# An Insured Section 303 Stock Redemption Plan

**For many people, building a family business...a business that is passed from one generation to the next...is the realization of the American dream. Successfully passing a business from one generation to the next, however, may require that a variety of financial obstacles be overcome.**

Prepared for:

***Brought to you by:***

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*Life Insurance, Annuities and Long-Term Care*

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## Objective: Retain the Family Business

For many people, building a family business...a business that is passed from one generation to the next...is the realization of the American dream.

The primary requirement for successful family retention of a closely-held corporation at the owner's death is a family member, such as a son or daughter, who both is capable and wants to assume responsibility for owning and operating the business.

**Without adequate advance planning, however, even the most capable family member may face insurmountable financial obstacles at the owner's death.**

## Obstacles to Successful Family Retention

For a closely-held corporation to be successfully retained by the family at the owner's death, a variety of financial obstacles may need to be overcome, including:

**Estate Liquidity**

Will there be sufficient liquidity in the deceased owner's estate to pay estate taxes and other administrative costs without having to liquidate business assets?

**Need for Income**

Surviving family members not active in the business may have a continuing need for income. Will the deceased owner's estate have sufficient assets to satisfy the need, or will they look to the business to satisfy their income requirements?

**Equalizing Inheritances**

Will the estate have sufficient non-business assets in order to equalize inheritances for any children not receiving the business interest?

**Impact on Business**

Will the business have a sufficient financial reserve to withstand the transition to new management?

Without advance planning to overcome these financial obstacles, the funds needed for a successful family retention may not be available, and the family may have no choice but to sell or liquidate the business.

**There is, however, a way to provide the funds needed to assure a successful family retention...**

# A Potential Section 303 Stock Redemption Solution

A possible solution to an estate liquidity problem would be for the corporation to purchase, or redeem, a portion of the deceased owner's stock. In this way, the family would receive the cash it needs to pay the estate settlement bill, while retaining a controlling interest in the business.

The only problem with this solution is that the purchase by a corporation of its own stock is generally treated as a dividend, which means that ordinary income tax would have to be paid by the deceased owner's heirs on the proceeds of the stock redemption. There is, however, an exception to this general rule that enables a corporation to redeem its stock under favorable tax conditions.

When certain requirements are met, Section 303 of the Internal Revenue Code allows a corporation to purchase enough of its stock from a deceased owner's estate to pay estate taxes, funeral costs and estate administration expenses. Any gain from a Section 303 stock redemption is taxable as a capital gain. Since, however, the value of the stock takes a step-up in basis to its fair market value on the date of the owner's death, there is usually little or no gain actually subject to tax.

In order to complete a Section 303 stock redemption, however, a corporation must have a source of funds available to redeem a portion of the deceased owner's stock.

# How Can a Section 303 Stock Redemption Plan Be Funded?

There are **THREE** ways a corporation can fund a Section 303 stock redemption plan:

1. **Cash Method**

   The corporation could accumulate sufficient cash to buy the stock at the owner’s death. Unfortunately, it could take many years to save the necessary funds, while the full amount may be needed in just a few months or years. In addition, accumulated earnings tax problems might arise.

2. **Loan Method**

   Assuming that the corporation could obtain a business loan at a time when corporate credit is likely to be impaired, borrowing the purchase price requires that future business income be used to repay the loan PLUS interest. Alternatively, the surviving spouse or an adult child could lend the money to the corporation to fund the redemption, assuming a source of funds for this purpose is available. Future corporate earnings would then need to be paid out as repayment of corporate debt.

3. **Insured Method**

   Only life insurance can guarantee that the cash needed to redeem the stock will be available exactly when needed (guarantee is based on the continued claims-paying ability of the insurer). A life insurance policy on the owner in an amount equal to the expected partial redemption is the most efficient and effective source of funds for Section 303 stock redemption purposes.

