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Proposed regulations on corporate stock buyback excise tax

Tax Alert

Overview

The Inflation Reduction Act of 2022 (P.L. 117-169) included new section 4501, which imposes an excise tax of 1 percent on repurchases of stock by certain publicly traded corporations (the "Excise Tax") beginning after December 31, 2022.

On December 27, 2022, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service ("Service") released Notice 2023-2 (the "Notice"), which announced that Treasury and the Service intended to issue proposed Treasury regulations addressing the application of the Excise Tax, and to provide taxpayers with interim guidance until the publication of such proposed regulations. See the prior Deloitte Tax Alert discussing the Notice.

On April 9, 2024, Treasury and the Service released proposed Treasury regulations (REG-115710-22 and REG-118499-23) implementing section 4501 and related procedural provisions (the "Proposed Regulations"). As described in more detail below, the Proposed Regulations:

- Largely adopt the interim guidance in the Notice;
- Provide a revised "Funding Rule" for publicly traded, foreign-parented groups; and
- Set a new expected deadline for the information reporting and payment of the Excise Tax, tied to the later of the date of release of final regulations or taxpayers' year-ends.

General Summary

As noted above, the Proposed Regulations largely implement the interim guidance provided in the Notice. Consistent with section 4501 and the Notice, taxpayers are subject to an Excise Tax equal to the following amount:

0.01 x Stock Repurchase Excise Tax Base

In computing the "Stock Repurchase Excise Tax Base," the Proposed Regulations closely follow the Notice, including, among other things:

- Adopting a similar set of defined terms to aid in the application of the rules;

- Setting forth what constitutes a "repurchase," including an exclusive list of "economically similar transactions" and a non-exclusive list of transactions that are not economically similar (with two additions noted below);
- Providing detailed rules for the manner in which taxpayers may reduce the Stock Repurchase Excise Tax Base either for (i) repurchases exempt under the "Statutory Exceptions," or (ii) stock issued under the "Netting Rule;"
- Retaining but revising the Funding Rule, which broadens the application of the Excise Tax to foreign-parented groups with U.S. subsidiaries;
- Mechanical rules for determining the timing and amount of stock repurchased and issued under the Netting Rule; and
- Updating expected procedural rules for the annual filing of Form 720, *Quarterly Federal Excise Tax Return*, and payment of the Excise Tax.

Because the Proposed Regulations closely track the interim guidance in the Notice, the summary below will focus on the significant additions and changes in the Proposed Regulations. For a more detailed discussion of these rules, please see prior Deloitte Tax Alert discussing the Notice.

Repurchases

With respect to the scope of what constitutes a repurchase, the Proposed Regulations adopt the view that a distribution pursuant to a partial liquidation under section 302(b)(4) (generally a distribution of the proceeds from the sale of a trade or business) by a covered corporation, whether or not in the form of a redemption of shares, is treated as a repurchase under the Excise Tax rules. However, if the partial liquidation is not in the form of a redemption, the distribution paid to corporate shareholders of the covered corporation may be eligible for the statutory dividend exception.

In addition, Treasury and the Service introduced a new "constructive specified affiliate" rule, which treats certain indirect acquisitions of stock of a covered corporation as a repurchase. Under this new rule, if (i) a target corporation or partnership owns stock in the covered corporation that it acquired after December 31, 2022, (ii) such covered corporation stock represents more than 1 percent of the fair value of the target, and (iii) the target corporation or partnership becomes a specified affiliate of the covered corporation, then the covered corporation is treated as repurchasing the stock held by that target corporation or partnership at the time such corporation or partnership becomes a specified affiliate of the covered corporation.

Limited Preferred Stock Exception

The Proposed Regulations modify the definition of "stock" to exclude "additional tier 1 preferred stock." As a result, an issuance or repurchase of additional tier 1 preferred stock would be disregarded for purposes of the Excise Tax. Additional tier 1 preferred stock is preferred stock that, under applicable regulatory capital rules, (i) qualifies as additional tier 1 capital, but (ii) does not qualify as common equity tier 1 capital.

