KPMG

Stock repurchase excise tax proposed regulations—initial analysis

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On April 9, 2024, the U.S. Treasury Department released two sets of proposed regulations (REG-115710-22 and REG-118499-23) (the "**Proposed Regulations**") addressing the non-deductible one percent excise tax on repurchases of corporate stock under section 4501 (the "**excise tax**").[1] The Proposed Regulations set forth rules that would (1) provide procedural guidance regarding the reporting and payment requirements for the excise tax, (2) address the application of the excise tax to U.S. subsidiaries of publicly traded foreign corporate parents that differ from those contemplated by Notice 2023-2 (the "**Notice**"),[2] and (3) otherwise largely follow the approach of the Notice with a few changes and additions. The below discusses these points and the background of the excise tax in more detail.

Background

Section 4501 was enacted by Pub. L. No. 117-169 (commonly called the Inflation Reduction Act).[3] The statute generally imposes the excise tax on the net value of share repurchases by a publicly traded *domestic* corporation (a ''**covered corporation**'') within a taxable year, effective with respect to repurchases on or after January 1, 2023. In the domestic context, the value of stock repurchased by a covered corporation during a taxable year can be reduced by the value of stock issued, including stock issued or provided to an employee of the covered corporation or its specified affiliates (the ''**netting rule**'').[4] The statute also applies to certain acquisitions of the stock of publicly traded *foreign* corporations by the foreign corporation's domestic affiliates.[5] Section 4501(e) also provides certain exceptions to the excise tax (some of which are covered below).

On December 27, 2022, the Treasury Department released the Notice, providing interim guidance on the excise tax. The Notice, among other things, addressed: (1) what transactions constitute, or do not constitute, a repurchase or issuance,[6] (2) how to determine the fair market value of stock that is repurchased or issued or provided during the taxable year,[7] (3) how certain stock compensation arrangements are treated for purposes of the excise tax,[8] and (4) how the exceptions in section 4501(e) apply.[9] The Notice also addressed the expected procedures and timelines for reporting and paying the excise tax.[10]

More surprisingly, the Notice also introduced a funding rule (the "**Notice Funding Rule**") that would have significantly expanded the scope of the excise tax with respect to foreign corporations, by subjecting a U.S. subsidiary of a publicly traded foreign corporation to the excise tax to the extent it "funded" an acquisition of the stock of that publicly traded foreign parent.[11] Specifically, the Notice provided that an "**applicable specified affiliate**" (generally, a U.S. subsidiary)[12] of an "**applicable foreign corporation**" (generally, the

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[1] *See* REG-118499-23, *Excise Tax on Repurchase of Corporate Stock – Procedure and Administration*, 89 Fed. Reg. 25829 (April 12, 2024) and REG-11571022, *Excise Tax on Repurchase of Corporate Stock*, 89 Fed. Reg. 25980 (April 12, 2024).
[2] 2023-3 I.R.B. 374.
[3] *See* section 10201(d) of Pub. L. No. 117-169, 136 Stat. 1818, 1828-1831 (2022). *See also KPMG Analysis and observations: Tax law changes in the "Inflation Reduction Act"* at pp. 26-29.
[4] Section 4501(c)(3).
[5] Under section 4501(d)(2), the excise tax can also apply to the purchase of stock of a surrogate foreign corporation (generally as defined under section 7874) by the surrogate foreign corporation or a specified affiliate. This provision applies to a limited number of taxpayers and is not discussed further in this article.
[6] Notice § 3.08(3)-(4).
[7] Notice § 3.06(2); § 3.08(5).
[8] Notice § 3.07(3).
[9] Notice § 3.07.
[10] Notice § 4.
[11] Notice § 3.05(2)(a)(ii)(A).
[12] Notice § 3.02(4). The Notice defined the term "applicable specified affiliate" to mean a specified affiliate of an applicable foreign corporation, other than a foreign corporation or a foreign partnership (unless the partnership has a domestic entity as a direct or indirect partner). A "specified affiliate" is defined in section 4501(c)(2)(B) to mean, with respect to any corporation (1) any corporation more than 50 percent of the stock of which is owned (by vote or by value), directly or indirectly, by such corporation, and (2) any partnership more than 50 percent of the capital interests or profits interests of which is held, directly or indirectly, by such corporation.

publicly traded foreign parent of the U.S. subsidiary)[13] would be treated as acquiring stock of an applicable foreign corporation (and, therefore potentially subject to the excise tax) if:

- The applicable specified affiliate "funds by any means (including through distributions, debt, or capital contributions)" the acquisition or repurchase of stock of the applicable foreign corporation by the applicable foreign corporation (or by a non-U.S. specified affiliate), and
- Such funding is undertaken for a principal purpose of avoiding the stock repurchase excise tax.[14]

In addition to this general rule, the Notice Funding Rule contained a *per se* rule, providing that the principal purpose required in the general rule **will be deemed to exist** if:

- The applicable specified affiliate funds by any means, other than through distributions, the applicable foreign corporation (or the non-U.S. specified affiliate), and
- Such funded entity acquires or repurchases stock of the applicable foreign corporation within two years of the funding.[15]

There were (and are) numerous uncertainties regarding how the Notice Funding Rule would operate in practice, but it was clear that it would dramatically expand the application of the excise tax with respect to the U.S. subsidiaries of foreign-parented multinationals. Many commenters criticized the Notice Funding Rule as (*inter alia*) overbroad given the limited application of the statute to foreign-parented groups.

