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Client Alert

April 2024

United States: Proposed regulations under the stock repurchase excise tax - Key Considerations for inbound companies

Tax News and Developments

In brief

On 9 April 2024, Treasury released two sets of proposed regulations regarding the excise tax on repurchases of corporate stock under section 4501. The proposed regulations were published in the Federal Register on 12 April 2024. The first set of proposed regulations includes substantive guidance on the excise tax, while the second covers procedural matters including reporting and payment. Comments are due on the procedural matters by 13 May 2024, but taxpayers have until 11 June 2024 to submit comments on the substantive guidance. These rules have a potentially significant impact on publicly traded non-US companies with US affiliates.

Contents

Statutory framework: Section 4501(d)

Interim guidance: Notice 2023-2

Proposed regulations: A step in the right direction, but concerns remain

- Funding rule and rebuttable presumption
- Exceptions
- Application of the Funding Rule
- Procedural considerations
- Effective date

Statutory framework: Section 4501(d)

By way of background, the Inflation Reduction Act of 2022 added new section 4501 to the Code. This section imposes a 1% excise tax on the fair market value of any stock that a publicly traded US corporation repurchases during the year. Although the provisions of the excise tax are generally limited to US companies, two rules can potentially apply to publicly traded non-US corporations and their subsidiaries:

- Under section 4501(d)(1), the excise tax can apply where a domestic "specified affiliate" of a publicly traded non-US corporation (an "applicable foreign corporation") acquires stock of its publicly traded non-US parent (i.e., the applicable foreign corporation) from an unrelated person. A "specified affiliate" of a corporation means (i) any corporation in which the relevant corporation directly or indirectly owns 50% of the vote or value, or (ii) any partnership in which the relevant corporation directly or indirectly owns 50% of the capital interests or profits interests. Where section 4501(d)(1) applies, the domestic specified affiliate is subject to the excise tax as if it were purchasing its own stock. The same rule applies to acquisitions by a specified affiliate that is a foreign partnership, but that has a domestic entity as a direct or indirect partner.

- Under section 4501(d)(2), the excise tax also applies to repurchases or acquisitions of stock of certain "covered surrogate foreign corporations," i.e., publicly traded non-US corporations that engaged in certain inversion transactions subject to section 7874 after 20 September 2021. A US affiliate that is an "expatriated entity" within the meaning of section 7874 with respect to the covered surrogate foreign corporation may be subject to the excise tax on repurchases or acquisitions of stock by the covered surrogate foreign corporation itself or by the expatriated entity. Because the statute limits this rule to certain inversions that take place after 20 September 2021, this rule is relatively narrow.

The remainder of this article will focus on section 4501(d)(1). This provision applies broadly to any publicly traded non-US company with a US subsidiary, regardless of whether the company was inverted, and therefore potentially affects a large number of non-US multinationals with inbound investments into the United States.

Several statutory exceptions potentially provide some relief for companies subject to the excise tax under section 4501(d)(1). These include exceptions for:

- Repurchases that are part of a reorganization, to the extent that the transaction is treated as a non-recognition transaction.
- Repurchased stock that is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan.
- Cases in which the total value of the stock repurchased during the taxable year is USD 1,000,000 or less.
- Repurchases by a dealer in securities in the ordinary course of business.
- Repurchases by a RIC or REIT.
- Repurchases that are treated as dividends for US tax purposes.

In addition, the statute includes a "netting rule" that generally reduces the base for the excise tax by the fair market value of any stock that the publicly traded corporation issues during the taxable year. For repurchases of section 4501(d)(1), the reduction under the netting rule is limited to stock that is issued or provided to employees of the specified affiliate that is subject to the tax.

