Section 303 Stock Redemptions: A Post-1976 Tax Reform Act Appraisal

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SECTION 303 STOCK REDEMPTIONS: A POST-1976 TAX REFORM ACT APPRAISAL

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I. Introduction

The principal asset of the estate of a deceased stockholder of a close corporation frequently consists of his shares of stock in the corporation. Problems can arise concerning the value to be accorded the shares, since commonly the issues are not publicly traded, and there is usually no readily available market for their sale. The problems of stock valuation together with marketability can compound themselves to cause the executor to compromise the sale of the stock at depressed prices in order to create the liquidity needed by the executor to pay estate taxes and administration expenses. If the stock is that of a family corporation, it often means loss of control within the family as the decedent's stock is sold to outsiders in order that the executor may meet his obligations to the estate.

Where no valuation of the stock has been planned for, the executor will on the one hand be attempting to place as low a valuation on the business interests as is prudently possible in order to minimize estate taxes, while on the other hand the Internal Revenue agent will be seeking to place as high a value on the stock as is possible in order to maximize estate taxes. The anomaly of this situation could be avoided with proper planning. It is possible to arrange for a ready market for the stock, and at the same time assure receipt of full value for the stock when sold by the executor.

The first approach to these special problems of the close corporation has in large part been borne by section 303 of the Internal Revenue Code of 1954 (hereafter referred to as Code). The redemption provided by section 303 has been referred to as "perhaps the most useful estate planning device available to the practitioner." Another commentator calls it "one of the most useful elections available to the executor of the estate of the owner of a closely held corporation..." in order "...to save or reduce the total tax impact to the estate or to the beneficiaries."

These auspicious remarks clearly indicate that section 303 has been viewed by many estate planners as an estate planning "tool" that is deemed to be of con-

5 Goldstein & Coleman, Section 303 Under the Tax Reform Act, 176 NYLJ, Nov. 15, 1976, at 1, col. 1.
6 Kurzman, supra note 2, at 1463.
7 Penner, supra note 1, at 1546.
8 Id. at 1545.
Section 303 provides us with an exception to the usual rule\(^9\) that distributions of property by a corporation in redemption of its stock will be treated as a dividend, by providing that when the special conditions of the section are complied with, the distribution in redemption "shall be treated as a distribution in full payment in exchange for the redeemed stock,"\(^9\) thus providing for taxation at the more favorable capital gain rates. The Tax Reform Act of 1976\(^12\) produced several significant changes, including among them a new percentage limitation for section 303; a new provision for the deferred payment of estate taxes (section 6166); and a new carryover basis provision (section 1023), all of which directly or indirectly affect one another. As a result of these changes, a redemption of section 306 stock has also been affected. That these provisions of the Code can have a major effect upon many estates in which the decedent was a stockholder in a close corporation is evident. It is essential, therefore, that a review of the section 303 stock redemption agreement be undertaken.

II. Purpose and Legislative History

Prior to 1950, estates which consisted largely of stock of a close corporation were often financially unable to meet payment of the estate tax and other costs without liquidating some or all of the stock of the decedent. One source of relief was the ten-year extension for payment of estate taxes. To obtain this extension, however, there had to be a showing of undue hardship, and the extension was granted grudgingly at the discretion of the Commissioner.\(^13\) This provision by itself therefore often fell short of the total relief needed. Another way for the executor to satisfy the estate tax was to sell all of the stock held by the estate. If there was a complete termination of all of the decedent's interest in the corporation, the distribution in redemption of all of the stock was treated as a sale in exchange for the stock and not as a dividend.\(^4\) This approach, however, often meant the loss of the corporation as a family concern.

In 1950, section 115 (G) of the 1939 Code was amended (to become the forerunner of section 303 of the 1954 Code) to provide that a distribution by a corporation in redemption of its stock would be exempt from dividend treatment by the shareholder if certain conditions were met.\(^15\) The Report of the Committee on Ways and Means stated that the purpose of the amendment was to prevent the forced sale of the family business, and its absorption by large corporations, which would eventually result in an unbalanced concentration of industry.\(^16\)

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9 Taft, supra note 2, at 30, col. 3.
10 I.R.C. § 301(a) [hereinafter cited as 1954 Code].
11 1954 Code § 303(a).
13 Int. Rev. Code of 1939, § 822(a) [hereinafter cited as 1939 Code].
15 1939 Code § 115(G)(3).
16 H.R. Rep. No. 2319, 81st Cong., 2d Sess. 54 (1950). "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
Section 115(G)(3) as it was originally enacted required that the value of the stock included in the estate comprise 50 percent of the value of the net estate in order for the proceeds of the redemption to be exempt from being taxed as a dividend.\textsuperscript{17} Where the test was met, an amount equal to the total of the estate, inheritance, legacy or succession, taxes could be redeemed. The following year, 1951, section 115(G)(3) was amended by changing the percent requirement from 50 percent of the value of the "net estate" to 35 percent of the value of the gross estate.\textsuperscript{18}

The 1954 Code introduced several important changes designed to broaden the existing provisions. In addition to the 35 percent test already noted, it was provided that a redemption would likewise qualify where the stock comprised 50 percent of the value of the net estate. The amount that could be redeemed was increased by adding funeral and administrative expenses to the amounts that would qualify for exemption from ordinary income treatment on redemption of the stock. The time for redemption was extended to 60 days beyond the final decision of the Tax Court concerning the estate tax liability. Also introduced was the provision that two or more corporations would be deemed to be one for purposes of meeting the percentum requirement of stock ownership where the stock of each corporation included in the estate comprised 75 percent of the value of all of the outstanding stock of the corporation. Finally, it was provided that if subsequent to his death, the decedent's stock should be exchanged in a tax-free reorganization, and the old stock would have qualified for the special exemption of section 303, then the new stock should qualify also.\textsuperscript{19}

These were broad and sweeping improvements, but Congress was not yet satisfied with the relief measures thus far enacted for the closely held corporation. As a result, in 1958 many of the original concerns attendant with the death of a shareholder of a close corporation were reiterated and section 6166 of the Code was added to provide that the estate taxes could be paid in ten annual installments.\textsuperscript{20}

The last change before the 1976 Tax Reform Act was made in 1969. In that year, section 303 redemptions were again altered, this time by the amendment to section 537 of the Code, which provided that amounts accumulated in the year of death and later years to redeem stock in a redemption to pay death taxes should not be considered unreasonable accumulations.\textsuperscript{21} Life insurance had come to be an often used means of funding the contemplated section 303 re-

\textsuperscript{17} Under the House Bill, qualifying distributions were to be exempt from dividend treatment only if the value of the stock comprised more than 70 percent of the value of the decedent's net estate. This 70 percent provision was eliminated by the Senate amendment as being overly restrictive. The percentage limitation was computed by taking as the numerator the value of the stock included in determining the value of the decedent's net estate, and by taking as the denominator, the value of the decedent's net estate. H. R. REP. No. 3124, 81st Cong., 2d Sess. (1959).

