Notes

FUNDING STOCK REDEMPTION PLANS UNDER SECTIONS 302 AND 303 WITH LIFE INSURANCE

I. Introduction

Imagine a situation in which your friend who dropped out of law school to subsequently become one of three stockholders in what is probably the most successful closed corporation west of the Mississippi River and east of the Rocky Mountains, suddenly shows up at your office, located above the local 5 & 10. He desires your advice as to the best method to convert his stockholdings into a more liquid form of assets in the event of his death or retirement. He wishes to accompolish this while at the same time minimizing both federal income and estate taxes[1] and maintaining the status quo of the corporate structure. You immediately realize the solution to his problems lies in the proper drafting of a stock purchase plan funded by life insurance.

A stock redemption agreement, generally, provides that on the happening of some specified event, such as death, disability, or a severance of relations with the corporation the stock will be bought at a specified price or at a price which is easily ascertainable by the use of a formula. Such arrangements are subject to many laws, both state and federal, concerning corporations, stock transfers and contracts. In most states a corporation may purchase its own stock.[2] Most states also provide restrictions on the purchase of its own stock by a corporation. Generally such purchases must be made out of surplus; they may not jeopardize the rights of creditors or other shareholders; they may not force the corporation into dissolution or insolvency.[3] In drafting such an agreement there are many things to consider, such as what classes of stock may be redeemed, what type of notice of restrictions must be on the face of the stock certificate and whether the contract is enforceable.

The number of models of stock redemption agreements is almost boundless. Each agreement must be tailor-made to provide for the needs of the parties involved.

There are basically two types of stock purchase agreements.[4] The first type is normally referred to as a cross purchase agreement. The second type

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[1] This Note will not deal with the effects of state and local taxation, or with Int. Rev. Code of 1954, § 304 and redemptions through related corporations.

[2] *See, e.g.*, Iowa Code § 496A.5 (1973).

[3] *See, e.g.*, Iowa Code § 496A.63 (1973).

[4] The entity and cross purchase plans may be combined into a hybrid agreement when the situation necessitates such an arrangement. The hybrid agreement combines the advantages and disadvantages of the entity and cross purchase plans and hence will not be discussed separately.

of stock purchase agreement is the entity or stock redemption plan.[5] It is distinquished from the cross purchase agreement in that instead of having each of the remaining stockholders purchase a *pro rata* share of the departed shareholder's stock, the corporation itself purchases or redeems all the shares of the departed associate. After the purchase or redemption the corporation may then write off the purchased shares or hold them as treasury stock. The consequences of either option will vary little. However, if the redeemed shares are kept as treasury stock the corporation will not have to spend the time, paperwork and money involved in the issuance of new stock if reissuance of more shares ever becomes necessary. The effect of either the cross purchase or entity plans on the incidence of ownership of the stockholders remains the same, *i.e.*, in both cases each remaining shareholder's proportionate interest will increase in the amount of his *pro rata* share[6] of the outgoing shareholder's interest. As will be later discussed, however, the total cost of the funding of each of the arrangements is often vastly different, and the federal tax considerations of each are inevitably disparate.

A stock redemption agreement must somehow be funded. Whoever is to purchase the stock must have funds available to do so when the time comes. Life insurance is probably the most practical way to provide funds for the execution of such an agreement.

Generally speaking, life insurance is not the most profitable form of investment. Nonetheless, it still has certain advantages over other forms of investment. Insurance is a certain investment. Disregarding the effects of inflation, the value of the insurance will always remain stable. With stock purchase agreements one does not look for the greatest possible return on the investment, but rather one looks for security. Should the shareholder die a short time after the policy was purchased there will be no problem as the policy should provide enough funds to purchase the stock even though only a small amount was invested. In the stock market or in real estate the value may have fallen, or, more likely, in only a short time enough will probably not have been invested to insure that the purchaser will be able to carry through with its obligations. Such investments may be better in the long run, because they will hopefully provide greater returns for the corporation, but they do not adequately fulfill the needs of the stockholder whose principle need is certainty of redemption.

Insurance also has the advantage of almost instant liquidity. Once a death has taken place, the proceeds of a policy are due and collectible and are of a known value, whereas the sale of real estate or stock by the purchaser at any particular time may involve a loss. If the redemption takes place while a shareholder is still alive the cash value of an ordinary life insurance policy will

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5 INT. REV. CODE OF 1954, § 317(b) defines a redemption as an acquisition by a corporation of its own stock in exchange for property, whether or not the stock is cancelled, retired or held as treasury stock.

6 The shareholder's *pro rata* share is determined before the purchase is executed.

be available to at least provide a partial redemption fund while other investments still face the problem of uncertainty.

There are many varieties of life insurance policies available, but there are basically only two types: term and ordinary life. The particular type which should be used to fund a stock purchase plan will depend on the circumstances of the parties involved. The best type of insurance in one situation may not be suitable for another. When dealing with a small closely held corporation, many attorneys would prefer an ordinary life insurance policy to create the necessary surplus. But term insurance may also have its advantages. Assuming that the shareholder and/or corporation is relatively young the premiums on term insurance will probably be less than those of an ordinary life policy, and this advantage comes at a time when the availability of funds is probably at its lowest. However, the costs of such a policy increase with time. Decreasing term policies may be recommended if the difference between the costs of a term policy and an ordinary life policy were invested in sound investments. Term insurance has advantages, assuming that the insured shareholders are young, that the corporation is financially sound with good prospects for future growth, that the back-up investment program is profitable, that the investments are easily convertible into cash and that the corporation can afford the higher premiums when the shareholders become less insurable.

Unlike ordinary life insurance which has its cash surrender value to fund an *inter vivos* redemption, term insurance supplies no such funding reserve upon a similar redemption. Ordinary life policies may also have dividends which can be used to buy increments of insurance or to help pay the premiums of the policies. The cost of ordinary life policies remains constant, and does not increase with time. Of course, any policy may be supplemented by a sinking fund or some type of other supplementary investment program.

II. Purposes of the Stock Purchase Agreement

The purposes of a stock purchase agreement are fourfold:[7]

1. To protect the corporation and remaining shareholders from having the stock of the departing shareholder go to a third party or outside interest. Efficient and unfettered continuity of management is the *sine qua non* of successful business operations to a close corporation. By allowing a substantial portion of the stock of such a corporation to pass to an outside and/or competitive interest the effects upon the efficient continuity of management can be disastrous. The remaining shareholders may have had unique and time-tested policies and procedures which a new minority shareholder could disrupt through dissent and differing concepts of management. Moreover, should a competitor obtain the interest the corporation becomes almost incurably vul-

[7] There is a fifth purpose which relates to the making of a timely election if the corporation chooses to become a corporation under subchapter S of the Int. Rev. Code of 1954, § 1371 *et seq.*

nerable to subversive tactics and conditions. It should also be noted that in the event that the shareholder departed as a result of death, his beneficiaries, heirs, legatees, etc., who acquire their interest through the estate, could be equally disruptive. Naturally, the widow and children of the deceased shareholder are most often interested in obtaining liquidity from their inheritance, and hence, will vie for dividend distributions. The established shareholders, on the other hand, may wish to reinvest profits in anticipation of further corporate growth. By holding the stock of a withdrawing shareholder within the confines of the corporation itself or its present shareholders, the stock purchase agreement prevents such incumbrances and aids harmonious and continuous management procedures.

2. To provide each shareholder with a market for his or her stock upon his or her death or withdrawal. Oftentimes a withdrawing stockholder will have great difficulty in obtaining a satisfactory market for the shares to be sold. Most outside interests are unwilling to pay a fair price for a minority interest in a closely held corporation, as their policies, concepts, and goals in corporate management can easily differ from those of the pre-existing shareholders. Thus, the withdrawing shareholder or the estate of a deceased shareholder which is interested in maximizing its liquidity can be and often is subjected to substantial losses absent a market which is willing to pay a fair price for the vended shares. The stock purchase agreement, by setting or fixing a fair value for the stock, insures maximum liquidity. The stock purchase agreement, then, serves a beneficial double-edged purpose. The corporation and remaining shareholders are insured continuity of management while the withdrawing shareholder or his estate is insured a reasonable amount of liquidity.

3. To promote harmonious relations between the corporation and its shareholders. Stock purchase plans often help insure harmony between the corporation and its shareholders for the reason that they bind their interests more closely and tend to increase morale. The individual shareholder is secure in the knowledge that the corporation is guarding his interest and the interests of his or her heirs. Moreover, in furtherance of this purpose accumulations of earnings and profits by the corporation to fund the purchase plan have been seen as a reasonable need of the business[8] and exempted from the operation of the penalty tax of Section 531 to be discussed later.

4. To fix the value of the stock for estate tax purposes. It has been established that so long as the requirements discussed below are met, the price or method of valuation stated in the agreement concerning the amount of consideration to be paid by either the surviving shareholders or the corporation will become the amount determinative of the value of the stock for estate tax

[8] *See* Sanders v. Fox, 253 F.2d 855 (10th Cir. 1957); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1955); *contra*, Doran v. Commissioner, 246 F.2d 934 (9th Cir. 1957) where the shareholders, rather than the corporation were the beneficiaries under the policy.

purposes.[9] If no such value or method for its determination is made, the tax consequences to the estate of a deceased shareholder may be highly detrimental. If the amount paid by the remaining shareholder under a cross purchase agreement exceeds the amount the Internal Revenue Service[10] is willing to affix as the value of the decedent's disposed stock, there is the possibility that the excess will be treated as a gift to the decedent's estate or beneficiaries from the surviving shareholders.[11] Alternatively, if an otherwise successful entity plan is used the excess may be treated as a dividend taxable as ordinary income,[12] or, even if the amount realized by the estate of the deceased shareholder is less than the value affixed to the disposed stock by the Service, the estate will pay death taxes on what amounts to only "paper value" of the stock.[13] This "paper value" tax liability could conceivably be greater than the amount actually realized on the sale. For estate tax purposes, then, the price stated in the stock purchase agreement is controlling if three factors are present:[14]

(a). Price must be fair when the contract is formed.[15] So long as the price or method of valuation is established during an "arms-length" transaction among all parties and indicates that the agreement was made to serve a *bona fide* business arrangement and does not result in excessive consideration to the estate so as to indicate a gift, this requirement will usually be met.[16]

(b). Lifetime disposition of the stock must be restricted so that the shareholder may not dispose of his stock without first offering it to the corporation or remaining shareholders at the contract price.[17] There are different ways to impose such restrictions. A very common method is found in that described immediately above. Another way often used is to allow lifetime disposition while imposing the qualification that any lifetime transfer will be subject to the agreement. Thus, although a shareholder may transfer or assign his shares during his life, the transferee or assignee will be required to sell the stock to the purchaser(s) specified in the agreement upon the original shareholder's death. Other common restrictions include a requirement of consent by the purchaser specified in the stock purchase agreement before lifetime disposition is allowed, an option to the similarly specified purchaser to buy the shares on the occurrance of the named conditions, or a mandatory purchase upon the occurrence of named conditions.[18]

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9 Estate of Orville B. Littick, 31 T.C. 181 (1958); May v. McGowan, 194 F.2d 396 (2d Cir. 1952); *see also* Treas. Reg. § 20.2031-2(h) (1958); Treas. Reg. § 20.2031-3 (1958), which indicate that the price set by the agreement is a factor to be considered.

