

Internal Revenue Service
memorandum

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date: March 7, 2003
to: Thomas Scuderi, Revenue Agent

from: Area Counsel, LMSB Area 2
(Heavy Manufacturing and Transportation)

subject: **Deductibility of Insurance Premiums;**
Premiums as Constructive Dividends to Insured/Other Shareholders;
Deferred Compensation or Dividends/Sale of Stock/Installment
Redemption

This memorandum responds to your request for assistance. It should not be cited as precedent.

LEGEND

Taxpayer	=
Year 1	=
State	=
Founder's Heir (FH)	=
FH's Retirement Date	=
A%	=
A	=
B	=
C	=
Related	=
First Amendment Date	=
Second Amendment Date	=
Trust Creation Date	=
Shareholder's Trust	=
Year 2	=
Life Insurance Company	=
Insurance Purchase Date	=
Policy One	=
\$A	=
Policy Two	=

\$B =
 Insurance Change Date =
 Policy Three =
 \$C =
 Divorce Date =
 Year 3 =
 Year 4 =
 \$D =
 Retirement Date =
 X =
 Y =
 X + Y =
 Year 5 =
 \$P =
 Q% =
 R% =
 \$S =
 \$T =
 \$U =
 Year 6 =
 Compensation Agreement
 Date =

ISSUES

1. Whether life insurance premium payments by a closely held corporation on the lives of the corporation's officers, who were its shareholders, are deductible business expenses of the corporation.
2. Whether the aforementioned premium payments constitute constructive dividends to the insured shareholders where the corporation paid the premiums, although both corporation and shareholders guaranteed the payment.
3. Whether the redemption of corporate stock from the estate of a deceased insured stockholder, using proceeds of company owned life insurance, results in constructive dividends to the continuing shareholders where no primary purchase obligation had been imposed upon the continuing shareholders.
4. Whether premium payments by the corporation for life insurance for one stockholder creates constructive dividends to the other shareholders where the proceeds of such policy are obligated for the reacquisition of the corporation's stock from the insured shareholder's estate.

5. Whether the closely-held corporation and its retiring Chief Executive Officer (CEO), who was also a shareholder, entered into a valid deferred compensation agreement or disguised stock redemption.

CONCLUSIONS

1. Premium payments for life insurance policies on the lives of the officer/shareholders of a closely held corporation are not deductible business expenses. Firstly, the Code precludes deduction under § 264 since the corporation was the primary beneficiary of the stock reacquisition plan funded by the insurance proceeds. Secondly, since the payments are being used to fund the acquisition of a capital asset, treasury stock, they do not constitute ordinary and necessary business expenses. Thirdly, IRC § 162(k) specifically precludes deduction for expenses by a corporation in connection with the reacquisition of its stock.

2. Since the proceeds of the life insurance policies are obligated solely for the reacquisition of the corporation's stock from the decedent stockholder's estate, or that of any later surviving spouse, the corporation is a beneficiary of the plan. Under such circumstance, no constructive dividend will be deemed to arise to the insured shareholder by the corporation's payment of the premiums.

3. Not being relieved of a primary obligation to purchase the shares of a decedent shareholder, no constructive dividend occurs to the continuing shareholders upon the reacquisition of corporate stock from the decedent shareholder's estate funded with company owned life insurance benefits.

4. Since no constructive dividends would arise to the continuing shareholders when the corporation reacquires the shares of a deceased shareholder using the proceeds of the applicable life insurance policy, no constructive dividends to those same shareholders are generated as the premiums are being paid by the corporation.

5. The post-retirement annuity coupled with the eventual stock reacquisition may represent a disguised long-term installment redemption; however, we are unable to provide a definitive answer at this time and recommend further factual development.

FACTS

Founded in Year 1, the subject State corporation is engaged in bulk purchase and sale of chemicals as a middleman between chemical producers and manufacturing end-users. The company's founder passed ownership to Founder's Heir, FH. By FH's Retirement Date, FH had retired, passing control to three (3) of FH's heirs. At FH's retirement, FH owned A% of the outstanding preferred stock but no common stock. The corporation's common stock was owned equally by FH's heirs, A, B, and C. Between the three (3) shareholders, they owned equal amounts of Class A Common shares and a higher number of Class B, non-voting Common. All three shareholders, as FH and founder before, worked as officers of the corporation.