According to the preamble, taxpayers had requested that preferred stock be excluded from the Excise Tax, but the Proposed Regulations contain only this limited exception. The preamble to the Proposed Regulations noted that preferred stock that is additional tier 1 capital generally cannot be redeemed (including pursuant to the exercise of a call option) without regulatory approval, and any such stock that is callable has additional restrictions on redemptions. With respect to preferred stock generally, the preamble noted that the decision to not include a broader exception (e.g., for plain vanilla preferred stock) was based in part on facilitating the ability to administer and enforce the Excise Tax.

Employer-Sponsored Retirement Plan Contribution (ESRP) Exemption

There is a statutory exception for any repurchased stock (or an amount of other stock equal to the fair market value (FMV) of the repurchased stock) that is contributed to an ESRP that is qualified under section 401, including an employee stock ownership plan (ESOP) described in section 4975(e)(1).

The Proposed Regulations provide this exception is available for repurchased stock that is contributed to an "employer-sponsored retirement plan." The Notice defined the term "employer-sponsored retirement plan" as a plan sponsored by a covered corporation. The Proposed Regulations expand the definition of ESRP to include a plan that is maintained by a "specified affiliate" of the covered corporation. The expanded definition includes an ESOP sponsored by either the covered corporation or a specified affiliate. Further, the Proposed Regulations provide that either stock repurchased by the covered corporation or a specified affiliate of the covered corporation is eligible for the exception for stock contributed to an ESRP qualified under section 401, including an ESOP described in section 4975(e)(1).

The amount of the reduction to the Stock Repurchase Excise Tax Base depends on whether stock of the repurchased class or stock of a different class is contributed to the ESRP.

If stock of the same class is contributed to the ESRP, then the reduction to the Stock Repurchase Excise Tax Base for any taxable year is equal to the lesser of:

- The aggregate FMV of the stock of the same class repurchased, or
- The amount obtained by
  - Determining the aggregate FMV of all stock of that class repurchased or acquired during the taxable year, reduced by the FMV of shares of that class of stock that is a reduction to the Stock Repurchase Excise Tax Base under the other statutory exceptions provided under section 4501(e), then
  - Dividing the amount determined above by the number of shares of that class repurchased or acquired, reduced by the number of shares that qualify for the exception under section 4501(e) (other than shares contributed to an ESRP), then
  - Multiplying the amount determined above by the number of shares of that class contributed to an ESRP for the year.

If stock of a different class is contributed to the ESRP, then the reduction to the Stock Repurchase Excise Tax Base for the taxable year is equal to the FMV of the stock contributed to the ESRP, at the time of such contribution, but limited to aggregate FMV of the other class of stock that was repurchased during the taxable year.

Generally, only contributions made during or on account of a taxable year can reduce the Stock Repurchase Excise Tax Base for that taxable year. However, the Proposed Regulations permit taxpayers to retroactively reduce the Stock Repurchase Excise Tax Base for an immediately preceding taxable year if:

- The contribution is made to an ESRP by the filing deadline for Form 720 (the deadline for filing and payment is described below) for that preceding taxable year, and
- The stock must be treated by the ESRP in the same manner that the plan would treat a contribution received on the last day of that taxable year.

The Proposed Regulations include a rule against double counting, meaning that stock contributed to an ESRP after the end of the year that is treated for Excise Tax purposes as contributed in the prior year may not also be treated as contributed to an ESRP in any other year.

While the Notice stated that in order for stock contributed after year end to be counted in the prior year, the contribution had to be "on account of that taxable year within the meaning of section 404(a)(6)," the Proposed Regulations remove the reference to section 404(a)(6). As explained in the preamble, the reference to section 404(a)(6) was removed in response to certain concerns expressed that a corporation would have to take the same position for tax deduction purposes as it takes for purposes of the Excise Tax.

The Proposed Regulations contain one additional clarification related to the timing of the contribution. The Excise Tax is generally effective for repurchases of stock occurring after December 31, 2022. Some corporations will operate on a fiscal year basis, or maintain an ESRP on a fiscal year basis, or both. The Proposed Regulations indicate that if a taxpayer with a taxable year that begins before January 1, 2023 and ends after December 31, 2022, then the taxpayer may treat or include all stock contributed to an ESRP during that year, even stock contributed prior to January 1, 2023, as part of the exception for stock contributed to an ESRP.