10 Hereinafter referred to as the Service.

11 INT. REV. CODE OF 1954, § 2512; Rev. Rul. 58-614, 1958-2 CUM. BULL. 920; *see* Summerfield v. United States, 249 F.2d 446 (6th Cir. 1957).

12 Rev. Rul. 54-408, 1954-2 CUM. BULL. 165.

13 Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, *as modified by* Rev. Rul. 65-193, 1965-CUM. BULL. 370.

14 *See* 194 F.2d 396 (2d Cir. 1952); Commissioner v. Child's Estate, 147 F.2d 368 (3d Cir. 1945); Treas. Reg. § 20.2031-2(h) (1958).

15 Nee v. Katz, 163 F.2d 256 (8th Cir. 1947); Treas. Reg. § 20.2031-2(h) (1958).

16 Treas. Reg. § 20.2031-2(h) (1958).

17 *Id.*

18 It should be noted that the stock certificates themselves should bear a notation

(c). The estate must be obligated to sell. If for any reason the estate is not bound to sell, the agreement will be ineffective for estate valuation purposes.[19]

Having superficially described the nature and purposes of stock purchase agreements, the next consideration might be an identification of which of the two species, *i.e.*, cross purchase plan or the entity (stock redemption) plan, should be used. This, in actuality, places the cart before the horse, as such a determination should only be made after careful consideration of the logistical and tax advantages and consequences of each. In so doing, all the objectives, facts and circumstances surrounding the corporation and its shareholders are to be taken into account. After such careful consideration, it may be found that in certain instances a cross purchase arrangement may be best, indeed, the only viable alternative. In other instances, the entity plan may achieve better results; in still other instances, a combination of the two may best serve the corporate and shareholder ends. Whichever plan is ultimately chosen is generally a matter of judgment, possibly involving the amount of risk that the parties are willing to assume.

III. Characteristics of the Cross Purchase Agreement

In a very general sense the cross purchase agreement is a safer method of disposition of the shares to be purchased for reasons of federal taxation while being less practical and more cumbersome for logistical reasons. The Internal Revenue Code (hereinafter Code) assumes that any distribution of corporate property in return for corporate shares by the corporation will result in a dividend taxable upon the distributee as ordinary income regardless of the cost of the stock.[20] By executing the agreement at the shareholder level the cross purchase agreement totally avoids the consequences of Section 301. The corporation is not a party to the sale, and hence, distributes nothing to the vendor. The sale to the remaining shareholders is an "exchange" of a capital asset resulting in capital gain or loss treatment on the proceeds.[21] If the cross purchase was funded by life insurance proceeds from policies held by the surviving shareholders upon the life of the decedent, then the only factor of any tax significance to the surviving shareholders should be that their basis for newly acquired stock equals the price paid for it.[22] If the cross purchase was funded independent of life insurance the remaining shareholders' cost basis, of course, remains the price paid.[23] The cross purchase agreement,

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of the stock purchase agreement and the restrictions so imposed upon their face as required by the Uniform Stock Transfer Act § 15. Even if not required by local law the notation should be made to warn interested third party buyers of the agreement.

19 United States v. Land, 303 F.2d 170 (5th Cir. 1962).

20 Int. Rev. Code of 1954, § 301 subject to the exceptions provided by Int. Rev. Code of 1954, §§ 302, 303, 346.

21 Int. Rev. Code of 1954, §§ 1001, 1002, 1201, 1222.

22 Int. Rev. Code of 1954, § 1012.

23 *Id.*

then, usually results in favorable tax treatment to all parties so far as the above considerations are concerned.

There is, however, an important exception to the favorable tax treatment accorded a cross purchase arrangement which greatly affects the remaining shareholders when life insurance is used to fund the buy out. This exception is found in the "transferee for value" rule.[24] Section 101 exempts proceeds of an insurance policy from taxation when the proceeds are paid pursuant to the death of the insured. As stated earlier, execution of a cross purchase agreement naturally results in increased ownership of the corporation by each of the remaining shareholders. The concomitant effect of this increased incidence of ownership is to increase the burden of each of the survivors to buy out the interest of the next stockholder to die. One way to off-set this increased burden is for the surviving shareholders to purchase from the estate of the deceased shareholder those insurance policies which the decedent owned on the survivors' lives. At this point the transferee for value rule comes into effect.[25] It provides that a transferee of an insurance policy for a valuable consideration may not exclude from his gross income the amount by which the proceeds received by the transferee (upon the death of the next stockholder in this instance) exceeds the cost of the policy to him plus the premiums subsequently paid by that transferee on the policy. The Code suspends the rule when the transferee is the insured himself, a partner of the insured, a partnership in which the insured is a partner, or a corporation of which the insured is a stockholder.[26] There is no exception provided for fellow shareholders. Hence, a surviving shareholder purchasing an insurance policy held by a deceased shareholder on a third shareholder's life will incur a tax liability at ordinary income rates upon the aforementioned excess.[27] In situations where policies are sold to the corporation instead of the remaining shareholders, the seller, even if he is a shareholder, will be taxed at ordinary income tax rates on the proceeds of the sale if the purchase price is greater than the net premium (the total amount of premiums paid minus the dividends); the difference is taxable.[28] The stock redemption plan contains no "transferee for value" problems.

In addition to "transferee for value" problems, the cross purchase agreement involves a host of cost and logistical problems. Since the remaining individual shareholders are obligated to purchase a deceased shareholder's stock under such an arrangement, the number of insurance policies required to fund the agreement, if life insurance is the chosen source of capital, can become quite large and awkward. Each shareholder must purchase a policy on the life of every other shareholder. Thus, if N is the number of shareholders the

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24 INT. REV. CODE OF 1954, §101(a)(2).

25 This also comes in effect when one of the shareholders proves to be uninsurable, and then sells his personal life insurance policy to the corporation.

26 INT. REV. CODE OF 1954, § 101(a)(2)(B).

27 *Id.*

28 Treas. Reg. § 1.101-1(b) (1957).

total number of policies required is (N-1) x N. In the case of Z Corporation which has five shareholders, the number of policies needed becomes (5-1) x 5 or twenty insurance policies. If there were a total of ten shareholders the number needed would be ninety. Often the shareholders will arrange for a trustee to hold the policies and shares and to handle the logistical end of the arrangement. It should be noted, however, that with the entity or stock redemption program the corporation will normally purchase the necessary life insurance for its funding. It merely needs to purchase one policy per shareholder. In Z Corporation's case that would, of course, result in the purchase of only five policies.

Unless the stockholders are in a lower tax bracket than the corporation, the net cost of funding a cross purchase agreement will always be higher than with the entity plan. Whether funded by insurance or not, the cross purchase agreement must be financed by the individual shareholders. If they buy insurance they, and not the corporation, must pay the premiums lest they be subjected to dividend treatment on the corporate compensation to them.[29] The most probable source of acquiring the funds to finance the agreement is, of course, through corporate distributions. These take the form of actual dividends taxable at ordinary income rates.[30] Even if life insurance is purchased by the shareholders to fund the agreement, the premium payments are not deductible.[31] The corporation is not allowed to deduct its dividend payments from the taxable earnings and profits from which the dividends were derived.[32] Hence, there is a double taxation which must be reflected in the total cost of funding the agreement. Let us say, for example, that Z Corporation is in a 48% corporate income tax bracket.[33] In order to distribute enough money for the remaining shareholders to purchase a decedent's stock by the purchase of life insurance on which $10,000 in premiums must be paid, the corporation must earn first $19,230.71.[34] But, that takes into account only the first taxation. If all the shareholders of Z Corporation are in a 50% personal income tax bracket there will be only $5,000 left after both taxations have been levied—$5,000 too little. If a stock redemption plan were used, where the corporation purchases the insurance itself and pays the premiums, premiums paid by the corporation are still not deductible,[35] but the $10,000 accumulated earnings and profits would be enough to purchase the necessary life insurance after taxes and thereby fund the agreement. Instead, where the cross purchase is used by Z Corporation as in this example, an additional $9,230.71 must be earned by the corporation in order to provide the necessary $10,000 after taxes.

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29 Rev. Rul. 59-286, 1959-2 CUM. BULL. 103; Rev. Rul. 58-614, 1958-2 CUM. BULL. 920.

30 INT. REV. CODE OF 1954, § 301.

31 INT. REV. CODE OF 1954, § 264(a).

32 Moline Properties v. Commissioner, 319 U.S. 436 (1942).

33 INT. REV. CODE OF 1954, § 11.

34 In this example we are disregarding other factors and expenses which would otherwise ordinarily have to be taken into account.

35 INT. REV. CODE OF 1954, § 264.

It is possible, however, in rare cases to decrease the net cost of funding a cross purchase agreement even to the extent of making it cheaper than the stock redemption plan. As hinted in the preceding paragraph, this is contingent upon the shareholders (in the aggregate) being in a lower tax bracket than the corporation. It is also contingent upon the corporation's ability to distribute the funds in a deductible form, *e.g.*, as justifiable salaries or rent payments.[36] With both contingencies concurring the result is a single taxation at a lower rate (the aggregate personal income tax rate) than the corporate tax rate which must be paid under the stock redemption plan.

Although it is not often possible to have both contingencies working at once to decrease the net cost of the cross purchase agreement, the second contingency alone will substantially reduce the cost if it is met. Costs will, however, still be higher than with the entity plan in such a case.

IV. CHARACTERISTICS OF THE STOCK REDEMPTION PLAN

A. *Generally*

Section 301 creates a presumption that any corporate distribution of property out of the corporation's earnings and profits in exchange for its own stock will result in a dividend distribution, taxable as ordinary income, to the party receiving the distribution.

Section 302 and 303 were created to allow relief from Section 301.[37] Although these two sections may be considered complementary for certain purposes and may act as back-up mechanisms for each other, each carries a separate and independent set of rules under which the redeeming party must qualify before relief from Section 301 will be available. Furthermore, the scope and the availability of relief under each section differ to a substantial degree. The scope of relief under Section 303 is restricted by a dollar limitation upon the amount of stock which may be redeemed under it. Section 302 has no such limitation and will allow redemption of unlimited amounts of stock. However, the availability of relief under Section 302 is severely restricted by a set of stock attribution rules[38] to which Section 303 is not subject.[39] The major restriction upon the availability of relief under Section 303 is that it cannot be used during the life of the redeeming party. The death of the shareholder whose shares are to be redeemed is a necessary precondition to its use. Section 302 can be used as an *inter vivos* redemption device.

