The Demise of Section 303 Under the Tax Reform Act of 1976: A Policy Analysis

Stanley Hagendorf

Follow this and additional works at: https://repository.law.miami.edu/umlr

Recommended Citation
Available at: https://repository.law.miami.edu/umlr/vol32/iss2/3

This Leading Article is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.
THE DEMISE OF SECTION 303 UNDER THE TAX REFORM ACT OF 1976: A POLICY ANALYSIS

STANLEY HAGENDORF*

The Tax Reform Act of 1976 limited the use of Section 303 by estates of shareholders of closely held corporations. The author examines the redemption provisions of section 303 and the changes made by the new Act in light of the policy considerations supporting redemptions. He concludes that further relief is needed for estates which include a closely held business.

I. INTRODUCTION

The estate of a shareholder of a closely held corporation can be faced with a severe problem where nonliquid assets constitute a significant portion of the estate, namely the raising of funds to pay the estate taxes. There are several sections of the Internal Revenue Code which provides various forms of relief; this article will examine section 303, which covers the redemption of stock of a closely held corporation for payment of estate taxes and certain other estate taxes.

* Associate Professor of Law, University of Miami School of Law.
1. Unless otherwise indicated, references are to the Internal Revenue Code of 1954, as amended.
expenses.2 The problems raised by the Tax Reform Act of 19763 will be emphasized.

II. BACKGROUND

Prior to the enactment of the Revenue Act of 1950,4 the estate of a deceased shareholder seeking to redeem stock for payment of estate taxes, and thereby to avoid dividend treatment, was governed by the general redemption provisions of section 115(g) of the 1939 Code. This section required ordinary dividend treatment if the distribution was "in whole or in part essentially equivalent to the distribution of a taxable dividend."5 There was no special relief provision equivalent to the present section 303. The result was that frequently upon the death of the major shareholder of a family corporation, there was a forced sale of the stock which was usually purchased by larger competitors.

In order to avoid this undesirable result, Congress added section 115(g)(3) to the 1939 Code in the Revenue Act of 1950. The Senate Finance Committee Report recited, in part, as follows:

It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus

2. For other relief provisions, see I.R.C. §§ 6166, 6166A (extension of time to pay estate tax), 6163(b) (extension of time for reasonable cause), 6324A (lien for estate tax when deferred under sections 6166 and 6166A), 6503(d) (extension of period of limitations when extension of time for payments is granted), and 6601(j) (4% interest rate for extensions under section 6166). This article will not discuss section 303(d) which covers generation skipping transfers.


5. Act of Feb. 10, 1939, § 115(g), Pub. L. No. 76-1, 53 Stat. 48 (amended 1950). This section had provided:

If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

See Niemann, Essentials of Corporate Stock Redemptions Under Section 303, 1972 Wis. L. Rev. 1153.
tending to accelerate the degree of concentration of industry in this country.⁶

III. THE SECTION 303 REDEMPTION

The congressional decision to provide relief was embodied in section 303, which permitted stock of a corporation to be redeemed without dividend consequences, provided that certain requirements were met. Section 303 now provides:

A distribution . . . to a shareholder by a corporation in redemption of part or all of the stock of such corporation which . . . is included in determining the gross estate of a decedent, to [a limited] extent . . . shall be treated as a distribution in full payment in exchange for the stock so redeemed.⁷

Thus the congressional solution was to permit a redemption of stock without ordinary dividend treatment. In order to utilize section 303, however, the corporation had to have the cash available to redeem the stock. If the cash was not available, section 303 was of no use, and the result was that the corporate stock still would have to be sold. This was one of the evils which section 303 sought to eliminate.

This cash flow problem was partially solved when Congress enacted sections 6166 and 6166A.⁸ These sections provide for payment of the estate tax over a period of time which can be as much as fifteen years.⁹

The Tax Reform Act of 1976, as discussed subsequently, will have a deep impact on the present day usefulness of section 303, especially the carryover basis rules.¹⁰ Keeping the policy reasons of section 303 in mind, the following is an examination of the requirements and some of the questions raised by the Tax Reform Act of 1976 as it applies to section 303.

Section 303 requires that there be a redemption.¹¹ Is such a requirement the only means of providing funds to an estate within the policy purposes of section 303? The statute could have provided qualification by means of a cash or property distribution rather than

---

⁷ I.R.C. § 303(a).
⁹ I.R.C. § 6166A(a), (e); I.R.C. § 6075(a); I.R.C. § 6151(a).
¹⁰ I.R.C. § 1023.
¹¹ I.R.C. § 303(a). See also I.R.C. § 317(b) (definition of redemption).
a redemption in at least certain situations.\textsuperscript{12} For example, in the situation where an estate owns all the stock of a corporation, qualifying the distribution as a redemption is a meaningless act. Similarly, in a closely held corporation, the other shareholders might prefer a direct cash or property distribution without surrender of shares, where for tax and nontax reasons they might prefer to keep all the outstanding shares constant. An example of this would be where control of a corporation is divided and redemption of some of the shares could result in the acquiring of control by one group.