\textsuperscript{18} 1951 Act., § 320(b).


demption, and this provision made it clear that the lump-sum distribution to the corporation, as named beneficiary of the shareholder's life insurance, would not be subject to the accumulated earnings tax.

III. Statutory Discussion

A. Generally

There are several limitations and requirements to be considered by the tax planner prior to his making a decision with regard to whether he should use section 303 as an estate planning device. It should be borne in mind that section 303 is by no means the only method by which the payment of death taxes may be planned for. Where stock is redeemed from an estate and meets any of the tests of section 302(b), this redemption, too, will escape taxation as a dividend under section 301, and will be treated as a sale or exchange giving rise to capital gains. The attribution rules of section 318 that cause stock to be attributed to and from certain related individuals and entities, however, often make meeting the requirements of section 302(b) difficult or impossible. Hence, since the attribution rules of section 318 do not apply to section 303 redemptions, section 303 was distinctly engineered as an exception to the stricter tests of section 302(b) so that the special liquidity needs of the close corporation could at least be partially accommodated. It is possible, however, that the estate would fail to qualify for a section 303 redemption, but still qualify for capital gain treatment under one of the redemption provisions of section 302(b). Alternatively, the executor might want to plan for a 303 redemption, followed by a qualifying 302(b) redemption. Thus, strict attention must be paid to the statutory provisions of both sections.

B. Amount Redeemable

The total of the distribution proceeds that are allowed to be received in exchange for the stock redeemed is limited to the estate, inheritance, legacy, and succession taxes (including any interest collected as part of such taxes) imposed because of the decedent’s death together with the funeral and administration expenses allowable as deductions to the estate under Code section 2053. Those proceeds in excess of this amount must qualify for capital gain treatment, if at all, under some other provision of the Code. The seemingly obvious must be stated—the stock must first be “included in determining the gross estate” if the estate is to qualify to participate in a section 303 redemption. The gross estate means for this purpose the gross estate as computed in accordance with section

23 1954 Code, § 531.
25 If the estate can't meet the limitations that must be met before a section 303 redemption can be accomplished, it may nevertheless qualify, for example, under 302(b)(3) as a redemption in complete termination of a stockholder's interest in the corporation.
26 1954 Code, § 303(a).
27 Id. The stock must be included for federal estate tax purposes in determining the gross estate of the decedent.
It should be noted, however, that actual ownership of the shares at death is not necessary to cause their inclusion. For example, gifts made in contemplation of death and revocable transfers would be included in the gross estate. Thus, as to the redemption of stock included in the estates of decedents dying before 1977, the stock may be redeemed from any person who acquired the stock so included as heir, legatee, or donee of the decedent, a survivor of a joint tenancy, or a surviving spouse. For stock included in the estate of decedents dying after January 1, 1977, however, a new condition introduced by the Tax Reform Act of 1976 applies to limit the nondividend treatment to the extent that the shareholder’s interest is reduced directly (or through a binding obligation to contribute) by any payment of death taxes and funeral and administration expenses. The House Ways and Means Committee Report indicates that the change is designed to make the capital gains treatment that is available under a qualifying distribution in redemption of the stock available only where the shareholder whose shares are redeemed actually has a liability for death taxes or funeral and administration expenses in an amount at least equal to the amount of the redemption. Hence, the prophecy of the regulations that section 303 will most frequently have application in the case where stock is redeemed from the executor or administrator of an estate looms more real than ever in view of this new restriction.

Whether the amounts “allowable” as administrative and funeral expenses, as that word is used in the statute in describing the limitations in redemption of the stock, means those expenses which were actually claimed on the estate tax return, or that could have been, was resolved liberally in favor of the taxpayer. The Internal Revenue Service (hereinafter the Service) ruled that the dollar limitation would not be affected, regardless of whether the expenses were claimed by the estate against its income tax return, or whether they were actually claimed by the estate against the estate tax return as provided by section 2053. It is interesting to note at this juncture that despite the congressional “concern” for the liquidity needs of the close corporation, it has never been a prerequisite to non-dividend treatment that a showing be made of an actual liquidity need, and this remains unchanged by the 1976 Tax Reform Act. Thus, section 303 may be utilized whether the estate is liquid or not.
which passes through successive generations by use of a trust vehicle, by creating a “taxable distribution”\textsuperscript{39} from a “deemed transferor.”\textsuperscript{40} A typical planning arrangement often employed, which the new Chapter 13 is designed to reach, is this: Father would set up a trust with a life income provision to son, with the principal being distributed to son’s children when son died. The new rules will make son the deemed transferor of the property, and impose a tax on the deemed distribution.\textsuperscript{41} Previously, no tax would have been incurred on son’s death. The “taxable distributions” might well consist of stock of a closely held corporation. Consequently, new section 303(d) was added under the 1976 Tax Reform Act so that the stock redemption provisions of section 303 would also apply to the generation-skipping transfers.

The tax imposed by section 2601 on a generation-skipping transfer will primarily be paid from the corpus of the trust,\textsuperscript{42} and the amount of the tax\textsuperscript{43} will be deemed to be an estate tax\textsuperscript{44} of the estate of the deemed transferor. The section 2053 and 2054 expenses will be allowed as a deduction in the same manner as if the trust had been includible in the estate of the deemed transferor.\textsuperscript{45} Thus, the basic elements of section 303 are integrated with the new Chapter 13. The relief provisions of sections 6166 and 6166A, which can give additional time for the payment of the estate tax, however, are notably unavailable to the trust.\textsuperscript{46}

New section 303(d) has as its singular purpose to provide liquidity for the generation-skipping transfer, since the trust, as noted, is primarily responsible for the payment of the tax, and may well find it necessary to sell a portion of the corpus where it consists of stock of a closely held corporation in order to meet its tax liability.\textsuperscript{47} The Conference Report on the 1976 Tax Reform Act states that the “trust and the actual estate of the deemed transferor are to be treated separately for purposes of the section 303 qualification requirements.”\textsuperscript{48} Thus, the legislative intent seems to be that section 303(d) and its related provisions of Chapter 13 should in no way need to be consulted when any other section 303 redemption is being contemplated. It is expressly provided by statute,\textsuperscript{49} however, that the manner in which section 303(d) will ultimately be construed is to be determined by regulations prescribed by the Secretary; therefore, only the clairvoyant may navigate these unchartered tax shoals with any assurance. Until

