

Tax Management Portfolios  
Estates, Gifts and Trusts Series  
809-1st : Estate Planning for Owners of Closely Held Business Interests

TITLE PAGE

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PORTFOLIO DESCRIPTION SHEET

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Tax Management Portfolio, Estate Planning for Owners of Closely Held Business Interests, No. 809, is designed as a guide to the lifetime and post-mortem estate planning techniques primarily applicable to the owners of interests in closely held businesses.

Detailed consideration is given to various kinds of buy-sell agreements, including cross-purchase and stock redemption agreements; the gift and estate tax rules governing the lifetime disposition of closely held business interests, with special emphasis on §§ 2701-2704; the use of recapitalizations, charitable bail-outs, and private annuities to accomplish retirement, gift, and estate planning goals; §§ 303, 6166, and 2057 "relief"

provisions concerning the payment of estate tax where the estate consists in significant measure of an interest in a closely held business; and the rules which apply to subchapter S corporations.

For additional relevant Tax Management Portfolios, check the "Estates, Gifts and Trusts Series Classification Guide."

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### 1. Purpose and General Rule Summarized

The general rule of Section 303 is set forth in subsection (a), which provides in full as follows:

(a) IN GENERAL. A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of

(1) 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

(2) 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),

shall be treated as a distribution in full payment in exchange for the stock so redeemed.

Thus, there are several basic elements which must be satisfied in order to have Section 303(a) apply:

(a) There must be a "distribution of property" to a shareholder of a corporation;

(b) The distribution must be in redemption of part or all of the distributing corporation's stock; and

(c) The stock which is being redeemed must be included in determining the gross estate of a decedent.

If all three of these conditions are satisfied, the distribution

-- will be treated as a distribution "in full payment in exchange for the stock so redeemed," but only to the extent of

-- the sum of (a) the "estate, inheritance, legacy and succession taxes" imposed because of the decedent's death, and (b) the amount of funeral and administration expenses "allowable" under Section 2053 [FN220] or, in the case of a nonresident alien, under Section 2106. [FN221]

There are a number of important qualifications to this broadly stated rule, which considerably reduce its availability to decedents' estates. These qualifications relate principally to the size of the interest represented by the shares which may be redeemed. However, assuming that the Section 303 qualifications are met, an examination of the potential benefit of Section 303 to a decedent's estate or to persons inheriting the decedent's closely held stock must include mention of Section 301, Section 302 and Section 316, which, but for Section 303, might wreak havoc upon the estate or other shareholder whose stock is being redeemed.

Under Section 301 and Section 316(a), the basic income tax scheme is that all corporate distributions of a subchapter C corporation which do not fit within Section 302 are included in the shareholder's gross income to the extent of the paying corporation's "earnings and profits." Since this is so regardless of the shareholder's basis in the stock which is being redeemed, the fact that stock has been included in a decedent's gross estate and has therefore received a stepped-up basis [FN222] does not affect this result. This being so, while an estate will escape capital gains taxation if it sells its predecessor's closely held stock to a third party (assuming no increase in value since the date of death since the alternate valuation date), the estate may well find itself in receipt of ordinary income if the corporation redeems the stock and has earnings and profits sufficient to cover the amount of the redemption price. [FN223] The purpose of Section 303 is to give limited protection from this dividend treatment in the case where the stock being redeemed consists of, or is part of a holding which comprised a significant proportion of, the decedent's estate.

As will become apparent in the ensuing discussion, Section 303 has been the subject of a number of amendments over the years, notably in 1981 with respect to decedents dying after December 31 of that year.

## 2. Detailed Analysis

### a. Is There a Distribution of Property to a Shareholder in Redemption of Stock Included in the Decedent's Gross Estate?

Application of Section 303(a) depends upon a corporation's distribution of property to a shareholder in redemption of shares of the corporation's stock which are included in determining "the gross estate of a decedent" (not necessarily the gross estate of the shareholder). The simplest example of a redemption which crosses this initial Section 303 threshold is a redemption directly from the estate of the former shareholder. Suppose that at the time of her death, D, an unmarried individual, owned all of the stock of XYZ Corporation and left her entire estate to her sister. D's executor causes the

corporation to redeem 10% of the XYZ stock in order to pay for various expenses.

However, it is not every such redemption which qualifies as a "distribution in full payment in exchange for" the redeemed stock.

(1) Is There a Distribution of "Property"?

For purposes of § § 301-318, "property" is defined as "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." [FN224]

There have been several administrative interpretations of the term "property" as it appears in Section 303(a). In [Rev. Rul. 65-289](#), [FN225] a corporation's own installment promissory note was ruled to be property. A shareholder's estate tendered stock for redemption and received cash and an unsubordinated note bearing interest at the prevailing rate. The ability to pay the note existed when the note was issued and the note had a fair market value at the time of its issuance which was supposedly equal to its face value. The IRS stated in the ruling,

Since the note here distributed does not represent an equity interest in the corporation, the note is property for purposes of section 303 of the Code. This conclusion follows even though the note is not property of the corporation prior to delivery, and even though the full payment of cash in redemption of the stock will not occur until well after the prescribed [statutory] period. The statute requires merely that property be distributed within that period....