If a redemption were not required in every situation, the statute could have provided that a cash or property distribution would be treated as a return of capital. Such an approach would not have had a significant impact on the death of a shareholder prior to 1977 since the estate or redeeming shareholder received a stepped-up basis in the stock redeemed.\textsuperscript{13} That is, in most instances the estate of a shareholder who died prior to 1977 (or the inheriting beneficiary) paid little or no tax even though there was a redemption. This occurred because the appreciation between the date of death and the redemption was usually relatively small or nonexistent. Similarly, where there was a buy-sell arrangement for the decedent's stock, the tax results would primarily be the same. The section 303 distribution would reduce both the basis and the amount realized for gain or loss purposes.\textsuperscript{14}

For decedents dying after 1976, however, the difference in tax treatment between a redemption and a reduction of basis approach can be quite substantial. The estate of a decedent shareholder no longer gets a stepped-up basis so that under present law in many situations there will be a gain on the redemption of stock.\textsuperscript{15} The estate or the person by whom the redemption is made must pay a

\textsuperscript{12} The estate would still have to qualify under the other requirements of section 303. The statute could have eliminated the redemption requirement where all the stock is owned by the estate, or where all shareholders consent to such treatment.

\textsuperscript{13} I.R.C. § 1014(a). Cf. I.R.C. § 1014(d) (section 1014 does not apply to property for which carryover basis is provided by section 1023; that is, where decedent died after December 31, 1976).

\textsuperscript{14} For example, if the estate held 100 shares of the XYZ Corporation with a total basis of $50,000 ($500 per share) and the estate received $50,000 in redemption of all its shares, there would be no gain or loss assuming that $10,000 qualified under section 303, since the basis of the remaining stock would be reduced from $50,000 to $40,000. The amount received would also be reduced since $10,000 would be deemed received by reason of a section 303 redemption. There is a question, however, whether the estate would qualify for section 303 treatment by reason of subsection (b)(3). Qualification may depend upon the terms of the will and the terms of the buy-sell arrangement.

\textsuperscript{15} I.R.C. § 1023. There also might be loss, although in most cases the redemption produces gain.
If, however, redemption treatment were not required in all situations and when not required a distribution were treated as a return of capital, then this income tax would be eliminated, thereby reducing the need for additional cash to pay the income tax. Such an approach would be more in accordance with the original congressional intent in enacting section 303 in view of the changes made by the Tax Reform Act of 1976. The income tax would ultimately be paid when the remaining stock was sold since the distribution would reduce the basis of the stock held. The payment of tax would thus be deferred rather than eliminated. Nevertheless, section 303 of the Code, as it presently reads, uses the term redemption; therefore a contemplated distribution should adhere to the formalities of a redemption rather than risk litigation and possible disallowance.

In Estate of Cole v. United States a payment which was recorded on the corporate books as a dividend qualified under section 303. The distribution was made specifically for the payment of taxes and expenses of the estate and was so recorded on the corporate books. The court, in reaching its decision, was aided by the fact that the shares of stock had been escrowed at the time of the "dividend", and the shares of stock were surrendered to the corporation after they were released from escrow. This case, however, because of its particular facts should not be relied on for the proposition that an actual redemption is not necessary under section 303. Where a taxpayer wishes to use section 303 it would be advisable to follow the formal requirements of a redemption.

IV. QUALIFICATION OF STOCK

In order for the stock to qualify under section 303, several requirements must be met. The first and most obvious requirement is that the stock being redeemed must be includable in the gross estate for federal estate tax purposes. The remaining requirements for qualification of the stock theoretically should include: (1) the amount of the stock owned by the decedent in relation to the out-

---

17. In most cases the income would be capital in nature. I.R.C. § 1221.
18. Reduction in basis is not a new concept in the Code. See, e.g., I.R.C. § 301(c)(2).
21. The opinion, however, does not state exactly when the surrender occurred.
22. A sale to a related corporation under section 304 is also treated as a redemption for section 303 purposes. I.R.C. § 304(a)(1)(B).
23. I.R.C. § 303(a).
standing stock of the corporation and (2) the value of the stock of the corporation as compared to the value of the gross estate.

A. Percentage of Corporate Ownership

It would seem logical that in pursuit of its original intent, Congress would have required that the decedent's stock ownership constitute a certain percentage of total stock ownership to qualify under section 303. Nevertheless, no such requirement has ever been imposed. Thus, it is possible that a decedent could have owned a relatively small percentage of the outstanding stock of a corporation and yet that stock could be eligible for section 303 treatment. On the other hand, a stockholder could be a one hundred percent owner of a corporation and yet not be eligible for section 303 treatment.

If Congress was interested in relief for the family corporation, some percentage requirement should have been imposed. Imposing too high a percentage requirement, however, could result in undue hardship upon a stockholder since, in many instances, a stockholder may give away stock to members of his family or to key employees.

B. Percentage of Stock Included in Gross Estate

Qualification of stock under section 303 has always depended upon a relationship between the value of the stock includable in the gross estate and the gross estate itself. Thus, it is possible for stock of a wholly owned corporation to be excluded from section 303 where it constitutes an "insignificant" portion of the estate. On the other hand, stock in a publicly held corporation might be includable where it constitutes a significant portion of the estate.

The present statute as amended by the Tax Reform Act of 1976 retains the concept of requiring a valuation percentage as measured by the value of the gross estate. Section 303(b)(2)(A) provides:

In general.—Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate exceeds 50 percent of the excess of—

(i) the value of the gross estate of such decedent, over

25. In such a case, the shareholder's estate would normally not have enough control of the corporation to require a redemption under section 303. If there were a fortuitous redemption, however, such a redemption might qualify. See Kadish, Section 303—Redemptions to Pay Death Taxes and Administrative Expenses: A Relief Provision Liberally Construed, 18 W. Res. L. Rev. 895, 898 (1967).
(ii) the sum of the amounts allowable as a deduction under section 2053 or 2054.