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\bibitem{39} 1954 Code, § 2613(a).
\bibitem{40} 1954 Code, § 2612.
\bibitem{41} However, a special relief measure is provided. In the case of any deemed transferor, a maximum amount of $250,000 shall be excluded from the tax imposed on transfers to the grandchildren of the grantor of the trust.
\bibitem{42} 1954 Code, § 2601; 1954 Code, § 2603; H.R. 10612, 94th Cong., Pub. L. No. 94-455, at 578 states “neither the deemed transferor nor his estate is liable for the tax imposed on transfers to the grandchildren of the grantor of the trust.”
\bibitem{43} 1954 Code, § 2602.
\bibitem{44} 1954 Code, § 303(d)(2).
\bibitem{45} 1954 Code, § 2602(c)(5)(B).
\bibitem{46} 1954 Code, § 2621(b). Subject to certain limitations, sections 6166 and 6166A provide for the payment of the estate tax in annual installments extending over a period of 10 years in the case of section 6166A, and up to 15 years in the case of section 6166. These provisions are discussed in more detail at text accompanying note 100 infra.
\bibitem{47} H.R. 10612, 94th Cong., Pub. L. No. 94-455, at 578 states, “Generally, it was anticipated that the tax will be paid out of the proceeds of the trust property.”
\bibitem{49} 1954 Code, § 303(d).
\end{thebibliography}
regulations are published, it may be advisable to request an advance ruling when the availability of a stock redemption from a generation-skipping trust is under consideration.

D. Substituted Basis Stock

Where the value of old stock is included in the decedent shareholder's gross estate, and is exchanged in a tax free transaction for new stock the basis of which is determined by reference to the old stock, the new stock, in a section 303 redemption, will be treated the same as the old stock would have been. For example, if the stock of M Corporation is included in determining the value of the decedent's gross estate, and subsequently M Corporation merges with N Corporation, and the shares of M Corporation in a nontaxable transaction are exchanged for shares of N Corporation, then the shares of N Corporation, being in substance the same as the shares of M Corporation, may be redeemed under section 303.

E. Percentage Limitations

Before the stock included in the estate can qualify for sale or exchange upon redemption by the estate or beneficiary, the stock must bear a specified percentage to the gross estate. Prior law required that the stock must constitute more than 35 percent of the gross estate or more than 50 percent of the taxable estate. The 50 percent of the taxable estate test was less difficult to meet in the case of a married decedent, since the marital deduction reduced the size of the taxable estate before the 50 percent test was applied. Section 303(b)(2)(A), as amended by the 1976 Tax Reform Act, now makes it more difficult for stock to qualify. The value of all of the stock included in determining the value of the gross estate must be more than 50 percent of the adjusted gross estate, that is, the gross estate minus the amounts allowable as deductions under section 2053 or 2054. Thus, the 50 percent test is applied before the marital share is taken off.

For example, assume decedent's gross estate has a value of 1000x and consists of stock of Z Corporation with a value of 300x. After deducting 80x of section 2053 and section 2054 expenses from the gross estate, the adjusted gross estate equals 920x. Under the new law the estate would not qualify for a section 303 redemption of Z stock because the value of the stock of Z Corporation (300x) is not more than 50 percent of the adjusted gross estate (920x). Under prior law, a different result would have been achieved. 920x minus the marital deduction (460x) less the specific exemption (60x) leaves a taxable estate of 400x. Since the shares of Z Corporation included in the estate (300x) is more than 50 percent of the taxable estate, a redemption of the Z Corporation stock prior to the 1976 Tax Reform Act would have qualified under section 303. Clearly, this means that because of the stricter test, fewer section 303 redemption opportunities will be available.

50 Treas. Regs. § 1.303(2)(d) (1975). The substituted basis provision of section 303(c) applies to a section 368 reorganization, a spin-off under section 355, a section 1036 exchange, or a stock distribution under section 305(a).
In determining whether the value of the stock included in the decedent’s gross estate meets the percentage requirements, all of the stock of the distributing corporation included in the estate is aggregated. This includes all classes of stock, whether it be common, non-voting common, or preferred. This may be illustrated as follows: assume D’s gross estate is 1000x, and includes stock of each of two corporations, A and B. The stock of Corporation A included in the gross estate consists of 325x of common and 125x of preferred. The stock of Corporation B included in the estate consists of 300x of common. The sum of the section 2053 and section 2054 expenses equals 200x, so the adjusted gross estate is 800x. The estate can redeem the stock of Corporation A because the aggregate of all classes of stock included in the estate (450x) is more than 400x.

In contrast, the common stock of Corporation B does not qualify for a section 303 redemption since it did not meet the 50 percent test. Its value (300x) is not more than 400x. With one exception, the shares of each corporation included in the estate must meet the 50 percent test separately.

Section 303(b)(2)(B), however, does permit combination of the stock of two or more corporations for the purpose of meeting the 50 percent test where more than 75 percent of the value of the outstanding shares of each corporation is included in the gross estate. This may be illustrated by the following example: assume D’s gross estate is 1000x and includes all of the outstanding stock of each of two corporations, A and B. The stock of Corporation A included in the gross estate has a value of 200x, and the stock of B included in the gross estate has a value of 250x. The sum of the section 2053 and section 2054 expenses is 200x, so the adjusted gross estate equals 800x. Neither of the stock of A or B separately is more than 50 percent of the adjusted gross estate (400x). But since the stock of each corporation included in the gross estate represents more than 75 percent of the value of the outstanding stock of each, the stock of the two corporations may be treated as one. Together the stock of A and B equals 450x. Since this is more than 50 percent of the adjusted gross estate (400x) any of the stock of either A or B may be redeemed.

At this juncture, it should be noted that in attempting to meet the percentage limitations, only actual ownership of stock will be considered. That is, indirect ownership will not be considered. For example, “if the estate holds stock of Corporation A, and that company has as its only asset Corporation B stock, the value of which necessarily is used to determine the value of A stock for federal estate tax purposes, then the estate does not include the B stock under sec. 303.”