# Features of a Section 303 Stock Redemption Plan

**With advance planning, an insured Section 303 stock redemption can accomplish the following:**

- The deceased owner's heirs receive the funds necessary to pay estate settlement costs without liquidating business assets.
- The family is able to retain a controlling interest in the business.
- Other estate assets are protected against forced liquidation.
- Even if the estate has sufficient liquidity to pay its estate settlement bill, the proceeds of a Section 303 redemption can be used for other purposes, such as continuing an income to a surviving spouse or equalizing inheritances among children.
- Payment is prompt and certain. Life insurance proceeds are not subject to the time and expense of the probate process, making them immediately available to complete the partial stock redemption.
- The event creating the need for cash -- the owner's death -- also creates a source of cash -- the life insurance death benefit. The life insurance policy provides the dollars for a certain need -- a partial stock redemption -- that arises at an uncertain time -- death.
- If the death benefit exceeds the total premiums paid, this gain generally is received free of income tax. For example, if only 20 cents of each death benefit dollar received has been paid in premiums, the 80 cent gain is received income tax free!
- Life insurance avoids the problems associated with the other methods for financing a partial stock redemption at the owner's death.
- Any of the proceeds not needed for partial stock redemption purposes can provide additional working capital during the transition to new management.

# Requirements for a Section 303 Stock Redemption

The special tax treatment available under Section 303 is intended to protect **family corporations** from having to be sold or liquidated in order to pay the deceased owner's estate settlement bill. As a result, certain requirements must be met for a partial stock redemption to qualify as a Section 303 redemption:

1. The value of the deceased owner's stock must exceed 35% of the adjusted gross estate (gross estate less deductions for funeral and administration expenses, debts and losses). Ownership of 20% or more of two or more corporations can be combined to meet the 35% requirement.

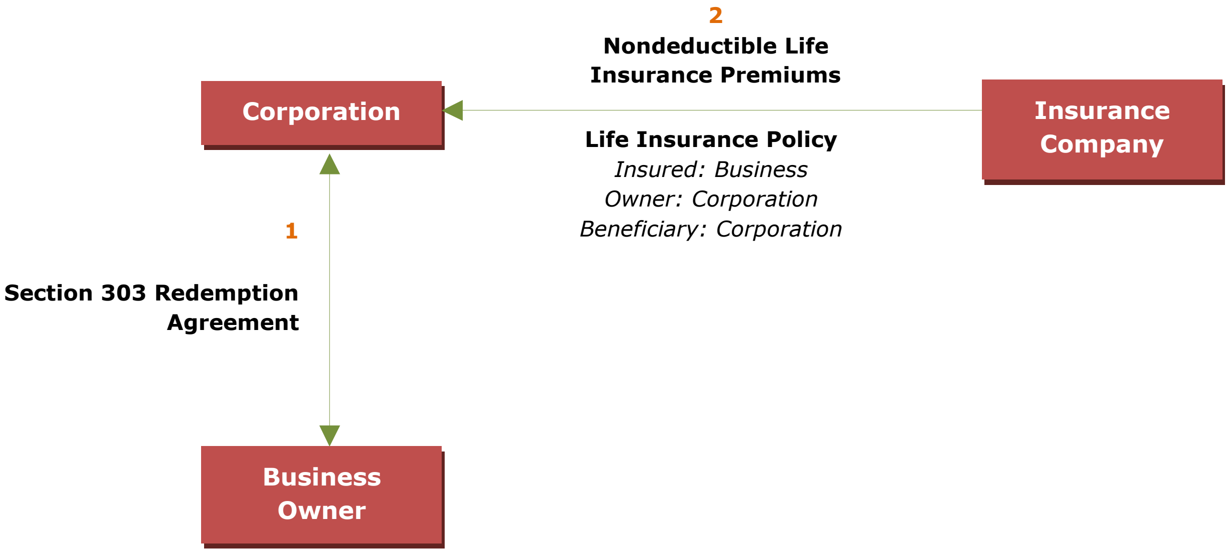
2. The amount of stock redeemed cannot exceed the total of all federal and state estate and inheritance taxes, plus funeral and administration expenses allowed as an estate tax deduction.

