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Proposed Regulations Issued on the Excise Tax on Repurchases of Corporate Stock

Tax Talks on **May 20, 2024**

Introduction

On April 9, 2024, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") issued two sets of proposed Treasury Regulations related to section 4501, REG-115710-22, which provides guidance on the application of section 4501, and REG-118499-23 (together with REG-115710-22, the "Proposed Regulations"), which provides guidance on the reporting and payment of the excise tax.[1]

Section 4501 generally imposes a nondeductible 1% excise tax (the "Tax") on stock repurchases[2] and "economically similar transactions" (discussed further below) made after December 31, 2022 by publicly traded corporations and certain "surrogate foreign corporations" (together, "covered corporations"). The Tax is imposed on the fair market value of stock repurchased by a covered corporation during the tax year (the "Tax Base "), reduced under the "netting rule" (discussed further below).

The Proposed Regulations generally adopt the guidance provided in Notice 2023-2 (the " Notice"), except (i) the Proposed Regulations exempt "additional tier 1 preferred stock" from the excise tax; (ii) the Proposed Regulations relax the per se anti-abuse rule in the Notice to a presumption that the acquisition by a domestic subsidiary of a foreign publicly traded was made with the principal purpose to avoid the Tax; and (iii) the Proposed Regulations adopt a de minimis rule to determine whether a domestically owned foreign partnership is an "applicable specified affiliate" that is subject to the Tax. Each of these points is discussed in greater detail below.

This blog post discusses key expansions and modifications to the guidance under the Notice. For additional information about the guidance under the Notice, please see our prior blog post here.

The Proposed Regulations

1. M&A

Section 4501(e)(1) provides an exception to the Tax for repurchases that are part of tax-free reorganizations (within the meaning of section 368(a)), which do not result in gain or loss to the shareholder by reason of the reorganization (the “reorganization exception”).

The Proposed Regulations retain the rules contained in the Notice to the effect that acquisitive reorganizations, E reorganizations, F reorganizations, split-offs[3] and complete liquidations to which both section 331 and 332 apply are “economically similar transactions”; however, the Tax applies only to the extent of non-qualifying consideration (i.e., boot) received in these transactions.

Accordingly, under the Proposed Regulations, fully taxable acquisitions funded by the covered corporation’s cash, or a leveraged buyout of a covered corporation financed with the covered corporation’s debt (including debt of a merger subsidiary that is assumed by a covered corporation in a taxable reverse subsidiary merger), are subject to the Tax to the extent of the cash sourced to the covered corporation. However, to the extent that the fully taxable acquisition is financed with cash or debt of the acquiror, the Tax generally would not apply.

For instance, in an all-cash reverse triangular merger in which the target corporation is acquired for $1 billion. If the parent corporation funds $800 million, and the merger subsidiary borrows $200 million, the transaction will be subject to $2 million of the Tax (1% of $200 million). By contrast, if the parent corporation, instead of the merger subsidiary, borrows the $200 million, the transaction should not be subject to the Tax.

2. The Netting Rule

Under section 4501(c)(3), the Tax is imposed on the Tax Base, reduced by the fair market value of stock issued by such covered corporation during the tax year (including stock issued to employees) (the “netting rule”). The Proposed Regulations retain the rule in the Notice that the Tax Base is reduced by the aggregate fair market value of stock of the covered corporation (i) issued or provided to the covered corporation’s employees of a specified affiliate’s employees during the covered corporation’s taxable year;[4] and (ii) issued by the covered corporation to other persons during its taxable year.

The Proposed Regulations further clarify the Notice regarding issuances of stock that could artificially erode the Tax Base (such as an issuance of stock with respect to existing stock), and, in particular, states that such issuances would not be taken into account under the netting rule. The following are a few examples.

First, stock that is issued by the acquiring corporation to the target corporation in exchange for qualifying property in a tax-free reorganization would not be taken into account because the issuance would have already been disregarded under the reorganization exception discussed above.[5] Likewise, stock that is issued in a section 1036 exchange (i.e., a tax-free exchange of common-for-common or preferred-for-preferred stock in the same corporation) would be disregarded for purposes of the netting rule. Finally, in an issuance of stock by a covered corporation to its specified affiliate followed by the specified affiliate’s transfer of that stock to its employees, the specified affiliate’s transfer would be disregarded under the netting rule if the covered corporation has already reduced its Tax Base upon the initial issuance.

The anti-avoidance rule in section 4501(f) generally addresses instruments that are not in the legal form of stock but are treated as stock for U.S. federal income tax purposes at issuance (such as “deep in the money” call options). However, for purposes of the netting rule, the Proposed Regulations would clarify that the issuance of such an instrument would not be taken into account until the instrument is actually repurchased. The amount of the issuance would be limited to the lesser of the fair market value at the time of issuance or repurchase.[6]

3. Applicable Foreign Corporations

Section 4501(d) provides that if a covered corporation’s specified affiliate purchases the stock of the covered corporation from an unrelated third party, this is treated as if the covered corporation repurchased its own stock and would, therefore, be subject to the Tax.