Where the estate consists of stock of two or more corporations and neither meets the 75 percent test, each must meet the 50 percent test separately. A merger of the two corporations under Code section 368(a)(1), however, may be used to advantage in this situation. The combined value of the corporations following the merger may well be able to meet the 50 percent test. For example, assume that the gross estate is 500x, the adjusted gross estate is 450x and the

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54 Id.
55 Chan, Planning a Sec. 303 Redemption, 7 Tax Advisor 4, 5 (1976); Estate of Otis E. Byrd, 46 T.C. 25 (1966), aff’d, 388 F.2d 223 (5th Cir. 1967).
taxable estate is 300x. The stock of Corporation A included in the estate has a value of 190x and the stock of Corporation B has a value of 180x. None of the stock meets the 75 percent test. Prior to the 1976 Tax Reform Act, the old 35 percent-50 percent tests were met by each corporation. As a result of the 1976 Tax Reform Act, however, neither stock qualifies since neither has a value in excess of 50 percent of the adjusted gross estate (225x). Corporations A and B cannot be combined in applying the percentage requirement since the 75 percent test cannot be met. A merger, however, will cause the combined value of the stock of the two corporations to meet the 50 percent test. The combined value equals 370x, which is more than 50 percent of the adjusted gross estate (225x).

It is important to effectuate the merger before the death of the shareholder. It had often been thought by tax planners that a tax free reorganization by the estate, and prior to the alternate valuation date, would not be challenged by the Internal Revenue Service since the new stock would take a basis with reference to the old stock and could then be redeemed pursuant to Code section 303(c) (stock with a substituted basis). The Service, however, ruled that such a post-mortem reorganization would fail: since at the date of death the stocks were separate, and did not meet the percentage requirement, they were deemed to have remained separate for purposes of section 303. In view of the position of the Service, it is now clear that such a plan must be expedited during the life of the shareholder if it is to achieve the desired result.

In addition to the direct merger technique, there are other planning aids which may be utilized to meet the percentage requirements:

1. Lifetime Redemptions

Another method by which the estate may be assisted in meeting the 75 percent test where the estate consists of two or more corporations is to redeem the shares of another shareholder. If Corporation A has 100 shares outstanding, and the estate owns 70 percent, a redemption of 10 shares from another shareholder would increase the estate’s percentage of ownership to 77 percent, thus enabling the estate to combine Corporation A with Corporation B which already meets the 75 percent test.

2. Alternate Valuation Date

Use of the alternate valuation date may also be helpful in meeting the percentage requirement. The alternate valuation date before the 1976 Tax Reform Act could be used to achieve an additional step-up in basis in the value of the stock. Because of the new carryover basis provisions, it will no longer
serve this purpose. It may now, however, be used to advantage by capturing the value of "other" property at the alternate valuation date where the "other" property is expected to have decreased in value. Thus, the lower value of "other" property relative to the value of the stock included in the estate will increase the percentage of the value of the stock when compared with the gross estate.

3. Pegging the Value of the Stock

The value placed on the stock is of course a key factor in whether or not the percentage requirement can be met. The difficulty is that stock in a close corporation seldom has an ascertainable market value. The dilemma facing the executor is that his responsibility is to reduce estate taxes as far as possible, and at the same time, where circumstances dictate, to insure that the value of the stock remains high enough to facilitate a section 303 redemption. Until the final audit is conducted, it will be necessary for the executor to monitor the following three variables: (1) the value of the stock, (2) the value of the other assets in the estate, and (3) the amount of death taxes due. Thus, it may happen that the value shown on the federal estate tax return will ultimately prove to be different from that as determined on the estate tax audit, in which case the redemption should be delayed until final audit. Indeed, this problem of valuation has been so vexing as to be described as "a continuing area of controversy between the IRS and a decedent's estate."

Fixing the value of the stock has been sanctioned by both the judiciary and Internal Revenue Service, and it has become fairly well settled that if these following conditions have been established as part of a stock purchase agreement, then the agreement will be controlling in fixing the value for estate tax purposes: (1) the estate must be obligated to sell the shares, (2) the corporation must either be required to buy, or have an option to buy, the shares, (3) lifetime sales must be prohibited before a first offer is made to the corporation at the offered price, and (4) the price must be the result of an arm's-length transaction, that is, the price must have been fair when set.

The folly of ignoring lifetime planning for meeting the post-death valuation problem is well demonstrated by the case of Estate of John L. Huntsman. There, the decedent owned all of the outstanding stock of two corporations, steel and supply. The decedent died on February 5, 1971. On November 22, 1971, the boards of directors of steel and supply each agreed to redeem 7,300 shares of its stock held by the decedent's estate, pursuant to section 303. The redemption

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61 Note, Funding Stock Redemption Plans under Sections 302 and 303 with Life Insurance, 22 Drake L. Rev. 775, 806 (1973).
63 Id.
64 Henkel, supra note 58, at 1563.
65 Klein, Valuation of Closely Held Corporate Stock: Effect of Corporate Owned Life Insurance, Taxation of Individuals 151 (Spring 1977).
68 Guild, supra note 5, at 31, 32.
price agreed on was $18.40 for steel, and $5.58 for supply. The estate received $134,000 from steel, and $40,000 from supply. The IRS protested, and asserted their own, higher valuation on the shares. Litigation followed, and the Tax Court in its opinion, filed August 17, 1976, placed a final value of $33 and $11 on the shares of steel and supply. Thus, the additional value placed on the shares by the Tax Court resulted in an additional inclusion in the estate of approximately $146,000. This was costly to the estate not only because it resulted in additional estate tax liability, but also because of the protracted controversy, lasting nearly five years, concerning the value to be placed on the shares. Had a lifetime stock purchase agreement been entered into, in which the necessary criteria noted above were established, the value placed on the stock could have been controlling for estate tax purposes, and the expense incurred in this case averted.