[Rev. Rul. 65-289](#) was followed in [Rev. Rul. 67-425](#), [FN226] which ruled that a 6% unsubordinated five-year installment note was "property." In [PLR 8330071](#), [FN227] the redeeming corporation's cancellation of a decedent's promissory note in exchange for shares owned by the estate was similarly ruled to constitute a Section 303(a) distribution of property.

(2) What Is Section 303 "Stock"?

(a) Any Class of Stock

The stock contemplated by Section 303 is not limited to any particular class of stock; [FN228] it need not be common stock or voting stock. [FN229] This may be contrasted with one of the definitions of a closely held business interest for purposes of Section 6166, which requires that the stock comprise at least 20% in value of the corporation's total voting stock.

(b) Stock with Substituted Basis

Regs. Section 1.303-2(d) provides that the stock to be redeemed may be stock which was not itself included in the decedent's gross estate, but which represents the stock which was owned at death and has a tax basis which is determined with reference to stock which was so included. See the discussion of stock with substituted basis at III, B, 2, a, (2), (f) below.

(c) Subchapter S Stock

The benefits of Section 303 are as readily available for the redemption of the stock of a an S corporation as for its subchapter C counterpart. [FN230]

In [Rev. Rul. 71-272](#), [FN231] D, the decedent, was the majority shareholder of Z Corporation, an electing small business corporation. D died in 1966. All of the taxable income of Z for all years through 1966 was included in the returns of the Z shareholders (including D's estate). On January 1, 1967, Z had previously taxed income of \$220x, of which D's share was \$85x. D's estate's share of Z's undistributed taxable income for that part of 1966 during which the estate was a shareholder which was not distributed in 1966 was \$90x. On December 31, 1967 Z distributed to its shareholders (including D's estate) an amount equal to its 1967 earnings and profits. It also distributed to D's estate an amount equal to its, the estate's, share of Z's undistributed taxable income for 1966 and, in redemption of the estate's stock, an amount equal to the estate's share of Z's previously taxed income.

The IRS ruled that the first distribution (the amount equal to 1967 earnings and profits) was a Section 301 distribution constituting a taxable dividend; the second was a distribution which would not be considered a dividend and would reduce the estate's basis for its Z stock; and the third (the estate's share of Z's previously taxed income) would be treated as a Section 303 redemption and taxed accordingly. [FN232]

(d) Stock Which Was Included in a Decedent's Gross Estate but Is Now in Other Hands

Stock which was included in a decedent's estate but which at the time of its redemption is in other hands may be eligible for Section 303 treatment, depending upon (a) how the shares got into the subsequent owner's hands, and (b) the relationship which the new owner has to the federal estate tax on the

decedent's estate.

(i) Stock Received Directly from the Decedent

Regs. Section 1.303-2(f) provides that if all of the other requirements of the statute are met, Section 303 applies to stock held at the time of redemption by any person who acquired the stock "by any of the means comprehended by part III, subchapter A, chapter 11 of the Code Sections 2031-2046], including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust created by the decedent.... Similarly, section 303 may apply to the redemption of stock from a beneficiary of the estate to whom an executor has distributed the stock pursuant to the terms of the will of the decedent." [FN233]

(ii) Stock Received in Satisfaction of Monetary Bequest

Stock which is acquired in satisfaction of a monetary bequest may not be the subject of a Section 303 redemption. [FN234] In [Rev. Rul. 70-297](#), [FN235] a corporation redeemed stock which the executor had distributed to the decedent's widow in satisfaction of a formula pecuniary marital gift. The will did not authorize the distribution of the shares, but the widow consented to the satisfaction of her bequest in kind. The IRS ruled that the redemption fell outside Section 303 as being the "satisfaction of a specific monetary bequest," noting that the result would have been the opposite if the executor had discretion to make an in-kind distribution.

(iii) Stock Received from Someone Other than the Decedent

Regs. Section 1.303-2(f) specifically prohibits application of Section 303 to stock in the hands of one who acquired the stock, whether gratuitously or by purchase, from someone to whom the stock initially passed from the decedent.

The term "purchase" as used in Regs. Section 1.303-2(f) was considered in *U.S. v. Lake*. [FN236] The taxpayer (TP) was the daughter of the decedent, who created a testamentary trust for his daughter's benefit. Acting pursuant to a prior family agreement, TP exercised her option under that agreement to buy from the executor of her father's estate the shares which were to go into her trust, borrowing the purchase price from a bank to which she pledged the shares as security. As a condition to the loan, the bank insisted that the IRS subordinate its estate tax lien to the bank's security interest, which the IRS did on condition that the loan proceeds were placed in escrow for payment of

the estate taxes. When the taxes were so paid, together with the estate's state inheritance taxes, the balance of the escrow fund became the corpus of TP's trust. TP then surrendered her shares to the company for redemption; the redemption proceeds were used to discharge the bank loan; and TP reported the redemption as a dividend on her federal income tax return. The suit arose over her subsequent claim for a refund based upon the argument that the redemption was a Section 303 redemption.