The tax objective of a properly constructed stock redemption agreement under Section 302 and 303 is to allow the corporation to make a distribution

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36 INT. REV. CODE OF 1954, § 162.

37 INT. REV. CODE OF 1954, § 346 is another provision which is an exception to Section 301. If a redemption qualifies under Section 346 and Sections 302 or 303, the partial liquidation provision of Section 346 overrides the other provision. INT. REV. CODE OF 1954, § 346(c); Treas. Reg. § 1.346-2 (1960). In such a situation the partial liquidation may have some advantages. *See generally* 7 CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 149.13 (1972).

38 INT. REV. CODE OF 1954, § 318.

39 *In re* Estate of Byrd v. Commissioner, 388 F.2d 223 (5th Cir. 1967).

out of its earnings and profits to a withdrawing or decreased shareholder that will not be deemed a dividend (as per Section 301), but which will qualify as an "exchange" and receive capital gains treatment. Keeping this objective in mind, a detailed examination of the operations of Sections 302 and 303 will follow.

B. *Stock Redemptions under Section 302*

1. *Generally.*

Whether a stock redemption will be treated as a "sale or exchange" under Section 302 depends upon the number of shares surrendered. For purposes here, there are three[40] basic ways by which a corporation and its shareholders may attain "sale or exchange" treatment under that section:

(1) By making a redemption that is "substantially disproportionate."[41]

(2) By making a redemption that is in *complete* termination of all of the shareholder's interest in the corporation.[42]

(3) By making a redemption that is "not essentially equivalent to a dividend."[43]

Before considering each of these three methods it must first be explained that they are all susceptible to a set of stock "attribution" rules[44] that are provided by Section 318. These "attribution" rules have a major effect upon whether or not a particular corporation, especially family corporations, may utilize Section 302 in order to receive "exchange" tax treatment following execution of a stock redemption agreement. The effect of these rules is to "attribute" stock not actually owned by a party to that party by virtue of his, her or its close relationship to the party which actually does own the stock. But the converse is also true. For example, if party A owns stock, and by virtue of his close relationship to party B, has party B's stock attributed to him, party B will also have party A's stock attributed to him. After such "attribution" is made to a party he is then said to have "constructive ownership" of the attributed stock. Repeating the general postulate that "exchange" treatment depends upon the number of shares redeemed, it will be seen that stock which is "constructively owned" by the redeeming party may cause his, or her or its incidence of ownership to increase to the point where: the number of shares actually owned and actually redeemed in relation to the total number of shares both actually and constructively owned before redemption will be insufficient under Section 302 and will result in a "constructive dividend" to the redeeming party.

Family Attribution. Probably the greatest and most widely imposed attribution rules under Section 318 and those which are hardest upon the

40 There is a fourth method, but it relates only to the surrender of certain railroad stock when the railroad itself becomes insolvent. INT. REV. CODE OF 1954, § 302(b)(4).

41 INT. REV. CODE OF 1954, § 302(b)(2).

42 INT. REV. CODE OF 1954, § 302(b)(3).

43 INT. REV. CODE OF 1954, § 302(b)(1).

44 INT. REV. CODE OF 1954, § 302(c)(1).

family corporation are found in the "family attribution" rules.[45] "Family attribution" means that stock owned by a spouse, parent, child, or grandchild of the redeeming party will be attributed to that party. There is no attribution between or among siblings. An example will better explain. X Corporation has 100 shares outstanding. A, who started the corporation, is married to B. They have a son, C, and by C a grandson, D. A, B, C, and D each own 25 shares.

—A will be deemed to own all 100 shares. He will constructively own the 25 shares of his spouse, B; the 25 shares of his child, C; and the 25 shares of his grandchild, D.

—B (A's spouse) will also be deemed to own 100 shares exactly as A.

—C (A and B's son) will also be deemed to own all 100 shares. He will constructively own the 25 shares of his parent, A; the 25 shares of parent, B; and the 25 shares of his child, D.

—But, D will be deemed to own only 50 shares. Although *his* shares are attributed to both A and B, his grandparents, the shares of a grandparent are not attributed to the grandchild. D, then, is deemed to own only his own 25 shares and the shares of his parent, C.

Furthermore, double attribution is specifically prohibited.[46] Thus, the fact that D constructively owns C's shares does not mean the service can attribute D's grandparents' shares to him because C is deemed to own those shares, *i.e.*, A and B's shares cannot be attributed to D through C. This prohibition of double attribution, however, is to be in all cases distinguished from re-attribution which is not prohibited. What this means is that the attribution of constructively owned shares will occur if the shares are treated as being owned under the application of any of the other attribution rules to be discussed below.[47]

Estate-Beneficiary Attribution. Attribution also applies between an estate and its beneficiaries.[48] Thus, the beneficiaries of an estate are deemed to own proportionately the shares owned by the estate, and an estate is deemed to own all the shares owned by its beneficiaries. The Commissioner has defined, for purposes of the attribution rules, the term "beneficiary."[49] Under that definition a person is not a beneficiary when he has received the interest to which he is entitled, has no claims arising from his status as a beneficiary, and is unlikely to be required to return any of the interest already conveyed to him. Only a person with a present interest in an estate is deemed a beneficiary for the purposes of estate-beneficiary attribution.[50] It should be noted, however,

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45 INT. REV. CODE OF 1954, § 318(a)(1).

46 INT. REV. CODE OF 1954, § 318(a)(5)(B).

47 *See* Treas. Reg. § 1.318-4(c)(1) (1955); Commissioner v. Baerenbaum, 369 F.2d 337 (10th Cir. 1966).

48 INT. REV. CODE OF 1954, § 318(a)(2)(A).

49 Rev. Rul. 60-18, 1960-1 CUM. BULL. 145; *see also* Treas. Reg. § 1.318-3(a) (1955); Webber v. United States, 404 F.2d 411 (6th Cir. 1968).

50 Treas. Reg. § 1.318-3(a) (1955); 403 F.2d 411 (6th Cir. 1968); *see* Rev. Rul. 67-24, 1967-1 CUM. BULL. 75.

that a residuary beneficiary may still qualify as a beneficiary for attribution purposes because his interest cannot be determined until the estate is closed.[51]

Trust-Beneficiary Attribution. Stock owned by a trust and stock owned by beneficiaries of a trust are attributable in the same manner as with estate-beneficiary attribution.[52] If, however, a trust beneficiary's interest in the trust is merely a contingent interest, attribution will not apply because the beneficiary's interest is considered too remote.[53] The contingent trust interest, however, must be worth 5% or less in order to preclude attribution.[54] In addition to the trust-beneficiary attribution a grantor-trust attribution is possible if all or part of the trust income is taxable to the grantor.[55]

Corporation-Stockholder Attribution. Attribution will also apply between a corporation and a stockholder owning 50% or more in value of the corporation's stock.[56] Thus, if Z Corporation has a 51% stockholder, any stock Z Corporation owns in M Corporation is attributed to the 51% stockholder on a 51% constructive ownership basis. And, any stock actually owned by the 51% stockholder in M Corporation is attributed to Z Corporation.[57]

Option Attribution. A person having an option to purchase corporate shares will be deemed to constructively own those shares.[58] A person with an option is deemed to own not only the shares he has an option to purchase but also those shares held by persons whose shares would be attributed to him if the option was exercised.[59]

One cannot over-emphasize the importance of giving careful scrutiny to the attribution rules of Section 318 when formation of a stock redemption agreement is contemplated under Section 302. Though they are very hard, they do not in all cases present an insurmountable obstacle. As will be discussed later in connection with the "complete" redemption, relief from the all important family attribution rules is provided within Section 302 itself when the specified requirements have been met. Finally, it should be mentioned that although the attribution rules may seem to the reader somewhat arbitrary, they, too, serve a *bona fide* purpose in the prevention of sharp business practices and quasi-legitimate, if not illegitimate, tax avoidances. That purpose is to prevent persons and legal devices from avoiding federal income tax liabilities by making a redemption of stock which they actually own while retaining a substantially undiminished element of control by virtue of their close relationships to other stockholding interests.

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51 *See* Treas. Reg. § 1.318-3(a) (1955); Webber v. United States, 404 F.2d 411 (6th Cir. 1968).

52 INT. REV. CODE OF 1954, § 318(a)(2)(B)(i).

53 INT. REV. CODE OF 1954, § 318(a)(3)(B)(i).

54 *Id.*

55 *See generally* INT. REV. CODE OF 1954, §§ 671-678.

56 INT. REV. CODE OF 1954, § 318(a)(2)(C).

57 *Id.*

58 INT. REV. CODE OF 1954, § 318(a)(4).

59 *Id.*; INT. REV. CODE OF 1954, §§ 318(a)(5), 318(a)(5)(D).

2. *The "Substantially Disproportionate" Redemption*

Under Section 302(b)(2) a stock redemption will be treated as an "exchange" if it is "substantially disproportionate." Though this sub-section provides specific criteria for what will be a "substantially disproportionate" redemption, its overall effect is to cause a meaningful reduction in the redeeming stockholder's interest and ownership in the corporation so that he does not pocket goodly amounts of funds otherwise taxable at ordinary income rates without having forfeited a certain degree of control. The criteria for a "substantially disproportionate" redemption are as follows:

a. After redemption the redeeming stockholder must own less than 50% of all combined voting power of all classes of stock.[60]
b. The redeeming stockholder's percentage of voting stock still outstanding after redemption must be less than 80% of the percentage previously owned by him.[61]
c. The redeeming stockholder's percentage of voting and nonvoting stock after redemption must be less than 80% of percentage previously owned by him. In making this computation where there is more than one class of common stock still outstanding for for the redeeming stockholder, the fair market value of each class is to be used.[62]

A mere reduction of 21% of one's stock is never sufficient. The reason for this is that while the redeeming shareholder does surrender 21% of his stock, the total number of shares outstanding also decreases. Thus, although the stockholder has 21% less stock than before redemption, his percentage of all the outstanding stock after redemption will not be 21% less than the percentage of outstanding stock that he owned before redemption. To illustrate, take the example of X Corporation with 100 shares outstanding. A owns 40 of the 100 shares. A redeems 10 shares or 25% of his actual holdings. Now there are only 90 shares of X Corporation still outstanding and A owns 30 or 33 1/3% of them. This is not "substantially disproporationate" since 33 1/3% ownership is greater than 80% of a 40% ownership.[63]

Although a mere 21% redemption is insufficient, there are formulae by which the percentage needed to be redeemed are easily determinable.[64] They are as follows:

a. If the stockholder prior to redemption owns not greater than 62 1/2% of the outstanding stock he will meet the 50% test if he meets the 80% test. The following formula works:

$$\frac{XY}{5Y\text{-}4X}$$

—X equals the total number of shares owned
—Y equals the number of shares outstanding

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60 INT. REV. CODE OF 1954, § 302(b)(2)(B).
61 INT. REV. CODE OF 1954, § 302(b)(2)(C).
62 *Id.*
63 80% of a 40% ownership is equal to $\frac{4}{5}$ of 40 or ($\frac{40}{5}$) $\times 4 = 32$.
64 7 CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 149.06[2] (1972).

