Cannon Insights
A Monthly Publication by
Cannon Financial Institute

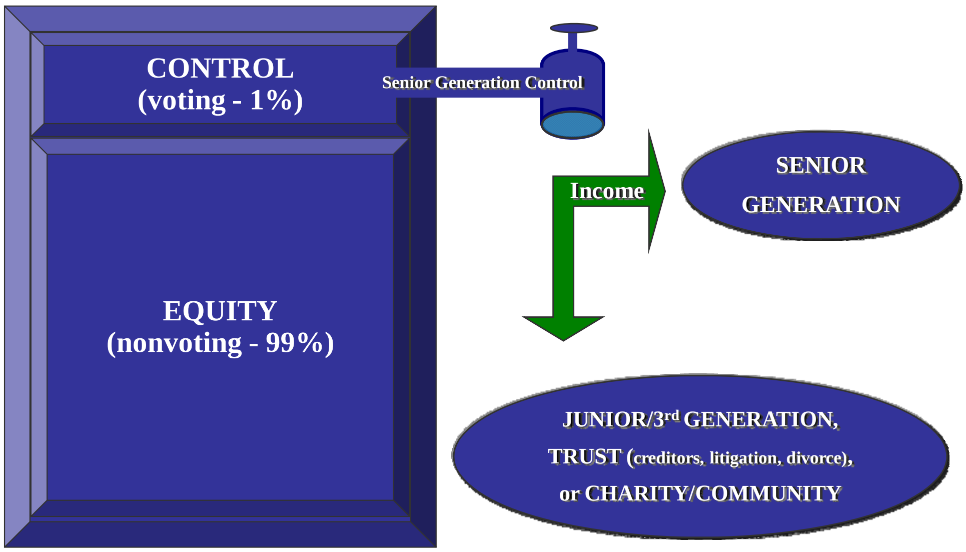
Planning Ideas—IRC Section 303 Redemptions

When a business owner client says he wants to leave his successful business to one or more of his children, a number of questions arise including the following:

- Is the selected successor qualified to run the business?
- Will management and other family members respect and follow the selected successor?
- When will the transition occur—following the death of the current owner or during his or her lifetime?
- What is the value of the business?
- What will the owner do to assure that other heirs are treated fairly?
- Will the surviving spouse have adequate income?
- How will estate and inheritance taxes, administrative costs, and funeral expenses be paid?

A good plan might be to recapitalize the business so that income and control of the business are separated from future growth. This is often accomplished through the vehicle of a family limited partnership (FLP) or family limited liability company (LLC). In either case the current business owner retains management control and income rights while the successor and/or other family members enjoy the future growth. At retirement or death, control can be shifted to the successor while retaining income rights for the surviving spouse. While not without its own issues, especially valuation of the partnership or LLC interests, this “divide and conquer” strategy addresses many of the questions raised above.

Figure 1--Divide and Conquer



But what about the client who procrastinates, as many clients are wont to do? He hears your advice, but doesn't listen, and drags his feet. Time passes, and one day you receive a phone call. The client has passed away. His solely owned $20 million business makes up 80 to 90 percent of his estate. The ten or twenty percent of the estate that is not the business consists of the now deceased client's residences, automobiles, other "toys," and $2 million squirreled away in mutual funds. After bequeathing the stock in his business to his oldest son, who is involved in the day-to-day operations of the business, the client's estate planning documents divide his estate among a family trust, which benefits two inactive children, and a marital trust. The family trust receives any unused exemption amount and the marital share the balance.

It doesn't take a rocket scientist to realize that the client's estate faces a liquidity crunch. State and federal taxes, administrative costs, and funeral expenses of about $7 million are due and payable, and even after taking into account the cash available from sale of the mutual fund shares, the estate faces $5 million in death costs. Not only that, the surviving spouse is frantic; she's unemployed by the business, and already she's wondering where the income will come from to provide her with enough income to live in the style to which she's become accustomed. As for Son #1's younger siblings, they're gainfully

employed, but both are deep in debt. They were really counting on their inheritance to get right with creditors, and they want to know why their older brother should get all the goodies.

Of course, the family is looking to you to sort all of this out. If you can, the prize is a happy surviving spouse and three younger-generation beneficiaries who will love you and engage your services forever.

IRC Section 303 to the Rescue

IRC Section 303 seems a little old-fashioned in today's world of FLPs, family LLCs, irrevocable life insurance trusts (ILITs), and intentionally defective grantor trusts (IDGTs). In fact, it was enacted over fifty years ago as part of the Internal Revenue Code of 1954. In what may seem a little quaint in today's political environment, a unified Congress wanted to make it easier for small businesses to pass from generation to generation. This was at a time when the estate tax exemption was $60,000, the top rate was 77 percent, and no more than half of the estate could qualify for the marital deduction.