The Proposed Regulations expand the contribution rule for leveraged ESOPs. In a leveraged ESOP, the ESOP will acquire shares with financing in some form that is guaranteed by the employer. The shares are collateral for the loan and are held in a suspense account in the plan (i.e., not allocated to any specific participant). As the ESOP makes payments on the loan (with funds obtained through employer contributions to the ESOP), a certain number of shares, determined based on rules set forth in Treas. Reg. § 54.4975-7(b)(8) are released from suspense, and the released shares are allocated to the accounts of plan participants. The Proposed Regulations provide that the shares held in the ESOP, that are released as a result of an employer contributions used by the ESOP to make a payment on the loan are treated as shares contributed to an ESRP for purposes of section 4501(e)(2). This specific exception is limited to shares released as a result of an employer contribution to the ESOP. In some cases, an ESOP might receive dividends with respect to shares held in the suspense account and use those dividends to release shares from the suspense account. Shares released for this reason are not eligible for the section 4501(e)(2) exception.

Section 4501(e)(2) applies to repurchased stock contributed to an "employer-sponsored retirement plan." The Notice, as well as the Proposed Regulations, include both qualified plans under section 401(a) and ESOPs under section 4975(e)(7) within the definition of ESRP. Other types of plans may also fit this definition, however, the Proposed Regulations do not include any specific other plans. In the preamble, the Service and Treasury requested comments on the types of plans that should be included.

To the extent a reduction in the Stock Repurchase Excise Tax Base is claimed under the ESRP exception, no reduction may also be claimed under the Netting Rule relating to the issuance or provision of stock to employees (i.e., no double benefit).

Netting Rule

Non-Compensatory Issuances by Specified Affiliates

Under section 4501(c)(3) and the Notice, taxpayers would have been permitted to reduce the Stock Repurchase Excise Tax Base for a taxable year (after applying any available reductions under the Statutory Exceptions) by the FMV of the stock of the covered corporation that is:

- Issued or provided to employees of the covered corporation or a specified affiliate of the covered corporation; or
- Issued by the covered corporation to persons other than employees described above.

The Proposed Regulations retain the foregoing rules but provide further clarification with respect to certain other cases. First, stock issued by a covered corporation to a specified affiliate of the covered corporation is not counted under the Netting Rule if such stock is transferred to a non-employee service provider of the specified affiliate (e.g., an independent contractor). Importantly, however, stock issued by a covered corporation to a specified affiliate of the covered corporation is counted under the Netting Rule if such stock is delivered in the same year by the specified affiliate as consideration to a non-employee for anything other than services.

Thus, for example, if a covered corporation transfers its stock on behalf of a specified affiliate as consideration in a taxable asset acquisition by the specified affiliate, such stock would be counted under the Netting Rule.

Compensatory Issuances

Under the Notice, stock issued or provided to employees of a covered corporation or a specified affiliate as compensation for services includes transfers of stock in connection with the performance of services described in section 83, or pursuant to the exercise of a nonstatutory stock option, or pursuant to an option described in section 421. The Proposed Regulations clarify the Netting Rule is applicable to issuances by the covered corporation to both employees and non-employee service providers.

Consistent with the Notice, the Proposed Regulations provide stock will be treated as issued or provided in connection with the performance of services pursuant to a restricted stock award (RSA) or restricted stock unit (RSU) under the Netting Rule when the recipient is treated as the beneficial owner of such stock for U.S. federal income tax purposes. Generally, beneficial ownership of the stock underlying an RSA occurs when substantially vested stock is transferred to the recipient. The recipient will be treated as the owner of the stock underlying an RSU when the corporation or specified affiliate initiates payment. With respect to an RSA, however, if an election is made to include an amount in income at grant under section 83(b), then the stock is treated as issued on the transfer date. The stock transferred to the recipient pursuant to the exercise of an option or a stock appreciation right is treated as issued or provided to the employee on the date the option or the stock appreciation right is exercised.