Example: A owns 40 out of 100 shares. In order to have a "substantially disproportionate" redemption he must surrender the following number of shares:

$$\frac{40 \times 100}{(5 \times 100) - (4 \times 40)} = \frac{4000}{500 - 160} = \frac{4000}{340} = 11.8 \text{ or } 12 \text{ shares.}$$

b. If the stock holder owns more than 62 1/2% of the outstanding stock prior to redemption he must independently meet both the 50% and the 80% tests. The following formula will work: (X and Y are the same as above) any number of shares greater than 2(X) - Y.
Example: A owns 75 out of 100 shares before redemption. He must, therefore, redeem any number of shares greater than (2 x 75) - 100 = 150 - 100 = 50 shares.

c. If the stockholder owns both voting and non-voting stock the dollar value to be redeemed is as follows: $\frac{X - N}{Y - N} = \frac{.8X}{Y}$

—X equals the market value of the stock owned
—N equals the market value of the stock to be redeemed
—Y equals the market value of the stock outstanding
Example: T Corporation has 10,000 shares of voting stock worth \$1/share and 20,000 non-voting shares worth \$10/share. A owns 3,000 shares voting and 400 shares non-voting. A must redeem more than \$1,452 worth of stock:

$$\frac{\$\ 7{,}000 - X}{\$210{,}000 - X} = \frac{.8 \times \$7{,}000}{\$210{,}000} = \$1{,}452+.$$

Again, it should be emphasized that the attribution rules must at *all* times be taken into account when considering the use of a stock redemption agreement. Although a stockholder may make a "substantially disproportionate" redemption out of his own holdings, those shares that he will be deemed to constructively own due to Section 318 can easily disqualify the redemption with disastrous tax consequences if they are not also computed into the total number X. In fact, if the total number of shares to be attributed is not relatively minor there exists a great possibility that a "substantially disproportionate" redemption cannot be made.

One final note needs to be made concerning the "substantially disproportionate" redemption program before passing on to the others authorized by Section 302. A dividend taxation will occur to the redeeming parties despite the disproportionate nature of the redemption if it can be established that a planned series of redemptions has been made by the stockholders which, in the aggregate, results in essentially the same incidence of ownership as before the series took place.[65] This, however, should not present a serious problem to corporations and shareholders wishing to arrange a stock redemption agreement for the limited purpose of preventing disruptions of business upon the death or withdrawal of a major stockholder.

65 INT. REV. CODE OF 1954, § 302(b)(2)(D).

3. *The "Complete" Redemption*

"Exchange" treatment will also be given a stock redemption if it is in complete termination of the redeeming shareholder's interest in the corporation.[66] But for relief provisions within subsection 302(c)(2), family attribution rules, wherever applicable, could completely rule out the possibility of attaining a "complete" redemption. The attribution relief provisions contained in Section 302(c)(2) have been ruled to apply only to family attribution situations.[67] Relief provisions take the form of four requirements all of which must be met:

(a). *Complete Termination of Interest.* The erstwhile stockholder may not retain any interest whatsoever in the corporation as a shareholder, officer, director, or employee.[68] He may retain, however, a *bona fide* creditor's status[69] so long as his creditor's claim is not in any sense a proprietary interest.[70]

(b). *Satisfaction of the "Ten Year—Look Ahead" rule.* The "Ten Year—Look Ahead" rule means that the erstwhile shareholder may not voluntarily obtain any of the above prohibited interests within a ten year period following the date of redemption.[71] The erstwhile stockholder may, however, involuntarily obtain an interest during this period by bequest or inheritance.[72]

(c). *The "Ten Year—Look Back" rule.* This rule establishes a ten year period dating back from the date of redemption in which neither of the following occurances may have taken place:[73]

(1) Any part, even a single share, of the redeeming stockholder's stock is acquired from a person whose ownership of stock at the time of redemption would be attributable to the redeeming stockholder at the time of redemption.

(2) A stockholder related to the redeeming stockholder obtains and owns at the time of redemption either directly or indirectly any, even a single share of, stock from the redeeming stockholder.[74]

Section 302(c)(2)(B) does allow, however, a way to "beat" the family attribution rules if the "look back" rule cannot be satisfied. If the redeeming party can prove that the "complete" redemption is made not for the purpose of avoiding federal income tax, attribution relief is available. Of course, one of the purposes of employing the stock redemption agreement is to avoid excessive federal income taxation wherever it can be helped. But, the rule states *the* purpose and not *a* purpose. If a corporation and its shareholders can show that, among other things, the

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66 INT. REV. CODE OF 1954, § 302(b)(3).
67 Rev. Rul. 59-233, 1959-2 CUM. BULL. 106.
68 INT. REV. CODE OF 1954, § 302(c)(2)(A)(i).
69 Estate of Oscar L. Mathis, 47 T.C. 248 (1966).
70 Treas. Reg. § 1.302-4(d) (1955).
71 INT. REV. CODE OF 1954, § 302(c)(2)(A)(ii).
72 *Id.*
73 INT. REV. CODE OF 1954, § 302(c)(2)(B).
74 This requirement will be met if the acquired stock is redeemed in the same transaction. INT. REV. CODE OF 1954, § 302(c)(2)(B)(ii).

stock redemption agreement was instituted to serve what has been called "reasonable needs of the business" (*e.g.*, insuring a harmonious continuity of management) they may have established the legitimacy of that agreement.[75]

(d). *Filing of the appropriate form.* The erstwhile stockholder must also file with his personal income tax form for the year of redemption a statement providing information concerning the redemption and an agreement to promptly notify the Service if he does voluntarily acquire any of the above prohibited interests within the ten year "look ahead" period.[76] Although this requirement is probably the easiest with which to comply, it is also the easiest to forget. If a "complete" redemption can be made despite family attribution under the rules of Section 302(c)(2), there is no easier way to destroy the whole tax product than to file away the appropriate form and forget to attach it to the redeeming party's personal income tax return. Careful attention must be given this requirement.

4. *The Redemption "Not Essentially Equivalent to a Dividend"*

If neither a "substantially disproportionate" nor "complete" redemption can be made, "exchange" treatment is still possible under Section 302(b)(1). Generally, if a redemption is deemed "not essentially equivalent to a dividend" it will be taxed as an "exchange". But, it is in the definition of the phrase "not essentially equivalent to a dividend" that utilization of this subsection can become risky. The Internal Revenue Code of 1939[77] put this phrase in its positive context. It stated that a redemption will be treated as a distribution (dividend) if it is "essentially equivalent to a dividend". But, no definitions or criteria were established to guide a potential stock redeemer as to how much interest he must surrender in order to avoid dividend taxation upon his redemption proceeds. Consequently, it was left to the courts to provide a definition. As might be expected, the post-1939 courts were divergent in the criteria they supplied.

Two schools of judicial thought developed out of this ambiguity. One school expounded what came to be called the "flexible net effect" test.[78] Courts within this school looked to both the business purpose behind the redemption and its economic result to determine whether it was "essentially equivalent." The second school rejected the business purpose of the redemption and looked only to its economic result. This test came to be known as the "strict net effect" test.[79] In 1954 the revised Code put the phrase in its

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75 Surprisingly, the Service has placed a liberal interpretation on the application of this exception. *See* Rev. Rul. 57-387, 1957-2 CUM. BULL. 225; Rev. Rul. 56-584, 1956-2 CUM. BULL. 179; Rev. Rul. 56-556, 1956-2 CUM. BULL. 177.

76 INT. REV. CODE OF 1954, § 302(c)(2)(A)(iii).

77 INT. REV. CODE OF 1939, § 11(g).

78 *See* Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954) for a general discussion of the case history of this view.

79 *See* Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940) for a general discussion of the case history of this view.

negative, "not essentially equivalent" context.[80] Still, neither the courts nor the Congress had given a definite numerical criteria as is provided with the "substantially disproportionate" 80% and 50% tests.

Until the case of *United States v. Davis*,[81] the "flexible net effect" vs. "strict net effect" controversy continued. *Davis* adopted the "strict net effect" test as the controlling test. In that case, the Supreme Court refused to recognize the existence of a valid business purpose. Prior to the decision in *Davis*, courts often considered a corporation's record of dividend distribution in making a decision as to whether a redemption was "essentially" or "not essentially equivalent". *Davis* rejected this also. Instead, the Court in *Davis* looked only to the economic effect of the redemption upon the redeeming stockholder's proportionate interest in the corporation. It further held that all attribution rules[82] are applicable in making the determination of dividend equivalency. In effect, the Court said that if a redemption had the effect of distributing corporate property to the redeeming shareholder without changing his relative economic position in the corporation, there will be dividend equivalency on the distribution. As the reader may have guessed by now, the Supreme Court in *Davis* also did not provide any definite numerical criteria for a redemption that will be disproportionate enough to receive "exchange" treatment when it cannot meet the "substantially disproportionate" tests.[83] The Court merely stated that a "meaningful reduction" in the shareholder's proportionate interest is required.

If by now the reader is thoroughly confused as to what is and what is not a redemption that is 'not essentially equivalent to a dividend," he is in no worse position than anyone else involved with the subject. Obviously, a redemption that is either "complete" or "substantially disproportionate" is "not essentially equivalent." But, it is at this point that the certainty stops. To the conservative businessman and/or corporate attorney the history of this controversy and undecided area of corporate tax law should be no less than a red flag staring him in the face. Moreover, when more than a single class of stock is outstanding and redemptions involve only a single class further complications arise and should be carefully considered.[84]

Recent developments in the area of non-dividend equivalency have given further cause for strict scrutiny of proposed redemptions which cannot qualify as "substantially disproportionate" or "complete". Revenue Ruling 71-261[85] states that where a portion of a distribution does not qualify for Section 303 treatment, *infra*, it is taxable as a dividend as per *Davis* to an estate even

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80 INT. REV. CODE OF 1954, § 302(b)(1).
81 397 U.S. 301 (1970).
82 *See* Treas. Reg. § 1.302-2(b) (1955).
83 INT. REV. CODE OF 1954, § 302(b)(2).
84 *See* Himmel v. Commissioner, 338 F.2d 815 (2d Cir. 1964); *see generally* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 9.24 (3d ed. 1971).
85 1971-1 CUM. BULL. 108.

though the estate's post redemption ownership of 100% was due *solely* to application of Section 318 attribution rules. In *Fehrs Finance Co.*[86] the Tax Court held that a reduction from 98% actual and constructive preredemption ownership to 88% constructive postredemption ownership was not a "meaningful reduction" under *Davis*. The same type of result occurred in *Stanley F. Grabowski*[87] involving a redemption of preferred stock by an estate whose postredemption interest remained unchanged solely because of Section 318 attribution. These developments indicate, then, that at least the Commissioner and the Tax Court are strictly applying the language of the Regulations[88] and *Davis* concerning the use of the attribution rules in determining dividend equivalency. However, they have offered nothing more to fulfilling the need for more definitive standards of nondividend equivalency under Section 302(b)(1).

