IT'S NEVER TOO LATE TO REDEEM YOURSELF: REDEMPTIONS AS AN ESTATE PLANNING TECHNIQUE

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When a client engages an estate planning attorney to assist with business succession planning, transfers of economic interests in the business usually top the list. The most common methods to accomplish these transfers are gifts (outright or in trust), sales of stock to family members, and Grantor Retained Annuity Trusts. Each method has advantages, but each also has drawbacks. For example, any gift of an amount over the client's remaining lifetime exemption will be subject to a substantial gift tax. And if the client sells an interest in the business, capital gains tax will usually be imposed. As we discuss below, when the proposed transferee is already a part-owner of the business, redemption of the client's interest by the business will sometimes be a more tax efficient means of transfer than either a gift or a sale.

I. HISTORICAL BACKGROUND

Redemption of corporate shares is the reacquisition of those shares by the issuing corporation. Treating redemption proceeds as a tax-free dividend has historically been an effective method for transferring an owner's interest in a family-held S corporation. For owners of C corporations, however, redemptions have only recently become a useful planning strategy.

Although Congress had lowered capital gains tax rates to 20 percent in 1997, prior to 2003, dividends were taxed at ordinary income rates.[1] It was therefore more advantageous to treat redemptions as exchanges, which were subject to lower capital gains tax. However, redemptions that do not result in a meaningful reduction of the shareholder's proportionate interest in the company are required to be treated as dividends, which were taxed at the higher ordinary income rate.[2]

In 2003, Congress included qualified dividend income as capital gain and lowered the capital gains rate to 15 percent, effectively eliminating the difference between treating a redemption as an exchange or a dividend.[3] This allowed owners in family-held C corporations to consider redemption as an alternative to a gift or sale.

II. ANALYSIS OF A REDEMPTION

S corporation shareholders are taxed on their pro rata share of the entity's income at their individual income tax rates, whether or not the income is actually distributed to the shareholders.[4] Amounts actually distributed do not incur an additional tax, provided they are treated as a dividend.[5]

In contrast, dividend distributions to C corporation shareholders, including redemptions of stock that are treated as dividends, are taxed at 15 percent, the same as capital gains rates.[6] Unlike a sale, however, when a redemption is treated as a dividend, the shareholder's basis in the redeemed stock is not deducted from the amount recognized. However, that basis is not lost forever. It is reallocated among the retained shares. It can be used later against a subsequent sale of the retained shares.

A redemption of stock is treated as a dividend when it is "essentially equivalent" to a dividend.[7] The Internal Revenue Code (IRC) does not define "essentially equivalent," but provides that if the redemption of stock is "substantially disproportionate" among shareholders or a complete termination of the redeeming shareholder's interest, it is treated as an exchange subject to capital gains treatment rather than a dividend.[8] The Supreme Court has confirmed that a redemption of part of a *sole* shareholder's interest is "essentially equivalent" to a dividend because the effect is to "transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the [shareholders]."[9]

In determining whether a redemption is substantially disproportionate or a complete termination of the redeeming shareholder's interest, constructive ownership rules apply. These rules tell us that a person constructively owns any shares held by his or her spouse, children, parents, or grandchildren.[10] In the case of a business held by several family members, this rule can operate to deem one shareholder the constructive owner of all shares. For example, if a company has a total of 20 outstanding shares and the mother owns 10 shares and her daughter holds the other 10 shares, the mother constructively owns all 20 shares. In such case, even a complete redemption of the mother's interest would not be substantially disproportionate, nor a complete termination of the mother's interest, because her constructive ownership of 100 percent of the outstanding shares through her daughter remains unchanged after the redemption.[11]

III. THE PRACTICAL USES OF REDEMPTIONS

Redemptions have been a staple of transfer planning at death for decades. The special treatment of corporate redemptions at death[12] is a testament to the popularity of redemptions to meet the liquidity crises brought on by death. There are also practical uses for inter vivos redemption.

Redemptions are most effective when a shareholder wishes to gift his or her shares to the remaining shareholders in proportion to the remaining shareholders' current interests. This can work with one class of common stock or with both voting and nonvoting common stock. It is also important that the company has cash avail-

able to redeem the shares; preferably, it has been paying regular dividends that it can suspend and use that cash to redeem the owner's interest. Ideally, the redeeming shareholder and the other shareholders have alternate sources of income and do not rely on dividends from the business. One cost of an ongoing redemption program that should be explained to the client upfront is annual appraisals to determine the value of the shares.

Redemptions are not a one-size-fits-all solution. In the family business context, they are often used as an alternative to a sale when the children do not have enough money to buy the stock. If the transaction is partly driven by the parents' desire to maintain a certain level of cash flow, the parents and children may agree to a lower redemption price for the stock with additional income paid to the parents in the form of a consulting fee. This is possible when the parents provide a service to the business, which is often the case in a family-owned business.

A. C Corporation Redemptions

Qualified dividends are taxed at 15 percent, just like capital gains (at least for the time being). At the corporate level there is no deduction for the distribution, and so long as appreciated property is not being used to accomplish the redemption, there is no taxable gain to the corporation.

As an example, ABC Corporation is a business operated as a C corporation and regular dividends are being paid to the shareholders. The parents own 65 percent of the company and the son, who is running the business, owns 35 percent. The son has no need of the dividend income, as he can (within reasonable limits) adjust his deductible compensation to maintain his cash flow.