On June 29, 2023, the IRS released Announcement 2023-18,[16] which stated (*inter alia*) that, before the time specified in forthcoming regulations, taxpayers (1) are not required to report or to pay the stock repurchase excise tax and (2) will not be subject to penalties for failure to file or pay the stock repurchase excise tax.[17]

The Proposed Regulations

Procedural points

Filing, payment, and recordkeeping requirements

The Proposed Regulations provide that any covered corporation (or person treated as a covered corporation) that makes a stock repurchase after December 31, 2022 (or that is treated as making a stock repurchase) would be required to file a stock repurchase excise tax return. The "stock repurchase excise tax return" means a Form 720, *Quarterly Federal Excise Tax Return*, where the tax liability is reported, with an attached Form 7208, *Excise Tax on Repurchase of Corporate Stock*, where the excise tax is calculated.

KPMG observation

The requirement to file a stock repurchase excise tax return would apply to all covered corporations (or persons treated as covered corporations) that make a repurchase (or that are treated as making a repurchase) in a taxable year, even if each repurchase in that year is eligible for a statutory

[13] An "applicable foreign corporation" is defined under section 4501(d)(3)(A) to mean any foreign corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)).
[14] Notice § 3.05(2)(a)(ii)(A).
[15] Notice § 3.05(2)(a)(ii)(B).
[16] Announcement 2023-18, 2023-30 I.R.B. 366.
[17] *See* Maury Passman, Tim Nichols, Taylor Cortright, and Greg Armstrong, *KPMG report: Reporting and paying the stock repurchase excise tax—not quite yet*, TaxNewsFlash No. 2024-025 (January 18, 2024).

exception or is fully offset by issuances. In other words, there is no *de minimis* rule that would excuse filing a return – each covered corporation that redeems or repurchases even a single share of any class of its stock in a taxable year and each corporation that purchases or that is treated as repurchasing one or more shares of the stock of its foreign parent would be required to file a stock repurchase excise tax return, regardless of whether any excise tax liability would be reported on the return.

For taxable years ending after the date final regulations are published, the due date for the stock repurchase excise tax return would be the due date of the Form 720 for the first full calendar quarter after the taxable year of the covered corporation (or person treated as a covered corporation) ends.[18] For example, if a covered corporation's taxable year ends on December 31, 2024, during the 2024 taxable year the corporation makes a stock repurchase, and the final excise tax regulations are published before January 1, 2025, the corporation must file its stock repurchase excise tax return for its 2024 taxable year by April 30, 2025 (the due date for a first-quarter Form 720).[19]

For taxable years ending on or before the date the final regulations are published, the Proposed Regulations would require a covered corporation, or person treated as such, to file the stock repurchase excise tax return by the due date of the Form 720 for the first full calendar quarter after the final regulations are published in the Federal Register.[20] For instance, if a covered corporation's taxable year ends on December 31, 2023, during the 2023 taxable year the corporation makes a stock repurchase, and the final regulations are published in the Federal Register on September 16, 2024, the corporation would be required to file the stock repurchase excise tax return for its 2023 taxable year by January 31, 2025 (the due date for a fourth-quarter Form 720).[21] If the covered corporation has multiple taxable years ending after December 31, 2022 and before the date final regulations are published, the corporation should file a single Form 720 with a separate Form 7208 for each relevant taxable year with its initial stock repurchase excise tax return.[22]

The Proposed Regulations also provide that the due date for paying the excise tax is the same as that for the stock repurchase excise tax return.[23]

KPMG observation

Consistent with the Notice and Announcement 2023-18, the Proposed Regulations provide that any excise tax liability for repurchases after January 1, 2023, will eventually have to be reported and paid, but that reporting and payment are not currently required and will not be required until the due date of the Form 720 for the first full calendar quarter after the date the final regulations are published.

Under the Proposed Regulations, the earliest expected due date for filing the initial stock repurchase excise tax return (and thus the due date for the first payment of the excise tax) would be October 31, 2024, provided that the Treasury Department and the IRS publish final regulations on or before June 30, 2024. If final regulations are published after that date and before October 1, 2024, the anticipated due dates for filing and payment would be January 31, 2025.