3. The redemption must take place no later than three years and 90 days after the deceased owner's federal estate tax return is filed.

# The Mechanics of an Insured Section 303 Stock Redemption Plan

The bottom line is that a Section 303 stock redemption plan funded with life insurance is an economical and efficient method of providing the cash necessary to settle a deceased owner's estate, while retaining a controlling interest in the business for the family.

**Here's how an insured Section 303 stock redemption plan could work for your corporation today...**

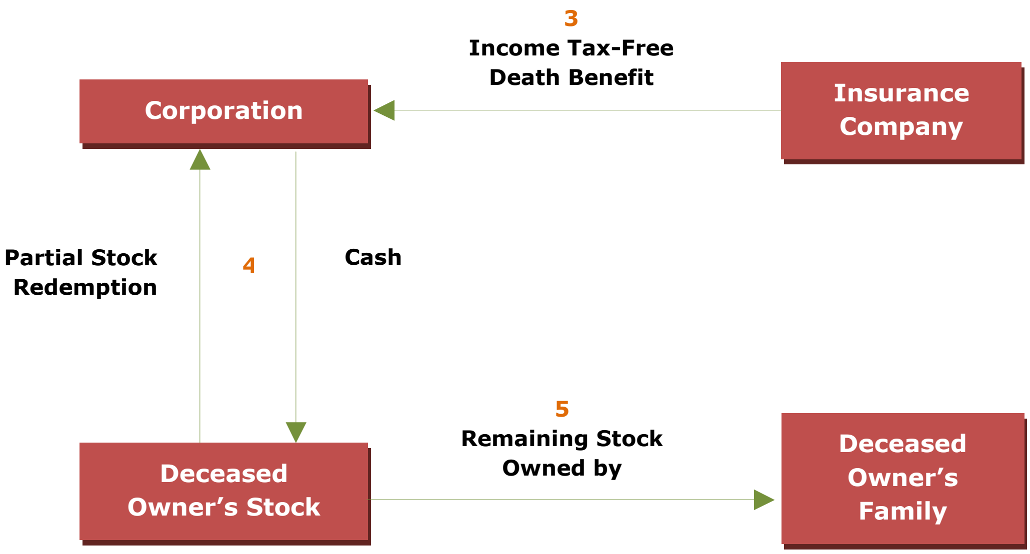



1. The corporation and the business owner enter into a Section 303 redemption agreement under which the corporation agrees to redeem a portion of the deceased owner's stock equal in value to estate taxes, funeral costs and estate administration expenses and the deceased owner's executor is directed to sell that stock to the corporation.

2. The corporation owns, is the beneficiary of and pays the nondeductible premiums for insurance on the owner's life in the approximate amount required to make the partial stock redemption.

# The Mechanics of an Insured Section 303 Stock Redemption Plan

**Here's how an insured Section 303 stock redemption plan could work at *the owner's death*..**




3. At the owner's death, the corporation receives the income tax-free death benefit from the life insurance policy it owns on the deceased owner.

4. The corporation uses the proceeds of the life insurance policy to redeem a portion of the deceased owner's stock equal in value to estate taxes, funeral costs and estate administration expenses.

5. The remaining stock is then distributed to the deceased owner's family, which retains a controlling interest in the corporation.

# Summary of Insured Section 303 Stock Redemption Plan Tax Results

- Premium payments for life insurance to fund a Section 303 stock redemption plan are not tax deductible by the corporation.
- While life insurance proceeds received by the corporation at the owner's death generally are not subject to federal income tax, they may be subject to the corporate alternative minimum tax.
- Assuming that Section 303 requirements are met, the partial redemption is treated as a capital transaction, subject to capital gains tax, instead of a dividend, subject to ordinary income tax.
- Since the basis of the stock is stepped-up to its fair market value on the date of the owner's death, the amount received from a Section 303 partial redemption will be subject to little or no capital gains tax.
- Any redemption in excess of the amount eligible under Section 303 (federal and state death taxes, funeral costs and estate administration expenses) is treated as dividend income, subject to ordinary income tax.
- A Section 303 partial stock redemption causes no attribution problems in a family corporation.

