February 17, 2005

Redemption of Stock in Family-Owned Corporation

By: Elliot Pisem and David E. Kahen

When the founders of a family-owned corporation decide to retire and to transfer ownership of the corporation to one or more family members, a common concern is whether a cash distribution by the corporation to effect a "redemption" of the founders' stock can be treated as a sale or exchange of shares resulting in capital gain, rather than as a dividend, taxable as ordinary income under Internal Revenue Code ("Code") section 301, to the extent of the current and accumulated earnings and profits ("E&P") of the corporation.

Background

Why is the distinction between sale or exchange, giving rise to capital gain, on the one hand, and a dividend, on the other, so important? There are a number of key tax advantages to capital gain treatment, even though dividends are currently taxed to individuals at the same rates as long term capital gains. First, dividend income is not considered to be capital gain. Therefore, capital losses cannot be used to offset dividend income.

In addition, if shares in a closely held corporation are to be redeemed for payments to be made over time, any capital gain realized from the redemption will generally be includible in taxable income as payments are received, under the installment method. By contrast, a deferred payment obligation received in a redemption treated as a dividend must be taken into account immediately in determining income, based on its fair market value.

Also, if a stock redemption is treated as an exchange, the holder's basis in the redeemed shares will be taken into account as an offset in determining the amount of any gain recognized. By contrast, to the extent the transaction constitutes a dividend, the shareholder's stock basis cannot be taken into account.

Finally, the current rule taxing qualified dividends at favorable capital gains rates will not apply (absent further action by Congress) to taxable years beginning after December 31, 2008.

In this regard, the Tax Court recently addressed, in *Hurst v. Commissioner*, 124 TC No. 2 (Feb. 3, 2005), whether a redemption completed as part of a complete termination of the founder's equity interest in a corporation would be treated as a sale for tax purposes. Although the taxpayer prevailed on this issue, the case merits discussion as indicative of the stakes that may be involved in the resolution of this issue. (The case also addressed two other issues, relating to the applicability of Code §304 and to the treatment of medical insurance premiums, that are not discussed below.)

Code §302(a) provides, in substance, that a stock redemption will be treated as a sale or exchange if is described in any of paragraphs (1) through (4) of section 302(b). Paragraphs (2) through (4) describe three relatively well-defined categories of redemptions that are treated as exchanges: a redemption that is "substantially disproportionate" (as defined) with respect to the shareholder, but only where the redeemed shareholder owns less than 50% of the voting power of the stock of the corporation immediately after the redemption (IRC §302(b)(2)); a complete redemption of all of the stock of the corporation owned by the shareholder; and a redemption from a non-corporate shareholder in partial liquidation of the corporation (IRC §302(b)(4)).

A redemption of stock that is not within any of the above three categories will nonetheless be treated as a sale or exchange if it is determined to be a redemption that is "not essentially equivalent to a dividend."

Certain constructive ownership rules apply in determining the ownership of stock for these purposes. For example, an individual is generally deemed to own any stock owned by his spouse, parents, children and grandchildren.

Thus, in general (but subject to an important exception discussed below), a redemption of all of a shareholder's stock will not qualify for exchange treatment if, after the redemption, the remaining outstanding shares of stock of the corporation were all owned by members of the redeemed shareholder's family, because the redeemed shareholder would be considered not to have suffered the substantial reduction in proportionate stock ownership which is generally the key characteristic of a redemption treated as an exchange for tax purposes.

Hurst v. Commissioner

Prior to the transactions described below, Richard Hurst ("Richard") owned all of the stock of Hurst Mechanical, Inc. ("HMI"). HMI's business, founded by Richard, consisted of the repair and maintenance of HVAC systems.

In addition, Richard and his wife Mary Ann each owned 50% of the stock of R.H., Inc. ("RHI"), a corporation engaged in the same business.

Mary Ann provided accounting and bookkeeping services to HMI. Richard and Mary Ann also leased to HMI the building used by the business.

HMI elected S corporation status in 1989 but had almost $400,000 of accumulated E&P from taxable years preceding the S election.

The Hursts began to consider retirement and ultimately decided to transfer HMI and RHI to their son Todd, who was employed in the HVAC business, and to two other employees for $2.5 million payable over 15 years. To effectuate these transfers, the following occurred on July 1, 1997: HMI redeemed 90% of its stock from Richard, for a promissory note in the amount of $2 million; Todd purchased 51 of the remaining 100 outstanding shares of HMI, and the other two employees purchased the other 49 shares, for $2500 per share, paid in the form of promissory notes; and HMI leased the building from the Hursts for a term of 15 years with an option to purchase.