The history of the percentage requirement under section 303 indicates that Congress legislated in reverse in 1976 when it amended section 303(b)(2)(A). The forerunner of section 303 was originally enacted in 1950. At that time the stock of a corporation had to comprise more than fifty percent of the value of the net estate to qualify for redemption treatment. The provision was changed in 1951 by omitting the “more than fifty percent test” and requiring that the stock must comprise more than thirty-five percent of the value of the “gross estate.” When Congress enacted the 1954 Code, both tests were adopted and the decedent’s estate could qualify if it met either one. Rather than enacting these alternative provisions, congressional intent would have been better implemented by allowing only “closely held corporations” to qualify. The justification for the enactment of the alternative provisions was based upon the marital deduction—at least with respect to enacting the over fifty percent test. The committee stated:

[The new provision allows] stock to be redeemed where it not only constitutes 35 percent of the value of the gross estate but also if it constitutes 50 percent of the value of the net estate. Thus, the marital deduction allowed for estate tax purposes will not preclude the availability of this special redemption provision.

Although the apparent purpose of the alternative provision was to provide relief in the marital deduction situation, the alternative provision was not limited by statute to require utilization of the marital deduction. For example, an estate could have qualified under the “more than fifty percent” test where it had either a large charitable deduction or substantial debts even though it would not

---

have qualified under the “more than thirty-five percent of the value of the gross estate” test.

The thirty-five percent and fifty percent alternatives remained in effect until the Tax Reform Act of 1976, by which section 303 was changed to require that the value of the stock exceed fifty percent of the value of the adjusted gross estate. As originally proposed, Congress would have required an excess of sixty-five percent of the value of the adjusted gross estate but this was reduced by conference agreement to the present more than fifty percent requirement. Thus, the present statute has regressed to a single percentage test somewhat similar to the statute’s original enactment in 1950.

Section 303(b)(2)(A), as presently constituted, restricts the use of section 303. The present section 303 can produce some inconsistent results. Consider and compare, for example, the following situations. An unmarried individual dies, leaving a gross estate of $1,200,000 and $600,000 in debts. The decedent was a twenty percent owner of stock of a corporation which was valued in the gross estate at $350,000. This estate would qualify for the redemption treatment under section 303 since the stock constitutes more than fifty percent of the value of the adjusted gross estate. (Gross estate of $1,200,000 less debts of $600,000 leaves a taxable estate of $600,000.) Compare the situation of a married person who leaves an estate of $1,200,000 and only has $100,000 in debts. Assume further that the estate utilized the full marital deduction of $550,000, leaving a taxable estate of $550,000. Included in the gross estate is stock of a corporation which was wholly owned by the decedent and valued at $500,000. This estate would not be eligible to use section 303 even though it has a slightly smaller taxable estate and the stock of the corporation was one hundred percent owned.

Is this the result intended by Congress? Obviously it was not since there is no equitable reason why the estate of the unmarried decedent in the first example should be allowed the relief of a section 303 redemption while the estate of the married decedent owning a wholly owned corporation is barred from such relief. Congress meant to avoid these very situations when it enacted the alternate relief provision.

C. Stock of Two or More Corporations

One of the problems facing Congress in 1954 was how to provide relief for estates which held substantial blocks of stock of two or more corporations. In such situations, it was difficult for either block of stock to meet either of the alternate tests promulgated by the 1954 Code. For example, assume an individual had a gross estate of $1,000,000 and included therein was stock of three wholly owned corporations with a value of $250,000 for each corporation. Assuming that the taxable estate was $900,000, the estate would not qualify for section 303 treatment with respect to any of the blocks of stock. In considering this situation, Congress decided to provide relief by enacting section 303(b)(2)(B) which provides rules for aggregating separate corporations. A relief provision obviously should cover the situation where an estate owned stock in more than one corporation. On the other hand, the relief provision should not allow an estate with a stock portfolio to be eligible for the aggregating rule.

The test adopted by Congress in 1954, which is still in effect under the present Code, provides that the stock of more than one corporation may be aggregated if more than seventy-five percent of each corporation is owned by the estate. The “more than seventy-five percent” rule is based upon the value of the outstanding stock. The legislative history fails to disclose why the seventy-five percent figure was used, except that Congress sought to restrict the relief given.

Again, section 303 seems to be paradoxical. In determining the qualification for the general requirements of section 303, there is no requirement regarding the percentage of stock which the decedent owns as compared to the percentage of stock outstanding. However, for purposes of aggregating corporations, Congress has looked to the percentage of stock owned by the decedent with respect to the value

34. I.R.C. § 303(b)(2)(B) now provides as follows:
   For purposes of the 50 percent requirement of subparagraph (A), stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as the stock of a single corporation.

