?

Partial redemption of a deceased shareholder's stock will be treated as the sale of a capital asset rather than a dividend distribution when the sale meets four tests:

1. The stock must be included in the decedent's gross estate.
2. The stock's value must exceed 35% of the adjusted gross estate.
3. The stock must be held by a person whose interest in the estate would be reduced by the payment of estate costs.
4. The redemption generally must occur within four years of the stockholder's death.

The maximum amount of stock that may be redeemed is equal to the sum of state and federal estate taxes, costs of estate administration and funeral expenses.

Where Will the Money Come From?

Of course, the corporation must have cash available to redeem the stock. One solution is for the corporation to purchase a life insurance policy covering the eligible shareholder. The corporation notifies the shareholder-employee that it intends to buy life insurance on the shareholder-employee and obtains the shareholder-employee's written consent. When the shareholder dies, the business receives the proceeds and uses the cash for the partial redemption.

What Are the Benefits?

When funds for estate settlement are arranged for in advance—such as when life insurance is purchased specifically for that purpose—important benefits result. The estate and heirs are assured of funds to help pay estate settlement costs. Ownership remains in the family because the heirs avoid a forced sale of shares. Corporate dollars can be used to make a tax-favored partial redemption, and income taxes can be minimized or eliminated.

In situations where other cash is already available for estate settlement, the heirs can use the Section 303 distribution for other purposes. In a family business, for example, the cash may be used to ensure adequate income for the heirs, or to equalize inheritances among the estate owner's children.

Are There Other Concerns?

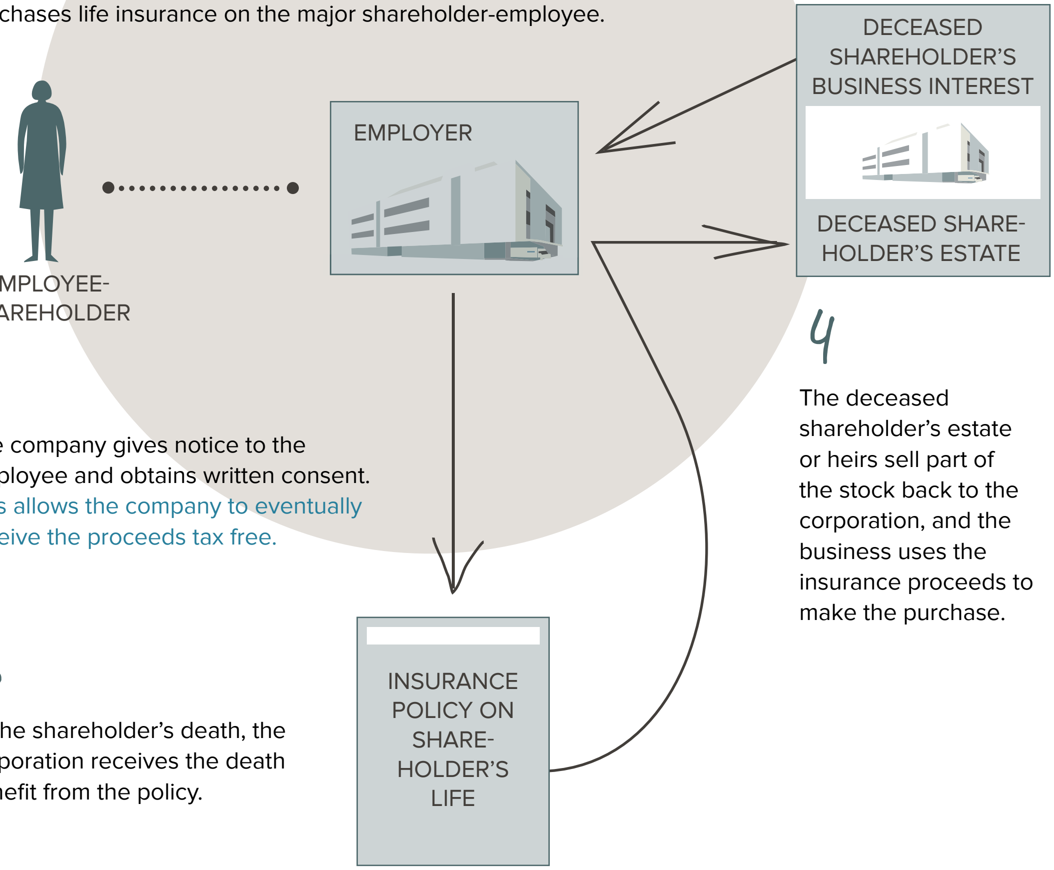
Like any stock redemption, a Section 303 redemption can alter the ownership percentages of surviving shareholders.

A Section 303 redemption may not be useful in the case of a married business owner whose estate plan optimizes the use of the unified estate tax credit and the marital deduction, since there will be no federal estate tax to pay at the owner's death. A Section 303 redemption is generally more useful when there is no surviving spouse.

Still, a Section 303 stock redemption funded by life insurance remains an effective way to create needed estate liquidity at an owner's death without incurring needless taxation, while ensuring that the business (a major family asset) will remain in the hands of the surviving stockholders.

1

At the death of a significant shareholder, the estate may obtain needed liquidity by selling back a portion of the shares to the business without the resulting payment being treated as a dividend. To ensure its ability to buy back the shares, the business purchases life insurance on the major shareholder-employee.



2

The company gives notice to the employee and obtains written consent. This allows the company to eventually receive the proceeds tax free.

3

At the shareholder's death, the corporation receives the death benefit from the policy.

4

The deceased shareholder's estate or heirs sell part of the stock back to the corporation, and the business uses the insurance proceeds to make the purchase.

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