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[18] Prop. Reg. § 58.6071-1(a).
[19] Prop. Reg. § 58.6071-1(b).
[20] Prop. Reg. § 58.6071-1(c).
[21] Prop. Reg. § 58.6071-1(d). The covered corporation would also be required to file its stock repurchase excise tax return for its 2024 taxable year on or before April 30, 2025.
[22] Thus, for example, if final regulations are published on September 16, 2024, a covered corporation with a taxable year ending on March 31 would be required to file its initial stock repurchase excise tax return on a single Form 720 on or before January 15, 2025, and to attach to its Form 720 separate Forms 7208 for its taxable years ending March 31, 2023 and March 31, 2024.
[23] Prop. Reg. § 58.6151-1(a).

The Joint Committee on Taxation had estimated that the excise tax would raise nearly $5.7 billion in the Federal Government's Fiscal Year ending September 30, 2023, and $7.9 billion in the Fiscal Year ending September 30, 2024.[24] However, at this point, it appears reasonably certain that no amount of the excise tax will be collected prior to the Federal Government's Fiscal Year that begins on October 1, 2024.

Contemporaneously with the release of the Proposed Regulations, the IRS released an updated draft version of Form 7208, *Excise Tax on Repurchase of Corporate Stock*, and instructions for the draft Form 7208.

KPMG observation

The current draft Form 7208 and accompanying draft instructions are just that – drafts. While they are useful in understanding the required reporting, they are not to be used for filing. In the meanwhile, taxpayers that expect to be required to file stock repurchase excise tax returns can use the current draft Form 7208 and accompanying draft instructions to understand the information that is likely to be required to be reported. This will give taxpayers time to gather and compile the relevant information, and to position themselves to satisfy the filing requirements once final regulations are issued.

The Proposed Regulations also would require covered corporations to maintain "such complete and detailed records as are sufficient to establish accurately the amount of the repurchases, adjustments, or exceptions required" to be reported on the stock repurchase excise tax return.[25] These records must be available for IRS inspection and retained as long as their contents may become material to the administration of any internal revenue law.

Applicability dates

In general, the Proposed Regulations would apply to any transactions occurring in tax years ending after December 31, 2022.[26] However, certain rules that were not outlined in the Notice but were included with the Proposed Regulations would apply only to transactions that occur after April 12, 2024 (the publication date of the Proposed Regulations). In addition, as noted below, certain provisions relevant to foreign-parented groups have separate effective date rules.

KPMG observation

The Proposed Regulations are, as of the date of this document, simply proposed rules and are not in effect. However, the Proposed Regulations, if promulgated as temporary or final regulations in their current form, generally would have retroactive effect. This is consistent with the statutory rule in section 7805(b)(1) that allows the Treasury Department to issue final regulations that retroactively apply to taxable periods ending after the date on which a notice substantially describing the expected contents of a regulations was issued to the public (as noted above, the Notice was issued on December 27, 2022).

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[24] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 117th Congress* (JCS-1-23), at 537 (December 2023); Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions of Title I – Committee on Finance, of an Amendment in the Nature of a Substitute to H.R. 5376, "An Act to Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14," as Passed by the Senate on August 7, 2022, and Scheduled for Consideration by the House of Representatives on August 12, 2022*, (JCX-18-22) (August 9, 2022).

[25] Prop. Reg. § 58.6001-1(a).

[26] Prop. Reg. § 58.4501-6(a).

The Notice provided that taxpayers could rely on the rules in section 3 thereof until the issuance of regulations.[27] The preamble of the Proposed Regulations provides that a covered corporation may generally rely on the Proposed Regulations with respect to transactions occurring, and tax years ending, prior to the publication of final regulations.[28] While particular rules in the Proposed Regulations might change in certain respects when published as final regulations, it is likely that many of the provisions in the Proposed Regulations will be incorporated in the final regulations and retroactively applicable in any event.

Publicly traded foreign corporations and U.S. subsidiary entities

In general, with respect to a foreign corporation the stock of which is traded on an established securities exchange (an applicable foreign corporation), by statute the excise tax is imposed on the entity's U.S. subsidiary entities (applicable specified affiliates) to the extent a subsidiary entity acquires its foreign parent's stock from an unrelated seller.[29]

The Notice Funding Rule, discussed above, would have significantly expanded the scope of the excise tax, to subject certain foreign-owned U.S. entities to the excise tax where the U.S. entity funds its foreign parent's stock repurchase. The Proposed Regulations would modify the Notice Funding Rule, and expand it to include indirect fundings through certain lower-tier foreign entities. More specifically, the Proposed Regulations provide that an applicable specified affiliate is treated as acquiring stock of an applicable foreign corporation to the extent it funds "by any means (including through distributions, debt, or capital contributions), directly or indirectly" a "covered purchase"[30] of the stock of that applicable foreign corporation with a principal purpose of avoiding the excise tax (a "covered funding"). The Proposed Regulations further provide that if, based on all the facts and circumstances, a principal purpose of the covered funding is to fund, directly or indirectly, a covered purchase, then there is a principal purpose of avoiding the excise tax.