On the same date, HMI purchased the stock of RHI from the Hursts for a $250,000 note. HMI also entered into a ten-year employment agreement with Mary Ann providing for a small salary and for fringe benefits including health insurance for herself and Richard and the use of a pickup truck owned by HMI (and formerly used by Richard).

None of the agreements provided for contingent payments tied to the performance of the business, and Richard did not retain any role in managing or advising the business. The stock purchase agreements, the lease, and the employment agreement were secured by the buyers' stock and had cross-default provisions.

The Hursts reported the dispositions of stock on their 1997 tax return as installment sales qualifying for capital gain treatment, with the redemption portion presumably qualifying for such treatment under Code §302(b)(3). Their return did not include the separate statement required to be filed by a redeemed shareholder in order to prevent the application of the family constructive ownership rule to a redemption otherwise meeting the requirements of section 302(b)(3), but that statement was filed after Richard obtained IRS consent to a late filing.

The IRS ultimately disagreed with the treatment of the redemption (and of the sale of the stock of RHI) as sales for tax purposes, however, and asserted that the transactions resulted in more than $400,000 of dividends required to be recognized in the year of sale, principally on the basis that the redemption of the stock of HMI did not qualify under IRC §302 for treatment as an exchange. The IRS allowed the Hursts to treat their remaining gain, in excess of the corporation's E&P, as capital gain, but without the benefit of deferring any part of that gain under the installment sale rules.

The Hursts argued that the stock redemption was within section 302(b)(3) as a distribution in complete redemption of Richard's stock in HMI, and that the application of the family constructive ownership rule was precluded by the special rule in IRC §302(c)(2) that a redeemed shareholder who, after the redemption, "has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor," and who meets the other requirements of section 302(c)(2) (not at issue here), will not be treated as owning stock actually owned by members of his family.

The Commissioner acknowledged that none of the continuing interests of the Hursts as creditors under the notes, as landlord under the lease, and as an employee (in the case of Mary Ann), constituted a prohibited interest in respect of Richard that would prevent the redemption of his stock in HMI from qualifying as a sale or exchange under section 302. The Commissioner argued, however, that the quantity and extent of such interests gave Richard an interest in the success of HMI that precluded satisfaction of the "no interest other than as a creditor" standard.

The Tax Court reviewed and then dismissed each of the arguments made by the Commissioner in this regard. The court agreed with the taxpayers that the cross-default clauses in the various agreements constituted a common form of protection for the Hursts' interests as creditors, and rejected the Commissioner's argument that the broad scope of the cross-default provisions gave the sellers a proscribed non-creditor interest in the corporations.

With respect to the lease and the employment agreement, the opinion notes that there was no evidence that the lease was on anything other than on arm's length terms, and that an IRS published ruling (Rev. Rul. 77-467, 1977-2 C.B. 92) concluded that such a lease was not a proscribed interest that would prevent meeting the "no interest other than as a creditor" standard. The opinion also notes that Mary Ann's employment agreement provided that her duties would be tasks of a similar nature to those that she had performed for HMI for many years; and that there was no evidence that the Hursts intended to use or in fact used their rights under the various agreements as a means of continuing to manage or oversee the business.

The Commissioner also argued that HMI's surrender in 2003 of its option to buy the building was further evidence of Richard's retention of "too much control" to satisfy the requirements of a complete redemption pursuant to IRC §§302(b)(3) and 302(c). The court observed, however, that, in connection with the cancellation of the purchase option, the Hursts agreed to a two percentage point reduction in the annual interest rate under the notes, and that this indicated a negotiation between parties acting at arm's length, rather than collusion between a principal and an entity under his control.

Observations

The court's analysis of the section 302(b)(3) issue, as to whether Richard retained an interest other than as a creditor that would preclude "turning off" the family ownership attribution rule as necessary here to meet the complete redemption requirement, seems sound.

Although it is always tempting (but frequently unfair) to critique a transaction with 20/20 hindsight, one may speculate that the parties to the transaction might have avoided having this case go as far as it did, or even avoided the issuance of a notice of deficiency challenging treatment of the transactions as sales of stock, if, for example, the cross-default clauses had been limited to the stock purchase transactions (or eliminated entirely), and if Mary Ann had foregone any employment agreement, perhaps in consideration of a slightly higher purchase price for the shares. There was a significant benefit to the Hursts in obtaining capital gain treatment, and some small sacrifices might have been in order to provide greater assurance of obtaining that treatment.