For business owner clients needing cash to pay death costs, Section 303 can be a savior. Cash from the business can be tapped to meet liquidity needs, leaving other assets in place to fund bequests and/or provide income to a surviving spouse.

The gist of IRC Section 303 is that distributions in redemption of a deceased shareholder's stock are treated not as a dividend but as a capital transaction, up to a certain amount and provided the estate qualifies.

Without Section 303, a distribution in partial redemption of a decedent's stock would most likely be fully taxable at ordinary income tax rates. With Section 303, a qualifying redemption would be taxable only to the extent that the amount of the redemption exceeded the estate or beneficiary's basis. Given that basis would be stepped-up at death, there would probably be little or no taxable gain. Thus, without Section 303 a $1million distribution would receive a tax hit of about $350,000. With Section 303, the tax hit would be about zero.

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Qualifying Amount

The amount that qualifies for the favorable tax treatment granted by Section 303 is limited to the sum of the following:

- The **estate, inheritance, legacy, and succession taxes** (including any interest collected as a part of such taxes imposed because of such decedent's death); and
- The amount **of funeral and administration expenses** allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States).

Thus, even in situations where no **federal tax** is imposed due to the increased exemption of $5 million, Section 303 could nevertheless be relied on to the amount of **state** inheritance and estate tax, funeral expenses, and administrative expenses.

In many instances, qualification for Section 303 will be a foregone conclusion, but it's important to note that the requirements that the redeemed stock be included in the decedent's gross estate and make up more than 35 percent of the adjusted gross estate make qualification for Section 303 treatment anything but certain until after death. It is only after death that the relative values of estate assets will be known. Consequently, a Section 303 redemption is best thought of as a post-mortem estate planning tool.

In addition, a special rule applies to allow for redemptions up to the amount of generation-skipping taxes imposed.

Note that the amount received in distribution of stock does **not** have to be applied to taxes or administrative and funeral expenses. These items merely limit the amount that qualifies the Section 303 tax break.

Qualifying Estates

To be eligible for Section 303 treatment, the value of the decedent's stock included in the gross estate must exceed 35 percent of the value of the adjusted gross estate. For purposes of this requirement, stock of two or more corporations, with respect to each of which there is include in determining the value of the decedent's gross estate 20 percent or more in value of the outstanding stock, will be treated as the stock of a single corporation. For purposes of the 20-percent requirement, stock which, at the 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 treated as having been included in determining the value of the decedent's gross estate.

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Qualifying Distributee

Although the distribution in redemption under Section 303 does not have to be used to pay taxes and expenses, the interest of the shareholder from whom the stock is redeemed must be reduced directly (or through a binding obligation to contribute) by payment of taxes or expenses. In general, this means that the estate or beneficiary from whom the stock is redeemed must be liable for the estate or inheritance taxes and administrative and funeral expenses. Usually, this requirement does not present an obstacle.

> *Keep in mind, that even if the estate doesn't need cash, a Section 303 redemption can be a tax-efficient way of getting cash out of the business that would otherwise have been taxed as a dividend when distributed. Remember, there is no tracing requirement on funds received in a Section 303 redemption.*

Qualifying Time Period

In general, in order to qualify under Section 303, the redemption must take place after the business owner's death and no later than (1) three years and 90 days from the due date of the federal estate tax return; or (2) 60 days after a tax court decision in an estate tax liability contest has become final; or (3) the time permitted for the payment of estate tax installments, pursuant to IRC Section 6166, if applicable. However, in situations where corporate distributions on a redemption are made more than four years after the decedent's death, the distribution by the corporation is subject to Section 303 only to the extent of the lesser of (i) the amount of taxes, funeral and administration expenses remaining unpaid at that time, or (ii) the taxes and expenses that are actually paid within one year of the distribution.

Other Considerations

Another key consideration with Section 303 redemptions relates to where the corporation will find the cash (or other property) to implement the redemption. Obvious alternatives include cash on hand, cash from life insurance proceeds received from policies owned by the corporation on the decedent's life, and cash borrowed from a lender. Some states require that any stock redemption be paid for with corporate surplus. Permanent life insurance on the life of the owner may be used to create the necessary surplus.

Bottom Line

For clients with successful businesses and a potentially large estate tax bill, a divide and conquer strategy utilizing a FLP or family LLC is likely to be the best way to go. But for clients who fail to plan, procrastinate, or get caught short of cash following the owner's death, an IRC Section 303 redemption can be a lifesaver. Also, keep in mind, that even if the estate doesn't need cash, a Section 303 redemption can be a tax-efficient way of getting cash out of the business that otherwise would have been taxed as a dividend when distributed. Remember, there is no tracing requirement on funds received in a Section 303 redemption.

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