Stock Redemption Agreements and the Accumulated Earnings Tax

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STOCK REDEMPTION AGREEMENTS AND THE ACCUMULATED EARNINGS TAX

It is generally agreed that a planned redemption of stock of a retiring or deceased shareholder in a close corporation is very advantageous to both the shareholder and the corporation. The basic reason is that there is no established market for the stock of a close corporation. This handicap can be overcome by the stock redemption agreement which creates a market for the sale of the deceased or retiring shareholder's stock. If the shareholder could be assured that upon his death, his dependents would receive reasonable dividends, he might want to retain the stock for their benefit. However, uncertainty as to both future corporate earnings and future dividend policies emphasize the desirability, from the shareholder's standpoint, of an arrangement which assures the sale of his stock at retirement or death. From the corporation's standpoint, in the absence of a restrictive agreement, the stock may fall into the hands of individuals whose interests are inimical to those of the corporation. Harmony of management and independence of action which are important ingredients of corporate success may be impaired or destroyed by the intrusion of outsiders.

A customary mode of obviating the above problem is the stock redemption agreement. Under a stock redemption agreement the corporation agrees to buy its outstanding stock from the estate of a decedent shareholder or from the shareholder himself during his lifetime if he should decide to sell prior to his death. The shareholder obligates his estate to sell his stock to the corporation after his death and also binds himself to offer it first to the corporation, if he should decide to sell during his lifetime. The corporation usually finances the redemption agreement by accumulating surplus or by purchasing life insurance on the individual stockholders. The premiums paid on the insurance policies are paid out of surplus. The corporation owns the policy and is the sole beneficiary.

The corporation in accumulating surplus to finance the purchase of the outstanding stock is necessarily confronted with the issue of whether such an accumulation is improper under sections 531 and 532 of Internal Revenue Code. Where the stock redemption agreement is funded by life insurance, premiums are usually paid out of surplus.

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1 Another important purpose of such an arrangement is to establish an estate tax value of the decedent stock, which eliminates any dispute in respect there-to. Lowndes and Kramer, Fed. Est. and Gift Tax; §46 at 533 (1956 ed.).
2 See generally Mannheimer and Friedman, Stock Retirement Agreements, 28 Taxes 423 (1950) see also Henry F. Prunier et. al. v. Commissioner of Internal Revenue, 248 F. 2d 818 (1st Cir. 1957).
3 Appleman, Basic Estate Planning, p. 90 (1957).
5 Since under section 264 premiums are not a deductible expense of the corpora-
Premiums will necessarily reduce dividends and a cash surrender value of the policies will be building up. The question may be raised as to whether the above will encourage the imposition of the accumulated earning tax by the Commissioner.\(^6\)

The initial hurdle to overcome, even before considering the code and cases on improper accumulations, is whether a stock redemption agreement represents a proper business purpose of the corporation. This writer believes that a number of reasons sustain stock redemption agreements as a proper business purpose of the corporation which can be summed up as the right of corporate self-preservation. Elaborating further it can be seen that even while the shareholder is still alive the agreement benefits the corporation because it tends to stabilize the corporation's business. If the bank knows about the agreement, it may well be inclined to extend credit more liberally to the corporation because the possibility of inexperienced shareholders injecting themselves into management is eliminated. If the key employees are informed of the agreement, it will be an inducement to them to remain with the corporation because they realize that the continuation of the business in the hands of the survivors is assured and with this their positions. If there is no stock redemption agreement when the decedent dies his family may ask an exorbitant price for his stock, or demand dividends without regard to the needs of the corporation. They may even press for liquidation of the corporation. The surviving shareholders may be unwilling to work indirectly for the benefit of the former shareholder's family. As has been stated previously a well planned stock redemption agreement will obviate the above problems.\(^7\)

Before discussing the code or the cases it should be noted that a finding of an improper accumulation as a result of a poorly planned stock redemption agreement will have a three-pronged effect:

1) The corporation would be subjected to an improper accumulation surtax under code section 531.
2) The directors could be the objects of a derivative suit by the stockholders.\(^8\)
3) The assessing of a surtax may limit the corporation's ability to fulfill its obligation under the stock redemption agreement.

**Codes and Regulations**


\(^6\) Funding With Life Insurance, 71 Harv. L. Rev. 710 (1958).