The shareholders entered a Stock Redemption Agreement on FH's Retirement Date, the relevant terms of which detailed that for the best interests of the corporation, in the event of the death of a shareholder, the company would purchase the shares using funds from life insurance covering some or all of the shareholders. The agreement further described the manner that share value was to be determined and how the purchase would be effected if the insurance proceeds exceeded, or fell below, the value of the shares to be acquired.

The agreement was amended on First Amendment Date to add provisions for the acquisition of corporate stock upon the voluntary retirement or disability of a shareholder. With respect to a retirement, both shareholders and corporation agreed to the mandatory sale and purchase of stock. On Second Amendment Date, a second amendment was executed modifying the method of payment of the purchase price.

On Trust Creation Date, the stockholders created the Shareholder's Trust whose stated sole purpose was "to facilitate the acquisition of shares of a deceased shareholder by some or all of the surviving shareholders in accordance with the provisions of the Stockholders' Agreement." No contemporaneous Stockholders' Agreement was executed at that time however.

The trust estate was generally to consist of one or more life insurance policies on the life of one or more of the shareholders. This aspect mirrored the Year 2 Stock Redemption Agreement which had indicated use of life insurance to fund the stock redemption. The trustee was empowered to cause himself to be named the beneficiary under the policies. Upon maturity, the trustee was to collect the proceeds under the applicable policy and disburse same in accordance with the provisions of the Stockholders' Agreement.

According to the trust formation documents, policy premiums were to be paid from and out of the principal and income of the trust or as otherwise set forth in the trust document. No other provision specifically detailed a source of funds for the premiums, but it is our understanding that the premiums were paid by the corporation from its funds rather than by the trustee from any principal or income of the trust. Interestingly, the trust documents explicitly relieved the trustee from any obligation to pay the premiums.

A schedule attached to the trust agreement lists the policies extant at formation, two policies from Life Insurance Company, actually acquired on Insurance Purchase Date. Policy One provided for survivorship life insurance in the face amount of \$A on the lives of A and A's spouse. Policy B provided for survivorship life insurance in the face amount of \$B on the lives of B and B's spouse. On Insurance Change Date,

Policy Three was acquired with the face amount of \$C on C's life.¹ In Year 3, the respective ages of A, B, and C were 63, 58, and 53.

In Year 3, A announced that A would be retiring from active employment with the company as of the end of that year. Purport-edly in recognition of A's past services to the company as an employee since Year 4, and more recently as the company's CEO, an agreement titled, "Deferred Compensation Agreement" was entered between A and the corporation. Under its terms, A was to receive \$D per year in monthly installments, commencing on Retirement Date. In the event of A's death or incapacity, the payments would be made to A's spouse for life or to A's caretaker, if any. The stated purpose of the Deferred Compensation Agreement was to redress the corporation's professed earlier inability to fully fund a qualified retirement program during a considerable portion of A's employment.

On Retirement Date, A and A's spouse entered into a Stock Sale Agreement with the corporation and its other shareholders. A and A's spouse agreed that upon the death of the latter, the representative of such decedent's estate would offer the shares to the remaining persons or entities that were then shareholders of the corporation. Any shares not purchased by the other shareholders were to be purchased by the corporation at the price set in the agreement.

The Stock Sale Agreement contemplated that A would "as soon as practicable" convert A's Class A shares to non-voting Class B. All of A's non-voting stock possessed at death was to be purchased for \$A, the face amount of the life insurance policy. At the time the agreement was executed, A owned X shares of Class A and Y shares of Class B. Describing the reacquisition, the stock agreement states, "The [X + Y] common shares owned by A shall be purchased for a price of \$A." Since the total number of common shares to be repurchased was numbered at [X + Y], it appears the conversion contemplated was one-for-one between the common share classes.

In variance to the Year 3 trust agreement, the stock sale agreement stated that the corporation and the shareholders were obligated to pay the insurance premiums. The shareholders personally guaranteed the payment of the life insurance premiums. According to the stock sale agreement, payments made directly by the corporation were to be treated as reducing the outstanding guarantees of the shareholders on a pro rata basis.