Interim guidance: Notice 2023-2

Treasury issued Notice 2023-2 on 27 December 2022, which provided interim guidance with respect to the stock repurchase excise tax. The Notice was particularly concerning to inbound companies because of a proposed "funding rule" that would vastly expand the scope of section 4501(d)(1). Under the funding rule, the excise tax could apply if an "applicable specified affiliate" funds, by any means, the repurchase or acquisition of an applicable foreign corporation's stock by the applicable foreign corporation or a specified affiliate, if the funding has a principal purpose of avoiding the excise tax. An "applicable specified affiliate" means a specified affiliate that is a domestic corporation, a domestic partnership, or a foreign partnership with a domestic entity as a direct or indirect partner. Under the funding rule, the applicable specified affiliate would be treated as acquiring stock of the applicable foreign corporation. To the extent of the relevant funding, the applicable specified affiliate would therefore be subject to the excise tax under section 4501(d)(1) based on the fair market value of the repurchased stock. The applicable foreign affiliate would be responsible for reporting and paying the excise tax annually.

The Notice indicated that, among other things, debt, capital contributions, and even distributions could be treated as funding. Legitimate questions could be raised as to whether a distribution could ever appropriately be "funding" because a distribution merely gives a shareholder access to assets that the shareholder already owns or controls indirectly through the subsidiary. In other words, a distribution simply converts an indirect interest in a subsidiary's assets to a direct interest.

In addition to the general funding rule, the Notice proposed a per se rule under which the applicable specified affiliate would be deemed to have a principal purpose of avoiding the excise tax if it funded (other than through distributions) the applicable foreign corporation or another specified affiliate (other than an applicable specified affiliate), and the funded entity acquired or repurchased stock within two years of the funding. The Notice did not explicitly state whether this period was intended to cover two years both before and after the funding (in effect, a four-year period).

The guidance in the Notice raised significant concerns for non-US multinationals. The Notice significantly expanded the scope of the statutory rule in section 4501(d)(1) by applying the excise tax not only to acquisitions by an applicable specified affiliate (a relatively limited category) but also to acquisitions by other specified affiliates and even potentially to repurchases by the parent company itself. Moreover, the Notice did not specifically define "funding" and seemed to sweep in a wide variety of transactions. Without a more tailored definition, taxpayers were concerned that even ordinary business transactions such as payments for trade inventory, service fees, royalties, interest, or reimbursements for stock-based compensation issued to employees of the public parent's subsidiaries could be considered "funding" that would trigger the excise tax. Taxpayers that submitted comments on the Notice criticized the funding and per se rules. In unofficial public statements, Treasury and IRS officials acknowledged that concerns taxpayers raised about the impact the rules in the Notice could have on ordinary business transactions were legitimate. These officials suggested that the Treasury would revise the rules in the forthcoming proposed regulations to make them less rigid.

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Proposed regulations: A step in the right direction, but concerns remain

Prop. Treas. Reg. § 58.4501-7 provides updated guidance under section 4501(d)(1). The proposed regulations retain the general structure of the funding rule in the Notice but with some material modifications. In particular, the proposed regulations replace the *per se* rule in the Notice with a rebuttable presumption that applies only in limited circumstances. The new proposed regulations, while an improvement over the prior guidance, still raises some fundamental concerns for inbound companies, including the possibility that ordinary business transactions, without a tax avoidance motive, may trigger the excise tax.

Funding rule and rebuttable presumption

Under the revised funding rule, the excise tax may apply if (i) an applicable specified affiliate funds, by any means, a repurchase or acquisition of stock of an applicable foreign corporation either by the foreign corporation itself or by a specified affiliate that is not an applicable specified affiliate (a "covered purchase"), and (ii) the funding has a principal purpose of avoiding the excise tax under section 4501(d) (a "covered funding"). As in Notice 2023-2, funding includes but is not limited to, debt, capital contributions, and distributions. Whether there is a principal purpose of avoiding the excise tax is determined based on all the facts and circumstances. If the funding has a principal purpose of funding a covered purchase, directly or indirectly, then it is treated as having a principal purpose of avoiding the tax.

The proposed regulations also introduce a rebuttable presumption that a principal purpose exists in certain circumstances. The rebuttable presumption applies if: (i) the domestic specified affiliate funds, directly or indirectly, a "downstream relevant entity," and (ii) the funding occurs within two years of a covered purchase by or on behalf of the downstream relevant entity. The proposed regulations clarify that this rule applies to fundings within two years before and two years after the covered purchase. A "downstream relevant entity" means an entity that is a specified affiliate (but not an applicable specified affiliate) and that is at least 25% owned, directly or indirectly, by one or more domestic specified affiliates of the applicable foreign corporation, individually or in the aggregate. In the case of a corporation, the 25% threshold applies either by vote or by value. In the case of a partnership, the 25% threshold refers to either capital or profits interests.