The Fifth Circuit held for the taxpayer, stating that "it seems to us that the [Senate] Finance Committee's reference to 'purchasers' meant ordinary purchasers, i.e., strangers; that the Committee would not have denied the benefits of Section 303] to the intra family arrangements within the Lake family designed to prevent the distressed sale of P.G. Lake, Inc." [FN237] The court further stated

Since the purpose of the 'purchase' exclusion is to deny special treatment to those who do not redeem stock in order to pay estate taxes, it should not be extended to cover those who do redeem to pay estate taxes.... What matters is that having a substantial relationship to the estate as daughter of the decedent and as a beneficiary of the will, she used the redemption proceeds to provide cash for the payment of estate taxes.... The justification, and the enforceability of the regulation, fail where the taxpayer excluded is precisely the type of taxpayer meant to be protected by the underlying statute.... [FN238]

(iv) Stock Included by Reason of Section 2035

Section 2035(c)(1)(A), as amended by the Taxpayer Relief Act of [1997, P.L. 105-34, Section 1310](#), (pre-1997 Act Section 2035(d)(3)(A)) provides that for the limited purpose of Section 303(b) (dealing with limitations upon the general rule of Section 303(a)), the three-year inclusion rule of Section 2035, although of restricted application since 1981, continues to apply.

This is illustrated by the two contrasting situations in [Rev. Rul. 84-76](#). [FN239] In the first of these, the decedent D, no longer owned any stock at his death, having given it all away to a beneficiary B, during the last three years of his life. However, had D still owned the stock at his death, it would have comprised a large enough part of his estate to bring Section 303 into play. In the second situation, D still owned stock at his death, which he bequeathed to B, but the percentage requirement of Section 303(b)(2) could only be satisfied if the previously gifted stock were added back into D's gross estate.

In the first situation, the IRS ruled that the redemption of stock from B would not qualify under Section 303 since its inclusion in D's gross estate stemmed solely from pre-1997 Act Section 2035(d)(3) (current Section

2035(c)(1)). In the second situation, the redemption from B of stock received by B at D's death (not the previously gifted stock) would qualify for Section 303 treatment.

For a detailed analysis of Section 2035, see 818 T.M., Section 2035 Transfers.

(e) Holding Company Stock

In *Byrd Est. v. Comr.*, [FN240] the court held that Section 303 does not apply to stock which a decedent owned through a holding company, rather than by direct ownership in the corporations whose stock was being redeemed.

The decedent controlled four corporations, A, B, C and D, through a combination of direct ownership of A and indirect ownership of B, C, and D through A, which was a holding company whose principal asset was stock in B, C and D. When the estate claimed a Section 303 redemption of the stock which the decedent directly owned in B, C and D, the IRS denied Section 303 treatment, arguing that only the decedent's directly owned stock could properly be taken into account in determining whether the percentage requirements of Section 303(b) had been met, and that the decedent did not otherwise own enough stock directly to accomplish this. [FN241]

The taxpayer's position was based upon two arguments. First, it maintained that the stock ownership attribution rules of Section 318 would make the estate the owner of the same proportion of the shares of B, C and D Corporation owned by A as the proportion of A Corp. owned by the estate. The estate's second argument was that Section 303(b)(2) speaks of the redemption of stock "which is included in determining the value of the decedent's gross estate," and that the value of the B, C and D stock was indeed included in the value of the decedent's gross estate because it was owned by A, the holding company, whose stock was actually owned by the estate. Both arguments failed, the first because, after careful analysis, the court concluded that when Congress added the Section 318 attribution rules to the law, it could not reasonably be said to have intended that these rules apply to Section 303. The estate's second argument foundered because the underlying assets which made up the value of the actually included holding company stock were not themselves so included. The court concluded that a share "is property distinct from the tangible property of the corporation."

(f) Stock with Substituted Basis

(i) In General

Section 303(c) provides that where a shareholder owns stock of a corporation ("new stock") whose basis is determined by reference to the basis of stock of a corporation ("old stock") which was included in a decedent's gross estate, and where Section 303(a) applies to a distribution to such shareholder in redemption of the old stock, Section 303(a) applies to a distribution in redemption of the new stock.

The regulations list the following examples of stock which qualify under Section 303(c) for Section 303(a) treatment:

- (1) stock received in connection with a Section 368 reorganization;
- (2) stock received in a distribution or exchange under Section 355 or so much of Section 356 as relates to Section 355;
- (3) stock received in a Section 1036 exchange; and
- (4) stock received in a Section 305(a) distribution. [FN242]

In [Rev. Rul. 87-132](#), [FN243] an estate and an individual were equal owners of the 300 shares of the voting common stock of X Corporation. In order to maintain relative voting power and preserve continuity of management, X issued 10 shares of a new, nonvoting stock for each outstanding share of common. Immediately thereafter, 1,000 shares of the nonvoting common were redeemed from the estate for cash. The IRS ruled that the redemption was within Section 303, explaining that the issuance of the nonvoting stock to the two shareholders was a tax-free Section 305(a) distribution, and the shares thus fell within the substituted basis rule of Section 303(c).

