



BUSINESS PLANNING

Section 303 Redemption

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SECTION 303 REDEMPTION

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



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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.



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