There is an additional important reason now for emphasizing the need of fixing the value of the shares through a stock purchase agreement. Prior to the 1976 Tax Reform Act, the estate enjoyed a step-up in basis to the date of death value of the stock\(^70\) or, if elected, to the optional valuation date.\(^71\) The lowest reasonable value placed on the stock by the agreement would likewise result in reducing the estate tax liability. Because of the step-up in basis, there would be little or no income tax liability to the shareholder redeeming the shares.\(^72\) Now, however, because of the carryover basis provision\(^73\) (subject to a so-called "fresh start" basis as of December 31, 1976),\(^74\) there is potential income tax to the estate when the sale price exceeds basis. The amount of the income tax liability will become greater as the stock continues to appreciate in value. The further from the fresh start date the stock purchase occurs, the greater will be the income tax liability to the estate. Therefore, not only will the lowest reasonable value placed on the shares by the stock purchase agreement reduce the estate tax liability, it will at the same time aid in reducing the difference between the basis in the stock and its value at time of redemption, thus reducing income tax liability. This means that it has become increasingly important that the planned-for redemption qualify as a sale or exchange rather than a dividend distribution, since the difference in tax on ordinary income and capital gain income to the estate can be significant. If the redemption fails to qualify as a sale or exchange under section 303, then it can only be saved from the ordinary income treatment of section 301 by the exceptions provided in section 302(b).\(^75\) It is much more

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\(^70\) 1954 Code, § 1014(a).
\(^71\) 1974 Code, § 2032(a).
\(^72\) Any appreciation in value from the date of death value would usually be minimal. If necessary, the alternate valuation date was used to step-up any appreciation in value occurring subsequent to the date of death.
\(^73\) 1954 Code, § 1023(a).
\(^74\) 1954 Code, § 1023(h). Very generally, the fresh start basis simply means that if the fair market value of property on December 31, 1976 is in excess of its adjusted basis on the same date, then the adjusted basis of the property shall be increased by the amount of such excess.
\(^75\) Sale or exchange treatment will be accorded under Code section 302(b) if the redemption qualifies in any one of the following three ways: (1) the redemption is substantially disproportionate, (2) the redemption is in complete redemption of all of the stock owned by the shareholder in the corporation, and (3) the redemption is not essentially equivalent to a dividend.
difficult to qualify under these exceptions than for section 303 because the attribution rules of section 318 apply to attribute to the redeeming shareholder stock owned by certain other related parties. As previously noted, section 318 does not apply to a section 303 redemption.

The regulations have been amended\(^7\) to provide that where redemptions are successive, they shall first be applied in the amount allowable as a section 303 redemption, and the balance shall qualify or not under section 302(b). For the unwary, this rule can cause unwanted ordinary income. For example, a redemption will qualify for favorable capital gain treatment under section 302(b)(2) if: (1) after the redemption the shareholder owns less than 50 percent of all outstanding stock entitled to vote; and (2) when all of the outstanding stock is voting common, the ratio of his voting stock after the redemption to total stock after the redemption is less than 80 percent of the ratio of his voting stock before the redemption to total stock before the redemption. Now assume 100 shares of voting common stock is outstanding. A owns 80 shares and B, an unrelated individual, owns 20 shares. A plans a series of redemptions which in the aggregate will result in the redemption of 65 shares. Under the above tests this qualifies as a substantially disproportionate redemption. But if, under the regulations, the redemption of 60 shares qualifies under section 303 the result will be different. The balance redeemed after the section 303 redemption will not qualify as a disproportionate redemption. Thus, if the redemption would otherwise qualify under section 302(b)(2) as substantially disproportionate, but fails to because of the application of section 303 first, the portion qualifying under section 303 would be taxed as a capital gain, and the balance would be subject to ordinary income treatment under section 301.

F. Time Limitation for Distribution

Distributions in redemption of stock under section 303 must be made within three years and 90 days after the federal estate tax return is filed,\(^7\) or if a petition for redetermination of a deficiency has been filed with the Tax Court, within 60 days after the decision of the court becomes final.\(^7\) The 1976 Tax Reform Act provides for an additional extension.\(^7\) If an election has been made to pay the estate tax in installments under either section 6166 or section 6166A, then distributions in redemption of stock may be extended up to a period of years which is the same period as that in which the installment payments may be made. In the case of section 6166 this period is up to 15 years,\(^8\) and in the case of section 6166A, up to 10 years.\(^9\)

The Service has ruled\(^8\) that a distribution which was made within 3 years and 90 days from the due date, though a longer period had elapsed from the

\(77\) 1954 Code, § 303(b)(1)(A).
\(78\) 1954 Code, § 303(b)(1)(B).
\(79\) 1954 Code, § 303(b)(1)(C).
\(80\) 1954 Code, § 6166(a).
\(81\) 1954 Code, § 6166A(a).
\(82\) Rev. Rul. 47, 1969-1 C.B. 94.
filing date, was nevertheless timely. The Service has also ruled\(^8\) in favor of the taxpayer where the distribution was made within 3 years and 90 days from the filing of the federal estate tax return, although the return was filed subsequent to the due date of the return, and more than 3 years and 90 days had elapsed from the due date.

If a distribution is made more than 60 days following a decision of the Tax Court, but is nevertheless prior to the expiration of 3 years and 90 days after the federal estate tax return is filed, the distribution shall be timely.\(^4\) Thus, the 60-day limitation is not to be construed to be a limitation on any other provision.

If a corporation, rather than making an actual cash distribution, instead issues a note within the time limitations already discussed, it will be deemed to be a distribution for purposes of satisfying the time limitations.\(^8\) The date of distribution can be established by this device even though the corporation is unprepared to make a cash distribution.

IV. Cross Purchase Agreements

If a cross purchase agreement is used, that is, an agreement which is entered into between shareholders rather than between a shareholder and a corporation (the remaining shareholders agree to purchase the decedent's stock from the estate), then the risks of the proceeds of the sale being treated as a dividend rather than as capital gain are eliminated. Dividend treatment will only occur on distributions from a corporation to a shareholder with respect to its own stock.\(^8\)

Accordingly, there is no risk of dividend treatment from a cross purchase agreement. This fact, coupled with the new carryover basis provisions of section 1023, now reduces considerably the attractiveness of section 303, and concomitantly makes the cross purchase plan even more desirable.

When stock is redeemed by a corporation, there is no gain or loss to the corporation,\(^8\) and thus no basis adjustment in any of the stock.\(^8\) Although the remaining stockholders' interests in the corporation will increase proportionately, because of section 1023 they will have no commensurate increase in the basis of their shares as was the case under section 1014. To this extent, they will not have benefited from the stock redemption. On the other hand, where the stock is purchased by the remaining shareholders, as in a cross purchase type of agreement, their basis in the stock purchased will be increased by its cost to them.\(^8\) This in effect gives them a step-up in basis. Thus, any subsequent sale of the stock acquired in a cross purchase transaction will result in lower capital gains to the seller as the result of this stepped-up basis.

