WELLS FARGO Advisors

Any Questions?
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Stock redemption

Hypothetical example of a stock redemption treated as a sale:

A, B, and C are all officers of ABC, Inc., a corporation with 100 outstanding shares. Each officer has been employed by ABC, Inc. and held an interest in the company for more than 10 years. A is looking to retire and no longer be involved with the company. A has a basis of $80,000 and the corporation redeems all 80 of his shares for $120,000. The first $80,000 will be treated as a return of basis and the excess — in this example, $40,000 — will be subject to capital gains tax treatment.

Before redemption	**"A" has 80 sh.**	**"B" has 10 sh.**	**"C" has 10 sh.**
	80%	10%	10%
After redemption		**"B" has 10 sh.**	**"C" has 10 sh.**
		50%	50%

This example is hypothetical and is provided for informational purposes only.

How does it work?

A stock redemption is a type of business sale structure in which a corporation buys back or "redeems" stock from a shareholder. It could involve a sale for cash, or could be structured as an installment sale:

- You sell your stock back to the corporation.
- The corporation could pay cash, all at once. Or the transaction could be structured as an installment sale, with the corporation executing a promissory note to the seller.
- If structured as a cash sale, the corporation would either use existing cash, or finance the amount needed.
- If structured as an installment sale, the corporation uses after-tax cash flow from the business to make note payments to you.
- Typically, the transaction is structured so that principal payments in excess of the adjusted basis (original cost or basis adjusted for certain items) to the seller will qualify for treatment as capital gain. If the transaction does not meet the specific requirements necessary to get capital gain tax treatment, then principal payments would be taxed as a dividend.
- The seller's shares are retired by the corporation; remaining owners now hold all shares.

This strategy could fit if:	This strategy may not fit if:
You want to sell the business to family members, a key employee, or a co-owner.	You have doubts about the buyer's ability to run the company.
You have confidence in the successor's ability to run the company.	The business's cash flow is insufficient or varies greatly from year to year.
The person you want to sell to currently has some ownership interest in the business.	You are not willing to give up voting control or completely separate yourself from the business.
The minority owner does not have sufficient resources to buy the company outright or obtain bank or other financing.	
The business will have sufficient cash flow to pay taxes and make note payments to you, and still make a reasonable return on the business for the remaining owners.	

What else should you consider?

- Would you be better off selling to a buyer with greater financial resources?
- There is generally no tax benefit to spreading capital gains taxes over several years. At present, long-term capital gains are taxed at the 15% or 20% rate whether you pay all at once or over several years. Keep in mind that a stock redemption is typically used as a financing tool versus a tax planning strategy.
- A stock redemption is often structured as an installment sale, which simply defers capital gains tax until later. Remember, capital gains taxes are at historically low levels. If capital gains tax rates increase, you could end up deferring yourself into a higher tax rate in the future.
- A "bargain sale" to a family member creates a gift, with possible gift tax consequences. You must sell at fair market value, and use market interest rates, to avoid gift tax consequences.
- The balance on the note will still be part of your taxable estate. If you die before the note is paid, your heirs can continue to receive payments.
- Except for the interest portion, the note payments to you are not a deductible expense to the company.
- The sale must comply with IRS rules to qualify for installment sale treatment; otherwise gain will not be deferred.
- To receive capital gains treatment, the sale must qualify as a "complete redemption" or a "substantially disproportionate redemption."
  - A complete redemption means that you have no further participation in the business; you cannot be a director or employee after the sale.
  - A substantially disproportionate redemption means that there is a significant reduction in your voting or management power, and you will not control the business after the redemption. The IRS imposes specific mathematical tests to determine if your control has been reduced sufficiently.
  - Complex "attribution" rules may apply. This means that stock owned by certain family members may be treated as if you still owned and controlled the stock.
  - It is very important to work with your attorney and CPA so that you comply with applicable tax requirements.
- If the sale does not qualify for capital gain treatment, all payments to you are taxed as dividends. (That may not be an issue if dividend tax rates remain low.) The primary impact of dividend treatment is that you do not qualify for tax-free recovery of your cost basis.
- Consider having a security agreement in the event of default.
- Consider requiring life insurance on the remaining owners to secure payment of what is due to you in the event that key managers die before the note is paid.
- You may want the sale agreement to include loan covenants to forbid or limit certain activities by the company (for example, excessive borrowing) and require the company to maintain certain financial ratios.
- Particularly if structured as an installment sale, the transaction may affect the corporation's ability to borrow. The liability changes the composition of the corporation's balance sheet. Lenders will also consider the cash flow effects when assessing the corporation's ability to pay back loans or lines of credit.
- Note that in a stock redemption, the remaining owners do not obtain any increase in cost basis. They own a larger, and more valuable, piece of the corporation, but their cost basis does not change because the individual owners did not buy additional shares.
- A stock redemption will typically change the balance of voting power among shareholders.

Redemptions after death

A stock redemption may also be a component in an estate plan when your objective is to transfer stock at death through a will or trust. Section 303 of the tax code allows for capital gains treatment if a certain portion of stock is redeemed to allow heirs to pay estate taxes due after death.

How is this strategy implemented?

- Work closely with your tax advisors and be sure you understand all of the income tax, gift tax, and estate tax implications.
- Work with your CPA and other qualified professionals to help you value your business.
- Your attorney can prepare necessary documentation for the sale, security agreements, etc.
- As part of the sale, consider requiring that the corporation arrange to hold life insurance on remaining key managers or shareholders to secure payment of the note. Your financial advisor can offer life insurance products from many different companies and help you select an appropriate insurance policy.
- Your financial advisor offers personal financial planning services* through an approved Wells Fargo Advisors financial planning program. A financial plan may help you valuate the impact a sale would have on your overall financial picture. Talk to your financial advisor for more information.

*Financial planning services offered through our High Net Worth Planning team for those with a minimum $5 million net worth.