Similar to the rules provided in the Notice, the Proposed Regulations provide stock withheld by a covered corporation or a specified affiliate to satisfy the exercise price of an option (a net exercise) or withheld to cover a withholding obligation under section 3402 or section 3102 is not treated as issued or provided for purposes of the Netting Rule. The Proposed Regulations clarify that shares withheld by a covered corporation or specified affiliate to satisfy the stock option exercise price or cover any withholding obligation, including state, local, or foreign withholding, is not treated as issued or provided under the Netting Rule.

In contrast to the net settlement rule, if a third party advances or pays the amount required to cover the exercise price of an option or a withholding obligation (i.e., a "sell-to-cover" transaction), then the full amount of the stock transferred generally will be treated as issued or provided for purposes of the Netting Rule. The Proposed Regulations retain this rule.

With respect to the determination of the FMV of stock issued or provided in connection with the performance of services for purposes of the Netting Rule, the Proposed Regulations confirm the FMV is determined under section 83 on the date the stock is treated as issued or provided under the foregoing rules. The Proposed Regulations clarify FMV is determined under section 83 rules regardless of whether the service provider includes an amount in income under

section 83 in connection with the underlying award, including, for example, stock issued to a nonresident alien for services performed outside the U.S.

Publicly Traded Foreign Corporations

Scope of Applicable Specified Affiliates

Section 4501(d)(1) provides that if a foreign partnership that is a specified affiliate of an applicable foreign corporation has a direct or indirect partner that is a domestic entity, then the foreign partnership is treated as an "applicable specified affiliate" of the application foreign corporation, and so directly subject to the Excise Tax. In such case, if the foreign partnership acquired stock of the applicable foreign corporation, the Excise Tax would apply. Section 4501(d)(1) does not contain any exceptions relating to the size of ownership interests in the foreign partnership by domestic entities. The Notice requested comments regarding factors that should be considered in determining whether a domestic entity is an indirect partner of a foreign partnership.

The Proposed Regulations provide that a foreign partnership is an applicable specified affiliate of an applicable foreign corporation if (i) more than 50 percent of the capital or profits interests of the foreign partnership are held, directly or indirectly, by the applicable foreign corporation (i.e., the foreign partnership is a specified affiliate), and (ii) at least one domestic entity is a direct or indirect partner. A domestic entity is an indirect partner if the domestic entity owns an interest in the foreign partnership through (x) one or more foreign partnerships, (y) one or more foreign corporations controlled by one or more domestic entities, or (z) an ownership chain with one or more entities described in the preceding clauses (x) and (y). For this purpose, a foreign corporation is controlled by one or more domestic entities if more than 50 percent of the stock of such foreign corporation (by vote or value) is owned, directly or indirectly, in the aggregate by one or more domestic entities (the preamble notes that these domestic entities do not need to be related). In addition, the Proposed Regulations provide that a domestic entity is not treated as indirectly owning stock in a foreign corporation or an interest in a foreign partnership solely by reason of owning, directly or indirectly, stock of the applicable foreign corporation (e.g., a public U.S. shareholder of the applicable foreign corporation).

The Proposed Regulations also provide for a de minimis exception pursuant to which 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 aggregate, less than five percent of the capital and profits interests in the foreign partnership. Treasury and the Service noted in the preamble to the Proposed Regulations that, given the statutory language, the applicable foreign corporation and the domestic entity do not need to be related but that the foregoing de minimis rule provide some limitation. Finally, the Proposed Regulations provide that a domestic entity that is classified as a disregarded entity for U.S. federal income tax purposes would not be treated as a domestic entity that could be a direct or indirect partner.

