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Section 303—Redemptions To Pay Death Taxes and Administrative Expenses: A Relief Provision Liberally Construed

Stephen L. Kadish

Because of the uncertainty as to whether a corporate redemption of stock held in a decedent's estate results in a capital gain or ordinary income, section 303 was enacted as a step towards predictability and as a guideline to reduce the danger of having the redemption treated as a dividend. The author briefly sets forth the statutory qualifications for capital gains treatment under section 303, intended to provide relief for estates which consist largely of stock in one or more corporations. A number of interesting tax planning possibilities are discussed, including corporate merger, reorganization, recapitalization, inter vivos gifts, and formation of a personal holding company. Even if the section is not satisfied at the time of the decedent's death, several avenues of post-death planning are available in order to secure the full benefits of section 303.

PRIOR TO 1950 there was a high degree of uncertainty as to whether a stock redemption would result in capital gain or ordinary income.¹ Redemptions were tested under section 115(g) (1) of the Internal Revenue Code of 1939, and only if, as a factual matter, they were found to be "not essentially equivalent to a dividend,"² was capital gains treatment allowed. If a redemption failed this test, it was treated as a dividend, taxable at ordinary income rates without reduction for the shareholder's basis in the shares.³

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¹ S. REP. NO. 1622, 83d Cong., 2d Sess. 44 (1954).

² Section 302(b) (1) of the INT. REV. CODE OF 1954 [hereinafter cited as CODE] uses this exact language paraphrased from Int. Rev. Code of 1939, § 115(g), 53 Stat. 46.

³ This test, retained as CODE § 302(b) (1), has continued to be an unpredictable criterion, because each case is judged on its own facts. As stated in a recent Tax Court opinion, "The colors of the cloth of dividend equivalency are not completely fast. Indeed, the fabric 'bleeds,' madras-like, to such an extent that the decided cases have been described as a 'morass' . . . and the underlying statutory provisions referred to as 'exasperatingly complex.'" Henry McK. Haserot, 46 T.C. No. 87 (Oct. 7, 1966) (currently on appeal to the Sixth Circuit). In fact, an entire book, SEGHERS, REINHART & NIMAROFF, ESSENTIALLY EQUIVALENT TO A DIVIDEND (1960), has been written on the subject.

The first step towards predictability of the tax effects of a redemption was taken by Congress through the addition of section 115(g)(3) to the 1939 Code, providing certainty for redemptions of stock held in a decedent's estate at the time of his death if the requirements of the statute were met.⁴ The basic purposes of this legislation were to make tax-free dollars available for payment of death taxes and administration expenses and to prevent the concentration of industrial ownership which could result from forced dispositions of closely held businesses to outside interests, especially large competitors.⁵ When a large shareholder in a closely held corporation died and his estate required money to pay death taxes and expenses, sales to third parties might have been required if insufficient liquid assets made it infeasible for the corporation to redeem the decedent's entire interest. Redemption of only a part of a decedent's stock interest was usually impractical because it had to meet the "dividend equivalence" test. Congress therefore enacted section 115(g)(3) as part of the Revenue Act of 1950. The Revenue Act of 1951 further amplified the treatment of these redemptions and provided the framework for section 303 of the 1954 Code.

I. SCOPE OF SECTION 303

A. *Effect of Section 303*

As with section 115(g)(3) of the 1939 Code, the basic purpose of section 303 is to relieve an estate of the danger of having a redemption distribution treated as a dividend. If the mechanical requirements of the section are met, the amount of any gain on the redemption will be taxed at capital gain rates without having to meet the requirements of section 302 or the attribution rules of section 318. Since this redeemed stock will have acquired a new stepped-up basis under section 1014(b)(9) as of the date of death or alternate valuation date,⁶ there is ordinarily little or no gain taxable on a redemption of stock which was included in a decedent's estate. This is in sharp contrast to having the redemption distribution treated as a dividend if it failed to qualify under section 302.