V. Life Insurance Funding

Funding for the section 303 redemption has very often been provided by life

\(^{86}\) 1954 Code, § 301(a).
\(^{87}\) 1954 Code, § 311(a).
\(^{88}\) 1954 Code, § 1001; 1954 Code, § 1012.
insurance on the life of the controlling stockholder. The death proceeds would be payable to the corporation as named beneficiary, and the corporation would in turn distribute the proceeds to the estate as payment in exchange for the redeemed stock. Prior to the 1976 Tax Reform Act, the life insurance proceeds would be received income tax free by the corporation, and would essentially retain their tax-free character in the hands of the executor, because the proceeds paid would equal the step-up in basis provided by section 1014. As noted, the section 1023 carryover basis provision eliminates this step-up in basis. The proceeds will now be taxable to the executor to the extent of the difference between the carryover basis and the price paid for the stock. Since the primary attraction of life insurance is the exemption of its proceeds from income tax, the loss of this benefit when the proceeds are paid to the executor, makes an investment in this funding vehicle for a section 303 redemption questionable. In fact, for all of the reasons pointed out thus far, the continued viability of the section 303 stock redemption is called into question. If stock redemption agreements "are part of every private corporate organizational structure today," then it is equally true that untold numbers of these agreements are funded by life insurance. Thus, the importance for tax planners to review such agreements to determine whether in fact they should be continued cannot be overstated.

In the future the cross purchase type of agreement will be favored over the corporate purchase agreement. Life insurance funded cross purchase agreements do not have the same disadvantage as the corporate purchase agreement, because the proceeds, when used to pay for the stock, increase the basis of the shares to the purchasing shareholder. This use of the income-tax-free proceeds allows the shareholder to achieve a step-up in basis which is not possible with the corporate purchase agreement. If the corporate purchase plan is to be discontinued in favor of some other plan, some disposition of the policies currently funding the existing plan must be made.

Short of cancelling the policies, or transferring them to the insured, the means by which one can "unwind" the corporate-owned life insurance is limited. At first blush it would seem that a simple solution would be to transfer the policies to the individual shareholders, to be used to fund a cross purchase agreement, since that type of plan would achieve a step-up in basis for the purchasing shareholder. This is not a practical solution, however, because of the transfer for value rule of section 101(a)(2), which provides that the proceeds will be subject to income tax except to the extent of the consideration and subsequent premiums paid by the transferee. Section 101(a)(2) will not apply if the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Notably absent from this list of exempt transferees is a transfer to a shareholder of a corporation in which the insured is a shareholder or officer.

90 Kurzman, supra note 2, at 1454; White, supra note 3, at 407.
91 1954 Code, § 101(a).
92 Taft, supra note 2.
93 Turner & Dillingham, supra note 89, at 139.
There is no documented explanation for this. The Senate Report, when referring to the provision in the original House Bill that granted complete exemption from income taxation for life insurance proceeds, said only that this would result in speculation on the death of the insured, and so only transfers made for certain legitimate business reasons should be exempt. The House Bill was amended and the provision providing for complete exemption was eliminated. Instead, the exemption for the transferees as noted above was substituted. Apparently, a transfer to a fellow shareholder of the insured was not deemed to be for a legitimate business purpose. Thus, a transfer of corporate-owned life policies to fellow shareholders of the insured to fund a cross purchase agreement is not possible without destroying the income-tax-free character of the proceeds.

There is perhaps a way, however, to use the policies advantageously while avoiding necessity for qualifying under one of the exceptions to the transfer for value rule. If the corporation already has, or establishes, an employee stock ownership trust (ESOT), a transfer of the policies to the trust would be deductible by the corporation. There would be no tax consequence to the trust, since it is exempt from income taxation. Thus, whether the transfer of a policy to the trust would qualify under one of the exceptions to the transfer for value rule is irrelevant. Its proceeds, when paid to the trust at maturity, will be income-tax-free in any event.

The trust, established under an employee stock ownership plan (ESOP), is designed to invest principally in securities of the employer. Its advantages are several. First, unlike either the cross purchase or stock redemption plans, the purchase of shares is financed with pretax dollars. The contributions to the trust by the corporation are deductible. Premiums paid on corporate-owned life insurance are not deductible. Second, since the trust rather than the corporation is the purchasing party, there are no accumulated earnings problems. Under the conventional stock redemption plan, it is unclear whether annual accumulations to fund the corporation's obligation under a buy out agreement are reasonable accumulations. Third, in a private letter ruling, the Service announced that a sale of the stock to the trust would be deemed a sale or exchange, not a redemption subject to the requirements of section 302; therefore, potential ordinary income and the difficulties the attribution rules of section 318 present are avoided. This is because ESOT is purchasing, not the corporation. Fourth,
the danger of a shift in control is minimized, since the sales of stock to the trust are discretionary with the selling shareholder, and thus the marketability problem often inherent in close corporation stock is solved with an in-house buyer.\textsuperscript{105} Finally, when the ESOT is purchasing from the estate of a decedent, capital gains treatment is assured. Since the ESOT is not the corporation, the purchase will not be deemed to be a redemption, and the usual requirement of qualifying under the rules of section 303 can be disregarded.\textsuperscript{106}

This brief review of the use of the ESOT as a purchasing agent in substitution for the corporation, and as a receptacle for existing life insurance policies, should not be construed to be an unqualified endorsement. There are some disadvantages as well, and many problems yet to be resolved regarding the use of the ESOT. Furthermore, governing regulations have not yet been published. This has not, however, inhibited the imagination of commentators, and the literature is replete with suggested uses and interpretations.\textsuperscript{107} As always, risks must be weighed, and individual circumstances analyzed, before proceeding to implement any plan, and this is especially true when probing new tax planning frontiers such as the ESOT.

VI. Election to Defer Estate Tax

The 1976 Tax Reform Act produced some liberalizing changes with regard to extensions of time for payment of the estate tax, and with regard to the installment periods over which the tax may be paid. The estate tax is required to be paid nine months after the death of the decedent.\textsuperscript{108} The two provisions of the Code which provide exceptions to this general rule have each been liberalized by the 1976 Tax Reform Act. The first of these is a provision which allows the Secretary to grant an extension of time for the payment of the estate tax. Formerly, the taxpayer had to demonstrate that the payment would result in undue hardship, but the standard has been changed to a showing of reasonable cause.\textsuperscript{109} The House Ways and Means Committee Report\textsuperscript{110} reveals that this easier test "can be satisfied by showing that the executor needs time to collect liquid assets or to convert liquid assets to cash." The second exception to the general rule, section 6166, permitted payment of the estate tax in installments extending over a period of ten years when the business constituted a certain value of the estate.\textsuperscript{111} This provision has now been designated section 6166A and a

