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IRS Publishes Proposed Regulations on Stock Buyback Excise Tax

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On April 12, 2024, the US Department of the Treasury and the IRS published proposed regulations (89 FR 25980 and 89 FR 25829, the "Proposed Regulations") on the application of Section 4501,[1] which imposes a 1% excise tax[2] on certain repurchases of stock of publicly traded US corporations (the "Excise Tax"). The Proposed Regulations generally follow the same approach as the interim guidance under Notice 2023-2 (the "Notice"), which was summarized in this January 2023 Cooley M&A publication.[3] Like the Notice, the Proposed Regulations generally would apply to stock repurchases occurring after December 31, 2022, and stock issuances during taxable years ending after December 31, 2022, except that certain specific rules not addressed in prior guidance would be effective only for transactions after April 12, 2024, the publication date of the Proposed Regulations.

The Proposed Regulations adopt a broad approach to application of the Excise Tax, with limited exceptions. As a result, the Excise Tax applies to transactions that are not conventionally regarded as stock buybacks, and companies may have Excise Tax liability or tax return filing obligations in myriad circumstances. This client alert summarizes the basic framework of the Excise Tax, as implemented by the Proposed Regulations, and discusses key implications in a variety of contexts.

Background and general rules

The Excise Tax Base and the Netting Rule

Consistent with the Notice, the Proposed Regulations impose the Excise Tax on a corporation's stock repurchase excise tax base (the "Excise Tax Base"). The Excise Tax Base is the aggregate fair market value of all stock repurchases and economically equivalent transactions in a taxable year, **reduced by** the aggregate fair market value of any such transactions covered by a statutory exception, and **further reduced by** the fair market value of all stock issuances, subject to certain exceptions, during the same taxable year. The reduction for the fair market value of stock issued during the same taxable year is hereinafter referred to as the "Netting Rule."

The Proposed Regulations provide rules for calculating and paying the Excise Tax and reporting transactions that are relevant to those determinations. The Excise Tax is not deductible and cannot be offset by tax losses or other income tax assets. Notably, corporations subject to the Excise Tax generally must file Excise Tax returns in any taxable year in which a repurchase occurs, even if there is no net Excise Tax liability because of the statutory exceptions or because application of the Netting Rule "zeroes out" the Excise Tax Base for that taxable year.

The scope of Covered Corporation and timing rules

The Excise Tax applies to "Covered Corporations," which are domestic corporations whose stock is traded on an established securities market. The definitional scope of an "established securities market" includes both regulated stock exchanges (such as Nasdaq, the New York Stock Exchange or analogous foreign exchanges) and interdealer systems that regularly disseminate buy or sell quotations by identified brokers or dealers (such as the over-the-counter, or OTC, market). Notably, the Proposed Regulations do not provide a safe harbor for private corporations whose stock is not listed on any regulated exchange, but for which price quotes are regularly available, regardless of whether the corporation plays a role in establishing or facilitating the quotation system. Therefore, private companies for which stock price quotes are readily available may be subject to the Excise Tax and/or required to file Excise Tax returns.

The Proposed Regulations clarify the time at which a corporation becomes and ceases to be a Covered Corporation subject to the Excise Tax. Generally, a corporation will be a Covered Corporation at the beginning of the date on which stock of the corporation begins to be traded on an established securities market, and it will cease to be a Covered Corporation at the end of the date on which stock of the corporation ceases to be traded on an established securities market (the "cessation date"). However, all repurchases pursuant to a plan in which

a corporation ceases to be a Covered Corporation are subject to the Excise Tax, regardless of whether the repurchases occur before or after the cessation date.

Valuation methods

For purposes of the Excise Tax, repurchased stock generally is valued based on its fair market value at the time of the repurchase, rather than based on the purchase price of the stock. The Proposed Regulations follow the Notice in requiring taxpayers to utilize one of four methods for valuing publicly traded stock for purposes of computing their Excise Tax Base:

1. daily volume-weighted average price on the date of the repurchase or issuance;
2. daily closing price on the date of the repurchase or issuance;
3. daily average high-low price on the date of the repurchase or issuance; and
4. trading price of the stock at the time it is repurchased or issued.