⁴ The enactment of CODE §§ 302(b)(2) and (3), relating to redemptions which are substantially disproportionate and complete terminations of interest, has further aided tax planning by providing objective criteria against which redemptions can be measured.

⁵ H.R. REP. NO. 2319, 81st Cong., 2d Sess. 63 (1950).

⁶ CODE § 2032. See text accompanying note 25 *infra*.

B. Statutory Requirements of Section 303

In order to qualify for capital gains treatment under section 303, the stock which is redeemed must have been includible in the decedent's gross estate under sections 2032 through 2043. This stock must have comprised at least thirty-five percent of the value of the decedent's gross estate or fifty percent of his taxable estate.⁷ For purposes of this "35-50% test," the stock of two or more corporations may be treated as the stock of a single corporation if the decedent owned more than seventy-five percent in value of the outstanding stock of each.⁸ If the 35-50% test is satisfied, section 303 insulates a redemption distribution from dividend treatment, to the extent that the amount of the distribution does not exceed the sum of estate, inheritance, legacy, and succession taxes (including interest) imposed because of the decedent's death, and the amount of allowable funeral and administration expenses.⁹ If the amount of the redemption distribution is in excess of these amounts, such excess is governed by sections 302, 306, or 346.¹⁰

Any class of stock can qualify for a redemption under section 303,¹¹ which applies not only to stock actually included in the decedent's gross estate but also to stock with a substituted basis determined by reference to stock in the decedent's gross estate.¹² Thus, stock received in a tax-free reorganization or as a result of a stock dividend, although not actually held by the decedent at his death, can be redeemed. Despite this latitude, the Internal Revenue Service recently has contended successfully that, for purposes of the seventy-five-percent test,¹³ a decedent could not take advantage of the value of his indirect ownership of a subsidiary's stock held by the parent corporation of which he was the principal shareholder.

One of the most helpful aspects of section 303 is the liberality of its time limitations. Redemption distributions must be made either within ninety days after the three-year statute of limitations provided by section 6501(a) or within sixty days after a final Tax

⁷ CODE § 303(b)(2)(A).

⁸ CODE § 303(b)(2)(B).

⁹ CODE § 303(a).

¹⁰ Treas. Reg. § 1.303-3 (1955) [hereinafter cited as Reg.].

¹¹ Reg. § 1.303-2(c), as amended, T.D. 6724, 1964-1 CUM. BULL. 128.

¹² CODE § 303(c). See also Reg. § 1.303-2(d), as amended, T.D. 6724, 1964-1 CUM. BULL. 128; Rev. Rul. 55-91, 1955-1 CUM. BULL. 364.

¹³ Estate of Otis E. Byrd, 46 T.C. 25 (1966) (currently on appeal to the Fifth Circuit). For a discussion of this case, see note 23 *infra*.

Court decision.¹⁴ Flexibility is provided by the fact that there can be either a single redemption or a series of redemptions, so long as all redemptions are made within the statutory period. A recent Revenue Ruling¹⁵ construed the prescribed periods as being in the alternative, so that the longer of the two periods can be chosen. Despite these liberal provisions, two caveats should be noted. First, no provision is made for refund suits, so that an executor who intends to utilize section 303 after a value is judicially established must go to the Tax Court if he is to avoid loss of rights by operation of the three-year and ninety-day period. Second, the statute of limitations under section 6501(a) begins to run with the *filing* of the estate tax return rather than from the end of the permissible fifteen-month filing period.

II. LACK OF RESTRICTIONS IN SECTION 303

Section 303 is a relief provision which, according to the rules of statutory construction, should be liberally construed.¹⁶ Moreover, there is almost a total lack of restrictions on the use of section 303 if its mechanical requirements are met. This is in distinct contrast to the statement in the 1950 Committee Reports that the section would "restrict relief to situations in which true hardship exists."¹⁷

Section 303 was intended to provide relief in those cases in which an estate consisted largely of stock in one or several corporations. Subject to meeting the mechanical 35-50% test, any redemption distributions with respect to stock which was actually included in the decedent's gross estate or which derived its basis therefrom could be made without the fear that the redemption proceeds would be treated as a dividend. The ostensible purpose of this provision was to provide an estate with liquid assets with which it could pay death taxes or administration expenses. Despite this legislative purpose, section 303 may be used where there is no federal estate tax liability;¹⁸ where the estate has ample liquid assets; where the distribu-

¹⁴ CODE § 303(b)(1).