\textsuperscript{105} Id. at 1527.
\textsuperscript{106} Terry, Employee Stock Ownership Plans, 34 N.Y.U. INST. ON FED. TAX. 1383, 1401 (1975).
\textsuperscript{108} 1954 Code, § 6151(a); 1954 Code, § 6075(a).
\textsuperscript{109} 1954 Code, § 6161(a)(2).
\textsuperscript{111} 1954 Code, § 6166A(a).
new provision designated section 6166 has been added. If section 6166A has been elected, no election can be made under section 6166.\textsuperscript{112} The differences between “new” section 6166 and “old” section 6166A can perhaps be best demonstrated by the comparison illustrated below:

<table>
<thead>
<tr>
<th>Provisions</th>
<th>§ 6166</th>
<th>§ 6166A</th>
</tr>
</thead>
<tbody>
<tr>
<td>The value of the interest in the closely held business must exceed:</td>
<td>65% of the adjusted gross estate (gross estate less 2053 &amp; 2054 deductions)</td>
<td>35% of the gross estate or 50% of the taxable estate.</td>
</tr>
<tr>
<td>Definition of interest in a closely held business:</td>
<td>20% or more in value of the stock of the corporation is included in the gross estate or the corporation had 15 or fewer shareholders.</td>
<td>Same 20% rule but shareholder requirement is 10 or fewer.</td>
</tr>
<tr>
<td>The period of time over which estate tax installment payments may be extended:</td>
<td>10 years, first installment due with estate tax return, but may delay first installment up to 5 years after estate tax is due. Balance is due in 9 equal annual installments so that total period payment can be extended is 14 years.</td>
<td>10 years. The first installment is due on date estate tax normally due. The balance is due in 9 equal annual installments.</td>
</tr>
<tr>
<td>Maximum amount of tax payable in installments:</td>
<td>Amount of closely held business included in the estate x estate tax ÷ adjusted gross estate</td>
<td>Same, except the denominator is the gross estate.</td>
</tr>
<tr>
<td>Amount of interest that is payable on the estate tax deferred:</td>
<td>4% on the lesser of $345,800 (reduced by § 2010(a) credit) or the amount of estate tax deferred. Any balance bears the adjusted rate prescribed by § 6621.</td>
<td>The adjusted rate prescribed by § 6621.</td>
</tr>
</tbody>
</table>

Note that the percentage interest the stock must bear to the rest of the estate is different than the 50 percent test of section 303(b)(2). Thus, the qualifying tests of sections 303, 6166 and 6166A are mutually exclusive. Section 303 provides a means for the shareholder to receive capital gains treatment on redemption of stock. Sections 6166 and 6166A determine whether the estate tax can be paid in annual installments. As discussed more fully below, section 303 becomes synchronized with section 6166 or section 6166A when the period during which the section 303 redemption can be accomplished is extended to the same

\textsuperscript{112} 1954 Code, § 6166(a)(4).
period of time elected under either section 6166 or section 6166A.\textsuperscript{113}

As previously noted,\textsuperscript{114} two or more corporations may be combined to meet the 50 percent test of section 303 if the decedent owned more than 75 percent of the stock of each corporation. Two or more corporations may also be combined in order to meet the percentage requirements of section 6166 and section 6166A, but the tests are not as strict. In meeting the 35-50 percent test of section 6166A, two or more corporations may be combined when the decedent owned more than 50 percent of the stock of each corporation,\textsuperscript{115} while under section 6166 the stock of two or more corporations may be combined in meeting the 65 percent test if the decedent owned more than 20 percent of the stock of each corporation.\textsuperscript{116}

The tax due but deferred by installment payment under either section 6166 or section 6166A will be accelerated if a certain portion of the business is disposed of. This will occur in the case of section 6166 if one-third (fifty percent in the case of section 6166A) or more in value of the business interest is sold.\textsuperscript{117} Similarly, a section 303 redemption will result in acceleration of the tax due unless the aggregate of all federal estate taxes paid on or before the installment date following the redemption exceeds the sum of all redemption proceeds received.\textsuperscript{118}

The period within which section 303 redemptions can qualify has been extended to coincide with the section 6166 or section 6166A installment payment periods by new section 303(b)(1)(c). If an installment payment period has been elected, then the time within which section 303 redemptions can be made is extended to the time determined under the installment election. Any redemption under section 303 made more than four years after the death of the decedent is available, however, only to the extent that the redemption proceeds do not exceed the lesser of the amount of death taxes, funeral, and administration expenses unpaid immediately before the redemption, or the aggregate of these amounts which are paid within one year after the redemption.\textsuperscript{119} It is important to note that even if the prerequisites to a utilization of section 6166 or section 6166A are not met, the provisions for the extension of the payment of the estate tax for reasonable cause should, nevertheless, remain available.\textsuperscript{120}

The election to pay the estate tax in installments is an affirmative one, and will be lost unless made within the time prescribed.\textsuperscript{121} Where the estate tax return indicates that the estate will not qualify for the special installment privilege, or where no tax is due, a protective election should nevertheless be made.\textsuperscript{122} The prudent executor may in this fashion preserve the option of paying

\begin{itemize}
  \item \textsuperscript{113} For an excellent discussion of the simultaneous use of sections 303, 6166 and 6166A, see Fleming, Jr., \textit{Funding Estate Tax Installment Payments With Section 303 Redemptions After the 1976 Tax Reform Act}, J. of Corp. Tax 22-41 (Spring 1977).
  \item \textsuperscript{114} See text accompanying note 34 supra.
  \item \textsuperscript{115} 1954 Code, § 6166A(d).
  \item \textsuperscript{116} 1954 Code, § 6166(c).
  \item \textsuperscript{117} 1954 Code, § 6166(g)(1); 1954 Code, § 6166A(h)(1).
  \item \textsuperscript{119} 1954 Code, § 303(b)(4).
  \item \textsuperscript{120} 1954 Code, § 6166(a)(2).
  \item \textsuperscript{121} 1954 Code, § 6166(d); Treas. Reg. § 20.6166-1(e)(1).
  \item \textsuperscript{122} Treas. Regs. § 20.6166-1(e)(3).
\end{itemize}
the estate tax in installments should the final audit prove the privilege to be available. This same election will also preserve the option of paying any deficiency in installments.123 Previously, many executors refused to embark upon a plan which would call for the payment of the tax over an extended period of time, since they remained personally liable until the tax was finally paid. Now, a procedure for placing a lien on property has been established which, when accomplished, will allow for the discharge of the executor from any personal liability.124 Clearly, the executor’s task in meeting the estate tax obligation has become much less burdensome as the result of these more relaxed means for meeting that obligation. Just as clearly, and for the same reasons, there will in many instances be a reduction in the need for section 303 redemptions.