Revised Funding Rule

In general, section 4501(d) provides that the Excise Tax applies to acquisitions of stock of an applicable foreign corporation (i.e., a publicly traded foreign corporation) by a U.S. specified affiliate (e.g., a U.S. subsidiary). The Notice significantly expanded the statutory rule, whereby the Excise Tax would apply if the U.S. specified affiliate does not acquire, but is treated as funding (by any means, including through distributions, debt, or capital contributions) the repurchase or acquisition of stock of the applicable foreign corporation by the applicable foreign corporation or a foreign specified affiliate, and the principal purpose of such funding is to avoid the Excise Tax. In such case, the U.S.

specified affiliate was treated as acquiring the stock of the applicable foreign corporation and would include the repurchase in its Excise Tax calculation. Under the Notice, a principal purpose was presumed to exist (the "Per Se Rule") if the U.S. specified affiliate provides funding (other than by means of a distribution) to the applicable foreign corporation of foreign specified affiliate, and the repurchase or acquisition of the applicable foreign corporation's stock occurs within two years of the funding.

The Proposed Regulations generally follow the Notice funding rule (the "Revised Funding Rule") but replace the Per Se Rule with a rebuttable presumption (the "Rebuttable Presumption"). The preamble to the Proposed Regulations provides that the changes took into account numerous comments received to the effect that the Notice funding rule, and especially the Per Se Rule, were overbroad. Accordingly, the Revised Funding Rule retains a principal purpose test pursuant to which a U.S. specified affiliate would be treated as acquiring stock of the applicable foreign corporation to the extent the applicable specified affiliate funds by any means (including through distributions, debt, or capital contributions), directly or indirectly, an applicable foreign corporation's repurchase or acquisition of its stock (a "Covered Purchase") with a principal purpose of avoiding the Excise Tax (such funding, a "Covered Funding"). The Proposed Regulations provide that (i) if a principal purpose of a Covered Funding is to fund, directly or indirectly, a Covered Purchase, then there is a principal purpose of avoiding the Excise Tax, and (ii) whether a principal purpose exists is determined based on all the facts and circumstances.

The Rebuttable Presumption would apply if (i) a U.S. specified affiliate funds by any means, directly or indirectly, a "downstream relevant entity" (defined as an entity in which 25 percent or more of the stock is owned, or 25 percent or more of the capital or profits interests are held, directly or indirectly, by one or more U.S. specified affiliates of an applicable foreign corporation (individually or in the aggregate), and (ii) the funding occurs within two years of a Covered Purchase by the downstream relevant entity. The Rebuttable Presumption may be rebutted only if facts and circumstances clearly establish that there was not a principal purpose to fund a Covered Purchase. In addition, a U.S. specified affiliate that takes the position that the Rebuttable Presumption does not apply must disclose the relevant fundings and Covered Purchases, and the facts that rebut the presumption, in connection with filing the Form 720/Form 7208, *Excise Tax on Repurchase of Corporate Stock*.

Thus, unlike the Per Se Rule, the Rebuttable Presumption only applies to purchases of an applicable foreign corporation's stock by a "downstream relevant entity" of a U.S. specified affiliate. In contrast, the principal purpose test would be the relevant inquiry with respect to other fundings by a U.S. specified affiliate. For example, if the applicable foreign corporation repurchases its own stock, only the principal purpose test of the Revised Funding Rule should be relevant.

In addition, for purposes of determining the amount of a Covered Purchase, the Proposed Regulations provide for an unfavorable ordering rule pursuant to which a Covered Purchase is first treated as funded by Covered Fundings (and in the order in which the Covered Fundings occurred). The preamble to the Proposed Regulations provides that Treasury and the Service believe that this ordering rule is both reasonable and administrable, and a tracing rule was rejected due to the view that it would be less administrable and could potentially permit avoidance of the Revised Funding Rule with relative ease give the fungible nature of liquid assets. To the extent any applicable foreign corporation stock is treated as acquired by the U.S. specified affiliate, such stock would be treated as acquired on the later of the Covered Funding or the Covered Purchase.

