BUSINESS INSURANCE

Section 303 Stock Redemption

BUSINESS CONTINUATION

A successful business has a business succession strategy.

You care about the future of your business and want it to carry on. Many options are available for ensuring that your business will, even after one of the owners dies. If one of your primary goals is to help avoid ordinary income taxation of stock assets, then something called a Section 303 stock redemption arrangement might work for you.

If you can identify with one or more of these statements, establishing a Section 303 stock redemption arrangement funded with life insurance may be beneficial.

- At least 35% of the value of your estate consists of a closely held corporate interest.
- Other family members (spouse, parent, children) own an interest in the corporation.
- You desire to keep your closely held corporation in your family after your death.
- Your estate lacks sufficient liquidity to pay part or all of the estate/state tax liabilities and administrative expenses.

WHAT IS A SECTION 303 STOCK REDEMPTION ARRANGEMENT?

Section 303 of the Internal Revenue Code (IRC) permits corporate stock from the estate of a deceased owner to be redeemed and considered a capital transaction rather than ordinary income when proceeds are used to pay estate taxes, state death taxes, and administrative expenses. In a Section 303 stock redemption agreement using life insurance, the corporation buys and owns life insurance on the key owner/shareholder. Life insurance helps facilitate this arrangement by giving the corporation, through the policy's death benefits, the liquidity it needs to purchase company stock from the deceased owner's estate. This can help solve the business' liquidity issue at the very time when funds are needed while continuing the business and keeping it in the family.

POTENTIAL BENEFITS

- An orderly and predetermined disposition of the business owner's interest is possible.
- An element of certainty that there will be liquidity to help pay tax and administrative obligations is provided to the estate and the business owner's heirs.
- Good will is promoted with employees, suppliers, and creditors by providing for the stability of the business.
- The business continues uninterrupted with the remaining owners in control with the same proportion of ownership as before the redemption.
- The policy cash values can potentially improve the balance sheet of the business. Policy cash values, if any, can be accessed by the business for use during the insured's life.[1]

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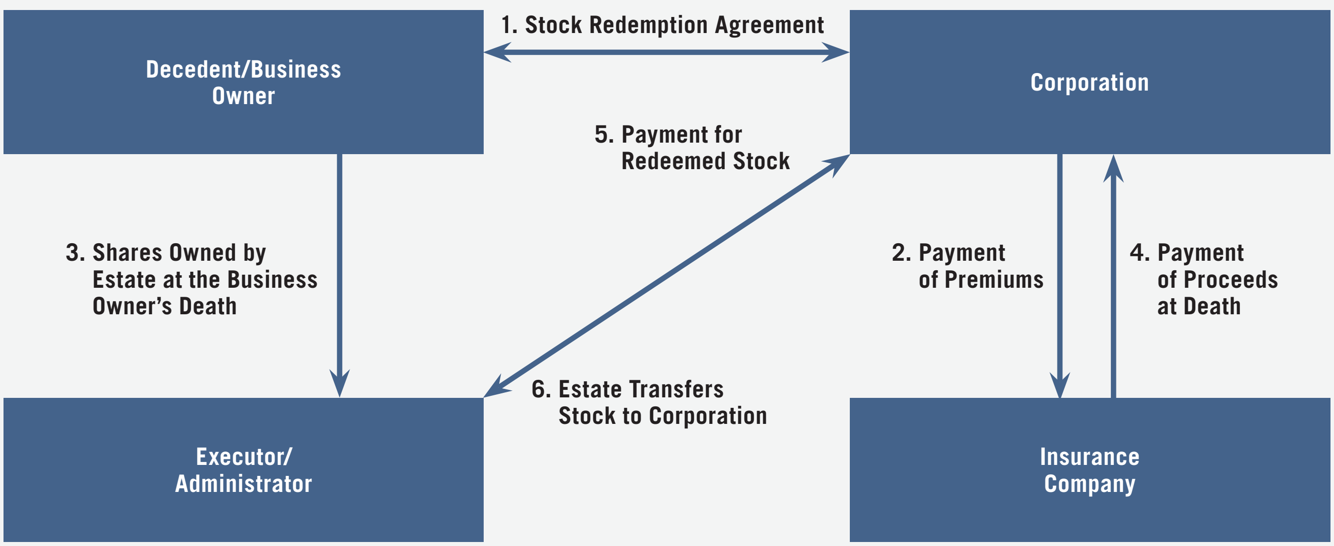
SECTION 303 REQUIREMENTS

To qualify for capital gains treatment under IRC §303:

- The value of the stock included in the deceased owner's gross estate must exceed 35% of the value of the adjusted gross estate.
- The stock that may be redeemed under IRC §303 and that will receive capital gains treatment is limited to an amount equal to the total of all federal and state death taxes, generation-skipping taxes, funeral costs, and administration expenses.
- Section 303 is available only to stockholders who have an obligation to pay death taxes and administration costs—usually the estate or family.
- The redemption generally must take place within four years of the deceased shareholder's death.

HOW A SECTION 303 STOCK REDEMPTION WORKS



1	The corporation and business owner enter into a stock redemption agreement: the corporation agrees that, when the shareholder dies, it will purchase (from the shareholder's estate or heirs) shares of stock equal to the sum of the death taxes, funeral costs, and administration expenses.
2	The corporation purchases life insurance protection on the life of the business owner. The corporation is the policyowner, premium payer, and beneficiary of the policy. You should consult your legal counsel to determine whether, to receive tax-favored treatment,[2] notice and consent under IRC §101(j) is required before the policies are issued.
3	At the death of the business owner, the stock passes to the estate.
4	At the death of the business owner, the corporation collects the life policy proceeds.
5	The corporation redeems the stock of the business owner and pays the agreed-upon value to the business owner's estate.
6	The estate transfers the stock of the deceased business owner to the corporation. When the redemption qualifies for capital gains treatment and the decedent's stock is stepped-up to fair market value at death, no gain is recognized.

TAX CONSIDERATIONS

- The redemption of the business interest at the death of the owner should not result in income tax to the selling heirs due to a step-up in basis received by the estate.
- Section 303 stock redemptions are exempt from the constructive ownership/attribution problems that typically affect stock redemptions in family corporations.
- Insurance premiums paid by the corporation for the policy on the life of the business owner are not tax-deductible by the corporation.
- Death benefits received by the corporation are generally income tax-free under IRC §101(a) but may be subject to alternative minimum tax (AMT) unless exempted under the small business exemption.[3] In addition, for employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax-free under IRC §101(j).
- Additional requirements may apply at the state level (e.g., some states require that any stock redemption be paid for with corporate surplus).

[1] Life insurance policy cash values are accessed through withdrawals and policy loans. Loans are charged interest. Loans and withdrawals reduce policy cash values and death benefits, may affect any guarantees against lapse, and may have tax consequences.

[2] Life insurance death proceeds are generally received income tax-free [IRC §101(a)]. For employer-owned contracts issued after August 17, 2006, death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain exceptions apply, death proceeds can be received income tax-free [IRC §101(j)]. Please consult your tax advisor.

[3] Corporations in their first year or having average annual gross receipts less than $7.5 million for the preceding three-year period (average annual gross receipts of $5 million for initial qualification) are not subject to AMT.

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