\(^7\) Supra, note 2, also it should be noted that even if a business purpose exists an accumulation that is beyond that reasonably reduced to satisfy such a purpose will be subject to the accumulated earnings tax.

\(^8\) 1 P.H. §4719 (1960).
generally under section 531 an accumulated earnings tax of $27\frac{1}{2}\% of the taxable income not in excess of $100,000 plus $38\frac{1}{2}\% of the accumulated taxable income in excess of $100,000 is imposed on any domestic or foreign corporation,\textsuperscript{10} formed or availed of to avoid or prevent the imposition of the individual income tax on its shareholders by permitting earnings and profits to accumulate instead of dividing or distributing them.\textsuperscript{11} Under Regulation 1.533-1(a)(2)\textsuperscript{12} certain circumstances are enumerated as manifesting a purpose to avoid income tax by shareholders. For our discussion it would appear that the following are germane:

(1) Dealings between the corporation and its shareholders such as withdrawals by the shareholders as loans or \textit{expenditures of funds by the corporation for the personal benefit of the shareholders}.

(2) \textit{The extent to which the corporation has distributed its earnings and profits}. It is interesting to note that "the personal benefit to shareholders" in clause one above and "the extent to which the corporation has distributed earnings and profits" in two have been emphasized by the courts in sustaining assessments of the accumulated earnings tax.

Regulation 1.537-1(a)\textsuperscript{13} provides among other things that the need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for a bona fide business purpose. Subsection (b)\textsuperscript{14} provides that a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs must show that the future needs of the business require such accumulation. The corporation must have specific, definite, and feasible plans for the use of such accumulation. The regulation enunciates specific circumstances which are grounds for accumulating earnings and profits.\textsuperscript{15} The grounds specified are not intended to be exclusive and only one of the enunciated grounds would appear germane for the purpose of determining if a stock redemption agreement is a proper purpose for accumulating surplus. The pertinent ground states: "To provide for the retirement of bona fide indebtedness created in connection with the trade or \textit{business}, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with the contract obligation incurred on issue." Query, could a stock redemption contract be considered to create an indebtedness on the part of the corporation so as to bring it within the ambit of this example?

\textsuperscript{9} §531 \textit{supra}, note 4.

\textsuperscript{10} §532(c) specifically exempts personal holding companies (defined in §542), a foreign personal holding company (§552) or corporation exempt from tax under subchapter F (§501).

\textsuperscript{11} See Reg. 1.532-1(a).

\textsuperscript{12} Reg. 1.533-1(a)(12).

\textsuperscript{13} Reg. 1.537-1(a).

\textsuperscript{14} Reg. 1.537-1(b).

\textsuperscript{15} Reg. 1.537-2(b).
Before leaving the code it should be noted that under section 535(c)(2) a minimum credit or exemption of $100,000, from the section 531 penalty tax is allowed. Hence, if one is dealing with a corporation whose total earned surplus is not likely to exceed $100,000, he need have no further interest in the subject.

MINORITY BUYSOUT—STOCK REDEMPTION AGREEMENTS FUNDED BY ACCUMULATING EARNINGS

It should be noted that the Tax Court has hardly been consistent in its interpretation of the concept "business purpose." However, the business purpose test, minority interest being purchased, promotion of harmony, and fortuitous events or emergencies are the points emphasized by the courts in sustaining stock redemptions of minority interests as valid reasons for accumulating surplus.

In Fred F. Fischer,17 the Tax Court termed the promotion of harmony in the conduct of the business a proper business purpose. The taxpayer in that case was the majority shareholder of a corporation. The taxpayer's sister, a minority shareholder, had been constantly complaining about the conduct of the business. She had threatened to commence a legal action seeking a receivership for the corporation. In order to put an end to such dissention, the corporation purchased all the sister's holdings at a price in excess of its fair market value. The commissioner contended that the stock purchase was prompted by reasons personal to the shareholders and was not in furtherance of any corporate purpose. The Commissioner assessed against the remaining shareholders a tax on that portion of the purchase price which was excessive, on the theory that it constituted a constructive dividend. The Tax Court found for the taxpayer, holding that the corporation's purchase of the sister's stock was in furtherance of a corporate business purpose. This case would appear to sustain an accumulation in order to purchase a shareholder's interest on the ground that it promoted harmony in the conduct of the business and hence is furthering a legitimate corporate purpose.

