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Section 303 Stock Repurchase vs. Accumulated Earnings Tax

Mel J. Massey, Jr.*

ONE OF THE FIRST THINGS a tyro life insurance agent learns after, of course, the phrases, "May we sit down and discuss your life insurance?" and, "Are you saving any money?" is the bare facts about I.R.C. Section 303.¹ He has been told by his manager or trainer that Congress has armed him with this wonderful insurance sales tool.

Under its provisions the stockholder of a closely held corporation can look to the corporation to purchase sufficient shares of his stock in order to permit his executor to pay estate and inheritance taxes, executor's and attorney's fees and funeral expenses. The asset, his stock in the closed corporation, which has chiefly caused this stockholder's estate problem, will be used to solve it. Section 303 will provide the key to the otherwise "locked in" stockholder. Without a doubt the insurance man's knowledge of Section 303 includes the fact that the decedent's stock interest in the corporation must represent more than 35% of the adjusted gross estate or more than 50% of his taxable estate, that the corporation should have the cash to make this redemption and that the easiest and cheapest way to provide this cash is with substantial life insurance policies on the principal stockholders.

At this point, interested by what he has heard, the stockholder and prospective insured turns to you, his legal advisor. Your first move, of course, is to check the accuracy of the insurance man's statements about Section 303. Your research finds his sales arguments to be correct; but you find two other points favorable to the insured redemption approach. One is the redemption must take place within a statutory period of limitations, normally 3¼ years.² While the corporation could borrow money to provide the cash for the redemption, the presence of the statutory period favors the insured method. The other point favorable to the insured method is that there need not be an absence of cash or cashable items in the deceased's estate in order to work this partial stock redemption. It is sufficient that the estate has attracted estate and inheritance taxes and incurred funeral and administration expenses. The effect is that the corporation can provide the cash for these taxes and expenses and leave the deceased's stocks, bonds, other cash and personally owned life insurance largely available for the purposes for which they were originally purchased.

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¹ Int. Rev. Code of 1954.

² Int. Rev. Code Sec. 303(b)(1)(A) and (B).

The next question you should answer is whether the redemption of stock by this corporation would be prohibited by state law. Most states have a statute similar to Ohio Rev. Code, Sec. 1701.35, which bars a corporation from purchasing its stock if after the purchase its assets would be less than its liabilities plus its stated capital, or if it is insolvent. If you assume that insurance will be used to fund all or most of the stock purchase by the corporation and the corporate balance sheet looks strong, then this impairment-of-capital statute should not trouble you.

The next area of review is a talk with the corporation's accountant to determine whether there is sufficient cash flow to meet the premium payments the insurance man has discussed with the client. This may require a call-back to the insurance agent to find out what lower premium plan of insurance he could offer, if what he has offered might hinder cash flow.

Since the purpose of my writing this article was not to cover the above facets of Section 303, but to discuss the situation in which Section 303 is being planned for use in a corporation that is over-capitalized, let us assume that cash is no problem here. The corporation is in fact looking for a place to justify its present accumulation. Is Section 303 the place?

A surface study would indicate that the answer is, "yes," because under Revenue Regulation 1.312-5, corporate earnings and profits are decreased to the extent a redemption exceeds the par value of the stock redeemed. As a result the receipt of insurance proceeds followed by a redemption in the same tax year would not be taken into account in determining retained earnings. The reason further study is necessary, however, is that the insurance in most cases is not likely to provide all the cash needed to redeem under Section 303. Since no one, neither you, the insured nor the insurance company expect this man to die next week, increases in corporate values will require that other cashable assets of the corporation be used to complete the stock redemption. How have corporations fared in the federal courts when they sought to accumulate funds in order to carry out the partial redemption permitted by Section 303? The answer is, miserably.

Before relating the sad record in the courts, let me cover the major provisions of Section 531 of the Code as they pertain to this article; and then quote from the Committee Reports of the applicable Committees of the House and Senate at the time the predecessor section, 115 (g), to Section 303 was enacted.

Under Section 531 of the Code where the corporate surplus has already reached \$100,000, annual profits in this and following years can be subject to the accumulated earnings tax, where their retention is found to be unnecessary for the "reasonable" needs or the "reasonably anti-ci-

pated" needs of the business.³ Each year this condition is found to exist, the retained earnings for that year are subject to an additional tax of 27½% on the first \$100,000 and 38½% on the balance.

As to the congressional intent at the time the predecessor to Section 303 was passed, here is what the Committees of both Houses of Congress reported:

Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family business which is so vital and desirable an element in our system of free enterprise.⁴

If Congress specifically thought partial redemptions to be desirable through its legislative approval, why do the courts penalize the corporation when it seeks to do the approved act?

The answer lies in a review of the three cases in point. They are *Dickman Lumber Co v. U.S.*,⁵ *Youngs Rubber Corp. v. Comm.*,⁶ and *The Kirlin Corporation v. Comm.*⁷

In the *Dickman Lumber*⁸ case here is where the corporation stood in 1959, the year in question.

Profit and Loss Statement

Income		\$334,000
Less: Income Tax & Capital Gains Tax		192,000
Accumulated Income		142,000
Less: Dividends	12,000	
Other Payments to Stockholders	1,000	13,000
Income subject to Sec. 531		129,000
Accumulated Earnings Tax assessed		38,600
If \$129,000 had been paid to the Dickmans as dividends the income tax would have been		\$ 88,000

Balance Sheet

Total Assets		\$3,400,000
Cash & Government Securities		1,182,000
Current Assets to Current Liabilities		9.1 to 1
Cash and Securities to Current Liabilities		6.1 to 1.