Guarantees are subject to the claims-paying ability of the issuing insurance company.

**Estate planning provisions, reviewed on the next page, should be taken into consideration in planning for the retention of a closely-held corporation at a shareholder's death.**

# Estate Planning Considerations

The federal estate tax is a **progressive tax on the right to transfer property at death**. In 2020, federal estate tax rates begin at 18% and increase to as much as 40% of the taxable value of an estate.

The **federal estate tax** is a transfer tax imposed on the privilege of transferring property at death, while the **federal gift tax** is imposed on the transfer of property during the property owner's lifetime. Both taxes are levied on the **right to transfer property**, and not on the property itself. The amount of tax payable, however, is measured by the **value** of the transferred property.

Once the tentative federal estate or gift tax is determined, it is then reduced by an **estate and gift tax unified credit**. This means that **taxable estates with a value equal to or less than the unified credit equivalent** will not be liable for federal estate tax. The same is true of **cumulative lifetime taxable gifts** which, however, will be brought back into the owner's estate for federal estate tax calculation purposes. **The unified credit equivalent is equal to $11,580,000 in 2020, as adjusted for inflation**, meaning that an individual currently can transfer property valued up to $11,580,000, whether during life and/or at death, without incurring a tax liability.

In addition, **"portability" of the maximum estate tax unified credit between spouses** is available, meaning that a surviving spouse can elect to take advantage of any unused portion of the estate tax unified credit of his or her predeceased spouse (the equivalent of $11,580,000 in 2020). As a result, with this election and careful estate planning, married couples can effectively shield up to $23 million plus (as adjusted for inflation) from the federal estate and gift tax.

Finally, **estate tax deferral** allows payment of estate tax attributable to the value of a closely-held business included in the estate to be deferred for up to five years.

No discussion of estate planning considerations in regard to business continuation would be complete without mention of the **generation-skipping transfer tax** (GSTT). An objective of the federal government is to collect taxes on the transfer of property from one generation to the next generation. If, however, an estate owner is able to skip the members of the immediately lower next generation and transfer property to someone two or more generations removed, the government is deprived of the estate tax that would have been collected on that property at the death of members in the immediately lower next generation. As a result, a generation-skipping transfer in excess of available exemptions is subject to the maximum federal estate and gift tax rate of 40% in 2020. The GSTT is **in addition to** any federal estate or gift tax due and is payable by the transferor, the transferor's estate or by the trustee of a trust making a generation-skipping transfer.

**Your professional tax advisor can assist you in developing business and estate plans with the flexibility needed to adjust to an uncertain tax future.**

# Insured Section 303 Stock Redemption Plan Action Checklist

**Now…**

- ☐ Verify eligibility of owner's estate for section 303 treatment.
- ☐ Select the appropriate life insurance funding vehicle.
- ☐ Establish the owner's insurability.
- ☐ Arrange for payment of premiums.

**Short-Term…**

- ☐ Draft and execute a Section 303 stock redemption agreement.
- ☐ Review the issued policy.

**Longer-Term…**

- ☐ An annual review can help ensure that the plan and its funding remain current.
- ☐ Consider the purchase of key employee life insurance on the owner in order to provide additional working capital during the transition to new management.

# Important Information

The information, general principles and conclusions presented in this report are subject to local, state and federal laws and regulations, court cases and any revisions of same. While every care has been taken in the preparation of this report, VSA, L.P. is not engaged in providing legal, accounting, financial or other professional services. This report should not be used as a substitute for the professional advice of an attorney, accountant, or other qualified professional.

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