In the Dill Case18 the Commissioner asserted that the petitioner was availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being distributed. The petitioner corporation accumulated surplus to buy out recalcitrant minority shareholders who desired to merge the corporation with a large concern. During the year of redemption the corporation declared a con-

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servative dividend. The court held that the purpose is the germane fact in issue, i.e., was the accumulation effected solely to prevent a surtax on the individual shareholders, or was there a real business purpose. The question of what is reasonable or unreasonable purpose of a business is always one of fact. The court succinctly summed up the rationale of these cases stating,

A corporation certainly must have the untrammeled right, within reasonable limits, to financially protect itself and shareholders.\textsuperscript{19}

The court then reasoned that the redemption (purchase of 24,990 out of 50,000 shares outstanding) was not part of an elaborate plan to avoid individual tax by distributing the surplus but was a result of the petitioners then pressing and reasonable business need, i.e., self preservation.

The \textit{Gazette Case}\textsuperscript{20} further emphasizes the promotion of harmony concept and sudden emergencies as a result of dissension as a proper business reason for accumulating surplus to buy out the recalcitrant shareholder's interests. In that case, officers of the petitioner corporation testified that the accumulation in 1946-1947 was for repairs, replacement, and expansion which needs were immediate. The purchase of the stock of the minority shareholder (21\% interest) was not contemplated in either 1946 or 1947. In 1948 the dissention became manifest and the corporation to circumvent a sale by the minority shareholder to an outsider purchased his stock for $100,000.\textsuperscript{21} The Commissioner contended that the price of $100,000 was far in excess of the true market value of the stock, that it was evidence that there was no reasonable need for the accumulation of funds in 1946-1947. The district judge emphasized several factors in holding that the accumulation was reasonable. He observed that the corporation had a long history of paying generous dividends.\textsuperscript{22} Even in the year covered by the section 102\textsuperscript{23} assessment the corporate dividend was above the average dividend. The district judge also noted that certain outsiders sought to purchase stock in the corporation. The officers of the corporation felt that such a sale would result in a lack of harmony. The court concluded that the purchase of the minority shareholders' interest, even at the advanced price, was a reasonable need of the corporation.

\begin{footnotes}
\item[19] \textit{Id.} at 1031.
\item[21] The petitioner corporation was a newspaper. The sale of stock to an outsider would probably result in the destruction of its individualistic editorial policy.
\item[22] For the twenty years ending with 1945, the year immediately preceding the questionable years, the corporation had net earnings after taxes of $2,228,000 and paid out $2,167,000 in dividends, retaining in the business for this period no more than $120,000 of earnings.
\item[23] \\textsection 102, 1939 code, relevant section of that code has not been substantially changed by \\textsection 531 of 1954 Code.
\end{footnotes}
50% or Majority Buy Outs

The Pelton Steel case,\textsuperscript{24} decided in the Seventh Circuit leaves the question of the propriety of accumulating earnings for funding stock redemption agreements in the realm of speculation. Indeed one tax attorney has stated:\textsuperscript{25}

An accumulation to redeem stock for the purpose of preserving the independent existence and personality of a corporation is an improper accumulation which will cause the corporation to be considered as having been availed of for surtax avoidance.

Any understanding of the holding and ramifications of the Pelton case calls for a detailed analysis of the facts; indeed, a determination of a proper or improper accumulation can only be made after carefully scrutinizing all the facts of the individual case.

Pelton Steel Corporation was organized with $40,000 capital to produce steel castings. Its business had been successful and substantial dividends were paid regularly, except in 1931 through 1934. In 1945 and 1946, taxpayer's net profit was $46,000 and $170,000 respectively and the end of the year surplus was $244,000 and $921,000 for each year.\textsuperscript{26} The net worth of the corporation was $425,965 and $1,019,829 for the years 1945 and 1946.

At the end of 1945, Ehne, a 60% stockholder, and Fowick, a 20% stockholder, decided to retire. The taxpayer's remaining stockholder, Slichter, was concerned that the corporation might become a mere subsidiary of a large steel company, and of possible deleterious effects on employee relations and the status of key men. A plan was formulated whereby the taxpayer corporation would use its own funds to redeem the interest of the 80% shareholders at the price they asked with Slichter then becoming the sole shareholder. The plan was consummated with the aid of a $500,000 loan and foregoing a dividend in 1946.