We are informed that for the Year 5 tax year, B reported \$P as part of B's gross income. This amount had been reported on B's Year 5 Form W-2, Wage and Tax Statement, as a fringe benefit. The reported amount represented Q% of the premium for the policy for A, who had retired at the close of Year 3, plus R% of the premium paid for related shareholder C, the only other continuing common stock owner. We suspect

¹ C was divorced on Divorce Date. This policy, entitled "Modified Premium Whole Life," could represent the post-divorce striking of survivorship benefits of an earlier acquired policy.

that C similarly reported Q% of the premium paid for A and R% of the premium paid for B.

An appraisal of C's interest in the company and its related entities in Year 3, done for C's divorce, valued that interest at \$S. Also at that time, C owned a profit sharing plan valued at \$T and a defined benefit pension plan valued at \$U. Since the related shareholder's interests in the corporation were equal in Year 3, we have assumed that A probably possessed the same benefits. Upon A's retirement, A took a lump sum payment on A's pension and profit sharing plans.

LAW AND ANALYSIS

Deductibility of Premiums

Cogent business reasons exist justifying the purchase of key man life insurance by closely held corporations. Despite these reasons, the Code denies deductibility for stock redemption costs, as well as life insurance premium costs where the corporation is the beneficiary of such insurance.

In the case of Emeloid v. Commissioner, 189 F.2d 230 (3d Cir. 1951), rev'g 14 T.C. 1295 (1950), the Third Circuit expressively wrote of continuity-of-management as the business purpose underlying the need for key man insurance.

Harmony is the essential catalyst for achieving good management; and good management is the sina qua non of long-term business success. Petitioner, deeming its management sound and harmonious, conceived of the trust to insure its continuation. Petitioner apparently anticipated that, should one of its key stockholder-officers die, those beneficially interested in his estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate, not being bound by contract to sell the stock to petitioner, might sell it to adverse interests. The fragile bark of a small business can be wrecked on just such uncharted shoals.

Emeloid at 233.

Despite the business need for management continuity, Section 264(a)(1) denies deductions for premiums on any life insurance policy if the taxpayer is directly or indirectly a beneficiary under the policy. According to the within facts, the policies were possessed by the trust with the trustee named as beneficiary. The Trust Agreement, in discussing the disbursement of the life insurance proceeds, directed that the disbursement would occur pursuant to the Stockholders' Agreement. Although no contemporaneous agreement was made, the Year 3 Stock Sale Agreement executed with A specifically detailed that the proceeds were to be used for the reacquisition of corporate stock.

While the trust document failed to reflect who was responsible for making the premium payments, and in fact relieved the trustee from such responsibility, the Year 3 Stock Sale Agreement named the corporation and the shareholders as obligated for the payments. Nevertheless, the audit revealed that the premium payments were wholly made by the corporate taxpayer, with the corporation consequently seeking business deductions for the payments.

This situation is nearly identical to that confronted and analyzed in an earlier private letter ruling. LTR 6508270960A (Aug. 27, 1965). The only significant difference is that in that case, the trustee therein held possession of the stock certificates whereas the language of the applicable agreements in this matter states that the trustee will need to secure the share certificates from the relevant estate, suggesting that the stockholders retained possession of the shares.

Be that as it may, consistent with the letter ruling, the company is the true beneficiary, directly or indirectly, under the policies in question since the reacquisition plan permits the orderly continuation of the business after the death of a shareholder. Id. Thus, the deductions are not allowed under § 264(a).

Alternatively, the Service has already determined that premium payments as those within do not constitute ordinary and necessary business expenses. In Rev. Rul. 70-117, 1970-1 C.B. 30, the Service determined that such premium expenses were in the nature of amounts paid for the acquisition of a corporate asset, treasury stock, and therefore not deductible under I.R.C. § 162. The purchase of stock, including the repurchase by an issuing corporation of its own stock, is generally treated as a capital transaction that does not give rise to a current deduction. LTR 96-41-001, n.3 (May 31, 1996).

