Taking Cash Out: Stock Redemptions

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Family-owned or closely held corporations can be a handy source of cash for company owners-to pay for a child's college education, to finance a new business venture, or to supplement retirement savings, for example. One way to tap the company coffers is to borrow funds from the corporation. Another way is a straight dividend. Still a third way is for the corporation to buy back a shareholder's stock through a stock redemption. The latter course may be preferred when there are other shareholders who don't have the same cash needs.

We have prepared an explanation that explains the ins and outs of stock redemptions and alerts you to a special window of opportunity for certain types of redemptions.

Basic rules: A stock redemption may be treated either as a sale of the stock or as a dividend. If the redemption is treated as a sale, the redemption proceeds are nontaxable to the extent of the owner's basis for the redeemed shares and the excess is capital gain. If the redemption does not satisfy the requirements for sale treatment, the redemption is treated as a dividend to the extent of the corporation's earnings and profits.

In the past, dividend treatment had a distinct disadvantage. The redemption proceeds were taxed at ordinary income rates, rather than the favorable capital gain rates that applied to a sale, thus upping the tax cost of tapping the corporate coffers. However, it is often impossible for company owners to qualify a redemption as a sale unless they want to severely curtail their involvement with the corporation.

Key Point: Under current law (until 2009), qualified dividend income is taxed at the same rates that apply to net capital gain. Thus, both net capital gain and dividend income attributable to a stock redemption are taxable at a 15% rate for taxpayers in the higher brackets. The tax rate is 5% for income that would otherwise be taxed at a 10% or 15% regular tax rate. However, the 5% rate drops to zero for one year only in 2008 [IRC Sec. 1(h)(1)].

If there is a stock redemption in an owner’s future, this may be a good time to act. With favorable tax rates on dividends, a stock redemption will be lightly taxed whether it's treated as a dividend or a sale.

Bear in mind, however, that characterization of a redemption as a sale or a dividend may have less significance than in the past, but it is not totally without significance. For example:

As noted above, when a redemption qualifies as a sale, the redemption proceeds are tax-free to the extent of the shareholder's basis. Therefore, a redeeming shareholder who has a substantial basis in his or her stock will have significantly less income subject to tax with sale rather than dividend treatment.

Moreover, dividend income is treated as net capital gain not as long-term capital gain Therefore; dividends cannot be offset by capital losses.

In addition, when a shareholder's redemption qualifies as a sale, the redeeming shareholder immediately recovers his or her basis in the stock. However, when a redemption is treated as a dividend, the shareholder's basis may remain "in limbo" for an extended period.

Redemption as sale: A corporation's redemption of its stock is treated as a sale of the stock if the redemption is one of the following:

Not essentially equivalent to a dividend.

Substantially disproportionate.

In complete termination of the shareholder's interest.

A partial liquidation. [IRC Sec. 302(b)]

These conditions are discussed in more detail following.

Not essentially equivalent to a dividend: The determination of whether a redemption is or is not essentially equivalent to a dividend is based on facts and circumstances. Factors taken into account include the change in proportionate ownership interests in the corporation following the redemption, the corporation's pattern of dividend payments, and whether or not there has been a contraction of the corporation's business.

Substantially disproportionate: A redemption will be considered substantially disproportionate if, following the redemption, the redeeming shareholder owns (1) less than 50% of the outstanding voting stock or the corporation and (2) less than 80% the voting stock he or she owned before the redemption.

Complete termination: A redemption is treated as a complete termination if the redeeming shareholder has no ownership interest in the corporation following the redemption. (See more following the example.)

Partial liquidation: A redemption qualifies as a sale if it is made pursuant to a partial liquidation of the corporation's business (e.g., the sale of a business or business assets).

Family owned corporations: In the case of a family-owned corporation, a special attribution rule comes into play. A shareholder is treated as constructively owning stock that is owned directly or indirectly by or for his or her spouse, children, grandchildren, and parents [IRC Sec. 318(a)]. Consequently, a family member may redeem all or a substantial portion of his or her shares in the corporation and still fail to have the redemption qualify as a sale.