The implications to be drawn from all this is simply that if relief from Section 301 on a proposed stock redemption agreement cannot be had from the "substantially disproportionate" and "complete" redemption provisions of Section 302, careful examination of the cross purchase arrangement should be made. If it is still forsaken in favor of stock redemption the risk of untimely and expensive litigation will have to be assumed. It is the authors' view that despite its awkward nature, the tax safety inhering in the cross purchase agreement is salient enough to justify its implementation, absent the possibility of a "substantially disproportionate" or "complete" redemption until such time as a greater degree of certainty settles over the "not essentially equivalent" issue. There is, however, nothing to prevent the use of a combined stock redemption-cross purchase arrangement to accommodate those interests which have little or no chance of obtaining dividend non-equivalency and those which will have no such trouble.

C. *Stock Redemptions under Section 303*

Section 303 provides that in certain situations a distribution of stock, the value of which is included in determining the value of the gross estate of the decedent for federal estate tax purposes, shall be treated as a "sale or exchange" of stock. As mentioned above it provides an exception to the general policy of Section 301 that corporate distributions be taxed as dividends.[89] The advantage is that one may withdraw money from a corporation at capital gains rates, provided the conditions for qualification set by Section 303 are met.[90] It allows relief to estates which have liquidity problems because much of their

[86] 58 T.C. 174 (1972).

[87] 58 T.C. 650 (1972).

[88] Treas. Reg. § 1.302-2(b) (1955).

[89] Treas. Reg. § 1.303-1 (1955).

[90] As to stock issued for cash at par and later redeemed at par, it is obvious that no distribution of earnings has been made. DeNobili Cigar Co. v. Commissioner, 143 F.2d 436 (2d Cir. 1944).

assets consist of stock.[91] Its usefulness becomes most apparent when an estate consists largely of stock held in a close corporation. The market for such stock is usually very limited, if there is a market at all. Section 303 prevents the forced sale of the business[92] in order to provide liquidity. It also affords relief where other sections would not.[93] If the estate holds all or most of the stock of a corporation, redemption of a fractional share of the stock would in many cases not qualify for capital gains treatment under Section 302.[94] Such a redemption, in most cases, would also not qualify under Section 346.[95] A major advantage of Section 303 over Section 302 where the stock of an estate is to be redeemed is that the attribution problems created by Section 318 do not apply to it.[96]

Section 303 is not automatically available. Several conditions must be met before one may avail him/herself of its benefits:

(1). *Inclusion in the gross estate.* The first condition for qualification is that the value of the stock must have been included in the decendent's gross estate for federal estate tax purposes.[97] If the decendent owned the stock at the time of his death, it is obviously included in his estate.[98] Gifts given in contemplation of death are included in the gross estate,[99] as are revocable transfers.[100]

Obviously, Section 303 may be utilized only after the death of a shareholder.[101] It may, however, be utilized by almost anyone who owns the stock. Heirs, legatees, donees of the decedent, surviving joint tenants, surviving spouses, appointees, takers in default of appointment or trustees may utilize the benefits of Section 303, although it will most frequently be used by the executor or administrator of the estate.[102]

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91 The funds acquired in a Section 303 stock redemption need not be used to pay death taxes or expenses. Treas. Reg. § 1.303-2(f) (1955). In fact there does not even have to be an estate tax liability. Rev. Rul. 56-60, 1956-1 CUM. BULL. 443.

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

93 While it may provide relief where Sections 302 or 346 do not, it may be available as an alternative to utilization of one of those Sections or as an addition to a Section 302 redemption.

94 Substantially disproportionate redemptions, Section 302(b)(2) and redemptions in termination of a shareholder's interest, Section 302(b)(3).

95 BITTKER & EUSTICE, *supra* note 84, at § 9.42.

96 *In re* Estate of Byrd v. Commissioner, 388 F.2d 223 (5th Cir. 1967).

97 INT. REV. CODE OF 1954, § 303(a).

98 INT. REV. CODE OF 1954, § 2033. It may, however, be advisable to include the stock in the estate, where one has a choice, as the benefits of Sections 1014 and 303 may outweigh the detriment of the estate tax. Section 1014 provides that the basis of stock acquired from the decedent is equal to the amount of value placed on the stock for federal estate tax purposes, which is, generally, the fair market value at the date of death. Treas. Reg. §§ 1.1014-1, 1.1014-3 (1957). Thus, the amount of gain or loss will be minimal. Section 2032 provides for an optional valuation date which may be used. If it is used the basis will be the fair market value six months after the date of death or at the time of disposition if it is before the expiration of the six month period.

99 INT. REV. CODE OF 1954, § 2035.

100 INT. REV. CODE OF 1954, § 2038. *See generally*, INT. REV. CODE OF 1954, §§ 2031-2044.

101 INT. REV. CODE OF 1954, § 303(a).

102 Treas. Reg. § 1.303-2(f) (1955).

However, Section 303 will not be applicable where the stock is redeemed by one who acquired it from the executor in satisfaction of a specific monetary bequest.[103] Nor will it be available where stock is redeemed by one who acquired it "by gift or purchase from any person to whom such stock has passed from the decedent."[104] It is advisable to have the administrator of the estate redeem the stock and then distribute the cash to the beneficiaries or heirs. This would avoid any problems arising in regard to whether a certain individual could redeem the stock under Section 303. Needless to say the idea of providing liquidity is not a condition precedent for qualification. The proclamation that such relief would be available only in narrowly defined circumstances where true hardship exists is a dead letter.[105]

(2). *Substituted Basis.* Section 303(c) was enacted as an exception to the general rule that the stock which is to be redeemed must have been included in the decedent's gross estate. This section provides that if one owns stock, the basis of which is determined by reference to the basis of stock which was included in the gross estate of the decedent, then that stock may be redeemed under Section 303. This stock is referred to as substitute stock.[106] For example, after death but before redemption A Corporation merges with B Corporation, the stock of the newly formed C Corporation may be redeemed under Section 303. Such stock will necessarily be received in a non-taxable transaction.[107] Thus, Section 303 aplies to redemptions of stock received:

(a) in a spin off under Section 355,
(b) in a 368 reorganization,
(c) in Section 305(a),
(d) as 1036 exchange, and
(e) in a 306 distribution.[108]

The theory is that substituted stock is tax-wise in the shoes of the old stock and hence should receive the same treatment.

(3). *Percentage Requirements.* A more difficult requirement to meet is set by Section 303(b)(2). The stock must have a valuation for estate tax purposes equal to either 35% of the gross estate[109] or 50% of the net estate.[110]

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103 *Id.; but cf.* United States v. Lake, 406 F.2d 941 (5th Cir. 1969), where a beneficiary purchased stock from a testamentary trust established for her benefit and the court held that Section 303 could be utilized to help pay the estate taxes. *See also* Rev. Rul. 70-297, 1970-1 CUM. BULL. 66, the Commissioner ruled that Section 303 was not available in a situation where the decedent bequeathed to his wife the maximum amount allowed when utilizing the marital deduction. The administrator lacked the power to distribute assets in kind and the widow was considered to have received the stock in satisfaction of a specific monetary bequest.

104 Treas. Reg. § 1.303-2(f) (1955).

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

106 Treas. Reg. § 1.303-2(d) (1955).

107 INT. REV. CODE OF 1954, § 303(c); Rev. Rul. 55-91, 1955-1 CUM. BULL. 364.

108 Treas. Reg. § 1.303-2(d) (1955). Note that Section 303 overrides Section 306. Treas. Reg. §§ 1.303-2(d), 1.306-1(c), 1.306-3(e) (1955).

109 As computed by Section 2031. Treas. Reg. § 1.303-2(b) (1964).

110 As computed by Section 2051. The liberality of this requirement, especially when used in conjunction with the marital deduction, is shown by the following example:

When stock in two or more corporations is owned there are additional requirements. The stocks may be aggregated[111] to fulfill the 35-50% requirements only if more than 75% in value of the total outstanding stock is held by the shareholder.[112] In determining the value of the outstanding stock all classes of stock outstanding are included.[113] For example, if the decedent had owned stock in three corporations and the value of none of the stocks by itself would equal the 35-50% test, one may aggregate the value of those stocks which exceed 75% of the value of the stock outstanding to meet the 35-50% test. Assume:[114]

—Value of gross estate..........$1,000,000
—Value of taxable estate $700,000
—Death taxes and expenses $275,000

		outstanding	*amount owned*	
—Z Corp.	common	$100,000	$100,000	100%
	preferred	$100,000	$100,000	
—X Corp.	common	$ 50,000	$200,000	
	preferred	$350,000		50%
—Y Corp.	common	$200,000	$150,000	80%

The value of the stock of Z Corporation may be aggregated with that of Y Corporation since the estate owns more than 75% of the value of the outstanding stock in each corporation. But, the value of the stock owned in X Corporation does not meet the 75% requirement and, so, may not be aggregated. Neither does it meet the 35-50% requirement. Hence, it does not qualify for redemption under Section 303. However, if the entire common stock of X Corporation was owned, then by itself, it would meet the 35-50% requirement and qualify under Section 303.

In those situations where stock is owned in two or more corporations which cannot simply qualify under the 35-50% requirement and which cannot meet the 75% requirement for aggregation, it may be advantageous to effect a merger between the two corporations so that the stock may then qualify. This should

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Gross Estate	$ 1,000,000
Deductions and Expenses	100,000
Balance	900,000
Marital Deduction (maximum)	450,000
Net Estate	450,000
Exemption	60,000
Taxable Estate	390,000
50% test—taxable estate	185,000
35% test—gross estate	350,000

When used with the marital deduction the 50% test becomes rather easy to comply with and it bestows sizeable benefits.

111 INT. REV. CODE OF 1954, § 303(b)(2)(B).

112 Section 318 attribution rules do not apply to Section 303. In Re Estate of Byrd v. Commissioner, 388 F.2d 223 (5th Cir. 1967).