³ Int. Rev. Code Sec. 537.

⁴ Senate Committee Report, R.P.T. #2375, 81st Congress, 2d Sess.

⁵ 65-1 U.S.T.C. ¶ 9133 (1964).

⁶ 21 T.C.M. 1593, 331 F.2d 12 (1964).

⁷ P-H Tax Ct. Mem. Dec. ¶ 64,260 (1966).

⁸ *Supra* note 5.

The court noted that the corporation made advances to Mr. Dickman and his son, who was also an officer of the company. These advances were acknowledged by non-interest-bearing notes and the balance of these advances had grown from \$6,289 in 1958 to \$51,000 in 1963. These advances were in addition to the \$50,000 salaries paid to the father and the son and the dividends the family received.

In 1961, prior to the trial in district court, Mrs. Dickman died and \$300,000 of the stock she owned was redeemed under Section 303. The plaintiff stated that further redemptions would be needed in her estate, and probably in the estate of Mr. Dickman since he was in poor health. The plaintiff further stated that the accumulation was needed to provide reserves to meet competition, money for inventories and a planned modernization of the mill.

The court held that while the Dickmans were of good repute it was apparent that the purpose of the accumulation was to escape high income taxes in their personal tax brackets. With respect to retention of corporate earnings to provide for estate taxes, the court claimed that these were matters personal to the Dickmans rather than something of value to the plaintiff as a separate entity. As to the three other points raised by the plaintiff, the court ruled that the reasonably anticipated needs of the business must not be vague, uncertain or indefinite, and the plans to satisfy such needs must be feasible.

The *Youngs Rubber*⁹ case presented a similar set of facts, but with some variations. The corporation did not declare a dividend for 12 years, and then only after the death of its major stockholder. In 1956, one of the years in question, the major stockholder's salary was \$103,241. The court computed that the failure to pay a dividend resulted in a significant tax savings, \$64,340, to the stockholder and his wife. The court also noted but did not comment on the fact that at one time the company owned three pleasure boats which were later sold to this stockholder. Further, for a period of ten years it owned an entertainment center, which I gather was in a sylvan setting.

In 1958, this principal stockholder died and the corporation advanced \$400,000 to the estate of the deceased, and thought that an additional \$400,000 would be needed as permitted by Section 303.

The corporation also cited five other reasons for the accumulation of surplus, which stood at \$2,976,000, in 1956. The reasons were plant expansion, working capital, investments and loans to suppliers and customers, to acquire other businesses and a technological progress reserve.

The court found that the plant expansion reserve had stood for ten years and there was nothing to indicate any definite planning or authorization or execution of specific commitments to spend it. As to the tech-

⁹ *Supra* note 6.

nological progress reserve, there was no attempt on the part of the corporation to link the reserve with any specific plan to meet a competitive threat, or to show a competitive threat actually existed. As to the other points raised by the corporation, court ruled that the present surplus more than covered these exigencies.

Like the court in the *Dickman*¹⁰ case the trial court held that the accumulation to permit the taxpayer's principal stockholder's estate to pay estate taxes etc. was not an accumulation for the needs of the taxpayer's business. The court distinguished other cases, which involved complete stock redemptions under Section 302, saying that this case was not one where a corporation makes provision to buy out a dissident stockholder or arranges to redeem stock from the estates of stockholders in the interest of corporate harmony.

In the *Kirlin*¹¹ case, the Kirlin Corporation was another family corporation which found itself with a surplus of \$636,000, of which \$572,000 was cash and bonds in the year in question. The petitioner demonstrated this adequate cash position by paying off in 1956 and 1957, \$601,000 in notes held by the major stockholders, these notes not being due until 1959.

The trial court dismissed the various arguments of the petitioner, citing the *Youngs Rubber*¹² case in reply to the petitioner's argument that funds needed to be accumulated to provide at some later date for a redemption of a deceased stockholder's shares in accordance with the provisions of Section 303.

An amendment to Section 303 directly permitting a corporation to accumulate surplus in order to permit a redemption for purposes of paying the estate's taxes and expenses would probably accomplish little. The reason is that in almost every case the accumulation is well beyond what will be needed for Section 303. Evidence of this are the *Dickman Lumber*¹³ and *Youngs Rubber*¹⁴ cases. Even if the courts had felt differently about this section, because of the other factors the results would have been the same.

This is the reason why when a client with a wonderful cash position calls you about purchasing insurance for a Section 303 redemption, you should check his records for those things, the presence of more than one of which may trigger a Section 531 examination:

1. Accumulation of liquid assets in excess of operating expenses for one year.

¹⁰ *Supra* note 5.

¹¹ *Supra* note 7.

¹² *Supra* note 6.

¹³ *Supra* note 5.

¹⁴ *Supra* note 6.

2. A ratio of current assets to current liabilities in excess of 3 to 1.
3. A redemption of the stock of a 50% or greater stockholder.
4. Investments having no reasonable connection with the taxpayer's business.
5. Loans to stockholders, especially those at no interest.
6. Loans to corporations or business interests of the major stockholder.
7. Inactive investments in vacant land, government securities, mortgages and stocks.

If you have considered these points as a whole and found nothing alarming, then the insurance solution is the best way to provide the needed cash to redeem stock under Section 303. Obviously, at any time during the stockholder's lifetime, there would be a smaller amount of earnings accumulated as annual premiums paid than there would be if the entire amount necessary for a 303 redemption had been accumulated.

Periodic check-ups, however, will be needed of potentially unreasonable earnings accumulation, if your plan to "unlock" the corporation at the deaths of the major stockholders is to work without tax incident.