The Commissioner determined that the corporation was liable for a section 102 surtax for 1946. The Tax Court sustained the Commission's assessment. The Tax Court observed that the corporation could have effectuated the redemption and still declare a dividend in the year of purchase. The failure to declare a dividend was indicative of a scheme to avoid a surtax on dividends.\textsuperscript{27} The Tax Court concluded that the purchase and retirement by the corporation of 80% of its own outstanding stock did not constitute a reasonable business need of its

\textsuperscript{24} 28 T.C. 153 (1957).
\textsuperscript{25} C.A.-7 Opinion in Pelton Steel Clouds Rule on Surplus Accumulation, 8 J. Taxation 254 (1958).
\textsuperscript{26} $497,000 of the increase represented an adjustment of amortization reserves.
\textsuperscript{27} In that the nature of the underlying income is changed from ordinary income to capital gains.
own, but rather suited the personal or business needs of its shareholders.

The Court of Appeals affirmed,\(^ {28}\) distinguishing the two main decisions relied on by the petitioners on the ground that those cases involved situations where majority shareholders bought out a minority, while in *Pelton* a minority shareholder became the sole stockholder after the redemption.\(^ {29}\) Also the Pelton plan required, and had, unanimous shareholder approval; all three men enjoyed the benefits of the planned action. The Court of Appeal concluded:

Indeed we are satisfied *Pelton* was availed of during the taxable year.\(^ {30}\)

It is this writer's opinion that the *Pelton* decision is limited to its facts and is not precedent for holding all stock redemptions funded by accumulated earnings an improper accumulation and, hence, subject to the surtax. The case is precedent only for a situation where the same factors are present, viz.,

1) that stock of a controlling shareholder is redeemed.

2) that the corporation could have accomplished the same result by first paying a dividend and then redeeming at a lower value.

3) the dominant motive underlying the redemption is to personally benefit the shareholder whose stock is redeemed.

Another factor which should be considered is an impromptu plan to buy out a majority or 50% shareholder. In a recently decided case\(^ {31}\) the petitioner corporation had 2000 shares of outstanding stock which were held equally by the Stratton and the Miller family. All the corporate officers and a majority of the directors were members of the Stratton family. Due to the latter situation and because the Miller family needed more security than the mere possibility of dividends, a stock redemption plan by the corporation was approved by the stockholders. The withdrawing shareholders were given a small cash payment and promissory notes for their interest. The court sustained the Commissioner's assessment of surtax pursuant to section 102 for improper accumulation of earnings and profits on the ground that the petitioner was availed of by its shareholders for the purpose of avoiding surtaxes upon themselves. It should be noted that the petitioner was incorporated in 1947 and the plan of redemption was proposed and accepted at a stockholders' meeting in 1950. This, as in the *Pelton*

\(^{28}\) 251 F. 2d 278 (7th Cir. 1958).

\(^{29}\) *Supra*, notes 18 and 20.

\(^{30}\) *Id.* at 282. See also Hedberg Friedman Contracting Company v. Commissioner of Internal Revenue, 56 P-H Memo T.C., *affirmed* 251 F. 2d 839 decided a few months previous to the *Pelton* case. There the court considered a corporate accumulation of profit for an alleged corporate buy out of a disgruntled 50% shareholder. The court noted that corporate failure to pay dividends was prompted by the selling shareholders personal desire to have his stock retired and not by any business needs of the corporation.

case, manifests a sudden plan to redeem the stock solely for the personal benefit of the shareholder whose interest is redeemed. The latter gives rise to an inference of an endeavor by the shareholder to avoid a surtax on dividends.

The Penn Needle Art Company case\(^{32}\) involved a sudden unexpected purchase of a disgruntled 50% shareholders' interest financed by accumulated surplus. However in that case the surplus was initially accumulated to improve its plant and machinery. The Tax Court held that the plan to accumulate income for plant improvement was a proper business purpose and sufficient to nullify the assessment of a surtax under section 531. The court concluded that the facts do not manifest a deliberate accumulation to buy out the 50% shareholder so as to give him a capital gain rather than to provide for the needs of the business.