The Proposed Regulations also provide special rules, including a rebuttable presumption, for certain "downstream" funding transactions. Specifically, the Proposed Regulations provide that a principal purpose of avoiding the excise tax is presumed to exist if an applicable specified affiliate funds by any means, directly or indirectly, a "downstream relevant entity," and the funding occurs within two years of a covered purchase by or on behalf of the downstream relevant entity.[31] This presumption may be rebutted only if facts and circumstances clearly establish that there was not a principal purpose of avoiding the stock repurchase excise tax.[32]

A "downstream relevant entity" is defined as a relevant entity 25 percent or more of the stock of which is owned (by vote or by value) (or the capital interests or profits interests of which is held), directly or indirectly, by, individually or in aggregate, one or more applicable specified affiliates of an applicable foreign corporation.[33]

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[27] Notice § 5.03.
[28] Preamble, XV.
[29] Section 4501(d)(1).
[30] The term "covered purchase" means an "AFC repurchase" or an acquisition of stock of an applicable foreign corporation by a relevant entity. Prop. Reg. § 58.4501-7(b)(2)(vii). The term "AFC repurchase" means solely (1) a section 317(b) redemption with respect to stock of an applicable foreign corporation or a covered surrogate foreign corporation, as applicable, except as provided in Prop. Reg. § 58.4501-7(j)(3); or (2) a section 4501(d) economically similar transaction described in paragraph (j)(4) of Prop. Reg. § 58.4501-7. The term "relevant entity" means a specified affiliate of an applicable foreign corporation that is not an applicable specified affiliate of the applicable foreign corporation. Prop. Reg. § 58.4501-7(b)(2)(xiv).
[31] Prop. Reg. § 58.4501-7(e)(2).
[32] *Id.*
[33] Prop. Reg. § 58.4501-7(b)(2)(xi).

KPMG observation

The Proposed Regulations functionally contain two potential funding rules – one (the "**New Funding Rule**") that roughly corresponds to the Notice Funding Rule, and a second one (the "**Downstream Rule**") that applies with reference to fundings through lower-tier entities. Notably, the New Funding Rule is in certain respects broader than the Notice Funding Rule, while appearing to offer limited clarity to "inbound" multinationals evaluating its potential scope.

As an illustration of the apparent operation of the New Funding Rule, assume a publicly traded foreign parent corporation (FP) directly owned all of the stock of a U.S. corporate subsidiary (US Sub), and FP caused US Sub to distribute funds to it as a dividend so that it would have funds with which it could repurchase its own shares. The Proposed Regulations appear to assert that,[34] because the intended use of the funds was a repurchase of shares, the funding had "a principal purpose" of avoiding the excise tax that would have applied under section 4501(d) if US Sub (rather than FP) had purchased FP's shares.

However, fundamentally, the "purpose" of funding FP's share repurchase is different than a "purpose" of avoiding the excise tax. To implement a repurchase of a foreign parent's shares, it is generally most practical and logical for the foreign parent, rather than an affiliate, to reacquire its own shares, regardless of the excise tax. Further, certain jurisdictions may have so-called "anti-corporate-incest" rules that generally prohibit a subsidiary from owning or acquiring shares of its parent (something acknowledged in the preamble to the Proposed Regulations). Nevertheless, even if US Sub were legally prohibited from acquiring FP's shares (and, therefore, legally prohibited from engaging in the transaction described in section 4501(d)), the Proposed Regulations appear to treat US Sub's funding of FP as done with "a principal purpose" of avoiding the application of section 4501(d).

Typically, a foreign parent will receive funds from both U.S. and non-U.S. entities and use these funds for various purposes, potentially including stock repurchases. Often, these funds are deposited into a cash pool account, and thus commingled with general corporate funds of the applicable foreign corporation and its various subsidiary entities. From a practical perspective, it is not clear how a taxpayer establishes that transfers of funds from U.S. entities did not have "a" principal purpose of funding a repurchase of stock in this scenario. Can the foreign parent rely on its non-U.S. subsidiaries to fund its stock repurchases and its U.S. subsidiaries to fund its other needs? The preamble states that the Proposed Regulations did not adopt a "tracing" approach to determine which funding sources were used for which purposes. However, the Proposed Regulations do not answer how the purposes of a particular cash distribution are determined in the typical context of a foreign parent's receipt of funds from various internal and external sources to be used for various different purposes.[35] The language used in the Proposed Regulations – "funds by any means (including through distributions, debt, or capital contributions), directly or indirectly" – can cover an extraordinarily broad range of situations. For example, this language might capture a situation where a foreign parent uses cash from a reserve account to repurchase its shares, and later uses cash from its U.S. subsidiary entities to replenish the reserve account. Or what if the foreign parent intended to undertake a significant M&A transaction, and decided to fund the acquisition from distributions from its U.S. subsidiary entities while using its other financial resources to repurchase its shares (resources that otherwise would

[34] Technically, the relevant regulatory language appears circular, in that (1) the first sentence of Prop Reg. § 58.4501-1(e) defines a "covered funding" as a covered purchase with a principal purpose of avoiding the excise tax and (2) the second sentence provides that a principal purpose of a "covered funding" is to avoid the excise if a principal purpose of the funding is to fund a covered purchase. Thus, the second sentence literally only applies to a "covered funding," even though the purpose of the second sentence is to define when a "bad" purpose exists such that a funding is a covered funding. However, this literal reading also appears to make the second sentence essentially meaningless and presumably was not the intent.