35. Although it is not expressed in the Committee Report it is evidence that the requirement that 75 percent in value of the stock must be included in the decedent's gross estate before the stock of two or more corporations may be used to meet the basic tests of section 303, reflects the view of Congress that the redemption provisions under section 303 should not be construed as granting permission for an investment portfolio of the decedent to be redeemed on such favorable terms.

of the outstanding stock. The statute leads to results which are inconsistent with congressional intent. Consider the situation of a decedent who dies with a $1,000,000 adjusted gross estate and stock of a publicly held company which constitutes $550,000 (fifty-five percent of the adjusted gross estate). The estate would qualify. Compare this with a second estate with an adjusted gross estate value of $1,000,000, which consists of stock of three corporations, each with a value of $300,000. If the decedent only owned seventy-five percent of the value of each stock with the remaining twenty-five percent owned by his son (and excludable by the estate), the decedent’s estate would not be eligible for section 303 treatment. Here, the congressional purpose of providing relief for the closely held business is thwarted.

Illustrative of this result is Estate of Byrd v. Commissioner, where the court strictly construed the “over seventy-five percent test.” In Byrd, the estate owned eighty-nine percent of the stock of a banking corporation named Peoples Savings and also stock in three other corporations, none of which interest exceeded seventy-five percent of the outstanding stock of that corporation. The valuation of the estate’s eighty-nine percent interest in Peoples Savings fell short of the section 303 amount requirements of either thirty-five percent of the gross estate or fifty percent of the net estate. Although each of the three holdings in the other corporations did not meet the seventy-five percent test for aggregation, the estate attempted to justify section 303 redemption by aggregating the stock of the other corporations with that of Peoples Savings. This would easily put the estate over the fifty percent test. The estate substantiated its aggregation in spite of its not passing the seventy-five percent test by utilizing the attribution rules of section 318. The estate claimed that because Peoples Savings coincidentally owned substantial amounts of stock in the three other corporations, the ownership of that amount of stock could be indirectly attributed to the estate. This addition, therefore, would allow the amounts of stock held by the estate in the three other corporations to exceed the “over seventy-five percent test,” and thus be aggregated.

The court reasoned, however, that the basic concept of corporate holdings does not allow indirect attribution of assets in this way. It therefore held that no aggregation was possible and that none of the section 303 requirements for redemption was met.

36. 388 F.2d 223 (5th Cir. 1967).
37. See generally Henkel, How to Dispose of a Decedent’s Interest in a Proprietorship, Partnership or Corporation; The Structure of and Parties to, the Transaction, N.Y.U. 34TH
DEMISE OF SECTION 303

If Peoples Savings had qualified under section 303 the taxpayer could have avoided the results in Byrd by changing the nature of the transaction. For example, the three corporations could have made the cash available to Peoples Savings and then the estate could have redeemed the stock of Peoples Savings. In the alternative, the other three corporations could have purchased Peoples Savings shares from the estate. In this way, the taxpayer would have qualified under section 303, which would treat the transaction as a redemption rather than a sale. If it were a redemption, the transaction would be treated as though Peoples Savings had redeemed its own shares for section 303 purposes even though the money came from the other corporations.

The Internal Revenue Service strictly construes qualification under the "over seventy-five percent" test. In Revenue Ruling 69-5944 the Internal Revenue Service held that blocks of stock of two separate corporations held by decedent on the date of his death are considered separate corporations where the stock of one corporation is exchanged for the stock of the other corporation in a nontaxable exchange prior to the election of the alternate valuation date.

V. QUALIFICATION OF SHAREHOLDERS

A. Law Prior to the 1976 Reform Act

Under the prior law, any holder of qualifying shares could redeem under section 303. When section 303 was originally enacted, there were at least two methods by which Congress could have restricted the redemption to certain shareholders holding qualifying stock. The first method could have been to allocate the total amount received under section 303 pro rata to all distributees. Secondly, the Code could have provided a tracing of funds so that the executor would be entitled to a preference to the extent that he paid death taxes and expenses.

In order to restrict the scope of section 303, the Service promulgated Treasury Regulation section 1.303-2(f), which provided that section 303 was not applicable where stock is redeemed "from a

---

38. I.R.C. § 304(a)(1) specifically provides that a redemption covered by section 304 can qualify for section 303 treatment.
40. 1969-2 C.B. 44.
41. For example, the recipient of a gift in contemplation of death or a joint tenant might qualify. Treas. Reg. § 1.303-2(f) (1955) (amended 1964, 1975).
42. 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION 378 (1974).
stockholder who has acquired the stock by gift or purchase from any person to whom stock has passed from the decedent . . . [or] who has acquired the stock from the executor in satisfaction of a specific monetary bequest.” This Regulation could cause a problem where a beneficiary has received stock in satisfaction of a specific monetary bequest.43

One of the leading cases prior to the 1976 Reform Act was United States v. Lake.44 In that case decedent’s daughter borrowed funds and purchased shares from the estate, part of which were subsequently redeemed by the corporation. The proceeds were used to repay the loan and provide cash for the payment of estate taxes. The district court held that section 303 was available on two grounds.45 First, the court found the taxpayer was not a purchaser since the shares purchased would have been transferred to a testamentary trust which was established for her benefit.46 Second, the court would not support Treasury Regulation section 1.303-2(f).47 The court stated:

The language of Section 303 of the Internal Revenue Code of 1954 is plain and unambiguous, and its application can neither be limited nor expanded by treasury regulation or other administrative action, whether based upon language in reports of legislative committees or otherwise. The regulatory provision relied upon by the defendant is an invalid limitation upon the plain language and applicability of Section 303 of the Internal Revenue Code of 1954.48