(ii) Section 306 Stock

Section 306 stock [FN244] is stock defined as preferred stock which has been received by an existing shareholder as a tax-free stock dividend on his previously held common stock. [FN245] In order to accomplish the purpose of Section 306, which is to prevent a "bail out" of earnings by giving shareholders an asset (stock) which may be disposed of at capital gains rates, the Code gives Section 306 stock a "taint," making the disposition, rather than the receipt, of such stock a taxable transaction. The gain resulting from the sale of Section 306 stock is generally treated as ordinary income, rather than as a capital gain. [FN246]

The regulations under Section 303 make it clear that if the various Section 303 requirements are satisfied, the Section 306 taint will not

be present, and Section 306 stock received by the estate after the decedent's death, vs. passing to the estate from the decedent, [FN247] is treated like regular, non-Section 306 stock and is eligible to receive Section 303 treatment. [FN248]

In PLR 6706279131, a corporation redeemed preferred stock from an estate which had received the stock partly as a stock dividend on common stock before the decedent's death and partly as a dividend on common stock after the decedent's death. The distribution was ruled to be a distribution in redemption of the shares of preferred stock which made up both of the stock dividends.

(iii) Stock Received on Post-mortem Liquidation

In [Rev. Rul. 73-177](#), [FN249] an estate owned 60% of X Corporation's stock, which represented 78% of the value of the estate of the decedent, D, at the date of D's death. X Corporation's principal asset was 70% of the stock of Y Corporation. One year after D's death, X Corporation's shareholders liquidated X pursuant to Section 333, [FN250] and D's estate received its pro rata share of the Y Corporation stock owned by X Corporation, together with cash and other property. D's estate realized a gain on the liquidation which was recognized and treated as a dividend pursuant to Section 333(e)(1). Y Corporation then redeemed some of its stock from D's estate. The IRS applied Section 303(c), in ruling that since under former Section 334(c), [FN251] the basis of property received by a shareholder in a Section 333 liquidation is the same as the basis of the stock canceled or redeemed in the liquidation, decreased by money received and increased by gain recognized, the Y stock received by D's estate was in principle eligible for Section 303 treatment. The IRS stated

To apply the amount of a distribution under section 333 of the Code consisting of stock qualifying under section 303(c) of the Code to reduce the limitation contained in section 303(a)(1) and (2) would be contrary to the intent of Congress that section 303(c) would preserve the benefits of section 303(a) for the 'new stock.' Consequently, to the extent that a liquidating distribution governed by section 333 of the Code consists of stock that meets the requirements of section 303(c) of the Code, such distribution will not be applied to reduce the limitation contained in section 303(a)(1) and (2). [B]ecause section 333(e)(1) of the Code imposes dividend treatment without regard to the type of property distributed, the total amount treated as a dividend must be apportioned between the stock meeting the requirements of section 303(c) of the Code and the property other than stock meeting the requirements of section 303(c). Only that portion... that is attributable to the property other than stock meeting

the requirements of section 303(c) of the Code will be eliminated in determining the reduction to be made in the amount of the limitation contained in section 303(a)(1) and (2) as a result of the distribution under section 333 of the Code. Otherwise, there would be an unwarranted double elimination since the full amount of the stock meeting the requirements of section 303(c) of the Code will already have been eliminated once.

(iv) Identification of Redeemed Stock

In TAM 7734001, an administrative error resulted in the presentation for redemption of a stock certificate representing shares which were not the shares originally owned by the estate but shares in the same corporation which the estate had received pursuant to a post-death merger. The National Office advised that the redemption should be treated as having satisfied the statute. To invalidate it under the circumstances here present would be to exalt form over substance to the point of defeating the statutory purpose. The National Office explained that

The intent of the Regulations Section 1.1012-1(c)(4)] is not to lay down a particular form or method which must be undeviatingly followed -- thus creating a 'trap for the unwary.' Rather, the intent of the Regulation is merely to ensure that adequate written records exist so as to be able to determine with certainty what shares the trustee, administrator, or executor intended to dispose of. In the instant case, we have court records.... [which appear to us to meet] the intent of this Regulations subsection. [Here] the taxpayer needed no artifice or series of transactions to achieve his desired result. He seeks no more than what could have been his automatically and directly. The only question is whether a clerical or ministerial error -- or a moment's carelessness on the part of his Executors -- should deprive him of this result. [FN252]

(v) Legatee Dies Before Redemption

In [Rev. Rul. 69-616](#), [FN253] the deceased spouse named H, her husband, the beneficiary of a trust to be funded with an amount which would give her estate the maximum marital deduction. The executor was authorized to fund the trust with cash or with assets in kind at their federal estate tax values. H was to receive all the income for life and was given a general power of appointment over the principal. The executor and the IRS entered into an agreement provided for in [Rev. Proc. 64-19](#), [FN254] in which the distribution to the trust would be constructed so that the cash and other property actually distributed would have an aggregate fair market value representative of the trust's proportionate share of appreciation and

depreciation in value to the date of distribution of all property then available for distribution.

H died before the trust was funded and without exercising his general power of appointment. Had the trust been funded before his death, it would have received 66 2/3% of each available asset (including 66 2/3% of the stock of the closely held corporation to which the estate sought to apply Section 303).

Noting that H himself owned stock in the corporation, the IRS ruled that for purposes of applying Section 303 to H's estate, H's own stock should be aggregated with the proportionate number of shares to which the unfunded trust was entitled at the time of H's death.

b. To What Extent Do the Benefits of Section 303(a) Apply?