[35] Moreover, the "ordering rules" and examples discussing multiple "covered fundings" indicate that the amounts of fundings made with "a principal purpose" of funding a covered purchase can exceed the amount of that covered purchase. Prop. Regs. § 58.4501-7(e)(7)(iv); -7(p)(4). This seems to imply a broad view of what fundings can have the proscribed purpose and be caught by the excise tax.

have funded the M&A transaction—*i.e.*, an avoided cost method approach)? The Proposed Regulations also are not clear on whose purpose is relevant (e.g., does a U.S. CFO or tax director need to ascertain what the foreign parent intends to do with funds transferred?).

The apparent treatment by the New Funding Rule of a "purpose to fund" a stock repurchase as an automatic "purpose to avoid" the excise tax may result in a taxpayer having more excise tax exposure under the New Funding Rule than the Notice Funding Rule. Under the Notice, distributions were explicitly excluded from the "*per se*" rule whereas there is no comparable exclusion under the Proposed Regulations. In addition, under the Notice Funding Rule the presumption was limited to two years (presumably, two years before and two years after the funding); the Proposed Regulations contain no temporal limit on the New Funding Rule, and an example in the Proposed Regulations illustrates the application of the rule to a stock purchase that occurs more than two years after the funding.

What is further troubling about the New Funding Rule is the absence of an exception for ordinary course transactions. Presumably, such a transaction is not undertaken with a principal purpose to avoid the imposition of an excise tax, but many ordinary course transactions could fund in whole or in part a foreign parent's repurchase of its stock. For example, assume FP owns US Sub, and US Sub borrows funds from an external lender (with a FP guaranty) to build a manufacturing facility in the United States. Assume further that US Sub pays a guaranty fee to FP, and that FP repurchases shares in the same taxable year. If FP had a share repurchase plan in place at that time US Sub borrowed the funds and paid the guaranty fee, how can US Sub establish that "a" principal purpose of paying the guaranty fee to FP was not to indirectly fund, by any means, FP's share repurchase? The same issue might also arise if US Sub were to purchase inventory or pay for services or for the use of IP, if the underlying funds funded "by any means, directly or indirectly," the repurchase of FP stock.

An example in the Proposed Regulations illustrates that the "funds by any means, directly or indirectly" is intended to have a long reach.[36] In the example, two U.S. subsidiary entities loan funds to their foreign parent corporation with what we are told is a principal purpose of funding a covered purchase, the foreign parent corporation loans funds to a foreign subsidiary, and the foreign subsidiary buys stock in the foreign parent (presumably from unrelated sellers). The Example, which implicitly treats the foreign parent corporation as a conduit, concludes that the U.S. subsidiary entities are subject to the excise tax.

The downstream funding rule appears intended to cover situations where a US corporation funds a foreign parent's stock repurchase through transfers to lower-tier foreign entities. This latter aspect is similar to the Administration's FY 2025 revenue proposal to extend the excise tax to the acquisition of stock of an applicable foreign corporation by a specified affiliate of the applicable foreign corporation that is a controlled foreign corporation defined in section 957(a).[37] However, while the New Funding Rule would appear to have a significant effect, the Downstream Rule, which (unlike the New Funding Rule) includes a "rebuttable presumption," would apply only to a very unusual fact pattern and thus is likely to be of minimal relevance.

In general, the Proposed Regulations provisions addressing "fundings" by an applicable specified affiliate apply to transactions that occur after April 12, 2024. Under a transition rule, rules similar to the Notice Funding Rule would apply to a situation where both a funding and a covered purchase occur between January 1, 2023, and April 12, 2024.[38] However, the Proposed Regulations invite taxpayers to choose to apply the rules of the Proposed Regulations (including the New Funding Rule) in lieu of the rules in the

[36] Prop. Reg. § 58.4501-7(p)(7) (*Example 7*).
[37] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals*, pp. 4-5 (March 11, 2024).
[38] Prop. Reg. §§ 58.4501-7(o), -7(r)(2).

Notice (including the Notice Funding Rule) to transactions occurring after December 31, 2022, subject to certain consistency requirements.[39]

Other rules (generally consistent with the Notice)

Other than the modifications to the rules discussed above, the Proposed Regulations largely adopt the rules outlined in the Notice, with most additions elaborating on the application of the rules outlined in the Notice. For instance, the Proposed Regulations adopt substantially the same rules as the Notice with regard to:

- Operating rules for applying and calculating the excise tax;
- Lists of transactions subject or not subject to the excise tax; and
- Rules for the exceptions to the excise tax under section 4501(e).