The chosen method must be applied consistently by the Covered Corporation for all repurchases and issuances in the taxable year. Special rules apply for purposes of valuing contributions of stock to employee stock ownership plans (ESOPs) and similar plans.

Economically similar transactions

The Excise Tax generally applies to: (a) transactions that are treated as redemptions under Section 317(b) for US federal income tax purposes and (b) any transaction that the US Department of the Treasury determines is economically similar to a redemption. To reduce uncertainty regarding which transactions will be considered economically similar to redemptions, the Notice provided an exclusive list of economically similar transactions, such as exchanges of target stock in acquisitive reorganizations and “E” and “F” reorganizations, split-offs, and certain liquidations. The Proposed Regulations generally follow the Notice in providing that economically similar transactions will be clearly identified on an exclusive list, but the preamble to the Proposed Regulations (the “Preamble”) reserves for the possibility that additional items added to the list could be applied with retroactive effect. As a result, there is no guarantee that engaging in a transaction that is currently not identified as economically similar to a redemption will be exempt from the Excise Tax.

Implications for M&A transactions

Acquisitive reorganizations under Section 368(a)

Consistent with the approach taken in the Notice, and contrary to the views expressed by most commentators, the Excise Tax applies under the Proposed Regulations to the extent of any “boot” received by the stockholders of a Covered Corporation in a reorganization under Section 368(a) in which the Covered Corporation is the target, including forward and reverse triangular mergers and asset acquisitions. “Boot” generally means cash, certain preferred stock and other property that is not permitted to be received in a reorganization without the recognition of gain or loss. No special rules were proposed with respect to troubled companies, so the Excise Tax applies even to “G” reorganizations in bankruptcy.

Further, the Excise Tax applies regardless of whether gain is recognized in the acquisitive reorganization and regardless of whether the “boot” is sourced from the acquirer or the Covered Corporation. Under the narrow interpretation of the statutory reorganization exception adopted by the Proposed Regulations, the Excise Tax will apply to an acquisitive reorganization unless the Covered Corporation’s stockholders receive solely acquirer stock (excluding certain preferred stock) and cash in lieu of fractional shares. The payment of cash in lieu of fractional shares generally is not treated as a repurchase for purposes of the Excise Tax, whereas cash paid to dissenting shareholders may be subject to the Excise Tax, depending on whether it is sourced from the target or the acquirer. Notably, under the so-called “no double benefit rule,” acquirer stock issued in an acquisitive reorganization is not taken into account for purposes of the Netting Rule.

Taxable acquisitions and leveraged buyouts

The Proposed Regulations retain the approach of the Notice with respect to taxable acquisitions, under which the source of the consideration determines the application of the Excise Tax, with consideration sourced to the acquirer treated as not being a repurchase subject to the Excise Tax. The Preamble indicates that longstanding US federal income tax principles and guidance will apply to determine the source of consideration, including debt funding. Thus, a taxable acquisition of a Covered Corporation that is funded in whole or in part by the Covered Corporation’s cash or debt – including debt of a merger subsidiary assumed by the Covered Corporation in a taxable reverse triangular merger – will be treated as a stock repurchase by the Covered Corporation that is subject to the Excise Tax. In contrast, a taxable acquisition financed entirely with acquirer cash, apparently including debt financing incurred at the acquirer level, generally will not implicate the Excise

Tax. In this respect, taxable acquisitions are treated more favorably than tax-free reorganizations, where the source of any "boot" is irrelevant to application of the Excise Tax.

Constructive specified affiliate acquisitions

The Proposed Regulations introduce a new concept of a "constructive specified affiliate acquisition," which is relevant to both tax-free reorganizations and taxable acquisitions. An example of a covered specified affiliate acquisition described in the Preamble is where a Covered Corporation enters into an agreement to acquire all of the equity of a private target, and prior to the acquisition, the target uses cash on hand to purchase stock of the Covered Corporation in the market. If the purchase of the Covered Corporation stock had occurred after the acquisition, it would have been treated as a repurchase by a specified affiliate that was subject to the Excise Tax. The Proposed Regulations extend the Excise Tax to this situation if the target corporation or partnership becomes a specified affiliate of a Covered Corporation when the target owns stock acquired after December 31, 2022 that represents more than 1% of the fair market value of the target. The repurchase is treated as occurring when the target becomes a specified affiliate, including as a result of redemptions by a target corporation of its own shares. As a result, Covered Corporations should assess the Excise Tax implications of an acquisition of a target that owns stock of the Covered Corporation.