The fifth circuit affirmed the district court on a different ground. It decided that the taxpayer was indeed a purchaser, since it felt she obtained greater ownership by purchase than by being a beneficiary of the trust. Moreover, the Fifth Circuit refused to rule on the validity of Treasury Regulation section 1.303-2(f). The court expressed its reasoning as follows:

“Purchase,” as employed in the regulation, should be construed

43. For example, this could be applicable to a surviving spouse who receives a pecuniary bequest pursuant to a marital deduction provision in the will. See Rev. Rul. 70-297, 1970-1 C.B. 66-67.
46. Under Texas law she would have been considered the owner of the shares subject to the rights of the other beneficiaries. Tex. [Civ.] CODE ANN. tit. 125A, § 7425b-43 (Vernon 1960).
in light of the policies that moved Congress to adopt § 303. The Congressional purpose, as we have noted above, was to avoid dividend taxation of proceeds used to pay death taxes, administrative costs, and funeral expenses. Since the statute was drawn more broadly than its strict purpose would justify, the Treasury sought to limit its applicability by withholding § 303 benefits from redeeming parties who acquired their stock by purchase. The restriction, it may be conceded, makes sense: Shareholders who purchase stock that has passed through an estate do not usually bear the brunt of the estate taxes and expenses. If A dies and bequeaths his stock to B, whose testamentary share is diminished by estate taxes, and B later sells the stock to C, it is difficult to see why C, upon redeeming the stock, should enjoy the tax advantages merely because the stock passed at one point through A's estate. Nothing on the face of the statute, however, would preclude that result. It was to eliminate the abuses which a literal reading of § 303 might allow that the Regulation provided for exclusion of purchasers.

It is fundamental, however, that the language of statutes and regulations, insofar as they admit more than one meaning, cannot be read in isolation. They must be construed with the congressional purpose in mind. Since the purpose of the "purchase" exclusion is to deny special treatment to those who do not redeem stock in order to pay estate taxes, it should not be extended to cover those who do redeem to pay estate taxes.49

B. Present Law

Section 303 of the Code now limits those shareholders who can utilize the benefits of that section.

Section 303(b)(3) provides as follows:

(3) Relationship of shareholder to estate tax.
Subsection (a) shall apply to a distribution by a corporation only to the extent that the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by any payment of an amount described in paragraph (1) or (2) of subsection (a). [Payment of estate taxes or funeral and administrative expenses.]

Accordingly, under present law, only those shareholders whose "interest . . . is reduced" can utilize section 303.

The House Ways and Means Committee report on the provision indicated that the stock that can qualify for capital gains treatment

49. 406 F.2d at 949-50. It is interesting to speculate what the results of the case would have been under present section 303(b)(3).
is limited to stock which is redeemed from a shareholder who has the liability for estate taxes, or funeral and administrative expenses, in an amount equal to the amount received from the redemption. Thus, the solution by Congress to limit those shareholders who can utilize section 303 followed neither of the two solutions discussed previously in that there is no pro rata allocation to all distributees nor a tracing of funds with a preference given the executor. The congressional solution under section 303(b)(3) not only severely limits the use of section 303, but poses many problems of interpretation. Ultimately, the use of section 303 may depend on how the Service interprets the section 303 requirements.

An examination of the effect the new section 303 will have on some of the more common testamentary dispositions follows.

1. WIDOW AS SOLE BENEFICIARY

A common situation is where a widow is sole beneficiary of the estate and the stock of the closely held corporation passes to her under decedent's will. In such a situation, the executor would first bear the burden of all estate taxes and funeral and administrative expenses and the executor would be eligible to redeem stock under section 303. If instead of the executor redeeming the stock, all the stock were distributed to the widow, she would probably be eligible to redeem under section 303 since she would bear the liability for estate taxes and funeral and administrative expenses.

Assuming the same facts as above, except that the shares of stock of the closely held corporation were held in joint names but includable in the gross estate so that it passes to her outside of the probate estate, she still should be eligible to redeem these shares.

2. THE MARITAL DEDUCTION AND TESTAMENTARY TRUSTS

Assume that decedent left a widow and two children. The will provides for the widow to receive outright the maximum marital deduction with the remaining asset to pass in a nonmarital deduction (family) trust. This type of trust would generally provide income payable to the widow for life and upon her death, the corpus

52. I.R.C. § 2002. The term "estate taxes" as used herein refers to estate, inheritance, legacy and succession taxes.
53. Technically, the Service could argue that under section 2002 the executor (who never possessed the stock) has the liability and she is not eligible under section 303. On the other hand she ultimately bears the liability since her interest in the estate is reduced.
to be paid equally to the surviving children per stirpes. The estate includes stock of a closely held corporation which constitutes more than fifty percent of the adjusted gross estate. The will further provides that all estate taxes, funeral and administrative expenses are to be paid by the estate and that the marital deduction bequest to the widow shall not bear such taxes or expenses.

Based on the above facts, which shareholder's interest is reduced under section 303(b)(3) by reason of the payment of the estate tax, funeral and administrative expenses? Assuming first that the decedent owned the stock jointly with his wife, and the stock passed to her outside of the probate estate, she would not be eligible to redeem the stock. The reason for the noneligibility is that she would not bear the burden of estate taxes, funeral or administrative expenses since the will specifically provides that property eligible for the marital deduction should not bear the estate tax burden.