Finally, since 1986 the Code has specifically denied deductibility of expenses for a corporation's reacquisition of its shares. The current section reads in pertinent part, "[N]o deduction otherwise allowable shall be allowed ... for any amount paid ... by a corporation in connection with the reacquisition of its stock." I.R.C. § 162(k). Under the facts presented, the payments by the corporation of the insurance premiums fall within the broad "in connection with" language of section 162(k) since the proceeds of such policies were obligated for the reacquisition of the corporation's stock.

Constructive Dividends to the Insured Stockholders

When an individual shareholder receives an economic benefit through a diversion of corporate earnings and profits, such receipt may be taxed as a constructive dividend. Sachs v. Commissioner, 277 F.2d 879, 882 (8th Cir. 1960) cert. denied, 364 U.S. 833 (1960). Where a corporation pays premiums on an individual life insurance policy on the life of a corporate officer/ sole stockholder, and the officer is permitted to designate the beneficiary, and the corporation is not directly or indirectly benefited by the payments, those premium payments constitute income to the insured officer as they are paid. Yeungling v. Commissioner, 69 F.2d 971, 972 (3d Cir. 1934); Treas. Reg.

§ 1.61-2(d)(2)(ii)(a). Here, however, the named beneficiary on the life insurance policies is the trustee.

In the case of Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957), life insurance premiums similar to those within were found not to constitute income to the insured shareholder when it was determined that the true beneficial owner of the policies was the corporation. The above issue was directly addressed in Rev. Rul. 59-184, 1959-1 C.B. 65. In that matter, the named beneficiary was a trustee obligated to reacquire the corporation's shares from the decedent stockholder's estate.

Whenever a corporation purchases life insurance on the lives of its stockholders, the proceeds of which are to be used in payment for the stock of any stockholder, the premiums on such insurance do not constitute income to any stockholder ... if such right of the beneficiary to receive the proceeds is conditioned upon the transfer of the corporate stock to the corporation.

Rev. Rul. 59-184. Accord, Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958), Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957).

Interestingly, in Rev. Rul. 59-184, the insured stockholders' heirs were not the named beneficiaries of the insurance policies. The designated beneficiaries were trustees of an insurance trust who, by agreement with the corporation, were obligated to collect the insurance proceeds and pay those proceeds to the heirs of the deceased stockholders in return for the corporate stock. Nevertheless, the revenue ruling goes so far as to hold that even when the insured stockholders have the right to designate the beneficiaries of the life insurance policies, no constructive dividends result from the corporation's payment of the premiums, so long as the beneficiaries must surrender the corporate stock in order to receive the life insurance proceeds.

Since this ruling directs that no constructive dividend results when the corporation pays life insurance premiums for its stockholders where the beneficiaries named in the policies can be the insured stockholders's designees, provided those proceeds are to be used to reacquire the corporation's stock, it is plain that where the corporation itself is the beneficiary under the life insurance policy, no constructive dividend arises from the pre-mium payments. Admittedly, the policies herein reflect the trustee as the ostensible beneficiary, but as shown in LTR 6508270960A and Rev. Rul. 59-184, the corporation will be deemed the ultimate beneficiary. See also, Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43, 95 (2000) aff'd, 299 F.3d 221 (3d Cir. 2002) (For purposes of § 264(a)(1), it is not necessary that the deemed beneficiary be expressly listed as a beneficiary on the policy.).

Constructive Dividends to the Continuing Stockholders

The question arises whether, either by virtue of the current policy premium payments by the corporation, or by the future redemption event, constructive dividends accrue to the benefit of the other shareholders. Since the proceeds of the life insurance policies are obligated to redeem the decedent stockholder's shares, no constructive dividends result to the insured from the premium payments by the

corporation. On the other hand, the continuing shareholders derive a benefit by the plan of repurchase of the outstanding shares from the decedent shareholder's estate, or that of a later surviving spouse, if any. For example, upon the reacquisition of A's 1/3 interest in the corporation at A's death, C's and B's stockholdings, formerly representing 1/3 interests become 1/2 interests. This increase in ownership occurs to C and B without their having expended any personal funds.²

In comparison to the time period surrounding the premium payments, a clear accretion to wealth can be seen when a corporation converts the life insurance policy upon the death of an insured shareholder. For this reason, we first analyzed the authorities dealing with the impact to the continuing shareholders of a redemption. If such redemptions have no constructive dividend implications to the continuing shareholders, the Service would be hard-pressed to convincingly articulate that the life insurance premium payments on one insured shareholder constitute constructive dividends to the other shareholders.