If all of the other requirements of Section 303 are satisfied, Section 303(a) provides that the redemption distribution is treated as a distribution in full payment in exchange for the stock so redeemed to the extent of

(1) 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

(2) 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).

(1) Taxes

Section 303 is not limited to the federal estate tax, but, under subsection (a) applies also to death taxes of the enumerated categories which are imposed by the states or, for that matter, by foreign countries or their political subdivisions. It also applies to interest collected as a part of such taxes.

The death taxes to which Section 303(a)(1) refers are to be determined "after the allowance of any credit, relief, discount, refund, remission or reduction of tax." [FN255]

Example: D is domiciled in Vermont, where all of D's assets have their state estate-tax situs. Vermont imposes an estate tax equal to the federal credit for state death taxes under Section 2011. D's taxable estate is \$1,000,000. Assuming no interest was paid, the Section 303(a)(1) amount for a

redemption to which Section 303 applies is \$153,000 (federal estate of \$345,000, minus the \$192,800 unified credit and a \$33,200 credit under Section 2011 for state death taxes, plus \$33,200, the Vermont estate tax). The calculations are based on the 1997 tax rates.

## (2) Funeral and Administration Expenses

Under Section 303(a)(2), the other component in determining the amount for which Section 303 treatment may be obtained is the decedent's funeral and administration expenses "allowable" under Section 2053 (or under Section 2106 in the case of a nonresident alien decedent). Note that debts and losses deductible under Section 2053 and Section 2054, respectively, do not enter into the computation under Section 303(a), but do figure in computing the percentage limitation of Section 303(b)(2)(A) discussed under III, B, 2, c, (1), below.

It is not necessary that the decedent's administration expenses have been allowed as an estate tax deduction, merely that they be "allowable." In fact, they may have been claimed in whole or in part as income tax deductions on the estate's Form 1041; this will not prevent their entry into the computation of how much may be withdrawn dividend free from the decedent's corporation.  
[FN256]

### c. Is the Percentage Requirement of Section 303(b)(2) Satisfied?

#### (1) In General

Section 303(b)(2)(A) limits the benefit of Section 303(a) to a distribution by a corporation whose stock of all classes [FN257] included in the decedent's gross estate exceeds 35% of the excess of

(A) the value of the gross estate, over

(B) the sum of the amounts allowable (not actually allowed [FN258]) as a deduction under Section 2053 or Section 2054.

Example: A decedent's gross estate has a value of \$1,000,000, his funeral and administration expenses are \$275,000, and his taxable estate (after taking a \$25,000 charitable gift into account) is \$700,000. Included in his gross estate is stock of three corporations, valued as follows (percentage of value of all outstanding stock in parentheses):

A Corp.

Common	\$100,000	(51%)
Preferred	\$100,000	(100%)

B Corp.

Common	\$ 50,000	(30%)
Preferred	\$350,000	(90%)

C Corp.

Common	\$200,000	(100%)
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The threshold amount under Section 303(b)(2)(A) is \$725,000, 35% of which is \$253,750. Were it not for Section 303(b)(2)(B) (discussed immediately below), only the stock of B Corp. (\$400,000 in the aggregate) would be eligible for dividend-free redemption up to the Section 303(a) limitation since only it would have a value in excess of \$253,750. [FN259]

(2) Special Rule for Stock in Two or More Corporations [FN260]

Where the decedent's gross estate includes stock in two or more corporations with respect to each of which 20% or more in value of the outstanding stock is included in the gross estate, the stock of the corporations involved is treated as the stock of a single corporation for purposes of applying the 35% test of Section 303(b)(2)(A). [FN261] Thus, in the example in III, B, 2, c, (1), above, the stock of A Corp. (insufficient by itself to meet the 35% level) and the stock of C Corp. (similarly insufficient) will be treated as the stock of a single corporation, since each holding separately meets the 20% test. Accordingly, redemption distributions by one or more of the three corporations of amounts not exceeding \$275,000 in the aggregate will be treated as in full payment in exchange for the stock so redeemed. [FN262]

(a) Limited Attribution Rule

For purposes of applying this 20% rule, Section 303(b)(2)(B) provides that stock which represents the surviving spouse's interest in property which the decedent and the surviving spouse held as

- (a) community property,
- (b) joint tenants,
- (c) tenants by the entirety, or

(d) tenants in common is treated as having been included in determining the value of the decedent's gross estate.

Example: H and W own 80 of the 100 outstanding shares of A Corp. and 25 of the 100 outstanding shares of B Corp. equally as tenants in common. H dies.

H's gross estate is \$2,000,000 and the sum of his allowable § 2053 and 2054 expenses is \$450,000, resulting in a \$1,550,000 excess of the value of the gross estate over the sum of allowable § 2053 and 2054 deductions. The Section 303(b)(2)(A) amount is therefore \$542,500 (35% of [\$2,000,000 - \$450,000]).

H's and W's combined holdings of A Corp. stock represent an 80% interest and have a value of \$1,200,000; their B Corp. shares represent a 25% interest and have a value of \$550,000. If H's interests in the two corporations are viewed separately, only H's A Corp. stock would meet the 35% test. When W's interest in the B Corp. stock is added to H's, H is deemed to have a 25% interest in the B Corp. stock, which is sufficient to entitle H's estate to aggregate its B Corp. holdings with his A Corp. stock and satisfy Section 303 with respect to both corporations.