Operating rules

The Proposed Regulations set forth certain general ordering and operating rules for computation of the excise tax liability. The excise tax liability generally is computed as one percent of the total fair market value of the stock repurchased during the taxable year. Under the Proposed Regulations, this amount is first reduced by the fair market value of such stock that qualifies for one of the exceptions listed in section 4501(e),[40] and then reduced by the fair market value of stock issued in accordance with the netting rule.[41]

The Proposed Regulations provide that the determination of whether an instrument is stock for purposes of the excise tax is made based on the general classification of the instrument for U.S. federal income tax purposes as of the date of issuance.[42]

While section 4501 specifically grants authority to the Treasury Department to provide rules to address special classes of stock and preferred stock,[43] the Proposed Regulations generally do not exempt particular types of equity instruments from the application of the excise tax.[44] The preamble to the Proposed Regulations notes that multiple comments recommended exclusions for all preferred stock or alternatively for "straight" preferred stock.[45] However, other than a limited exception for "additional tier 1 preferred stock" issued by certain banks,[46] the Proposed Regulations treat preferred stock as stock for purposes of the excise tax.[47]

KPMG observation

The treatment of preferred stock as stock for excise tax purposes means that both issuances and redemptions of preferred stock affect the excise tax base. For corporations that issue preferred stock, it is not uncommon for a retirement of preferred stock to be accompanied by an issuance of new preferred stock with the same or similar par value. In this context, the timing of retirements and issuances may be important, particularly given that there is no carryforward of "excess issuances" from one tax year to the next. For example, if a covered corporation issues preferred stock at the end of tax year one and retires preferred stock at the beginning of tax year two (and assuming none of the

[39] Prop. Reg. § 58.4501-7(r)(3).
[40] Except for the *de minimis* exception in section 4501(e)(3).
[41] Prop. Reg. § 58.4501-2(c)(1).
[42] Prop. Reg. § 58.4501-1(b)(29).
[43] Section 4501(f)(2).
[44] Prop. Reg. § 58.4501-1(b)(29).
[45] Preamble to the Proposed Regulations, Part II.A.1.-3.
[46] Prop. Reg. § 58.4501-1(b)(29)(ii).
[47] *See* Prop. Reg. § 58.4501-1(b)(29).

stock is "additional tier 1 preferred stock"), the issuance in tax year one is not available to be netted against the repurchase in tax year two.

As an anti-abuse rule, unless otherwise provided[48] the issuance of an instrument that is not in the legal form of stock but is treated as stock for U.S. federal tax purposes (a "**non-stock instrument**") is disregarded for purposes of the netting rule.[49] Notwithstanding this rule, if a non-stock instrument is repurchased and certain requirements are satisfied,[50] the issuance of a non-stock instrument as part of the repurchase can be regarded for purposes of the netting rule at the time of such repurchase.[51]

KPMG observation

The preamble states that Treasury was concerned with the potential for taxpayers to issue non-stock instruments (e.g., deep-in-the-money call options) to accommodation parties with an understanding that the non-stock instruments would never be converted into actual stock. Treasury perceived that taxpayers could utilize these transactions to generate issuances of non-stock instruments to offset repurchases. To address this, the Proposed Regulations create a general rule that a non-stock instrument is not treated as "issued" for excise tax purposes (1) unless the taxpayer satisfies certain reporting requirements and (2) until the non-stock instrument is repurchased, **and** that the amount of the issuance is limited to the lesser of the FMV of the non-stock instrument at the time of its issuance or repurchase.[52] However, the repurchase of a non-stock instrument still constitutes a repurchase for purposes of the excise tax. Thus, any non-stock instruments appear to be subject to generally unfavorable treatment for excise tax purposes due to the differing treatment of issuances and repurchases.

Except in the case of certain issuances of stock to employees or employer-sponsored retirement plans, stock is generally treated as issued or repurchased on the date ownership of the stock is transferred.[53] The fair market value of stock repurchased or issued is generally its market price and may be calculated based on any one of the following methods:

- The daily volume-weighted average price;
- The closing price;
- The average of the high and low prices on the applicable date; or
- The trading price at the time of the issuance or repurchase.[54]

Generally, the method used to value stock repurchased must be consistently applied to determine the market price of all stock repurchased or issued under the netting rule throughout the covered corporation's