**Stock Purchase Agreement Funded by Life Insurance**

After the Emeloid decision\(^{33}\) it was generally recognized that funding redemption agreements with life insurance policies does not create any real risk of running afoul of the unreasonable accumulations tax.

Although the Pelton case\(^{34}\) does not deal with the subject of insurance funding as such, it might be interpreted as inconsistent with Emeloid,\(^{35}\) especially where insurance policies are acquired for the express purpose of funding the redemption of the stock of a majority shareholder and the facts involve large non-recurring premium expenditures in the year in issue. However, it could be argued that the existence of insurance policies with annual premiums paid over many years manifests that the corporation sincerely believed that a redemption was necessary to preserve its continuity.

In a recent case,\(^{36}\) the Tax Court sustained a self-insurance program funded by accumulating earnings as a reasonable accumulation. The insurance fund was set up to provide insurance on key members of the organization.\(^{37}\) The stated purpose was to provide stock insurance should a key member (executives and salesmen with 5 years service) be unable to continue with the business of the company. The amounts put into the fund were equal to the premium which would have been charged by a commercial insurance company. The Commissioner assessed a surtax for the calendar years 1951, 1952, 1953 stating

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\(^{32}\) Penn Needle Art Co., P.H. §58,098 May, 1958.

\(^{33}\) Emeloid v. Commissioner, 189 F. 2d 230 (1951). Although this case involved an excess profits tax the principles enunciated apply equally to accumulated earnings tax sections of the Internal Revenue Code.

\(^{34}\) Supra, note 28.

\(^{35}\) Supra, note 33.


\(^{37}\) Three shareholders were officers and directors. Together they owned 78.6% of the stock.
that the accumulation for the fund was improper and instituted for the purpose of preventing a tax on shareholders via dividends.

The court set aside the Commissioner's assessment, stating: that under the statute and under the decisions it is the purpose, the intention, motivating course of conduct which is made controlling in determining whether an accumulation is improper.38 The judge after scrutinizing the self-insurance fund could not find that the accumulation was beyond the reasonable needs of this particular business. In looking for a tax motive the court took into account a comparison of dividends paid to the chief stockholders and the varying surtax rates throughout the years. The court found that there was no correlation between the varying income tax rates and the various dividends paid to the stockholder, justifying the conclusions that the directors were not tax conscious and that the self-insurance plan was not a product of tax avoidance motive.39

CONCLUSION

The impact of the Pelton case40 can be obviated if certain factors emphasized by the courts are utilized by the shareholders of the closely held corporation in formulating a stock redemption agreement.

First of all, as has been previously noted under 535(c)(2)41 of the code a $100,000 accumulated earnings credit is granted. This will provide some shelter for most closely held corporations.

The most important factor is sound planning from the inception of the corporation. If the corporation historically had agreements with its shareholders (even before the existence of earnings and profits) providing for a redemption of their stock on death or retirement, this would be cogent evidence that the corporation really believed that such redemption was a requirement for survival.

A record of regular dividends is equally important. If regular dividends have not been paid, in a cash redemption of one or more controlling shareholders, it would be helpful to insulate at least the year of redemption by paying a substantial dividend. If all the current earnings are paid out in the year of redemption the stock purchase is

38 Supra, note 36 at 1279.
39 Professor Bowe in his text on Estate Planning feels that funding the stock redemption by purchasing life insurance out of profits is the only unassailable method. He points out: "accumulating profits in the form of cash or in investments unrelated to the business or the use of profits to purchase life insurance may be alternative methods of providing cash to retire stock. But one represents the generally recognized method of providing the full amount of cash for an event, uncertain as to time, and the other a rarely, if ever, adopted one. Where cash is accumulated year by year it's inadequacy in the earlier years and it's full availability for other purposes, tends to suggest that the real motivation may be other than to provide a fund to insure performance of the typical type stock redemption agreement. Bowe, Estate Planning and Taxation, §16.23 at 76 (1959-1960 Supp).
40 Supra, note 28.
41 Supra, note 16.
necessarily funded out of capital or accumulated earnings and profits of prior years.

It should be noted that the economics of the situation might make it more feasible to risk an attack under section 531 than to fund the redemption by accumulated earnings after first declaring a dividend. This would be the case where the individual shareholders are in such a high income tax bracket that they would prefer a corporate accumulated earnings tax.

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