Post-closing purchase price adjustments

M&A transactions often include purchase price adjustments under which consideration paid or issued at closing is subject to below-market repurchase or forfeiture by the target stockholders. For example, the target stockholders may be required or permitted to forfeit consideration to pay post-closing indemnity obligations, or they may be entitled to additional consideration if certain financial or event-based milestones are achieved (or required to forfeit consideration if such milestones are not achieved). Stock of a Covered Corporation generally is treated as issued for purposes of the Netting Rule when ownership of the stock transfers to the recipient for US federal income tax purposes. Under the Proposed Regulations, forfeiture of shares of a Covered Corporation would be taken into account as a repurchase if issuance of the shares was taken into account for purposes of the Netting Rule. The amount of the repurchase would be equal to the market price of the stock on the date of forfeiture (and not, for example, zero (because no consideration was paid) or based upon a negotiated below-market price). Notably, stock issued in an acquisitive reorganization that is disregarded by the acquirer for purposes of the Netting Rule because of the application of the no double benefit rule described above generally should not be treated as repurchased for purposes of the Excise Tax upon forfeiture or repurchase.

Implications for capital markets transactions

Definition of "stock"

For purposes of calculating the Excise Tax Base, the Proposed Regulations retain the broad approach of the Notice under which "stock" includes any instrument that is, or is treated as, stock for US federal income tax purposes at the time it is issued. There are no categorical exceptions for nonparticipating preferred stock, mandatorily redeemable stock, or other similar types of stock that have debt-like features.[4] The redemption of such stock (including pursuant to its terms) generally will constitute a repurchase subject to the Excise Tax. Similarly, the repurchase or cash settlement of non-stock instruments that are treated as stock for US federal income tax purposes, such as pre-funded warrants or deep-in-the-money options, generally also is subject to the Excise Tax.

For purposes of the Netting Rule, however, the Proposed Regulations generally limit "stock" to instruments that in legal form are stock. If a non-stock instrument was treated as stock for US federal income tax purposes, its value is not includable for Netting Rule purposes unless and until the instrument is repurchased or cash-settled, and its value is limited to the lesser of the fair market value of the instrument at issuance or repurchase. The issuing corporation also must satisfy several tax reporting and consistency requirements with respect to accounting for such non-stock instruments in calculating its Netting Rule offset amount.

Convertible debt and related transactions

The Proposed Regulations provide that instruments treated as debt at issuance for US federal income tax purposes are not "stock" for purposes of the Excise Tax, and this characterization is not retested while the debt remains outstanding for US federal income tax purposes. Therefore, the redemption or cash-settled conversion of convertible debt generally will not give rise to Excise Tax liability (even if the convertible debt has become deep in-the-money by the time of conversion). If a corporation physically settles conversion by issuing stock, the shares issued generally are includable in its Netting Rule offset amount for the taxable year of the conversion, based on the fair market value of the shares at the time they are issued.

A common transaction in the convertible debt market is a "tax-integrated" offering, in which a corporation issues

convertible debt and simultaneously enters into a derivative (e.g., a capped call or bond hedge). In a tax-integrated offering, the debt and derivative are treated as a single debt instrument for US federal income tax purposes. However, the Proposed Regulations provide that the tax integration is disregarded for Excise Tax purposes, so stock subsequently issued or received with respect to the debt and derivative components are evaluated separately.

Options

The Proposed Regulations provide that stock issued in physical settlement of an option is treated as an issuance or repurchase at the time of settlement. The amount of such issuance or repurchase is based on the stock's fair market value at the time of settlement, regardless of the strike price of the option. By contrast, the Proposed Regulations clarify that cash settlement of an option is not treated as an issuance or repurchase. These rules generally apply to call and put options on a Covered Corporation's stock, as well as other derivatives containing embedded call and put features. The Excise Tax implications for compensatory options and for options treated as stock at the time of issuance (e.g., "penny warrants") are discussed elsewhere in this alert.