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[48] Prop. Reg. § 58.4501-4(f)(13)(ii) includes situations in which Prop. Reg. § 58.4501-4(f)(13)(i) may not apply.
[49] Prop. Reg. § 58.4501-4(f)(13)(i).
[50] *See* Prop. Reg. § 58.4501-4(f)(13)(ii)(B)-(D).
[51] Prop. Reg. § 58.4501-4(f)(13)(ii)(A). For purposes of the Proposed Regulations, the delivery of stock pursuant to the terms of a non-stock instrument is treated as a repurchase of the non-stock instrument in exchange for an issuance or provision of the stock that is delivered. The amount of the reduction for purposes of Prop. Reg. § 58.4501-4(f)(13)(ii)(A) is calculated based on Prop. Reg. § 58.4501-4(f)(13)(ii)(E).
[52] *See* Prop. Reg. § 58.4501-4(f)(13).
[53] Prop. Reg. § 58.4501-2(g)(1) and -4(d)(1). In the case of issuances of stock to employees due to the exercise of options or stock acquisition rights, the stock generally is treated as issued on the date of exercise. In the case of issuances of restricted stock to employees under section 83 (i.e., stock that is either non-transferable or subject to substantial risk of forfeiture), the stock is not treated as issued or provided to the employee until it vests, unless the employee makes an election under section 83(b) with respect to the stock (in which case it is treated as issued on the date it is transferred to the employee). In addition, there is a special timing rule, which provides that transfers of stock to employer-sponsored retirement plans or similar plans (and not treated as repurchases under a statutory exception), during the first quarter following the close of a taxable year, may be treated as transferred to such plan during the preceding taxable year.
[54] Prop. Reg. §§ 58.4501-2(h)(2)(ii); -4(e)(2)(ii).

taxable year.[55] However, for stock issued or provided to employees, the Proposed Regulations provide that the value used for purposes of section 83 is used for purposes of the excise tax.[56]

KPMG observation

Presumably, in most cases the value used for purposes of section 83 is used to calculate the employer's deduction and therefore is already available to the corporation.

Finally, the Proposed Regulations clarify that for a regular way repurchase of stock traded on an exchange, the trade date (rather than the settlement date) is the date of the repurchase.

KPMG observation

This rule represents a helpful clarification. Given that the excise tax is based on the value of stock repurchased, differences in trading prices between the trade date and the settlement date could have added a degree of additional complication to the excise tax calculations.

Lists of transactions subject or not subject to the excise tax

The Proposed Regulations set forth an exclusive list of certain redemptions that are not treated as repurchases subject to the excise tax and an exclusive list of other transactions treated as repurchases subject to the excise tax.

Redemptions within the meaning of section 317(b) are repurchases subject to the excise tax, except for the following:

- Deemed distributions in redemption of stock under a section 304(a)(1) transaction;[57] and
- Certain payments of cash in lieu of fractional shares in certain transactions.[58]

Of note, transactions that can be subject to the excise can include, for example, leveraged buyouts to the extent consideration is furnished by the target corporation (e.g., due to incurrence or assumption of debt by the target corporation).[59]

KPMG observation

Even though it is only a one percent tax, it is worth considering the potential application of the excise tax to M&A transactions involving public companies. The amount of excise tax liability can differ

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[55] Prop. Reg. §§ 58.4501-2(h)(2)(iv)(B); -4(e)(2)(iv)(B).
[56] Prop. Reg. § 58.4501-4(e)(5). For discussions regarding the application of the rules in the Notice in the employee compensation context, *see* Robert Delgado, Gary Cvach, Maury Passman, Tim Nichols, and Dontrell Lemon, *The Stock Buyback Excise Tax: Practical Considerations for Retirement Plans and Equity-Based Compensation Arrangements*, 51 Tax Mgmt. Comp. Plan J. No. 5 (May 5, 2023).
[57] Prop. Reg. § 58.4501-2(e)(3)(i)(A).
[58] Prop. Reg. § 58.4501-2(e)(3)(ii). This exception generally applies to payments of cash in lieu of fractional shares in as part of a transaction that qualifies as a reorganization under section 368(a) or a distribution to which section 355 applies, or pursuant to the settlement of an option or similar financial instrument (for example, a convertible debt instrument or convertible preferred share). For this exception to apply the payments for fractional shares (1) must not be separately bargained for consideration, (2) must be made solely for administrative convenience, and (3) cannot exceed the value of a single share with respect to any shareholder.
[59] *See* Prop. Reg. § 58.4501-5(b)(4). *See also* Adam Murphy, Maury Passman, and Jeffrey Vogel, *Stock Repurchases Under the Build Back Better Act's Excise Tax*, 175 Tax Notes Federal 865 (May 9, 2022).

significantly depending on the transaction structure, including the location of any borrowing utilized to fund the transaction.]

Alternatively, the Proposed Regulations provides an exclusive list of transactions that are treated as repurchases subject to the excise tax. That list solely includes the following transactions:

- The exchange by target shareholders of target stock as part of an acquisitive reorganization;[60]
- An exchange by recapitalizing shareholders of stock in a recapitalization under section 368(a)(1)(E) (an "**E reorganization**");[61]
- An exchange of transferor corporation stock as part of a reorganization under section 368(a)(1)(F) (an "**F reorganization**");[62]
- An exchange of distributing corporation stock as part of a split-off in a distribution to which section 355 applies;[63]
- Any distributions made under section 331 to minority shareholders in the case of a complete liquidation to which both section 331 and section 332 applies;[64] and
- Certain forfeitures and claw-backs of stock.[65]

The Proposed Regulations also provide a non-exclusive list of transactions that are not economically similar to a repurchase and therefore not subject to the excise tax. Those transactions are:

- Distributions in complete liquidation to which section 331 or section 332 (but not both) applies;[66]
- A section 355 distribution other than a split-off (i.e., a spin-off or split-up);[67]
- Non-redemptive distributions subject to section 301(c)(2) or (3);[68] and
- Net cash settlement of an option contract or other derivative financial instrument.[69]
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KPMG observation

There had been concern that the Notice exception for most distributions in complete liquidation would not technically apply in certain cases, e.g., special purpose acquisition company or "SPAC" liquidations in which not all classes of shareholders received a distribution with respect to their shares. The Proposed Regulations generally clarify that most corporate dissolutions are not subject to the excise tax even if not all classes of shareholders receive a distribution.