It could be argued that since the widow is the sole income beneficiary of the nonmarital deduction trust, payment of the taxes and expenses would reduce the corpus of the trust and, accordingly, her income.

Changing the facts slightly, let us assume that the stock of the closely held corporation were held in decedent's sole name and thus became a probate asset. Initially, the estate is shareholder and the executor is responsible for payment of estate taxes and funeral and administrative expenses. It would seem, therefore, that if the executor redeemed the shares, the estate would qualify under section 303 since it is a shareholder and it is paying the taxes and expenses. Suppose, however, after the redemption of the stock under section 303, the executor distributes the stock of the closely held corporation to the widow in partial satisfaction of her marital deduction. Since the will provides that property passing under the marital deduction does not bear the estate taxes or expenses, does the distri-

54. This is a commonly used method of disposition.
55. Joint ownership of stock is also a common situation.
56. Since there are no regulations to date covering this situation, it is presumed that the Service would not allow the widow to redeem stock jointly held merely because she is an income beneficiary of a trust. It could be argued, however, that she might be forced to sell the stock if her income is reduced by payment of taxes and expenses; therefore, she should be allowed to redeem her shares under section 303.
58. This result is not clear under a literal reading of section 303(b)(3) since the estate is a transitory shareholder and there is a question whether the estate as such really has an "interest" within the meaning of section 303(b)(3).
bution nullify section 303 treatment?  

Now assume that the taxes and expenses are paid by the executor, and there is no redemption by the executor. Subsequently the stock is distributed by the estate to the trust. The trust is a shareholder whose "interest" is reduced. The trust should be able to redeem the stock under section 303, since the trust's interest is reduced by payment of the taxes and expenses.

In certain circumstances, however, the trust may be merely a further conduit for the beneficiaries and it would be questionable whether the trust could redeem the shares. For example, if there is a trust for the benefit of a child or children with a payment at age twenty-five and one of the children reaches twenty-five during administration of the estate, would the trust be considered a shareholder?

The resolution of these and other problems will ultimately depend upon the position of the Internal Revenue Service, as reflected in its regulations, and the courts.

VI. Income Tax Consequences of the Redemption

One of the most important changes in the Tax Reform Act of 1976 was the enactment of the carryover basis rules.

Prior to 1976 most redemptions under section 303 were income tax free because the tax basis of the stock involved was stepped-up to the fair market value as of the date of death of the decedent, or the alternate valuation date. Under the Tax Reform Act of 1976, however, the executor of an estate or other redeeming stockholder is faced with a problem of income tax liability by reason of the redemption of closely held stock under section 303.

---

60. Suppose the redemption took place shortly after the executor was appointed but the distribution of stock did not take place for several years thereafter. Should this affect the result?

61. A literal reading of H.R. Rep. No. 1380, 94th Cong., 2d Sess. 35, reprinted in [1976] U.S. Code Cong. & Ad. News 3356, 3389, indicates that the redemption proceeds must be used to pay the taxes and expenses. It is doubtful, however, that the Internal Revenue Service will take this position.

62. It might be argued that the children are the "beneficial owners" of the stock and, therefore, the trust is not eligible to redeem the stock. In such a case redemption under section 303 would not be possible from any trust—an unlikely interpretation.

63. This, in turn, may depend upon whether the stock is distributed to the age 25 child or whether it is accumulated in the trust. See Rev. Rul. 70-297, 1970-1 C.B. 66.

64. I.R.C. § 1023.

65. On occasion, there would be gain or loss where the stock of the closely held corporation either appreciated or depreciated between the date of death or alternate valuation date and the redemption.

66. There also could be a loss on the redemption which could give rise to problems under section 267. See Estate of Hanna v. Commissioner, 320 F.2d 54 (6th Cir. 1963); Sommers,
With respect to estates, each is a separate taxpayer and is subject to income tax liability. If the estate redeems stock under section 303, it will be initially responsible for the payment of income taxes. If the estate, however, in the same taxable year in which the redemption occurs distributes amounts to a beneficiary, the estate may, depending upon the terms of the will, get a deduction for such amounts up to the amount of the estate's distributable net income. The beneficiary in such case would realize income to the extent of the distributable net income.

The question of whether the estate gets the deduction and the beneficiary reports the income will depend upon the terms of the will. If the executor of the will has the discretion to allocate capital gains to income, and makes such an allocation with respect to its capital gain on the redemption, then the estate will obtain the deduction and the beneficiary will report the income. If the executor does not have such discretion, then the estate would pay a capital gains tax since capital gains would not be part of income. The capital gains tax would reduce the estate assets which presumably would reduce the interests of the residuary beneficiaries. Furthermore, additional cash funds would have to be raised by the executor to pay the income tax. Thus, if the executor does have the authority to allocate capital gains to income, the ultimate burden of the income tax liability will vary depending upon the actions of the executor.