113 Treas. Reg. § 1.303-2(c)(1) (1955).

114 For a similar example, *see* Treas. Reg. § 1.303-1(c)(2)(C) (1955).

be done prior to the death of the decedent. The new stock will qualify only if the old stock would have qualified.[115]

(4). *Amount.* There is a dollar amount limitation upon the amount of stock which may be redeemed under Section 303.[116] The redemption may not exceed the amount of the estate, inheritance, and succession taxes including those imposed by the shareholder's death and the amount of funeral and administration expenses allowable under Section 2053.[117] The amount of administration expenses allowed may be included even though it was used as a deduction for federal income tax purposes.[118] The amount of claims against the estate and the amount of unpaid mortgages deductible under Section 2053 are not included in the amount permitted under Section 303. The total allowable administration expenses may exceed the value of the estate if they are allowable under local law and paid within 15 months. In the example previously used, only $275,000 worth of stock may be redeemed under Section 303. This is true even though $360,000 worth of stock qualifies under Section 303.[119]

(5). *Time.* The benefits provided by Section 303 are available only if utilized within a limited time after the decedent's death. The distribution must be made within three years from the filing date of the estate tax returns[120] or within 90 days after the expiration of such period.[121] The date for the filing of a return may be as long as 15 months.[122] The total maximum time is four and one half years. If a petition for redetermination has been filed with the Tax Court the time for redemption may be delayed even longer, until 60 days after the decision of the Tax Court becomes final.[123] A petition within the time limit prescribed by Section 6213 must present a *bona fide* dispute and not one which is merely intended to prolong the running of the time limit.[124]

Section 6166 provides for a deferral of estate tax payments. It provides relief to estates which consist in the large part of stock in closely held businesses. It allows the estate tax payment to be made in up to ten equal annual install-

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[115] Rev. Rul. 69-594, 1969-2 CUM. BULL. 44.

[116] Under proposed Treas. Reg. § 1.303-2(g)(1), 35 Fed. Reg. 11184 (1970), if there is a series of redemptions, even if not solely under Section 303, that the amount of death taxes, funeral and administrative expenses will be applied to the distribution first.

[117] INT. REV. CODE OF 1954, § 303(a).

[118] Rev. Rul. 56-449, 1956-2 CUM. BULL. 180, *as amended by* Special Announcement I.R.B. 1957-8; Estate of Yetter, 35 T.C. 737 (1961).

[119] INT. REV. CODE OF 1954, § 303(a)(1).

[120] INT. REV. CODE OF 1954, § 6501(a).

[121] Rev. Rul. 73-204, 26 C.F.R. § 1.303-2 (1973).

[122] INT. REV. CODE OF 1954, § 6501. This period shall be determined without reference to any section other than Section 6501(c). INT. REV. CODE OF 1954, § 303(b)(1)(A). Hence those provisions which extend the time allotted for assessment where the return is filed early (Section 6501(b)), where items over 25% of the gross estate reported are omitted (Section 6501(e)), and where a fraudulent return was filed (Section 6501(c)) do not extend the time limit.

[123] INT. REV. CODE OF 1954, § 303(a)(1)(B). If the redemption is to be paid in installments at least a 4% interest rate should be charged; if this is not done and the payment is deferred for more than six months, the Service will impute interest at 5% compounded semi-annually. INT. REV. CODE OF 1954, § 483; *see also* Treas. Reg. § 1.483-1(b)(6) (1966).

[124] Treas. Reg. § 1.303-2(e) (1955).

ments. The requirements which must be met in order to utilize Section 6166 are similar to those of Section 303. The Code provides that when 50% or more in value of an interest in a closely held corporation is sold or disposed of the time extension provided ceases, and the unpaid portion becomes due upon notice by the Secretary.[125] However, this is alleviated in the case of a redemption under Section 303.[126] For the purposes of Section 6166, the interest in the closely held corporation shall be such interest reduced by the value of the stock redeemed.[127] The value of the closely held corporation shall be such value reduced by the value distributed.[128] Only the *pro rata* portion of the estate tax attributable to the corporation may be paid in installments, and then only when the executor gives the proper notice. Hopefully one may invest the money at a higher rate of interest and come out with a profit.[129]

V. The Possibility that a Stock Redemption Will Result in a Constructive Dividend to the Remaining Shareholders

Carried with the stock redemption agreement is a slight risk that its execution will result in dividend treatment to the remaining shareholders. The risk, however, can easily be overcome so long as proper planning procedures are used and certain terms are written into the agreement.

The most basic possibility of dividend treatment to the remaining stockholders after a redemption might be said to exist because the incidence of ownership of each remaining shareholder automatically increases when the departing stockholder sells out his interest. The possibility of dividend treatment based upon these grounds, however, has long since been dispelled by the case of *Eisner v. Macomber*.[130] In *Eisner* the court recognized that despite the remaining shareholders' increased incidence of ownership after a redemption of another shareholder's stock, there could be no constructive dividend to the remaining shareholder, because he was under no obligation to purchase the shares and "realized" no "direct" pecuniary benefit from the transaction.

A more real possibility of constructive dividend treatment exists when the corporation in some way pecuniarily compensates the remaining shareholder or discharges an obligation for him. In *Erickson v. United States*,[131] dividend treatment was accorded a remaining shareholder where he did, in fact, purchase the other stockholder's shares but then immediately redeemed them. He was still 100% owner after redemption, and he got his money back for the 50% interest he purchased. In *Zipp v. Commissioner*,[132] the remaining shareholder also received dividend treatment where he acquired the withdrawing share-

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125 Int. Rev. Code of 1954, § 6166(h)(1)(A)(ii).
126 Int. Rev. Code of 1954, § 6166(h)(1)(A).
127 Int. Rev. Code of 1954, § 6166(h)(1)(B)(ii).
128 Int. Rev. Code of 1954, § 6166(h)(1)(B)(i).
129 *See generally* Rev. Rul. 72-188, 1972 Int. Rev. Bull. 16 for a discussion of the relationship of Sections 6166 and 303.
130 252 U.S. 189 (1920).
131 189 F. Supp. 521 (S.D. Ill. 1960).
132 259 F.2d 119 (6th Cir. 1958).

redemption is in essence a debtor-creditor, employer-employee or vendor-vendee transaction.[157]

When a corporation redeems stock, its earnings and profits are affected by generally being increased. Income exempted from taxation must be included in the computed earnings and profits. The receipt of tax exempt life insurance proceeds increases earnings and profits,[158] but that is limited to the "excess of insurance proceeds over the aggregate sum of the premiums paid."[159] This is not too harsh because earnings and profits have already been reduced by the amount of the premiums. If the distribution qualifies as a sale, it will be applied, first, against the shareholder's capital account and then the balance against earnings and profits. If the stock redemption is a dividend, earnings and profits are then reduced.[160]

If the redemption is either a partial liquidation or "not essentially equivalent to a dividend" the effect on earnings and profits is ambiguous. The Code provides that the part that is properly chargeable to capital shall not be treated as a distribution of earnings and profits.[161] The problem is that the Code goes no further in explaining just what part is properly chargeable to capital. It is not clear whether the amount of the distribution reduces earnings and profits by the distributee's *pro rata* share or by an amount equal to the difference between the amount received and the amount chargeable to the capital account. According to the Service, the charge to the capital account should be determined by the ratio of the shares redeemed to the shares outstanding.[162]

VI. Life Insurance and the Stock Purchase Agreement

A. *Life Insurance Funding and Federal Income Taxation*

Section 264(a)(1) provides that where a corporation retains any direct or indirect ownership in insurance policies, premiums paid by it on those policies will not be deductible. Nor will premium payments be deductible by any of the shareholders owning policies on the lives of other shareholders under a cross purchase plan.[163] Hard as Section 264 may seem, it is better for all concerned under either stock purchase arrangement if the owner of the policy pays the premiums. The effect of having the corporation pay the premiums

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157 Treas. Reg. § 1.311-1(e).

158 Treas. Reg. § 1.312(6)(b) (1955).

159 Rev. Rul. 54-230, 1954-1 Cum. Bull. 114.

160 Int. Rev. Code of 1954, § 312(e).

161 Int. Rev. Code of 1954, § 312(a)(3). In *Helvering v. Jarvis*, 123 F.2d 742 (4th Cir. 1941) and *Herbert Enoch*, 57 T.C. 781 (1972), the courts refused to acquiesce to the Service's position which was announced in Rev. Rul. 70-531, 1970-2 Cum. Bull. 76. The courts held that Section 312(e) capital accounts consisted of the amount paid to the corporation for its stock. In a Section 302(a) redemption the amount which will be chargeable to this account is that percentage of the account which is equal to the outstanding stock as shown by the number of shares of stock which were redeemed. The remainder will go toward the reduction of earnings and profits.

162 Rev. Rul. 70-531, 1970-2 Cum. Bull. 76.

163 Int. Rev. Code of 1954, § 264(a)(1); Merimac Hat Corp., 29 B.T.A. 690 (1934).

under a cross purchase agreement without retaining any incidence of ownership in the policies can be near disaster. The corporate payment of premiums will normally result in taxable income to the shareholder-owner of the policy.[164] And, unless the corporation can establish that the premium payments constituted reasonable compensation to the stockholder, they may be treated as constructive dividends in which case the corporation cannot deduct the premiums paid by it.[165] Much the same holds true for the entity plan. If the corporation pays the premiums on policies not owned by it, the result will be taxable income to the owner-shareholder and constructive dividend treatment to all concerned.[166]

Due to a series of important cases it has been established that the corporation may purchase its own policies on the lives of its shareholders and pay the premiums without subjecting its shareholders to constructive dividend treatment.[167] So long as measures are taken to insure that the *corporation*, not its shareholders, is benefited by the insurance, such a program is quite suitable for funding of a stock redemption agreement.

The corporation should be the owner and sole beneficiary of an ordinary life policy as this provides the greatest amount of protection for the shareholder. The insured should have none of the benefits or incidents of ownership of the insurance policy[168] in order to prevent the insurance premiums from being considered constructive dividends to the shareholder. When the plan is so constructed, the money which is used is only taxed once as opposed to its being taxed twice if the shareholder pays the premiums.[169] However, even if the insured has the right to designate the beneficiary, the premiums may be taxable to him if the corporation has the rights of ownership and if the payment of the proceeds is conditioned on the transfer of the stock to the corporation.[170]

Upon the death of the insured the corporation will receive the death proceeds either in a lump sum or in installments. When the proceeds are redeemed by reason of death, they are exempt from income tax and need not be included in the gross income of the beneficiary.[171] If the insurance proceeds are to be paid in installments then the interest on them is taxable income and should be included in the gross income.[172]

If the insurance is owned by the corporation, which is also the beneficiary, then receipt of the proceeds should have no effect on the estate of the de-

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164 Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957); Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

165 Paramount-Richards Theaters, Inc. v. Commissioner, 153 F.2d 602 (5th Cir. 1946).

166 Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

167 253 F.2d 855 (10th Cir. 1958); 248 F.2d 818 (1st Cir. 1957); 247 F.2d 440 (2d Cir. 1957); Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

168 INT. REV. CODE OF 1954, § 2041.

169 248 F.2d 818 (1st Cir. 1957); Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

170 Commissioner v. Bonwit, 87 F.2d 764 (2d Cir. 1937); *see* INT. REV. CODE OF 1954, § 101(a); United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924).