The Revised Funding Rule and Rebuttable Presumption are more narrow in some respects than the Notice funding rule and the Per Se Rule. In this regard, the Rebuttable Presumption only applies to downstream fundings (and can be rebutted). The Proposed Regulations would not include any specific exceptions for ordinary course transactions. The preamble to the Proposed Regulations notes that comments suggested that certain ordinary-course fundings should be excluded such as payments for inventory, services, interest, or royalties, or pursuant to re-charge agreements but that no exclusions would be adopted and the Rebuttable Presumption would only include a limited category of fundings. The press release from Treasury stated that "[t]he proposed regulations also provide a targeted anti-abuse rule to foreign-parented multinational corporations pay their fair share of the stock buyback excise tax, without ordinary course intercompany funding transactions among their corporate affiliates being inadvertently captured." As a result, although unclear, taxpayers may be able to demonstrate that a principal purpose for certain ordinary course transactions (e.g., royalties) was not to fund repurchases or acquisitions of applicable foreign corporation stock (or rebut the Rebuttable Presumption). However, the application of the Revised Funding Rule to other transactions such as distributions and loans by the U.S. specified affiliate is unclear, especially given the unfavorable ordering rule for Covered Fundings, the fungible nature of liquid assets, and the possibility of having various potential principal purposes for undertaking such transactions.

Reporting and Payment

The Proposed Regulations also provide guidance relating to reporting and paying the Excise Tax. Covered corporations must comply with the reporting requirements regardless of whether there is an actual Excise Tax liability (i.e., repurchases fully offset by applicable exceptions and/or pursuant to the Netting Rule). The Excise Tax will be reported on Form 720, with a Form 7208 attached. The Form 7208 contains a worksheet for the calculation of the Excise Tax liability. A draft Form 7208 is currently available, and as mentioned in the press release from Treasury, a final version is expected to be released prior to the first due date for reporting the Excise Tax. Payment of the Excise Tax has the same due date as for reporting the Excise Tax.

The Excise Tax is not required to reported or paid until final Treasury regulations are published. For taxable years ending prior to the date the final Treasury regulations are published, the Excise Tax will be reported on the Form 720 that is due for the first full calendar quarter after the final Treasury regulations are published. For example, if the final Treasury regulations are published on September 16, 2024, the Excise Tax for the 2023 calendar year would be reported on the Form 720 for the calendar quarter ending on December 31, 2024, which is due on January 31, 2025. For taxable years ending after the date the final Treasury regulations are published, the Excise Tax will be reported on the Form 720 that is due for the first full calendar quarter after the taxable year of the covered corporation ends. For example, if the final Treasury regulations are published on September 16, 2024, the Excise Tax for the 2024 calendar year would be reported on the Form 720 for the calendar quarter ending on March 31, 2025, which is due on April 30, 2025.

Applicability Dates

The Proposed Regulations generally apply to (i) repurchases of stock of a covered corporation occurring after December 31, 2022, and during taxable years ending after December 31, 2022, and (ii) issuances and provisions of stock of a covered corporation occurring during taxable years ending after December 31, 2022. Accordingly, the Proposed Regulations generally apply instead of the rules set forth in the Notice (although, as mentioned above, the Proposed Regulations generally are consistent with the Notice). However, certain provisions that generally relate to rules not reflected in the Notice (e.g., constructive specified affiliate acquisitions; subsequent transfers by specified

affiliates to non-service providers; non-stock instruments treated as stock) apply to repurchases, and issuances and provisions, of stock of a covered corporation occurring after April 12, 2024, and during taxable years ending after April 12, 2024.

For the Proposed Regulations relating to foreign publicly traded corporations, including the Revised Funding Rule, the Proposed Regulations generally would apply to transactions occurring after April 12, 2024. In addition, with respect to the Revised Funding Rule, a funding that occurred on or after December 27, 2022, and on or before April 12, 2024, can be allocated to a covered purchase that occurs after April 12, 2024. For transactions that occur after December 31, 2022, and before April 13, 2024, the Proposed Regulations provide that the Notice Funding Rule applies, including a funding that occurs on or after December 27, 2022. However, a covered corporation may choose to apply the Proposed Regulations to transactions occurring after December 31, 2022 (and fundings occurring on or after December 27, 2022) so long as the Proposed Regulations are consistently applied.

Request for Comments

Treasury and the Service have requested comments on the Proposed Regulations. Comments on the Proposed Regulations addressing procedural and administration aspects of the Excise Tax must be submitted by May 13, 2024, and comments on the Proposed Regulations addressing the application of the Excise Tax must be submitted by June 11, 2024.