¹⁵ Rev. Rul. 66-246, 1966 INT. REV. BULL. NO. 34, at 17.

¹⁶ See, e.g., Harvey J. Johnson, 43 T.C. 736, 740-41 (1965); Gaynor News Co., 22 T.C. 1172, 1177-79 (1954); SUTHERLAND, STATUTES & STATUTORY CONSTRUCTION §§ 6701-11 (3d ed. 1943).

¹⁷ H.R. REP. NO. 2319, 81st Cong., 2d Sess. 64 (1950).

¹⁸ Rev. Rul. 56-60, 1956-1 CUM. BULL. 443. In the event that there is no federal estate tax liability against the estate because the gross estate is under sixty thousand dollars, only the thirty-five-percent test can be used, since there is no taxable estate.

tions are not actually used to pay death taxes or administrative expenses; or even where redemption is not made from the estate.¹⁹

Although most section 303 redemptions involve closely held family corporations, this need not be the case. Furthermore, since section 303(a)(2) refers to funeral and administration expenses *allowable* as deductions under section 2053 (rather than those actually *allowed* under that section), a 303 redemption can be used with respect to administration expenses which are in fact deducted on the estate's income tax return by election under section 642(g) rather than on the estate tax return.²⁰ Thus, so long as the formal, mechanical requirements of the section are met, it is immaterial that the redemption could have been made without the benefits of section 303 or that in fact no redemption was necessary.

III. TAX PLANNING POSSIBILITIES

A. *During the Shareholder's Lifetime*

Many interesting tax planning possibilities are available which enable a taxpayer to assure compliance with the requirements of section 303. First, the awareness that section 303 may be utilized may influence the shareholder to make inter vivos gifts of non-qualifying property, thereby increasing the proportionate value of the qualifying corporate stock in his gross estate.²¹ It may also prompt the corporation to effect a recapitalization under section 368(a)(1)(E), as in a situation where voting control might be endangered by a post-death redemption. Thus, a class of nonvoting stock could be created so that gifts, or redemptions of a portion of the taxpayer's shareholdings either before or after his demise, would not affect voting control.²²

In preparing an estate plan for a substantial stockholder, it may become clear that because he "has his eggs in more than one

¹⁹ The stock can be redeemed from anyone, so long as it was included in the decedent's gross estate (but not if acquired by gift or purchase from a donee or legatee, or acquired in satisfaction of a specific monetary bequest). Reg. 1.303-2(f) (1966). Cf. Rev. Rul. 56-270, 1956-1 CUM. BULL. 325; Rev. Rul. 60-87, 1960-1 CUM. BULL. 286.

²⁰ Rev. Rul. 56-449, 1956-2 CUM. BULL. 180.

²¹ In making such gifts, the shareholder should be aware of the possible impact of § 2035 which raises a rebuttable presumption that any gifts made within three years before his death are deemed to be in contemplation of death. They would therefore be includible in the gross estate and would not further the use of § 303.

²² Note that a recapitalization under § 368(a)(1)(E) or a tax-free stock dividend under § 305 may create § 306 "hot stock" if preferred stock is issued with respect to common stock. This "hot stock" will, however, lose its "taint" upon the decedent's death if it is included in his gross estate. Reg. § 1.306-3(e).

basket," he will not be able to qualify for relief under section 303. Although the value of his stock interests in several corporations may meet the 35-50% test when added together, he might not hold more than seventy-five percent of each of the corporation's shares. The recent case of *Estate of Otis E. Byrd*²³ points out that a taxpayer, for purposes of section 303, cannot rely on his ownership of the stock of one corporation in order to include the value of a subsidiary corporation's stock owned by that corporation. This can be remedied by use of a merger or other form of reorganization to consolidate the individual's holdings into fewer corporations. This, of course, presupposes a willingness on the part of a sufficient number of other shareholders to allow such a reorganization.