171 INT. REV. CODE OF 1954, § 101(c); United States v. Heilbroner, 100 F.2d 379 (2d Cir. 1938).

172 INT. REV. CODE OF 1954, § 101(c); Treas. Reg. § 1.101-3(a) (1957).

cedent.[173] The other shareholders should be similarly unaffected. Under some circumstances, the proceeds of the insurance may be paid directly to the surviving shareholders even though the corporation owns the policy. In this type of situation, the Service will want to have the proceeds taxable as dividends.[174] In *Ducros v. Commissioner*[175] the federal court held the proceeds received by the shareholders were life insurance proceeds received by reason of death and were therefore exempt. This is a point of some controversy.[176]

The earnings and profits of a corporation will be reduced to the extent that the annual premium is greater than the increase in the cash surrender value of the policy for an ordinary life policy. When there is term insurance the earnings and profits will be reduced by the cost of the premiums.

The corporation has an insurable interest in the lives of its officers, chief stockholders and executives when it would suffer a loss by reason of their death.[177] Many corporations have group life insurance policies in which each of their employees is insured. Under such policies the insured may name his beneficiary. The premiums of such policies are deductible by the corporation.[178] Some businesses have had nominal amounts of insurance on their ordinary employees and sums up to $100,000 on the executive-stockholder. On its face, such an arrangement has the obvious advantage of deductibility of premiums, but the Code provides for such treatment only in an employer-employee relationship and not in a corporation-stockholder relationship.[179] Such an arrangement should be avoided, especially as one of the planning goals of a stock redemption plan is to avoid litigation, and such an arrangement is almost certain to attract the attention of the Service.

B. The Accumulated Earnings Surtax and Purchasing the Necessary Life Insurance

Utilization of the stock redemption plan where the corporation purchases its own life insurance and pays the premiums carries with it important tax aspects of its own. The corporation, in order to purchase life insurance, must expend earnings and profits to do so. If ordinary life, or some variation thereof, is bought on the lives of the shareholders a cash surrender value will accumulate on the policies. In a sense, then, the corporation is not spending the premium dollars but is investing them. The result of these cash surrender values, which increase with the number of premiums paid, is an accumulation of earnings and

173 Rev. Rul. 56-397, 1956-2 CUM. BULL. 599; Ray E. Tompkins Estate, 13 T.C. 1054 (1949).

174 Rev. Rul. 61-134, 1961-2 CUM. BULL. 250.

175 272 F.2d 49 (6th Cir. 1959).

176 *Ducros* has not been followed by the Service. *See* Rev. Rul. 61-134, 1961-2 CUM. BULL. 250; Storey v. United States, 305 F.2d 733 (6th Cir. 1962); Charles J. Thornley, 41 T.C. 145 (1963).

177 265 U.S. 189 (1924); 272 F.2d 49 (6th Cir. 1959); Keckley v. Coshocton Glass Co., 86 Ohio St. 213, 99 N.E. 299 (1912).

178 INT. REV. CODE OF 1954, §§ 162(a), 264(c); Treas. Reg. § 1.264-1(b) (1957); Rev. Rul. 56-400, 1956-2 CUM. BULL. 116.

179 *Id.*

profits. Corporate earnings and profits are also increased by the amount of excess over premiums paid when the proceeds of the policy are realized upon the death of a stockholder.[180] But for Section 535(c)(2) and Sections 531-538 generally, these accumulations of earnings and profits would in all cases be quite beneficial. The Code allows earnings and profits to accumulate to $100,000.[181] After the $100,000 deduction is passed, however, the above mentioned general sections impose an "accumulated earnings penalty tax" of either 27½% or 38% in addition to the normal corporate income tax and surtax.[182]

Section 537(a)(2) provides that accumulations by a business to satisfy Section 303 redemption needs are for the reasonable needs of the business for purposes of the accumulated earnings tax with respect to the tax year in which the shareholder dies or a later tax year.[183] This section makes no reference to any accumulations made prior to that.

Section 533(a) creates a presumption that earnings and profits accumulated beyond the "reasonable needs of the business" are accumulated for the proscribed purpose of avoiding federal income tax as set out in Section 531. If the corporation has built up substantial equity in the insurance policies it owns on the lives of its shareholders to the point that its earnings exceed the $100,000 limitation, or its earnings and profits will exceed the limitation upon realization of the insurance proceeds, the corporation must establish that the accumulation was not beyond "the reasonable needs of the business" and, hence, not for the purpose proscribed in Section 531. Satisfaction of a *bona fide* business need cannot be ignored in the determination of whether there has been an unreasonable accumulation.[184] *Emeloid Co. v. Commissioner*[185] held that a *bona fide* business need or purpose can be served by a stock purchase agreement. It further stated that preservation of a harmonious continuity of management and compensation for loss of a "key-man" are *bona fide* business needs and purposes. *Prunier v. Commissioner*[186] and *Mountain State Steel Foundries, Inc. v. Commissioner*[187] lend support to the wording of *Emeloid.* One major case, *Pelton Steel Casting Co.*,[188] has held differently. But, *Pelton* was decided on a special set of facts and pertains mostly to the larger corporations. However, due to the split of authorities one should exercise caution in this area. One should at all times emphasize the importance to the business of

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180 INT. REV. CODE OF 1954, § 101(a).
181 INT. REV. CODE OF 1954, § 535(c)(2).
182 INT. REV. CODE OF 1954, § 11.
183 This applies to tax years ending after May 26, 1969. INT. REV. CODE OF 1954, § 537(b)(2).
184 Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960).
185 189 F.2d 230 (3rd Cir. 1951).
186 248 F.2d 818 (1st Cir. 1957); *see also* Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958).
187 284 F.2d 737 (4th Cir. 1960); *see also* Gazette Publishing Co. v. Self, 103 F. Supp. 779 (E.D. Ark. 1952).
188 251 F.2d 278 (7th Cir. 1958); *see* Kirlin Corp. v. Commissioner, 361 F.2d 818 (6th Cir. 1966); Youngs Rubber Corp. v. Commissioner, 331 F.2d 12 (2d Cir. 1964).

the redemption agreement. This is especially true when the redemption date is far ahead, because its importance to the corporation's business activities is more debatable under such circumstances. When considered with the fact that successful execution of the redemption agreement will increase the remaining sharholders' proportionate interest without any tax consequences, some courts may be less willing to align themselves with the pro-taxpayer decisions in this area.

However, it would appear that at least for the smaller corporation, the $100,000 accumulated earnings deduction and the "reasonable needs of the business" argument can be sufficient to justify funding of a stock redemption agreement by corporate purchase of life insurance. In order to minimize the risk of being assessed the accumulated earnings penalty tax, sophisticated and expensive insurance programs are to be avoided. Low premiums keep accumulated earnings down. Ordinary life policies purchased on the life of each stockholder are quite sufficient.

It is possible to avoid the whole accumulated earnings tax trap if term insurance is purchased instead of ordinary life. However, the cost of maintaining a stable amount of term insurance coverage over a long period of time can be prohibitive. This becomes especially true when one or more of the stockholders becomes uninsurable. If a sinking term plan is used the avoidance of the penalty tax is defeated. As the total coverage decreases with time, the gap between what will be realized from insurance proceeds and what is needed to purchase the deceased stockholder's shares grows steadily larger. To make up this difference, and to establish the necessary "surplus," earnings and profits must be accumulated. Once the accumulation has reached the $100,000 limit nothing has been gained by the purchase of a sinking term insurance plan.

C. *Special Insurance Problems and Solutions*

There a few minor problems associated with the use of life insurance in funding a stock purchase agreement. Some of these relate to both types of agreements while others are specific to each.

The first problem deals with the spectre of an uninsurable stockholder. If no type of insurance may be purchased on a stockholder because of his age or health, it is possible to remedy the situation by getting him to sell or assign policies owned by him on his own life to the purchasing party(ies).

The second problem involves only the cross purchase agreement. Because of the variations of percentage interests and insurability among the stockholders, there will most likely exist an unequal burden upon the different stockholders in carrying the necessary insurance. The older stockholders are more likely to own a greater percentage of corporate shares and are also more likely to be less insurable. Thus, the younger and lesser stockholders will have to purchase a greater amount of insurance at a greater expense than the older stockholders.

A possible solution to this problem might be to abandon the cross purchase arrangement in favor of stock redemption, if that solution is viable. Although not completely equitable in this respect, the stock redemption agreement is at least more equitable than cross purchase agreements. If a switch to stock redemption is not possible the stockholders might work out a more equitable arrangement of premium payments among themselves. The corporation should not compensate an overly burdened stockholder in any event. The result of such compensation, as earlier discussed, is likely to be constructive dividends upon the compensated shareholder.[189]

A third problem relates to the insufficiency of present amounts of insurance coverage after a stock redemption or a cross purchase has been completed. The increased incidence of ownership of each remaining shareholder antiquates the old amounts of coverage purchased to fund the agreement. This, in part, has already been discussed with respect to the cross purchase agreement and its troublesome "transferee for value" problem.[190] The remaining shareholders may be willing to assume the financial burden of this specific problem. If not, they may instead purchase new insurance if they deem that solution cheaper. If that, too, is unacceptable, the short term installment payment plan may be used. In this situation, the remaining shareholders provide the difference between insurance proceeds on the death of the next stockholder by paying periodic installments to the decendent's estate or family out of their own cash resources. If additional insurance is purchased on the stock redemption plan the corporation is subjecting itself to a greater risk of incurring the accumulated earnings penalty tax. Thus, a short term installment payment plan from the corporation to the decendent's estate may also be the best solution.

Finally, there is the problem of windfall to the surviving shareholders (especially if there is but one) from the insurance proceeds under the stock redemption plan. The insurance proceeds may be more than the contract price of the redeemed shares. This excess will increase the net worth of the corporation. This increase in net worth may lead to substantial inequities among remaining shareholders. A way to avoid this problem is to *include the insurance proceeds in the contract price*. This, however, might drastically reduce the net worth of the corporation to a point which it cannot stand. By the same token insurance proceeds should not be set as the minimum price for the shares as this may lead to inequities impinging upon the surviving shareholders. If the fair market value of the shares is far below the amount of insurance proceeds received for them, the surviving shareholders and the corporation have grossly overpaid the estate. In such a case the Service may claim that the insurance was purchased not for the purpose of funding a stock redemption agreement, but to bestow a gift upon the estate of a departed stockholder.[191]

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189 246 F.2d 934, (9th Cir. 1957); 153 F.2d 602 (5th Cir. 1946); Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

190 *See* notes 24-28 *supra*.