The Service has previously argued before the Tax Court that one way of interpreting a redemption is that the continuing shareholders have purchased additional control of the corporation from the exiting shareholder by having the corporation redeem that departing shareholder's stock and thereby have derived a taxable benefit. In the absence of a primary obligation on the part of the continuing stockholders to purchase the shares of the departing stockholder, this argument has not persuaded the courts. For example, in Arnes v. Commissioner, 102 T.C. 522 (1994)(reviewed opinion), no constructive dividend was found where a married couple had their corporation redeem the wife's shares even though the husband had guaranteed the corporation's obligation to do so.

If a corporation redeems stock that its remaining shareholder was obligated to buy, a constructive dividend results to the remaining shareholder. Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Hayes v. Commissioner, 101 T.C. 593 (1993); Edler v. Commissioner, T.C. Memo. 1982-67, affd [sic] 727 F.2d 857 (9th Cir. 1984). However, this rule is limited to those circumstances where the obligation of the remaining shareholder is both primary and unconditional. Enoch v. Commissioner, 57 T.C. 781 (1972); Priester v. Commissioner, 38 T.C. 316 (1962); Edenfield v. Commissioner, 19 T.C. 13 (1952); Edler v. Commissioner, *supra*.

Arnes at 527. Adams v. Commissioner, 594 F.2d 657 (8th Cir. 1979); Priester, *supra*, (Corporation's payment in complete redemption of majority stockholder's interest in closely held corporation did not cause constructive dividend to remaining stockholder who thereby became sole owner). Gerson v. Commissioner, T.C. Memo. 1989-52, appealable to the Third Circuit, (Redemption of stock by corporation results in a constructive dividend to a continuing shareholder under §§ 61(a), 301(c)(1), 302(a), and

² This hypothetical does not reflect the fact that A, after retiring, exchanged A's Class A Common shares for Class B.

316(a), if at the time of redemption, the shareholder was personally and unconditionally obligated to purchase the stock that was redeemed). See also, Sullivan v. United States, 244 F.Supp. 605 (W.D.Mo. 1965) cert. denied, 387 U.S. 905 (1967); Ward v. Rountree, 193 F.Supp. 154 (M.D.Ten. 1961).

The Third Circuit, to which any appeal of this matter would lie, has twice specifically opined on this issue, both times reversing opinions of the Tax Court. Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971). In Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954), rev'g 20 T.C. 352 (1953) and Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958), rev'g 28 T.C. 962 (1957), the Third Circuit held that no constructive dividend resulted to the continuing shareholders when their corporation redeemed the shares of another shareholder. The later case of Holsey clarified that even where the continuing shareholders possess an option to purchase, rather than an obligation to do so, no dividend results.

The Service announced its acquiescence to the Holsey case in Rev. Rul. 58-614, 1958-2 C.B. 920. "In the future, the Service will not treat the purchase by a corporation of one shareholder's stock as a dividend to the remaining shareholders merely because their percentage interests in the corporation are increased."

Underlying these cases and ruling is a recognition that there has been a diminution in corporate earnings and profits, or that debt has been incurred to finance the redemption. Hence, while the proportional ownership interests of the continuing shareholders have increased, "[t]he proportion of the corporation's assets owned by each of the shareholders was just the same as it was before. Neither was richer; neither was poorer." Schmitt at 820-821; Holsey at 868-869; Williams v. Commissioner, T.C. Memo. 1976-368, 35 T.C.M. 1672, 1677. As the Williams court succinctly described the relevant effects of a redemption, "[T]he assets of the corporation are at the same time reduced; therefore, the value of the continuing shareholder's interest in the corporation is not increased." Id.