An alternative to the use of a merger or other form of reorganization in order to combine an individual's interest in a group of corporations would be to form a personal holding company which would hold the stock of the various corporations. The stock of this holding company would be held by the individual shareholder and thus would be includible in his gross estate at the time of his death. After his death a one-month liquidation under section 333 (a)(2) could be employed, which would give rise to a substituted basis under section 334(b)(1) with respect to the shares of the operating companies. Because of the substituted basis, the stock of the operating companies would then qualify for relief under section 303(c).²⁴

In situations where a corporation does not have a large amount of liquid assets, it may be advisable for the corporation to fund a section 303 redemption of a majority shareholder by obtaining corporate life insurance on his life. Where the corporation is the

²³ 46 T.C. 25 (1966) (currently on appeal to the Fifth Circuit). In this case, the decedent owned 88.9% of the stock of P corporation which in turn held stock interests in three other corporations in which he was a substantial shareholder. Byrd owned less than 75% of the shares of any of the three other corporations individually, but if 88.9% of the stock of P corporation were added to his individual holdings he would have held well over 75% of the stock in each. He would thereby have been able to utilize successfully the relief provision of § 303(b)(2)(B), since the value of the stock in these four corporations combined would have easily satisfied the 35-50% test. In view of the inapplicability of the stock attribution rules of §§ 318 and 303, the court concluded that § 303 redemption values included only stock *directly* included in a decedent's gross estate, and the taxpayer was denied the benefits of § 303.

²⁴ Two possible pitfalls are inherent in such a plan. First, the "business purpose" requirements which have been engrafted by case law upon the reorganization sections of the Code might be invoked by the government to defeat the transactions. Second, the newly created holding company would be subject to the personal holding company surtax imposed by §§ 541-47 if it did not distribute its personal holding income to its shareholder.

beneficiary of the insurance proceeds, the value of the decedent's stock interest will be further increased, thus helping to meet the 35-50% test as well as providing liquid assets to effect the redemption.

B. Post-Death Planning

Even where the stock held by a decedent does not meet the requirements of section 303 at the time of his death, various avenues are still available to bring the section into operation. It is possible to utilize the alternative valuation date provided by section 2032 to value the decedent's property, despite the fact that his gross estate may be increased.²⁵ Thus, where the value of the corporate stock is not sufficient to meet the 35-50% test at the date of the decedent's death, a "second look" can be taken one year later. This may be extremely helpful in that the corporation could omit dividends, defer expenses, or do other acts during the year after the decedent's death which would increase the dollar value of his stock.

A similar method, whereby an executor can control the proportionate value of the stock in comparison to the taxable estate in order to meet the fifty-percent test, is the election provided by section 642(g). This section permits the executor to deduct funeral and administration expenses and claims against the estate on either the federal estate tax return under section 2053 or on the estate's income tax return under section 641(b). This allows the executor to reduce the size of the taxable estate by claiming the deductions on the federal estate tax return, thereby making it more likely that the fifty-percent test of section 303 will be satisfied.

It has also been suggested that one could couple the use of the section 2032 alternative valuation date with a merger, use of a personal holding company, or other reconstitution of the corporate structure in order to obtain the benefits of section 303.²⁶ There are possible flaws in this approach, and since it has never been approved by the Revenue Service or the courts, it should not be relied upon if more feasible alternatives exist.²⁷

²⁵ Rev. Rul. 55-228, 1955-1 CUM. BULL. 449.

²⁶ Levenfeld, *Postdeath Planning Under Section 303*, 51 A.B.A.J. 495, 496 (1965). *But cf.* Tiger, *How To Plan Stock Redemptions To Pay Estate Taxes — The Problems of Section 303*, 24 J. TAXATION 92, 93 (1966).