191 7 CAVITCH, *supra* note 64, at § 149.15(9)(b).

The insurance proceeds should be included in the contract price, thereby increasing the value of the shares. Share price should to some extent reflect the net worth if the corporation and insurance proceeds will increase the net worth of the corporation. Although computation of the insurance proceeds into the contract price increases the financial burden upon the corporation, this can at least be partially alleviated by allowing a portion of the purchase price of the redeemed shares to be paid off in installments.

VII. Fixing the Purchase Price

The fixing of the purchase price of the shares to be sold under a stock purchase agreement, as previously indicated, is an essential element of a properly drafted agreement. Without such a provision the Service will force the estate of the deceased stockholder to prove that the price paid for the decedent's stock is the proper price for estate valuation purposes.[192] And without a price set out in an agreement or a formula by which a price may be determined, the agreement may not be enforceable. If the estate cannot prove what it claims, the Service may afix its own value to the stock.[193] The price or method of valuation stated in the agreement must result in a fair and reasonable price set by arms length bargaining.[194] Stock in a closed corporation seldom has an ascertainable market value.

There are several methods available by which one may afix a fair and reasonable price to the stock of a withdrawing or deceased stockholder. Selection of a particular method or methods is essentially a matter of judgment, as no single method is perfect or practical in all circumstances. Some of the most commonly used methods of valuation are discussed below.

A. *Book Valuation at the Time of Purchase*

Book valuation is determined by dividing the corporation's net worth (total assets minus total liabilities) by the total number of shares outstanding. But it is a subject of a great deal of controversy concerning whether to have a strict literal utilization of the book accounts as reflected in the balance sheet or whether modifications, other than those for obvious mistakes, may be made to correct it and more fairly set forth the book values. The problem with the book value method is that it often has little relation to the actual value of the assets, *e.g.*, goodwill may be a great asset of the business. If one is going to use this method in the valuation procedure one should specifically provide what type of audit will be used. Indeed, one can and probably should, depending upon the type of business involved, specify the accounting procedures to be

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[192] *See* 194 F.2d 396 (2d Cir. 1952); Giannini v. Commissioner, 148 F.2d 285 (9th Cir. 1945); Estate of Lionel Weil, 22 T.C. 1267 (1954); *see generally* Treas. Reg. §§ 20.2031-2 (1958), 20.2031-3 (1958).

[193] Treas. Reg. § 20.2031-2(h) (1958).

[194] Commissioner v. Bensel, 100 F.2d 639 (3rd Cir. 1938).

used. Provisions should be made to identify the person who will actually determine the values.

B. Capitalization of Earnings

Many authorities contend that this method is not satisfactory for use as a price fixing device in buy-sell agreements.[195] This method carries with it the assumption that future earning potential determines the corporation's future worth and the projected value of its stock. Future earnings are predicted by using as a starting point, the projection of past earnings adjusted to reflect past occurrances which distort the past earnings record. First, average earnings for a given period of years (usually five years) are determined. The average earnings figure is then multiplied by an appropriate capitalization ratio (oftentimes four for closely held corporations).[196] This capitalization ratio represents the estimated future earning power of the corporation based upon such factors as price-earning ratios accepted by similar corporations in a similar or the same industry, and/or the future profit potential of the industry of which the corporation is a part.

But, such a figure is arbitrary and has no guarantee of application to any certain business, especially if it is a new or seasonal business, or if it is a personal type of business. Any rate is just a guess which, if used, may need revision in the future. The base period used must be examined to see that it will not distort the true value of the business.

Use of this method of valuation is also inaccurate because it is virtually impossible to account for every variable which may occur in the future as they affect the corporation's future ability to make profits. Moreover, profits accumulated to the point of execution of a stock purchase agreement may have been inflated by the abilities of the deceased, thereby disrupting accurate computations for the value of the stock upon the death or withdrawal of the next stockholder.

An agreement using this method should state whether pre- or post-tax earnings are to be used, the capitalization ratio to be used, who will make the computation, how he will compensate for unusual conditions, and whether the net income will be adjusted up to reflect the high salaries paid in a close corporation. Where the business is doing poorly, earning figures and the capitalization rates are poor indicators of the true value of the corporation.

C. Mutual Agreement

Under this method the parties agree upon a fixed price, in good faith and at arms length, when the agreement is made. They further agree to revise the price at regular intervals. Often some provision is made to negotiate a

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195 ROHLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES 109 (rev. ed. 1953).

196 DEWING, FINANCIAL POLICY OF CORPORATIONS 390 (1953).

new price when a stockholder dies without having had a chance to negotiate at a regular interval or if some other unusual event occurs.

A major defect of this method is that the parties may forget to revise at the regular intervals or at any other time. This defect can be overcome if the agreement also provides that upon the lapse of a certain amount of time wherein no revision is made, the mutual agreement will be abandoned in favor of a different valuation method. It is the cheapest method of valuation. It is also the one which carries the least amount of weight with the courts.[197] It is subject to the relations of the members of the firm with each other. For example, younger members may be able to hold the valuation down for the older members who would want and need the higher valuation. There is, also, the tendency for such arrangements to be carried out with complete disregard for the concept of arms length bargaining which is necessary for the valuation to be binding.[198]

D. *Market Value*

This method fixes the price at what the shares would bring if placed upon the open market. It, however, may be a completely worthless method of valuation since most close corporation stock is not easily sold on the open market unless it constitutes a controlling interest. Hence, the open market value of the stock will often be much lower than it is really worth.

E. *Appraisal and Arbitration*

This method of valuation specifies that at the time the purchase agreement is to become operative both the purchaser and seller will designate an appraiser. If the two appraisers cannot reach a mutually satisfactory price, a third appraiser will then be appointed. In such a case, the majority opinion should control. But, good appraisers are hard to find. In fact, the most qualified appraisers available will probably be competitors of the closed corporation, in which case otherwise privileged corporate information may become available to them if appointed. The method may also involve a large expense when complicated formulas and computations must be used. The appraisers may also over-emphasize the importance of current price and cost levels without regard to historical developments.

F. *Combining Methods of Valuation*

None of the above methods is flexible enough to provide the ideal price in a given situation. Thus, a combination of methods utilizing the best attributes of each combined method may allow a more equitable valuation. A combination of the mutual agreement which contains a provision for periodic revision and the

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[197] *See generally* Treas. Reg. § 20.2031-2(b) (1958); Rev. Rul. 59-60, 1959-1 Cum. Bull. 237.

[198] 100 F.2d 639 (3rd Cir. 1938).

arbitration-appraisal method may be used in the absence of a mutual agreement of all the parties upon the dates agreed for revision. A combination of other methods may also be used.

G. *Estate Tax Valuation*

Under this method the value accepted by the Service for estate valuation purposes would fix the value of the shares under the agreement. This method, however, usually involves unwanted delay. Also, the chance for determination of a better price that would be acceptable to the Service for estate valuation purposes because of the proper nature of the agreement is foregone.

VIII. CONCLUSION

The stock purchase agreement funded by life insurance held on the lives of major stockholders is an important planning device in the area of corporate and tax law. Without some provision for an orderly passage of shareholding interests into desirable hands upon the death or withdrawal of a major stockholder, the consequences to the corporation and remaining stockholders can be ruinous. There are different methods by which to accomplish an orderly passage of such interests through stock purchase agreements, and whichever method is employed should result in the most beneficial tax consequences available.

The cross purchase plan is a safe method to use from a tax standpoint, as it will invariably result in capital gains treatment to the selling party. It is, however, a cumbersome and expensive method and should be forsaken in favor of stock redemption programs whenever possible. The stock redemption plan executed under Sections 302 and/or 303 is an easier plan to administer and will often result in capital gains treatment to the selling party. However, these two sections carry definite qualification rules and will not be available in all situations. The facts and circumstances of each corporation and each major shareholder must be carefully considered in view of these qualification rules before the redemption plan should be used. The business and tax planner may well find that a combination of cross purchase and stock redemption plans will best suit the needs of a particular corporation and its shareholders. Whichever plan or plans are used, appropriate amounts of life insurance should be purchased and owned by the parties obligated under such agreements in order to create a dependable source of capital to make the necessary stock purchases when actual execution of these plans becomes necessary.

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THE APPLICABILITY OF ANTI-TRUST LAWS TO THE INSURANCE INDUSTRY

I. Introduction

This Note investigates the applicability of federal anti-trust laws to the insurance business. As the McCarran-Ferguson Act explicitly exempts the "business of insurance" from the purview of the anti-trust laws,[1] the extent to which the anti-trust laws apply is a matter of controversy and has yet to be definitely settled. Three distinct areas will be discussed. First, those activities which the McCarran Act does not exempt. Second, activities of the insurance companies which can be considered not within the "business of insurance" and thus subject to anti-trust laws. Third, areas which do fall within the McCarran exemptions, but which may nevertheless come within the sphere of influence of the anti-trust law in certain circumstances.

This Note does not deal with the history of the federal-state struggle over insurance regulation, nor the forces which moulded the McCarran-Ferguson Act. Additionally, the machinations of the NAIC[2]-AIC[3] to parry public and Congressional thrusts are not related. A booklet from the Department of Transportation written by John Day is a most cogent treatment of these matters.[4]

II. Boycott, Coercion, And Intimidation: The Three Musketeers Of Anti-Trust

Section 3(b) of the McCarran Act states that nothing within the act shall make the Sherman Act inapplicable to any action which causes or arises from a boycott and acts or agreements to coerce or intimidate.[5] Therefore such activity which falls within the prohibitions of the Sherman Act is actionable even though it occurs within the insurance industry. This includes the possibility of civil suits for treble damages.[6]

It includes activities which brought about the *South-Eastern Underwriters*[7] decision. Not surprisingly, the first cases dealing with §3(b) dealt with

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1 For a thorough treatment of the distinctions between the "insurance business" and the "business of insurance" *see* Clark, *State Regulation of "The Business of Insurance"—McCarran's Shattered Shield,* 21 Drake Ins. L. Annual 657 (1972) [hereinafter cited as Clark.]

2 National Association of Insurance Commissioners. Formerly the National Convention of Insurance Commissioners, which has been an active force since the early 1900's.

3 All-Industry Committee. This committee was established after passage of the McCarran Act at the request of NAIC to aid in preparing necessary legislation for passage by the states.

4 J. Day, Economic Regulation of Insurance in the United States (1970). [hereinafter cited as Day.]

5 15 U.S.C. § 1013(b) (1970).

6 15 U.S.C. § 15 (1970).

7 United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).