Accelerated Share Repurchase (ASR) programs

The Proposed Regulations follow the approach of the Notice for application of the Excise Tax to ASR programs. In the typical ASR, a corporation enters into a forward contract with a financial institution under which the corporation makes an upfront cash payment and receives a certain amount of its stock at the outset. Depending on the trading price of its stock on the later settlement date, the financial institution may deliver additional shares, or the corporation may make an additional cash payment to the financial institution. For Excise Tax purposes, each delivery of shares to the corporation under the ASR constitutes a repurchase. The repurchase occurs at the time legal ownership of the shares is transferred, and the amount of the repurchase is based on the fair market value of such shares at the time of transfer.

Implications for foreign-parented groups

Funding rule

Although the Excise Tax is primarily focused on repurchases by US corporations, it also can apply to repurchases of the stock of a publicly traded foreign corporation by certain US affiliates. The Notice included an expansive application of this rule, which treated a purchase of a publicly traded foreign corporation's stock as a repurchase subject to the Excise Tax if the purchase was directly or indirectly funded by any means (including through distributions, debt, or capital contributions) by a US affiliate of the foreign corporation and "a principal purpose" of such funding was to avoid the Excise Tax. Moreover, a principal purpose was *per se* deemed to exist if the funding and purchase occurred within two years of each other. The expansive scope of the funding rule and per se presumption in the Notice were criticized by commenters as an overbroad extension of the Excise Tax that could apply to ordinary course intercompany transactions, including cash management activities, of multinational groups.

The Proposed Regulations retain the general structure of the Notice's funding rule, including the principal purpose inquiry, but narrow its scope in several respects. The per se rule of the Notice has been replaced by a rebuttable presumption that downstream fundings, in which a US entity directly or indirectly provides funds to its 25%-owned (by vote or value) foreign affiliate to fund a purchase within two years of the stock of their public foreign parent corporation, have a principal purpose of avoiding the Excise Tax. This presumption may be rebutted if the facts and circumstances clearly establish that the downstream funding does not have a principal purpose of avoiding the Excise Tax. Outside of the downstream funding context, whether any purchase of a foreign parent corporation's stock has been funded by a US affiliate with a principal purpose of avoiding the Excise Tax is determined under general US tax principles based on all of the facts and circumstances.

Thus, foreign-parented groups with US entities in their organizational structure will need to balance all relevant facts and circumstances to determine whether purchases of the foreign parent's stock (particularly, but not limited to, purchases by members of the group in which a US entity has a material direct or indirect ownership interest) will be subject to the Excise Tax.

Implications for corporate distributions and liquidations

Dividend exception

Section 4501 contains a statutory exception (the "Dividend Exception") for repurchases to the extent the

repurchase is treated as a dividend for US federal income tax purposes. Transactions that are in form repurchases (such as a pro rata redemption of stock from all shareholders) could be treated as dividends that are potentially eligible for the Dividend Exception in certain circumstances, and otherwise would be treated as repurchases subject to the Excise Tax. The Proposed Regulations impose a rebuttable presumption that the Dividend Exception does not apply. Rebutting this presumption requires, among other things, obtaining a certification under penalties of perjury from each applicable shareholder containing information necessary to establish that the repurchase will be treated as a dividend and reported as such on the shareholder's US federal income tax return.

Nonredemptive distributions

The Proposed Regulations clarify that distributions by a Covered Corporation that are not in form repurchases (such as pro rata distributions to stockholders where no shares are surrendered or redeemed) are not subject to the Excise Tax, even if the distribution is treated as a return of basis or taxed as gain from the sale or exchange of the underlying shares under Section 301(c)(2) or (3).