What if ABC Corporation stops paying pro rata dividends and instead redeems shares from the parents every year with all of the cash previously used to pay dividends? Initially, there is not much movement in the parents' ownership, but as their percentage interest declines, each annual redemption reduces their interest in the company by a larger and larger percentage. It will not take many years until the parents are fully redeemed.

To illustrate how this works, assume there are 1,000 shares outstanding and the parents own 650 shares. Each share is worth $1,000. Instead of paying a $50,000 dividend to all shareholders, the full $50,000 is used to redeem 50 shares from the parents. The parents now own 600 out of 950 shares — a modest reduction in their percentage interest from 65 percent to 63 percent. But if this program is continued for 13 years, the parents' interest is completely redeemed with no change in what they were already doing anyway and with no taxable gifts. They can further reduce their interests with annual exclusion gifts of shares each year. At some point the basis in the stock will be equal to the value of the stock. At that time it will be necessary to file an agreement under IRC section 302(c)(2) to prevent the application of the constructive ownership rules, which will allow the parties to use their basis in this final redemption.

Year	Total Shares	Parents' Starting Shares	Shares Re-deemed	Parents' Ending Shares	Total Ending Shares	Parents' % Ownership at Year End
1	1,000	650	50	600	950	63%
2	950	600	50	550	900	61%
3	900	550	50	500	850	58%
4	850	500	50	450	800	56%
5	800	450	50	400	750	53%
6	750	400	50	350	700	50%
7	700	350	50	300	650	46%
8	650	300	50	250	600	41%
9	600	250	50	200	550	36%
10	550	200	50	150	500	30%
11	500	150	50	100	450	22%
12	450	100	50	50	400	12.5%
13	400	50	50	0	350	0%

B. S Corporation Redemptions

S Corporations are especially susceptible to this technique because S corporation dividends are not taxable. That means that stock redemptions that are "essentially equivalent to a dividend" are free of tax to the redeemed shareholder.

Considering ABC Corporation again as an S corporation, the attribution rules would result in the parents owning—outright or constructively—all of the shares both before and after the redemptions. The redemptions would therefore be considered "essentially equivalent" to a dividend and tax-free to the parents. As the parents' ownership interest is decreased, the son will pay tax on an increasing percentage of the corporate income, but actual dividend distributions to pay the S corporation taxes will continue as before and the son will receive an increasing percentage of those divi-

dends. At some point, the son may want to redeem all of his parents' remaining shares with a promissory note. Assuming no IRC section 302(c)(2) election, the redemption is recognized for income tax purposes on receipt of the note, but because it is treated as a dividend there is no tax to the parents by reason of the redemption. And if the redemption occurs on December 30, the parents will pay the tax on the income of the corporation attributable to the redeemed shares for the 364 days that they owned them. The son will pay the income tax attributable to his shares for that year and 1/365 of the tax attributable to the redeemed shares. Looking forward, he will pay the tax attributable to the cash used to make the payments on the note to his parents. But this means that only one tax is paid: on the corporate income. The redemption itself is tax-free.

Clients and their advisors need to focus on the basis calculation as mentioned in the discussion about C corporations. Each year, the parents' basis is decreased because distributions to them exceed their share of the income. When the parents' basis gets to zero (or close to it), the redemption should be completed. At that point, the redemption should be treated as a complete termination, and the final payment will be taxed at capital gains rates.

IV. A WORD OF CAUTION

Redemptions are not appropriate in every situation. They do not allow an owner to transfer ownership disproportionately to family members who are more actively involved in the business. In these situations, the family may want a separate plan to reduce the ownership of the uninvolved shareholders or provide additional compensation to the active shareholders. This technique also will not work if the owner wishes to transfer the interest to a sibling, cousin, aunt, uncle, niece, nephew, or other family member who does not have constructive ownership under IRC section 318. Further, if the business in question is a C corporation and the 2003 tax act is repealed or not extended, this approach will not be beneficial, since dividends will again be taxed at ordinary income rates.

V. CONCLUSION

Do not overlook the use of entity distributions to achieve a shift in equity ownership through a long-term plan for the redemption of interests. S corporations held by parents and their children that have sufficient cash can be prime candidates for such redemptions. If parents plan to transfer their interests to their children pro rata, redemption may be a tax-effective method to achieve their goal.

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ENDNOTES

1. White House Council of Economic Advisors, Pro-Growth Tax Policy (July 2, 2008).
2. See *United States v. Davis* (1970) 397 U.S. 301.
3. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 301, 302 (May 28, 2003), 117 Stat. 752.
4. IRC, § 1366; *Knott v. Commissioner* (1991) 62 T.C.M. (CCH) 287.
5. Under Subchapter S, for a corporation that has no C corporation earnings and profits, dividends are deemed to come first out of the corporation's Accumulated Adjustments Account ("AAA"). AAA is the aggregate of all previously taxed but undistributed S corporation income. If the shareholder has sufficient basis in his shares, the full amount of the distribution, to the extent of AAA, will be tax-free. The shareholder's basis in his retained stock will be reduced by the amount of the distribution.
6. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302 (May 28, 2003), 117 Stat. 752.
7. IRC, § 302(b)(1).
8. IRC, § 302(b)(2), (3).
9. *United States. v. Davis*, *supra*, 397 U.S. at pp. 307, 313.
10. IRC, § 318.
11. On a procedural note, in order to treat a complete termination as a dividend, the shareholder must not file the agreement under IRC section 302(c)(2) that prevents the application of the constructive ownership rules. For this technique to work, the constructive ownership rules must apply with full force.
12. IRC, § 303.

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