The Code provides that a beneficiary of an estate must include in his income all amounts distributed to him up to the amount of the distributed net income. For example, assume an estate redeems stock pursuant to a section 303 redemption resulting in a capital gain by reason of the redemption. The will provides for a maximum marital deduction to the widow with remainder to the decedent's children. The marital deduction amount is not to be diminished by estate taxes and expenses. The executor elects to


68. This assumes that the estate is eligible for section 303 treatment.
69. I.R.C. § 661.
70. I.R.C. § 662. Normally the income realized will be considered a capital gain.
72. Id. If the distribution were made in the final year of the estate, however, then the estate would be deemed to distribute capital gains, resulting in a deduction to the estate and income to the beneficiary. Treas. Reg. § 1.643(a)-3(a)(2) (1956).
73. This assumes that there is no will provision to the contrary.
74. I.R.C. § 662.
75. Id. For certain exclusions from this rule, see I.R.C. § 663.
treat capital gain as income. During the same tax year he makes a partial distribution to the widow in satisfaction of her marital bequest. The widow pays the capital gains tax and would bear the brunt of the tax, thereby reducing the net amount she economically receives.76

Other examples exist where there are multiple trusts or multiple beneficiaries and distributions are made to one or more beneficiaries during the same taxable year in which an estate redeems stock under section 303.77

VII. QUALIFICATION OF AMOUNT

Section 303 limits the amount qualifying as a redemption to the amount of estate inheritance, legacy and successor taxes imposed by reason of death and the amount of funeral and administrative expenses allowed as a deduction under section 2053.78 There is no requirement that the funds acquired by reason of the redemption actually be used to pay the taxes or expenses.79

For purposes of section 303, the amount of the Federal Estate Tax or other taxes is the net amount after allowance of any credit, relief, discount, refund, remission or reduction of taxes.80

Section 303 can be utilized where only state estate taxes are payable without any liability for the Federal Estate Tax.

VIII. TIME LIMITATIONS

Code section 303(b) provides that a distribution must be made within specific periods as provided in that section. There are three provisions covering the time limitation.

A. Distributions Within a Period of Assessment

Section 303(b)(1)(A) provides that the distribution must be made within the period of limitations provided in section 6501(a) which is three years from the date the estate tax return is filed (without regard to extensions of time to file), or ninety days after the expiration of that period.

76. I.R.C. § 662; Treas. Reg. § 1.663(a)-1(b) (1956). This example assumes that no other distributions are made during the taxable year.
77. The same would be true with respect to a testamentary trust which redeems stock and in the same taxable year makes a distribution to a beneficiary after allocating the capital gains to income.
78. I.R.C. § 303(a).
79. But see note 61 supra.
Section 303(b)(1)(A) presents several problems. Assume, for example, the estate files an early return. Does this reduce the amount of time available? The Service has ruled no. On the other hand, assume that the return is filed late. Does this extend the period of limitations? The Government has ruled yes, since the statute of limitations does not begin to run until the return is actually filed. This result seems incongruous, since a taxpayer who files a timely return is limited in the amount of time he can use if he plans on redeeming stock. If instead the taxpayer is delinquent in filing returns, he thereby extends his period of limitations. Unfortunately, there is no authority for the Commissioner to extend the period of limitations by consent.

B. Tax Court Petition

The second period of limitations, governed by section 303(b)(1)(B), covers a situation in which a tax court petition has been filed. In such cases, the redemption period is extended to sixty days after the tax court decision becomes final. This provision seems logical where there is a dispute which results in tax court litigation, but consider the situation where there is a dispute as to the estate tax deficiency but the dispute does not reach the tax court. Assuming a taxpayer does not wish to litigate the matter, the statutory period under section 303 would still not be extended. Accordingly, section 303(b)(1)(B) promotes litigation in tax court rather than settlements.

Another fault with section 303(b)(1)(B) concerns the situation where the taxpayer wishes to dispute the amount of deficiency and has the choice of filing a petition in tax court or paying the deficiency and suing for a refund in the district court or court of claims. In such a case, if the district court or court of claims procedure is followed, there would be no extension of the statutory period.

It may be possible to avoid the limitations of sections 303(b)(1)(A) and 303(b)(1)(B) if a corporation redeems the stock within the statutory period and issues notes for the amount payable.

---

83. I.R.C. § 303(b)(1)(B). Treasury Regulation section 1.303-2(c) states that where the litigation is not bona fide, but rather intended for the purpose of extending the period of limitations, section 303(b)(1)(B) will not apply.
84. I.R.C. § 303(b)(1)(A).
85. See Davis v. United States, 277 F. Supp. 602 (W.D. Pa. 1967) (holding that if the matter is settled by agreement, the period of limitations is not extended).
C. Payment of Taxes in Installments

The Tax Reform Act of 1976 includes section 303(b)(1)(C), a third period of limitation during which the stock can be redeemed. This limitation period applies only where an election has been made under section 6166 or section 6166A. In such cases, the time period is extended to the time determined under section 6166 or 6166A for the payment of the installments. 87

Generally, section 6166 provides for payment of the estate tax over a fifteen year period. 88 In order to qualify under this provision, the gross estate must include the value of an interest in a closely held business and such value must exceed sixty-five percent of the adjusted gross estate. 89 The term “interest in a closely held business” is specifically defined by that section. 90

Section 6166A also provides for an extension of time for payment of estate taxes where an estate consists of an interest in a closely held business. Under this provision, the estate tax can be paid over a ten year period. 91 To qualify under this section, the value of the interest in the closely held business must exceed either thirty-five percent of the value of the gross estate or fifty percent of the taxable estate. 92

A major difference between section 6166 and section 6166A, aside from the longer period provided under section 6166, is that under section 6166, interest is payable at a rate of four percent. 93