Under Section 2040, if H and W held as joint tenants rather than as tenants in common, H's interest in the A and B Corp. shares would pass automatically to W, thereby qualifying for the estate tax marital deduction. Consequently, there would be no estate tax attributable to the inclusion of one half of the value of those A and B shares in H's estate. Under Section 303(b)(3), considered in III, B, 2, e, below, Section 303 would not apply to the stock thus acquired by W, since (at least in the normal situation) her interest would not be reduced by any payment of death taxes, funeral expenses, or administration expenses. The same would be true, of course, if H gave W his one-half tenancy in common interest in the shares by will.

However, in a situation where, for example, H owns the other 20 of A Corp.'s shares and gives those to someone other than W or to a charity, the attribution rule may have practical utility.

(b) Is Section 303(b)(2)(B) Elective?

In [Rev. Rul. 79-401](#), [FN263] the IRS ruled that the two-corporations-treated-as-one provision is not elective. In that instance, an estate held 100% of the outstanding stock of A Corp. and 90% of the outstanding stock of B Corp. The A Corp. stock met the then applicable percentage requirement; the B Corp. stock did not. Shortly after the decedent's death, B Corp. was completely liquidated, and the liquidation proceeds

were treated as received in full payment in exchange for the B stock surrendered, in accordance with Section 331. Some months later, A Corp. redeemed 20% of its stock in the estate for an amount equal to the estate's taxes and Section 303(a) expenses. The estate sought to treat this entire amount as a Section 303 redemption; however, if the prior distribution in redemption of the estate's B Corp. stock were so treated, only one third of the estate's Section 303(a) taxes and expenses would remain unused at the time of the redemption of the A stock, and the other two thirds of the redemption distribution would accordingly fall outside Section 303. [FN264] Citing [Rev. Rul. 73-177](#), [FN265] the IRS ruled that the B Corp. liquidation did, in fact, reduce the amount remaining to "shelter" the redemption of A Corp. stock.

The taxpayer also took the position that the Section 303(b)(2)(B) treatment of two or more corporations as one was elective. Accordingly, the taxpayer argued that Section 303(a) would not apply to the B Corp. liquidation since its stock, standing on its own, did not meet the Section 303(b)(2)(A) percentage test. On this theory, the A redemption would have the whole of the Section 303(a) amount to shelter. The IRS rejected the taxpayer's argument here, also noting that nothing in the statute or its legislative history supported the taxpayer.

#### d. Serial Redemptions

Where there are two or more redemptions of stock which the estate seeks to bring within Section 303, the regulations state that

the distributions shall be applied against the total amount which qualifies for treatment under section 303 in the order in which the distributions are made. For this purpose, all distributions in redemption of such stock shall be taken into account, including distributions which under another provision of the Code are treated as in part or full payment in exchange for the stock redeemed. [FN266]

The regulations illustrates with an example.

Example: D has a gross estate of \$800,000; death taxes and funeral and administration expenses total \$225,000; and the taxable estate is \$500,000. The stock in question has an estate tax value of \$450,000. In the first year of the administration of the estate, one-third of the stock is distributed to a beneficiary from whom it is promptly redeemed for \$150,000. This is repeated during the second year. Only \$75,000 of the second distribution is eligible for Section 303 treatment. [FN267]

Note that the whole of the first distribution is applied against and

reduces the \$225,000 Section 303 amount, regardless of how it was treated. In other words, it is not possible to use another Code provision (e.g., Section 302(a)) to "cleanse" an early distribution, and thereby keep Section 303 for a later distribution for which no other Code provision would be available. On this point, see also [Rev. Rul. 79-401](#), [FN268] discussed in III, B, 2, c, (2), (b), above, and [Rev. Rul. 67-425](#). [FN269]

e. Does the Shareholder Have the Requisite Relationship to the Estate Tax?

One of the necessary elements of Section 303 is that the interest of the shareholder whose stock is being redeemed must be reduced directly (or through a binding obligation to contribute) by any payment of (1) an estate, inheritance, legacy, or succession tax imposed because of the decedent's death, or (2) the allowable Section 2053 (or Section 2106 in the case of a nonresident alien) funeral and administration expenses of the decedent. [FN270]

In other words, to the extent of the redemption, the shareholder must actually bear the burden of the taxes and expenses in question. Typically, it will be the residuary legatee whose gift is most likely to stand in the requisite relationship to the tax.

We have already noted [FN271] the provision in the regulations that Section 303 does not cover the redemption of stock from someone who acquired it by purchase or by gift from someone who acquired it from the decedent; [FN272] nor does it apply where the stock was distributed in satisfaction of a "specific monetary bequest." [FN273] These are both illustrations of the broad statutory rule, perhaps the most obvious example of which is the marital deduction bequest. If under (1) local law, (2) the terms of the will or other governing instrument, or (3) both, a gift by one spouse to the other (whether outright or in trust) qualifies in its entirety for an estate tax deduction -- so that no part of the estate tax is attributable to that gift -- the redemption of stock comprised in that bequest does not qualify for Section 303 treatment, and the benefit of the section will be limited to stock held by other "taxable" beneficiaries. Note: It should be noted that Section 303 in no way requires that the proceeds of a Section 303 redemption be actually applied towards the payment of death taxes, interest, funeral or administration expenses, any more than it requires that the estate actually have a liquidity problem. Thus, Section 303 may give a "windfall" effect or an incentive -- where death seems close at hand -- to deliberately postpone the payment of dividends until the corporation's earnings and profits have, as it were, been neutralized.