Complete liquidations

The Proposed Regulations follow the approach of the Notice in providing that distributions by a Covered Corporation made in complete liquidation, as well as other distributions by the Covered Corporation in the taxable year of its complete liquidation (regardless of whether such distributions are made pursuant to the plan of liquidation), are not repurchases subject to the Excise Tax. This exemption does not apply if the Covered Corporation has a corporate shareholder that owns at least 80% of the Covered Corporation (by vote and value) along with other minority shareholders. In such a case, liquidating distributions made to the minority shareholders generally will be treated as repurchases subject to the Excise Tax.

Following the Notice, commenters had expressed uncertainty about whether the complete liquidation exception would apply to a dissolution of a Covered Corporation if some classes of the stock do not receive a distribution. The Proposed Regulations clarify that redemptions of a Covered Corporation are not subject to the Excise Tax if they are pursuant to the Covered Corporation's plan of dissolution that is reported on the original (but not a supplemented or an amended) IRS Form 966 (Corporate Dissolution or Liquidation), or are pursuant to a deemed dissolution of the Covered Corporation for US federal income tax purposes (such as, e.g., deemed dissolutions resulting from "check-the-box" changes in an entity's classification).

Partial liquidations

If a corporation operates multiple lines of business and makes a distribution to its shareholders in connection with its ceasing to conduct one of its lines of business, such distribution may be treated as a "partial liquidation." Noncorporate shareholders receiving a distribution in partial liquidation generally will be treated as having received payment in redemption of their stock for US federal income tax purposes. The Proposed Regulations provide that distributions made in partial liquidations of a Covered Corporation also are treated as repurchases subject to the Excise Tax, regardless of whether any stock is actually repurchased in connection with the partial liquidation.

Implications for special purpose acquisition companies (SPACs)

General

Several commenters had requested special modifications or exceptions to the Excise Tax rules for SPACs. The Proposed Regulations generally declined to provide any such exceptions. As a result, the rules and issues summarized elsewhere in this alert generally apply in the SPAC context, some of which are discussed further in this September 2022 Cooley M&A publication.

De-SPAC redemptions and Netting Rule implications

SPAC shareholders typically have the right to cause the SPAC to redeem their shares in advance of a "de-SPAC" combination with a target corporation. Such redemptions are subject to the Excise Tax under the general rules described above, but the Netting Rule may reduce or eliminate the SPAC's Excise Tax liability to the extent of the value of SPAC shares issued in the same taxable year, including issuances to target shareholders in the de-SPAC or in any related private investment in public equity (PIPE) financings. However, certain de-SPAC combinations utilize transaction structures in which the SPAC is not the acquiring entity. These include "double dummy" structures in which a new corporation acquires both the SPAC and the target, as well as "reverse merger" structures in which the SPAC is the target. If the SPAC is not the acquiring corporation, the value of stock consideration issued in the business combination generally will not be available under the Netting Rule to

offset the SPAC's Excise Tax Base. The Proposed Regulations declined to provide any special exceptions for SPACs or any expansion of the Netting Rule for these types of transactions.

SPAC liquidations

Prior to the Proposed Regulations, there was concern that the exception for "complete liquidations" might not apply to SPAC liquidations if specific classes of stock held by the SPAC sponsors did not receive any liquidating distributions. As discussed above, the Proposed Regulations clarify that the liquidation exception applies to distributions pursuant to the plan of dissolution reported on IRS Form 966. Thus, distributions made in connection with the dissolution of a SPAC generally should be exempted from the Excise Tax, even if a sponsor waives rights to any distribution with respect to its stock.

Inbound and outbound reorganization transactions

Often in advance of a de-SPAC combination with a target corporation, the SPAC will undertake a redomicile transaction in which it becomes, or ceases to be, a US corporation. For US federal income tax purposes, the redomicile transaction typically qualifies as an "F" reorganization. The Proposed Regulations provide that a publicly traded foreign corporation that domesticates in an inbound "F" reorganization will not become a Covered Corporation until the day after the domestication. Thus, repurchases by a foreign SPAC that domesticates to the US prior to combining with a US corporation should not be subject to the Excise Tax, so long as the repurchases occur on or before the date of the domestication.

Implications for compensatory transactions

Restricted stock

Under the Proposed Regulations, the Excise Tax implications of the issuance and forfeiture of restricted stock depend on whether a valid election under Section 83(b) ("Section 83(b) election") is made with respect to the restricted stock.