Thus, under the Tax Reform Act of 1976, if an estate elects to pay its estate taxes under section 6166 or section 6166A, the period of time for redemption under section 303 can be extended if all the section 303 qualifications are met. 94 If, however, distributions are made more than four years after the decedent’s death, the redemption will qualify only to the extent of the lesser of either the estate taxes and funeral and administrative expenses unpaid prior to the redemption, or the amount of the payment of such estate taxes and

88. I.R.C. § 6166(a)(1)-(3).
89. I.R.C. § 6166(a)(1).
90. I.R.C. § 6166(b)(1).
91. I.R.C. § 6166A(a), (e).
92. I.R.C. § 6166A(a).
93. I.R.C. § 6601(j).
94. As subsequently discussed, sections 303, 6166, and 6166A have different qualifications of eligibility so that it is possible that an estate could qualify under section 6166 or section 6166A and still not qualify under section 303. Compare I.R.C. § 6166(c) with I.R.C. § 6166A(d) and I.R.C. § 303(b)(2)(B).
funeral and administrative expenses made within one year after the date of the redemption.\(^95\)

There appear to be no policy considerations supporting distinctions among the various provisions covering the redemption period with respect to extension of such period.\(^96\) If a redemption is made within a four year period from the date of decedent’s death, then there is no requirement that the funds from the redemption actually be used to pay estate taxes and funeral and administrative expenses.\(^97\) If the redemption is made after the four year period, the Code imposes a requirement that these expenses (at least to the extent of the redemption proceeds) be paid within a one year period, presumably from the funds acquired from the redemption.\(^98\) If a requirement were to be imposed for payment of estate taxes and funeral and administrative expenses from the redemption proceeds, then section 303 should so provide on a uniform basis and not on a cutoff basis of four years. It may be argued, however, that section 303 should only be applicable for the normal statute of limitations period (plus ninety days) and that any extension in addition is a matter of “grace.” Therefore, the only amount qualifying for redemption during the “grace” period should be the amount actually used to pay estate taxes and funeral and administrative expenses. Such a view, however, is hard to reconcile with the section 303 provisions since section 303 also provides for extension by reason of tax court litigation, even though such litigation may be unjustified.\(^99\)

There also are no policy considerations supporting the distinctions between the requirements of section 303 and the requirements of section 6166 and section 6166A. Section 303 provides that the stock of the qualifying corporation must exceed fifty percent of the value of the gross estate less estate taxes and funeral and administrative expenses.\(^100\) Section 6166 provides that the value of an interest in a closely held business must exceed sixty-five percent of the adjusted gross estate.\(^101\) The adjusted gross estate is defined as a value of the gross estate less deductible amounts for expenses, indebtedness, taxes and losses as defined in sections 2053 and 2054.\(^102\)

95. I.R.C. § 303(b)(4).
97. *But see* note 61 *supra*.
98. I.R.C. § 303(b)(4)(A), (B).
100. I.R.C. § 303(b)(2)(A).
102. I.R.C. § 6166(b)(6).
Section 6166A requires that the value of an interest in a closely held business exceed either thirty-five percent of the value of the gross estate or fifty percent of the taxable estate. Thus, the threshold requirements of these sections are not uniform. Yet, if Congress intended to ameliorate the payment of estate taxes where the estate consists in part of a closely held business, it would seem logical to use the same or similar definition in corresponding sections which provide relief where the estate contains a closely held business.

In addition, there are inconsistent definitions of "closely held business." Section 303 contains no explicit definition of a closely held business, but limits the application of section 303 to corporations since section 303 only refers to stock. Section 6166 and section 6166A also contain no explicit definitions of a closely held business, but contain differences in the maximum number of partners or stockholders necessary to qualify the business as closely held.

The inconsistencies between sections 303, 6166 and 6166A continue with respect to merging several businesses owned by the decedent for the purpose of qualification. Under section 303, multiple corporations can be merged for purposes of section 303 where more than seventy-five percent of the value of the outstanding stock is includible in the gross estate. Under section 6166, the test is the inclusion of more than twenty percent of the total value of each "business" whether or not incorporated. Under section 6166A, the test is for inclusion of more than fifty percent in value of each "business." Thus, there appears to be no uniform policy for ameliorating taxes where the decedent's estate includes a closely held business.

IX. Conclusion

Under the Tax Reform Act of 1976, much of the usefulness of section 303 has been eliminated. In addition to the various problems discussed above, the more serious question arises from the income tax consequences of the redemption.

The income tax on the redemption is based upon the difference between the amount received from the redemption and the tax basis of the stock. This tax increases the amount of cash needed which

103. I.R.C. § 6166A(a).
106. I.R.C. § 6166(c).
increases the hardship on the estate where a closely held business is involved. A possible solution, in addition to the previous suggestions mentioned, might be to allow a limited stepped-up basis for stock which is eligible for the redemption provisions of section 303. Such basis could be increased to the fair market value as of the date of death or the alternate valuation date. This solution has been adopted by Congress where appreciated property is used to satisfy a pecuniary bequest.108 This type of approach would seem useful in conjunction with section 303 redemptions.

What is presently needed is a revision of section 303 and the other provisions which purport to grant estate tax relief to the closely held business, with a view toward providing uniform provisions and true relief where the estate includes a closely held business.