When considering the capital gains tax that the estate will now have to pay as the result of the section 1023(a)(1) carryover basis provision, it must be remembered that there may be a minimum tax due for tax preferences.125 The reduction in the exemption to ten thousand dollars coupled with an increase in the minimum tax rate to 15 percent126 has insured that more transactions will be affected. Where the estate incurs a capital gains tax on redemptions, it must, in addition to the estate tax, now pay income tax on the capital gain earned, further compounding liquidity needs. On the other hand, where section 6166 is elected, the estate can defer paying any tax for the first five years, and although the estate will be paying interest of four percent on the tax due but unpaid, it should be able to earn nearly double that on the dollars which it in effect is borrowing from the government by virtue of the deferment of the tax. Thus, the corporation can in large part earn the dollars necessary to pay the estate tax from the very dollars that are due the government. Furthermore, there is an estate tax deduction for interest paid on estate tax installments. In Estate of Bahr, Sr.127 the Tax Court, in the first holding in favor of the taxpayer directly on this point128 concluded that since interest on a loan to pay estate tax is deductible, the result should be the same when the loan is from the government.

VII. Section 306 Stock

Prior to the enactment of section 306, shareholders had devised various methods for getting earnings and profits out of the corporation as capital gains, rather than as dividends. One method called for the corporation to issue preferred stock to its shareholders as a tax-free dividend on their common stock.129 The shareholder would sell the stock to a third party, reporting capital gain, and the corporation would then redeem the stock from the third party. In order to prevent this dividend bail-out, section 306 places a taint on the stock received in this transaction so that on its subsequent sale, the gain will be taxed as ordinary income.130 If a decedent held section 306 stock, however, a subsequent

123 Id.
124 1954 Code, § 6324A.
125 1954 Code, § 56(a).
126 Id.
128 Interest on Estate Tax Installments Held Deductible, J. of Tax. 36 (July 1977).
129 1954 Code, § 305(a).
redemption of it by the corporation from his estate would not require the same result. This was true because of the step-up in basis to its fair market value at date of death, or alternate valuation date. By definition, section 306 includes stock the basis of which is determined by reference to the basis of section 306 stock.\textsuperscript{131} The death of the decedent removed the section 306 taint because the basis of the stock in the estate was determined by reference to its fair market value. The Regulations\textsuperscript{132} have recognized this by providing that "section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent stockholder's death or the alternate valuation date under section 1014."

The new carryover basis provision, however, has caused some confusion as to how section 306 stock will be treated under a section 303 redemption, since the stock no longer takes a basis with reference to the fair market value at date of death. Will section 303 override section 306? The technical amendments to the 1976 Tax Reform Act have addressed this question. The amendment to section 306 of the Code will make it clear that dividend income will include only that amount in excess of the adjusted basis of the stock, including the fresh start basis adjustment.\textsuperscript{133} The amendment to section 303 of the Code will make it clear that capital gains treatment will not generally be available on a section 303 redemption of section 306 stock.\textsuperscript{134} The Act states that section 303 (a) "shall not apply to any distribution in redemption of section 306 stock."\textsuperscript{135} An exception is provided where the stock redeemed is substituted section 306 stock.\textsuperscript{136} Thus, the application of the technical amendment assumes that capital gains treatment can be expected where preferred stock is received by "a decedent's estate in a reorganization if the stock is in substitution for common stock which was eligible for capital gains treatment in a redemption to pay death taxes."\textsuperscript{137} This is because section 303 (c) provides that new stock, which takes a basis with reference to old stock included in the estate, will on redemption receive capital gains treatment if the old would have.\textsuperscript{138} These amendments mean that section 306 stock will retain its character as section 306 stock in the hands of the executor. Capital gains treatment will be applied to that amount of distribution in redemption of stock that is substituted stock within the meaning of section 303 (c). The balance of the proceeds would then be taxed as a dividend according to section 301.

\section*{VIII. Conclusion}

Once known as "perhaps the most useful estate planning device available to the practitioner,"\textsuperscript{139} section 303 has been dramatically changed by the 1976 Tax Reform Act. The technical amendments to the 1976 Tax Reform Act have addressed this question. The amendment to section 306 of the Code will make it clear that dividend income will include only that amount in excess of the adjusted basis of the stock, including the fresh start basis adjustment.\textsuperscript{133} The amendment to section 303 of the Code will make it clear that capital gains treatment will not generally be available on a section 303 redemption of section 306 stock.\textsuperscript{134} The Act states that section 303 (a) "shall not apply to any distribution in redemption of section 306 stock."\textsuperscript{135} An exception is provided where the stock redeemed is substituted section 306 stock.\textsuperscript{136} Thus, the application of the technical amendment assumes that capital gains treatment can be expected where preferred stock is received by "a decedent's estate in a reorganization if the stock is in substitution for common stock which was eligible for capital gains treatment in a redemption to pay death taxes."\textsuperscript{137} This is because section 303 (c) provides that new stock, which takes a basis with reference to old stock included in the estate, will on redemption receive capital gains treatment if the old would have.\textsuperscript{138} These amendments mean that section 306 stock will retain its character as section 306 stock in the hands of the executor. Capital gains treatment will be applied to that amount of distribution in redemption of stock that is substituted stock within the meaning of section 303 (c). The balance of the proceeds would then be taxed as a dividend according to section 301.

\textsuperscript{131} 1954 Code, § 306(c)(1)(C).
\textsuperscript{132} Treas. Regs. § 1.306-3(e).
\textsuperscript{133} Explanation of H.R. 6715 Prepared by the Joint Committee on Taxation 19 (1977).
\textsuperscript{134} Id.
\textsuperscript{135} H.R. 6715 Technical Corrections Bill of 1977, § 3(a)(2).
\textsuperscript{136} Id.
\textsuperscript{137} Explanation of H. R. 6715, supra note 130.
\textsuperscript{138} See text accompanying notes 50-51 supra.
Reform Act. Its use has in many instances been eliminated as a practical matter, and in others it has been severely restricted. The established notions upon which the usages of section 303 have been based, must be critically examined in light of the changes which have been made. Many of them are no longer viable, and indeed the mechanical use of section 303 could have previously unknown effects. It is therefore imperative for the practitioner to review existing plans and to embark on new plans only after a careful study of the far reaching effects of the 1976 Tax Reform Act.