Example 1: Bill and Alice Sanders, a married couple, are both officers of Sanders Corp. and each owns 50 of Sander's 100 total outstanding shares. Bill and Alice each have a basis of $100,000 for their shares and each has owned the shares for more than 10 years. In 2005, the corporation redeems all of Alice's 50 shares in exchange for a payment of $500,000.

Result: Alice's $500,000 redemption proceeds will be treated as a dividend. The redemption does not qualify as substantially disproportionate or a complete termination because Alice continues to constructively own 100% of the outstanding shares through attribution from Bill. Assuming Alice's tax bracket is 25% or higher, she will owe $75,000 ($500,000 x 15%) of tax on the redemption proceeds.

On the other hand, if Alice prefers to have the redemption treated as a sale, she does have an "out."

For purposes of the **complete termination test**, the attribution rules will be waived if:

Immediately following the redemption the redeeming shareholder has no interest-including a position as an officer, director, or employee -- in the corporation other than as a creditor;

The redeeming shareholder does not acquire an interest other than that of creditor within 10 years following the redemption, except by bequest or inheritance; and

The shareholder did not, within 10 years before the redemption, acquire stock from or transfer stock to a person covered by the attribution rules.

Example 2: Same facts as Example 1, except Alice cuts all ties with the corporation for 10 years.

New Result: Alice's redemption will qualify as a complete termination of her interest and the redemption will be treated as a sale of the stock. The first $100,000 of redemption proceeds will be treated as a tax-free return of basis. She will owe $60,000 of tax on the remaining $400,000.

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Because of the family attribution rules, when an owner of a family corporation redeems only a portion of his or her shares, the redemption will inevitably be treated as a dividend. However, there may be other ways to cut the tax on a redemption.

For example, a company owner who wants to redeem some shares to pay a child's college tuition can save by giving the shares to the child and having the corporation redeem the shares from the child. Since the child will have received the stock within 10 years of the redemption, he or she won't qualify for a waiver of the family attribution rules. Therefore, the redemption proceeds will still be taxed as a dividend. However, assuming the child is in a low tax bracket, the tax rate will be cut from 15% to 5% (or even to 0% if the redemption takes place in 2008).

Basis: If a redemption is treated as a sale, the redemption proceeds are nontaxable to the extent of the shareholder's basis for the redeemed shares; the excess is capital gain. In other words, the shareholder is treated as having received a return of his or her basis in the shares.

On the other hand, if the redemption does not satisfy the criteria for being treated as a sale, the redemption is treated as a dividend to the extent of the corporation's earnings and profits. Long-standing IRS regulations, issued in 1955, provide that when a stock redemption is treated as a dividend, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Under those regulations, if the shareholder continues to own stock in the corporation, the basis of that stock is increased by the basis of the redeemed shares. In addition, the regulations make it clear that if a husband and wife each own stock in a corporation and one spouse's stock is redeemed, the basis of the non-redeeming spouse's stock (which is treated as owned by the redeeming spouse under the attribution rules) is increased by the basis of the redeemed shares.

The regulations do not, however, address what constitutes a "proper" adjustment if a redeeming shareholder no longer owns any stock in the corporation either outright or by attribution. Perhaps because of this fatal flaw in the existing regulations, the IRS has issued proposed regulations that take a different approach to the basis question. Under the proposed regulations, when a redemption is treated as a dividend, an amount equal to the adjusted basis of the stock is treated as loss. The loss can be claimed by the redeeming shareholder when and if the conditions that caused the redemption to be treated as a dividend no longer exist. For example, a loss would be triggered when the redeeming shareholder no longer owns stock in the corporation either outright or through attribution or the redeeming shareholder has sufficiently reduced his or her interest in the corporation to qualify for substantially disproportionate redemption treatment. The proposed regulations will apply to redemptions occurring after the date the regulations are published in final form.

Key Point: Under either set of rules, it may be many years before the redeeming shareholder's basis is recovered. For example, under the current regulations, if a redeeming spouse's basis is transferred to the other spouse, basis recovery will not take place until the other spouse's shares are sold or redeemed. Similarly, under the proposed regulations, a redeeming spouse can claim the unrecovered basis as a loss only when the other spouse's interest is disposed of or significantly reduced.

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