If a timely Section 83(b) election is made for restricted stock, the shares are treated as issued and the fair market value of such shares at issuance is included in the corporation's Netting Rule offset amount for the year of issuance. A subsequent forfeiture of such shares is treated as a repurchase subject to the Excise Tax, with the fair market value of the shares at the time of forfeiture includable in the corporation's Excise Tax Base for the year of forfeiture. Because of changes in the fair market value between issuance and forfeiture and the absence of any carryover of excess Netting Rule credit, the forfeiture of restricted stock may result in Excise Tax liability without a corresponding Netting Rule offset.

If a valid Section 83(b) election is **not** made, restricted stock generally would not be considered issued, and would not be taken into account for Netting Rule purposes, until such time as the restricted stock vests. The subsequent forfeiture of any such unvested restricted stock would not constitute a buyback subject to the Excise Tax.

Clawbacks

Stock received by a corporation due to the application of a clawback policy or agreement (i.e., an arrangement requiring an individual to return vested stock due to the occurrence of an applicable clawback event) is treated similarly to restricted stock forfeited to the corporation due to a failure to vest. As such, the rules described above would apply. If the stock was treated as issued under the Netting Rule, then the stock would be treated as repurchased on the date of the clawback in an amount equal to the fair market value of the stock on that date.

Exercise of compensatory options and related tax withholding

When an option is exercised, a corporation often will satisfy tax withholding and/or the option exercise price by reducing the number of shares otherwise deliverable ("net settlement") or selling a portion of the deliverable shares ("sell to cover"). The Proposed Regulations provide that shares reduced pursuant to a net settlement transaction are disregarded for purposes of the Netting Rule. However, shares sold pursuant to a sell to cover transaction are treated as issued for Netting Rule purposes.

Stock contributed to retirement plans or employee stock ownership plans (ESOPs)

The Excise Tax contains a statutory exception for stock repurchases if the repurchased stock, or an amount of stock equal to the value of the repurchased stock, is contributed to an ESOP or similar plan. The Proposed Regulations provide rules for determining the timing and value of such stock contributions and the universe of eligible plans (including special rules for "leveraged ESOPs"), and procedures for reporting such contributions for purposes of claiming the statutory exemption.

Procedural aspects

The Proposed Regulations provide rules for reporting and paying the Excise Tax on Form 720 (Quarterly Federal Excise Tax Return). Following the IRS announcement in June 2023 which postponed the requirement to report or pay the Excise Tax until guidance was provided in regulations, the Proposed Regulations stipulate that corporations do not need to report or pay the Excise Tax until the Form 720 due date for the first full calendar quarter after the publication date of final regulations (see further discussion in this July 2023 Cooley alert). For example, if the Proposed Regulations are finalized on September 16, 2024, a calendar-year corporation that makes repurchases subject to the Excise Tax during its 2023 tax year would be required to report and pay the Excise Tax by January 31, 2025, the due date for its fourth quarter Excise Tax returns.

The Proposed Regulations clarify that Covered Corporations must comply with Excise Tax reporting requirements, including the filing of Form 7208 (Excise Tax on Repurchase of Corporate Stock), in any year in which a repurchase subject to the Excise Tax occurs, even if the corporation does not have any Excise Tax liability, e.g., because of the Netting Rule or statutory exception. Thus, while the extension of time to file Excise Tax returns and pay the Excise Tax provides taxpayers and their advisers time to further analyze the Excise Tax, the scope of the filing requirements under the Proposed Regulations remains broad.

Notes

1. References to “Sections” are to sections of the Internal Revenue Code of 1986, as amended.
2. Note that President Biden’s 2025 budget proposal contemplates quadrupling the rate of the Excise Tax to 4%.
3. Previous Cooley publications have addressed general and SPAC-specific implications of the Excise Tax, as well as the interim procedural rules for reporting and paying the Excise Tax.
4. The Proposed Regulations provide a narrow exception for “additional tier 1 preferred stock” required to be issued and repurchased by banks and other regulated financial institutions, due to the unique regulatory requirements in that context.

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