The Proposed Regulations generally adopt the rule in the Notice to the effect that the Tax is also imposed on transactions in which an "applicable specified affiliate" of a publicly traded foreign corporation acquires stock of the publicly traded foreign corporation from an unrelated third party. An "applicable specified affiliate" generally means a domestic subsidiary of a foreign publicly traded corporation, as well as a foreign partnership that has a domestic entity as a direct or indirect partner.[7]

In addition, under the Proposed Regulations (as under the Notice), if a domestic subsidiary funds by any means (including distributions, debt or capital contributions), directly or indirectly, the acquisition of a publicly traded foreign corporation's stock (a " covered funding"), the domestic subsidiary would be deemed to have acquired the stock if the principal purpose of such funding is to avoid the Tax (the "funding rule"). The Proposed Regulations provide a presumption that a principal purpose is deemed to exist when a domestic subsidiary funds by any means, directly or indirectly, a "downstream relevant entity" within two years of a repurchase by or on behalf of the downstream relevant entity (including through an agent or nominee). A "downstream relevant entity" would be defined as an entity whose stock (by vote or value), capital or profits interests is owned by 25% or more, directly or indirectly and individually or in the aggregate, by one or more domestic subsidiaries. This presumption may be rebuttable only if facts and circumstances show that the principal purpose of the funding was not to avoid the Tax. The rebuttable presumption helpfully replaces the "per se" rule in the Notice to the effect that a principal purpose was deemed to exist if the funding (other than through distributions) occurs within two years of the funded entity's repurchase or acquisition of stock of the applicable foreign corporation.

In addition, the Proposed Regulations would adopt a de minimis rule (that was not in the Notice) for certain domestically owned foreign partnerships. The rule would provide that a foreign partnership with one or more direct or indirect domestic entity partners is not considered an "applicable specified affiliate" if the domestic entities hold, directly or indirectly, in the aggregate, less than 5% of the capital and profits interests in the foreign partnership. The de minimis rule would make it easier to determine indirect domestic ownership and, therefore, would simplify compliance with section 4501(d).

4. Definition of "Stock"

The Notice did not include any specific rules related to special classes of stock and preferred stock and requested public comments on the application of the Tax on these instruments. The Proposed Regulations adopted a narrow carveout from the definition of "stock" for "additional tier 1 preferred stock".[8]

As such, generally, even straight vanilla preferred stock would be "stock" for purposes of the Tax (and the redemption of such stock could trigger the Tax). Convertible debt instruments, on the other hand, would not be treated as stock, and the Proposed Regulations clarify that the determination of whether an instrument is debt or equity for these purposes must be made at the time of issuance and should not be retested while the instrument is outstanding.

5. SPAC Transactions

The Proposed Regulations do not contain special rules for SPACs, and the Preamble to the Proposed Regulations state that special rules for SPACs are not necessary or appropriate.

6. Procedure

The Proposed Regulations state that the newly created Form 7208 (*Excise Tax on Repurchase of Corporate Stock*), is to be attached to taxpayers' Form 720 (*Quarterly Federal Excise Tax Return*) and would be used to report to the IRS the necessary information for assessment and collection of the Tax. Treasury and the IRS have issued a draft Form 7208 here, and a final version of Form 7208 will be released prior to the first due date on which the Tax must be reported and paid.

7. Effective Date & Request for Comments

The Proposed Regulations would apply to stock repurchases and economically similar transactions made after December 31, 2022, but certain rules in the Proposed Regulations that were not included in the Notice would apply to stock repurchases and economically similar transactions occurring after April 12, 2024. Out of the rules discussed above, this includes those related to disregarding the netting rule with respect to section 1036 exchanges, section 355 distributions and instruments not in the legal form of stock. In addition, Treasury and IRS request public comments on REG-118499-23 by May 13 and on REG-115710-22 by June 11.

[1] All references to section are to the Internal Revenue Code of 1986, as amended, or to the proposed regulations promulgated thereunder.

The Tax was enacted into law in August 2022 under the Inflation Reduction Act. For further background on the Inflation Reduction Act, please see our prior blog post here.

[2] The Tax applies to: (i) redemptions within the meaning of section 317(b), which is a transaction in which a corporation acquires its stock from a shareholder (and is not a dividend for federal income tax purposes); and (ii) transactions that are economically similar to section 317(b) redemptions.

[3] While the Notice did not provide guidance on whether an exchange of the securities of "Controlled" in a split-off would be treated as a repurchase, the Preamble clarifies that such securities constitute boot and, therefore, would be subject to the Tax. However, the Proposed Regulations do not adopt special rules to address this treatment.

[4] A specified affiliate includes any corporation or partnership that is owned 50% or more (by vote or value) by the covered corporation (including another specified affiliate).

[5] Of note, the transferor corporation and resulting corporation in an F reorganization would be treated as the same covered corporation for purposes of the netting rule and, accordingly, the transferor's issuances in the portion of the taxable year preceding the F reorganization could, in fact, offset the resulting corporation's repurchases in the portion of the year following the F reorganization (and vice versa).

[6] To prevent avoidance and abuse, a taxpayer would be entitled to regard such an instrument for purposes of the netting rule if they identify the instrument as a non-stock instrument on the return on which the Tax must be reported for the taxable year in which the repurchase occurs. In addition, the taxpayer must also report repurchases of comparable non-stock instruments within five taxable years ending on the last day of the year of the repurchase as repurchases of non-stock instrument (unless the failure to timely report the earlier repurchase was due to reasonable cause).

[7] A domestic subsidiary is any corporation that is more than 50% owned (by vote or value) by the publicly traded foreign corporation.

[8] "Additional Tier 1 preferred stock" generally means noncumulative perpetual preferred stock, tier 1 minority interests, grandfathered TRuPS, and Troubled Asset Relief Program instruments, less applicable regulatory adjustments and deductions. The Proposed Regulations specifically define this term by reference to the banking regulations under Title 12 of the Code of Federal Regulations.

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