The authorities previously noted have hinted that even when share value has appreciated in the redemption, such appreciation is not a taxable event to the continuing shareholders. In the Holsey case, the redemption was for less than book value of the stock redeemed. By such discount, the continuing shareholders benefitted because their stock value consequently increased. Nevertheless, the court determined that the purchase of a stock-holder's shares by the corporation at an option price below book value did not effect a dividend distribution to the remaining shareholder. Holsey at 868.

With respect to the differential resulting in increased value to the remaining shareholder, the Court cited the analogy initially proposed by the Schmitt court where a parcel of land appreciates in value over time, but no taxable event occurs. Similarly as to stock, although the value increases, this accretion does not give rise to taxable income within the meaning of the Sixteenth Amendment until the corporation makes a

distribu-tion to the stockholder or his stock is sold. Holsey at 868. The Tax Court in the Williams case specifically pointed-out as significant that the Holsey court determined no constructive dividend arose despite that the option price for the redemption was less than the market value of the redeemed shares. Williams at 1677 n.3.

While in Rev. Rul. 58-614, the IRS announced that it would follow the decision of Holsey, the Service went on, however, to caution that regardless of the form of the transaction, if the stock was in reality purchased by the remaining shareholders and paid for by the corporation, the payment would be considered a dividend to the remaining shareholders.

If, as the Stock Sale Agreement seems to permit, one or more of the continuing shareholders acquired the shares of the decedent using the life insurance proceeds, constructive dividends would arise. We discern this ability since the Stock Sale Agreement fails to specifically prohibit such action. The agreement states, "Any excess of insurance proceeds over the purchase price shall be retained by the purchaser of the common shares, free and clear of any obligations under this Agreement." "Purchaser" is undefined in the agreement, although the only parties authorized to purchase are the continuing shareholders, who possess an election to purchase, and the trustee who has an obligation to purchase any shares not earlier purchased.

It is unlikely that the continuing shareholders would purchase the shares since the continuing shareholders can achieve the same ownership increase by merely having the corporation redeem the decedent's shares. Similarly, the competing interests of the continuing shareholders would seem to preclude less than all of the continuing shareholders from attempting to purchase the shares using the insurance proceeds.

In this case, the potential corporate redemption causes no constructive dividend to occur to the continuing shareholders since they are not relieved of any obligation to purchase the decedent's shares. Unless the shareholders personally avail themselves of the life insurance proceeds, the authorities reflect that no constructive dividend would occur at the redemption.

That being the case, we do not foresee the Service prevailing on an argument that a portion of each life insurance premium payment on any one shareholder's life constitutes a constructive dividend to the other shareholders.

Finally, we reiterate another caution contained in Rev. Rul. 58-164.

[I]f a shareholder surrenders stock to a corporation for less than its fair market value, such surrender may be a gift or compensation to the shareholders who remain....Conversely, if a corporation pays more than fair market value for its stock, the payment may be compensation to the shareholder surrendering stock or may be a gift to him from the shareholders who remain interested in the corporation.

1958-2 C.B. 920, 921.

If a future redemption is for an amount disproportionate to the fair market value of the shares, tax implications may arise. Along this line, we point out that although A, C, and B purportedly owned equal shares of the company in Year 6, the policy to be used to reacquire A's shares was in the amount of \$A whereas that for B, acquired on the same date, was for \$B. C's apparently later acquired policy was similarly for \$C. This lack of uniformity should be investigated and explained by the corporation's representative.

Deferred Compensation or Redemption

After A had announced A's desire to retire, A and the company executed a purported "Deferred Compensation Agreement" on Compensation Agreement Date, wherein they agreed A would receive \$D per year for life, paid in monthly installments. Upon A's death, the payments would be made to A's spouse for life, if A's spouse survived A. The Service seeks to attack this agreement and A's Year 6 Stock Sale Agreement. Conflating the two agreements, the Service proposes to disallow all or part of the annual \$D compensation deductions taken by the corporate taxpayer on the grounds that such payments were in reality installment payments for the redemption of A's equity interest in the company. Viewed in this manner, the bulk repurchase payment using the \$A from the life insurance policy would represent a balloon payment for the balance.