Suppose that for good and sufficient reasons, a decedent leaves less than the maximum marital deduction amount to her husband, with the result

that there is an estate tax liability. If and to the extent that the stock of the Section 303-eligible corporation is allocated to the marital gift, it becomes ineligible for Section 303 treatment (assuming, of course, that under local law, the terms of the instrument, or both, no part of the death taxes arising at the decedent's death is chargeable to the marital gift). It may be desirable, therefore, to provide in the will or other instrument that such allocation be held to a minimum, i.e., that the stock be first allocated to the maximum extent possible (without causing a reduction in the marital deduction) to the nonmarital dispositions and only then to the marital gift.

f. Have the Time Requirements Been Met?

An essential element of Section 303 is its time requirement that the redemption distributions for which non-dividend treatment is sought take place within the period required by the statute.

Section 303(b)(1)(a) applies only to amounts distributed after the decedent's death which are distributed

(1) within the three-year Section 6501 statute of limitations period for the assessment of the estate tax (determined without the application of any provision other than Section 6501(a)) or within 90 days thereafter (Section 303(b)(1)(A)); [FN274]

(2) if a Tax Court petition for redetermination of an estate tax deficiency has been timely filed, within 60 days after the Tax Court's decision becomes final (Section 303(b)(1)(B)); [FN275] or

(3) if a Section 6166 election has been made to pay all or a part of the estate tax in installments, within the time determined under Section 6166 for the payment of the installments (if such time is later than that prescribed under (2)) (Section 303(b)(1)(C)).

Section 303(b)(1) must be read with Section 303(b)(4) [FN276] in mind, where Section 303(b)(4) contemplates the making of distributions more than four years after the decedent's death. Section 303(b)(4) applies to distributions falling under Section 303(b)(1)(C), which are still permitted (to the extent allowed by Section 303(b)(4)) because the time for making installment payments under Section 6166 has not yet expired. The time for payment of installments of estate tax is determined under Section 6166, which is discussed in depth in Part III, C, below. [FN277]

(1) Section 6501 Limitation Period

Section 6501(a) provides that any tax imposed by the Code

... shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed)...."

Although Section 6501 contains a multitude of other provisions (dealing, for example, with extensions, false returns, willful attempts to evade tax, etc.), Section 303(b)(1)(A) explicitly states that the right to use Section 303 is to be determined without reference to these provisions.

The IRS has had occasion to consider the Section 303(b)(1)(A) time limits in [Rev. Ruls. 69-47](#) [FN278] and 73-204. [FN279] In [Rev. Rul. 69-47](#), the stock redemption occurred more than three years and 90 days after the estate's Form 706 was filed, but less than three years and 90 days after the date fixed by statute for the filing of that return. The IRS ruled in the taxpayer's favor. As others have pointed out, this result, "fair" though it may be, can only have been reached by ignoring the explicit language in Section 303(b)(1)(A) which directs that the Section 6501 period shall be determined "without the application of any provision other than section 6501(a)," while provisions governing an early return are found in Section 6501(b)(1), which states that an early return "shall be considered as filed on [the] last day [prescribed by law or by regulations and promulgated pursuant to law for the filing thereof]."

[Rev. Rul. 73-204](#) dealt with a redemption which occurred within 90 days after the filing of an untimely (i.e., a late) return. Since Section 6501(a) speaks of the date "3 years after the return was filed (whether or not such return was filed on or after the date prescribed)," the redemption was ruled timely, even though the Form 706 was filed late. [FN280]

## (2) Tax Court Decision

The provisions governing the time for filing of petitions in the Tax Court are contained in Section 6213(a) and the date when a decision of that tribunal becomes final is determined in accordance with Section 7481. The regulations under Section 303(b)(1) state that the extension of the period of distribution provided for in Section 303(b)(1)(B) when a petition for redetermination of an estate tax deficiency has been filed with the Tax Court is

solely [for] bona fide contests in the Tax Court and will not apply in the case of a petition for redetermination of a deficiency which is initiated solely for the purpose of extending the period within which Section 303 would otherwise be applicable. [FN281]

See also *Davis v. U.S.*, [FN282] which held that the extension provision of Section 303(b)(1)(A), being couched in terms of a Tax Court proceeding,

does not apply where the estate pays the estate tax and then brings suit for a refund in the federal district court.

(3) Section 303(b)(4)

Section 303(b)(4) was added to the statute in 1976, and should be read in conjunction with Section 303(b)(1)(C). The primary effect of Section 303(b)(4) is to stiffen Section 303(b)(1)(C) by limiting the amount to which Section 303(b)(1)(C) may apply. Thus, Section 303(b)(4) provides that if a distribution which would otherwise come within Section 303(a) is made more than four years after a decedent's death (a period which is not geared to when the Form 706 was or should have been filed), the distribution may not exceed the lesser of

(A) the balance of the death taxes and funeral and administration expenses which remain unpaid immediately before the corporate distribution; and

(B) the aggregate of such taxes and expenses which are paid within one year after the distribution.