Rules for the exceptions to the excise tax under section 4501(e)

The Proposed Regulations provide certain rules for applying the statutory exceptions of section 4501(e). Particularly, the exception for reorganizations under section 4501(e)(1) applies to the extent that the relevant corporation's stock is exchanged for property permitted to be received under section 354 or 355 without recognition of gain or loss in a repurchase by a:

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[60] Prop. Reg. § 58.4501-2(e)(4)(i). "Acquisitive reorganization" is defined as a reorganization under section 368(a)(1)(A) (including by reason of section 368(a)(2)(D) or (a)(2)(E)), (C), (D) (that satisfies the requirements of section 354(b)(1)), or (G) (that satisfies the requirements of section 354(b)(1)). Prop. Reg. § 58.4501-1(b)(1).
[61] Prop. Reg. § 58.4501-2(e)(4)(ii).
[62] Prop. Reg. § 58.4501-2(e)(4)(iii).
[63] Prop. Reg. § 58.4501-2(e)(4)(iv).
[64] Prop. Reg. § 58.4501-2(e)(4)(v).
[65] *See* Prop. Reg. § 58.4501-2(e)(4)(vi).
[66] Prop. Reg. § 58.4501-(5)(i)-(ii).
[67] Prop. Reg. § 58.4501-2(e)(5)(iii).
[68] Prop. Reg. § 58.4501-2(e)(5)(iv).
[69] Prop. Reg. § 58.4501-2(e)(5)(v).

- Target corporation in an acquisitive reorganization;[70]
- Recapitalizing corporation in an E reorganization;[71]
- Transferor corporation in an F reorganization;[72] or
- Distributing corporation in a split-off.[73]

Thus, other property or money (i.e., "boot") received by a shareholder in exchange for stock of a corporation subject to tax in connection with a reorganization is generally subject to the excise tax.

Additionally, the exception for transfers of stock to an employer-sponsored retirement plan or similar plan under section 4501(e)(2) only applies to reduce the amount of repurchases subject to the excise tax by the amount of stock contributed to the plan during the same taxable year.[74] However, stock contributed to the plan prior to the deadline for filing the excise tax forms for a taxable year may be treated as contributed to the plan during that prior taxable year.[75]

The Proposed Regulations also provide that there is a rebuttable presumption that the dividend exception does not apply to repurchases, which may be rebutted by showing that the relevant corporation:

- Obtained certification from the shareholder that the repurchase was treated as a distribution under section 301 by reason of section 302(d) or had the effect of a dividend under section 356(a)(2),
- Treated the repurchase consistent with the shareholder certification;
- Had no knowledge of facts contrary to such shareholder certification, and
- Had sufficient earnings and profits to treat the repurchase as a dividend.[76]

KPMG observation

It took less than three pages of the Statutes at Large to reproduce the text of the excise tax statute. In contrast, the Proposed Regulations, including the preambles, consumed more than 325 pages of text. The Proposed Regulations provide a significant amount of meaningful guidance, though they also have created ambiguities and uncertainties. The excise tax—which on its face appears to be relatively simple and straightforward—has become complicated. Congress imported a subchapter C rule into the excise tax to define what constitutes a repurchase, and in so doing it appears to have opened the door to the attendant complexities of subchapter C. In addition, the Treasury Department and the IRS have layered on the funding rule—a rule seemingly tailor-made to generate controversy—to prevent what they perceive to be the potential for foreign-controlled US subsidiary entities to surreptitiously fund their foreign parents' stock repurchases while avoiding the excise tax. The net result is a complex series of proposed rules, and new recordkeeping and tax filing obligations.

Comments to the procedural package of the Proposed Regulations are due by May 13, 2024; comments to the package of substantive rules are due by June 11, 2024.

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[70] Prop. Reg. § 58.4501-3(c)(1). The repurchase must be pursuant to a plan of reorganization.
[71] Prop. Reg. § 58.4501-3(c)(2). The repurchase must be pursuant to a plan of reorganization.
[72] Prop. Reg. § 58.4501-3(c)(3). The repurchase must be pursuant to a plan of reorganization.
[73] Prop. Reg. § 58.4501-3(c)(4).
[74] Prop. Reg. § 58.4501-3(d)(5)(i).
[75] Prop. Reg. § 58.4501-3(d)(5)(ii).
[76] Prop. Reg. § 58.4501-3(g)(2)(i)-(iii).

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