In the case of a closely held corporation, special scrutiny is required of transactions between shareholders and their corporation because of the unfettered control exercised by the limited number of shareholders. Roschuni v. Commissioner, 29 T.C. 1193, 1201 (1958), aff'd per curiam, 271 F.2d 267 (5th Cir. 1959), cert. denied, 362 U.S. 988 (1960). [REDACTED]

We initially pause to clarify that since A had not agreed to the deferral of compensation as it was being earned during the years of A's active employment, the payments commencing upon A's retirement should more accurately be described as continuing salary or annuity rather than couched as deferred compensation.

Next, we note some evidence contradicting the company's stated purpose for the agreement. The Year 3 existence of C's profit sharing and pension plans, aggregating then to over a half-million dollars, may belie the company's assertion of a past inability to fully fund a pension plan for A who possessed an equal ownership interest to C. In fact, the revenue agent has informed us that indeed A did possess similar plans to C, but A exchanged such for a lump-sum payout at A's retirement. [REDACTED]

[REDACTED]

Shortly after A's retirement, A exchanged A's Class A stock for an equal number of non-voting Class B common stock consistent with the Year 6 Stock Sale Agreement. The relevant documents are unclear as to what consideration A received in exchange for A's 1/3 voting interest in the company. While A's Year 6 Stock Sale Agreement reflects that there was a one-for-one conversion of Class A voting stock for Class B non-voting, the agreement does not state whether additional consideration was paid to A for A's voting rights. [REDACTED]

[REDACTED] If additional consideration was not received, taxpayer's one-for-one exchange of voting stock for non-voting stock raises questions about the exchange. [REDACTED]

Taxpayer may argue that prior to the Year 6 Stock Sale Agreement, the amount that A's heirs were to receive on the stock redemption was uncertain. The Year 2 Stock Redemption Agreement, although reflecting that the repurchase was to be made primarily using life insurance proceeds, failed to specify an amount for the reacquisition. The agreement did direct that the stock's redemption price would be determined by reference to the corporation's book value. In Year 3, A's life was insured by a policy in the amount of \$A, although it was not made explicit in the trust document between the relevant parties whether this amount constituted the total redemption price. Presumably, reference would have been to the Year 2 agreement which directed that stock value for the redemption would be determined by reference to date of death corporate book value. [REDACTED]

[REDACTED]

[REDACTED] By couching the monthly payments as deferred compensation rather than dividends or redemption installment payments, the corporation can take deductions otherwise unavailable. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Correspondingly, since the annuity was to be paid to A and then to A's spouse, the amount to be paid by the corporate taxpayer is somewhat open-ended. In Year 3, A was aged 63. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Fundamentally, the true character of what transpired requires a determination of the value of the business at the time of A's retirement, the value of the annuity, and expectations regarding interest and corporate growth.

The question as to when a redemption is consummated for tax purposes is a practical one to be decided by weighing all of the various factors. Estate of Oscar L. Mathis v. Commissioner, 47 T.C. 248 (1966); Isidore Himmel v. Commissioner, 41 T.C. 62 (1963), rev'd on other grounds, 338 F.2d 815 (2d Cir. 1964); In re Lukens' Estate v. Commissioner, 246 F.2d 403 (3d Cir. 1957), rev'g 26 T.C. 900 (1956). It is also clear that § 302(b)(3) contains no prohibition against payment of the redemption price on an installment basis. Lisle v. Commissioner, T.C. Memo. 1976-140, 35 T.C.M. 627, 635.

Authorities have been uncovered whereby the Service has successfully challenged purported redemption payments and found them to be taxable to the redeeming shareholder as dividends. See, Hays v. Commissioner, T.C. Memo. 1971-95 (Although distribution was not prorated between shareholders, other determinates of dividend equivalence indicated the distribution to be dividends). In the case of Lisle, the Service unsuccessfully challenged the payments made to a corporation's two principal shareholders. Therein, the disputed redemption was structured using initial down payments followed by a 20-year installment payout. The length of payout, coupled with certain retained rights by the shareholders, lead the Service to argue the payments were dividends rather than redemption amounts.

In the present case, with A's surrender of voting power and agreement to \$A as the final payment for A's common shares, persuasive evidence of a disguised redemption has been shown. [REDACTED]

[REDACTED]

[REDACTED]

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If you have any questions, please contact the LMSB division of the Office of Chief Counsel at

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