(4) Redemption with Notes Payable Outside Permitted Time Period

As previously discussed, [FN283] a corporation's promissory note constitutes "property" within the meaning of Section 303(a), "even though the full payment of cash in redemption of the stock will not occur until well after the prescribed [statutory] period." [FN284] it is the distribution of the property which must occur within that time. [FN285]

g. Section 303(d) -- Generation-Skipping Transfers

Section 303(d), for certain purposes, brings the generation-skipping transfer tax imposed by Chapter 13 (§ § 2601-2633) [FN286] within the scope of Section 303. [FN287]

If stock is the subject of a Section 2611(a) generation-skipping transfer which occurs at the same time as and as a result of an individual's death:

(1) the stock is deemed for Section 303 purposes to be included in the individual's gross estate (Section 303(d)(1));

(2) taxes of the Section 303(a)(1) variety which are imposed as the result of the generation-skipping transfer are treated as having been imposed

because of the individual's death (and the generation-skipping transfer tax is treated as an estate tax) (Section 303(d)(2));

(3) the distribution period is measured from the date of the generation-skipping transfer (Section 303(d)(3)); and

(4) the relationship of the stock to the decedent's estate is measured solely with reference to the amount of the generation-skipping transfer (Section 303(d)(4)).

Example: T sets up an irrevocable trust to which he transfers all of his stock in X Corp., valued at \$2,000,000. All of the trust income is payable to T's son, S, for life and is then to be distributed to S' children equally. No part of T's generation-skipping transfer tax exemption was allocated to the trust. S dies survived by three children and there is therefore a "taxable termination" at that time within the meaning of Section 2612(a)(1). The X Corp. stock is the trust's sole asset and is now worth \$3,000,000. There is a generation-skipping transfer tax liability of \$1,650,000, which Section 2603(a)(2) provides is payable by the trustee, and which is treated for Section 303 purposes as an estate tax. The trustee may avail itself of Section 303(a) to the full extent of the tax, since the 35% requirement (tested against the \$3,000,000) is satisfied (the stock constitutes 100% of the "estate"). [FN288]

#### h. Section 537 -- Section 303 Redemption Needs of the Business

Subchapter G, Part I of the Code (§ § 531- 537) imposes a penalty tax on corporations which improperly accumulate earnings. [FN289] More specifically, Section 531 imposes an "accumulated earnings tax" on the "accumulated taxable income" of corporations which, under Section 532(a), are "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed."

"Accumulated taxable income" is defined by Section 535(a) as taxable income, with adjustments, minus the sum of the Section 561 dividends paid deduction and the Section 535(c) accumulated earnings credit. A corporation's accumulated earnings credit is defined in part in Section 535(c)(1) as "an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business" minus the net capital gains deduction of Section 535(b)(6). Section 535(c)(1) further provides that the earnings and profits which are retained for a given taxable year are the amount by which those earnings and profits exceed the year's Section 561 dividends paid deduction.

The term "reasonable needs of the business" has three elements listed in

Section 537(a)(1), (2) and (3). The second of these is the "section 303 redemption needs of the business", defined in turn in Section 537(b) as

with respect to the taxable year of the corporation in which a shareholder of the corporation died or any taxable year thereafter, the amount needed (or reasonably anticipated to be needed) to make a redemption of stock included in the gross estate of the decedent (but not in excess of the maximum amount of stock to which Section 303(a) may apply).

## C. Section 6166

### 1. Background

The Code contains several provisions which permit a taxpayer to defer the payment of estate tax: §§ 6161, 6163 and Section 6166. Although our primary interest here is Section 6166, it is helpful to briefly examine §§ 6161 and 6163. See 219 T.M., Estate Tax Payments and Liabilities, for a more complete discussion of §§ 6161, 6163, and 6166.

#### a. Section 6161

Section 6161 is broadly drafted to apply to any tax under any provision of the Code including the estate tax, the gift tax, and the generation-skipping transfer tax. In its application to the estate tax, Section 6161 differs very materially from Section 6166, which is discussed below at III, C.

The general rule, set out in Section 6161(a)(1), is that the IRS, "except as otherwise provided in this title," [FN290] may extend the time for the payment of the tax, or any installment of the tax, shown due on any return or declaration required under the Code. The extension may be "for a reasonable period" not to exceed six months for payment of the income or gift tax and 12 months in the case of the estate tax, from the date fixed for the payment of the tax, which in the case of the estate tax, is nine months from the date of death. [FN291]

Regs. Section 20.6161-1(a) gives a number of examples of circumstances which are considered to be "reasonable" within the meaning of Section 6161(a)(1), [FN292] including (1) liquid assets spread over several jurisdictions and not readily marshallable; (2) estate consists largely of assets which are rights to receive future payments, such as royalties, against which it is difficult to borrow; (3) estate consists largely of assets whose collection will require a lawsuit and whose eventual size is not presently ascertainable; and (4) insufficient funds with which to support decedent's