²⁷ A recently received private ruling approved a § 303 corporate redemption that was effectuated at the decedent's death, despite the subsequent merger with two other corporations in which the decedent was a less than seventy-five-percent shareholder. Under the facts presented, there was no tax avoidance motive in the post-death merger, which

In cases where the retention of voting control is important, a reorganization under section 368(a)(1)(E) enables the creation of a class of nonvoting shares, some or all of which could be redeemed from a decedent's estate or beneficiaries. In cases where the qualifying corporation does not have sufficient liquid assets to redeem the qualifying shares, a redemption by a related corporation under section 304 is sanctioned.²⁸

A problem which is often encountered in utilizing section 303 is that of establishing a value of the stock to be retained. Where it is financially possible, it may be desirable to delay the redemption under section 303 until after the shares have been valued for estate tax purposes by the Internal Revenue Service audit. Where the estate lacks sufficient liquid assets to pay death taxes or funeral and administrative expenses, etc., and a redemption in whole or in part must be made before the estate tax audit is complete, there would appear to be no reason why the redemption agreement could not provide for a valuation of the shares which is contingent upon the amount finally determined in the estate tax audit. Since the redemption agreement is in the nature of a contract between the corporation and the redeeming shareholders, the parties should be permitted to agree to revise the amount to be finally paid.

A Recent Revenue ruling points out a valuable method by which a corporation which does not have sufficient liquid assets, or does not wish to dispose of a large amount of its liquid assets, may utilize section 303.²⁹ This ruling sanctions the use of a corporate promissory note in lieu of a total cash or property distribution, even if the note is to be repaid after the statutory redemption period. Thus, a corporation which cannot or will not satisfy the redemption price in cash or property can make a down payment and pay the balance to the redeeming shareholders over a term of years.

One word of caution should be mentioned in this regard. It is possible that if such a method is used in situations where the corporation already has a heavy debt structure, or if the terms and duration of the promissory note so indicate, the Internal Revenue Service might invoke the doctrine of "thin incorporation" in order

was entered into for a bona fide business purpose. Although the Internal Revenue Service approved the redemption, it declined to state its reasoning; thus, a post-death merger utilized principally to avoid the seventy-five-percent test may find disfavor with the Service, notwithstanding the clear statutory language permitting the use of the alternative valuation date.

²⁸ Rev. Rul. 55-592, 1955-2 CUM. BULL. 573.

²⁹ Rev. Rul. 65-289, 1965-2 CUM. BULL. 86.

to characterize the note as a continuing proprietary interest in the corporation which would disqualify the section 303 redemption, since such "stock" would not be considered "property" for purposes of section 303.

Section 6166 of the Code, which is often overlooked, can be used either in conjunction with or in lieu of section 303. This section, which was enacted in 1958,³⁰ provides for an extension of time up to ten years for the payment of estate taxes where an estate consists largely of an interest in a closely held business. The tests which must be met in order to obtain relief are quite similar to those provided in section 303. Section 6166 applies to corporations having ten or less shareholders and also to sole proprietorships and partnerships.

If the specific requirements of the section are met, the amount of estate tax imposed on a decedent's estate with respect to the value of his interest in the closely held business can be paid in not more than ten annual installments. This may often provide an attractive alternative to a redemption of a decedent's stock (especially where the retention of voting control is a substantial problem), since interest is payable at only four percent on the installment payments. Section 6166 may be used in conjunction with a section 303 redemption, but under section 6166(h) the extension becomes inapplicable to the amount of estate tax attributable to any stock which is redeemed, and if more than fifty percent of the stock is redeemed, sold, or otherwise disposed of, the extension of time for payment on the total unpaid portion of the estate tax due ceases to apply.

It is important to note that in contrast to a 303 redemption which can be made after the filing of the estate tax return, but before the statutory period prescribed in section 303(b)(1), an extension under section 6166 must be elected not later than the statutory period for filing the estate tax return.³¹ It is often advisable to elect an extension under section 6166 even when the corporation has ample liquid assets if there is a danger that the value of a decedent's interest in the closely held business may be revised substantially in an estate tax audit. If a substantial revision in the value of the redeemed stock is made in that audit, the use of such an extension will protect the estate from having to raise a large amount of money to pay the additional estate tax immediately.

³⁰ 72 Stat. 1681 (1958).

³¹ CODE § 6166(a).

Finally, it should be noted that a section 303 redemption affords a valuable opportunity for a corporation to distribute appreciated property without recognizing gain (except installment obligations, LIFO inventories, or where the liabilities exceed the basis of the property distributed) under section 311, although earnings and profits will be reduced only by the adjusted basis of such property, and there may be recapture of depreciation.³²

IV. POSSIBLE PITFALLS AND UNANSWERED QUESTIONS

Because of the complex problems raised by certain of the courses of action suggested above, it may be advisable to obtain a Revenue Ruling, especially where the question of substance versus form is present. In particular, if a personal holding company is to be created and then liquidated under section 333, or if there is a question as to which corporation's earnings and profits are to be considered in a section 304 redemption by a related corporation, advance Revenue Service approval should be obtained.³³

When a corporation decides to accumulate a large amount of liquid assets to effect a redemption of a substantial shareholder, there is a substantial risk that it will subject itself to the imposition of an accumulated earnings surtax.³⁴ Whether or not the accumulation of liquid assets for such a redemption constitutes a sufficient business purpose which would negate the existence of a motive to avoid shareholder income tax has not been determined conclusively by the courts.³⁵ Until a more definitive body of case law has been developed, caution should be exercised in permitting substantial accumulations for the purpose of providing for a section 303 redemption.

An additional problem may occur when a series of redemptions is involved. Because redemptions can be made from persons other than the estate, some difficulty may be encountered when the total value of the stock to be redeemed exceeds the amount covered by section 303, and some of the redeeming shareholders will not be able to meet the requirements of section 302 because of the attribution rules of section 318.³⁶ In such a situation, the question arises

³² CODE § 312(a)(3).

³³ For the latest proceedings in obtaining Revenue Rulings, see Rev. Proc. 67-1, 1967 INT. REV. BULL. NO. 1.

³⁴ CODE §§ 531-37.

³⁵ See Washington, *Can Earnings Still Be Accumulated To Finance Section 303 Redemptions?*, 44 TAXES 43 (1966).

³⁶ CODE §§ 318 (a)(2), (3).

as to whether those redemptions which are first in time should be covered by section 303 on a first come, first serve basis or whether there should be a proration among all of the redemptions. In order to protect against a government position that only the earlier redemptions qualify for section 303, an executor would be well advised to redeem first the stock of those shareholders who would not be able to meet the tests of section 302 and then redeem those who would be entitled to capital gains under either sections 303 or 302.

As a final word of caution, it should be pointed out that when, because of the existence of a buy-sell agreement or otherwise, a redemption is made in an amount less than the date-of-death value of the decedent's stock, the redeeming shareholder may find his claim of a loss deduction disallowed because of the applicability of section 267, which disallows losses in transactions between related taxpayers. Fortunately for taxpayers in the Sixth Circuit, *Hanna v. Commissioner*³⁷ holds that the attribution rules of section 267 (b) do not apply to the estate-beneficiary relationship, so that no disallowance would result.

In summary, it can be seen that section 303 can provide significant relief, even beyond that originally intended by Congress, in situations where a substantial shareholder of a closely held corporation dies and all or a portion of his stock is to be redeemed. If the mechanical requirements of this section are met as to the value of the stock interest, non-dividend treatment is assured, and by utilizing some of the methods described above, creative tax planning can be accomplished.

³⁷ 320 F.2d 54 (6th Cir. 1963). See also Somers, *Stock Redemptions at Death: Does Section 267 Apply?*, N.Y.U. 23D INST. ON FED. TAX 1133 (1965).