The presumption may be rebutted if the facts and circumstances "clearly establish" that there was no principal purpose of avoiding the excise tax. This evidentiary standard puts the taxpayer in a different position than if the IRS merely asserted a principal purpose on audit, without a specific presumption rule. Generally, under section 7491(a)(1), a taxpayer can shift the burden of persuasion to the IRS by introducing "credible evidence" for its position. The proposed regulations seem to call for a higher standard to overcome the rebuttable presumption.

The rebuttable presumption is a clear improvement over the *per se* rule. The rebuttable presumption applies only to downstream transactions. Importantly, this limitation means that if the non-US parent company itself repurchases stock, the buyback is outside the scope of the rebuttable presumption. The rebuttable presumption would capture only a relatively narrow category of purchases by certain foreign downstream affiliates below US entities. For "upstream" or brother-sister funding transactions, no presumption applies. The principal purpose test nonetheless remains relevant for "upstream" and brother-sister funding transactions – including transactions in which the foreign parent repurchases its stock. Although legitimate concerns remain about the scope and application of the funding rule, limiting the rebuttable presumption to downstream relevant entities provides considerable relief to taxpayers concerned about the potential reach of the rebuttable presumption.

The following examples illustrate the limited scope of the rebuttable presumption (in the examples, all ownership is 100% unless otherwise specified). In Example 1, none of the entities shown is a downstream relevant entity. Thus, payments from the US entity to its affiliates should not be subject to the rebuttable presumption. Nevertheless, the principal purpose test would still apply, including, potentially, distributions from the US entity to its foreign parent.

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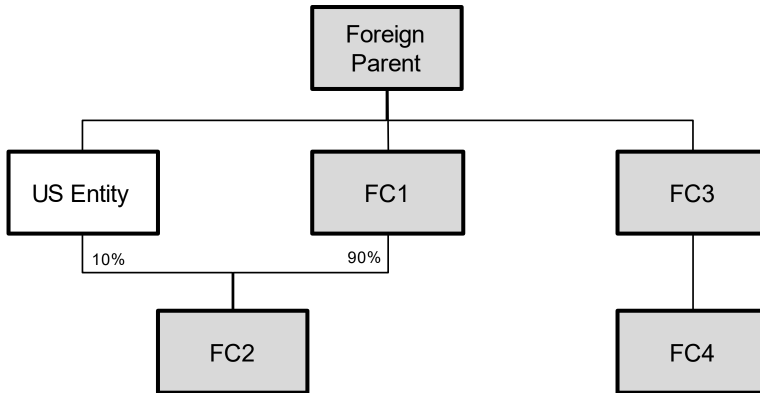
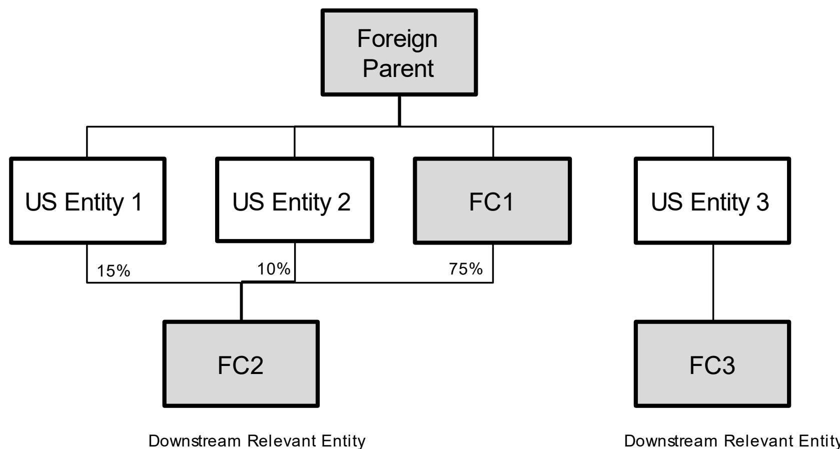
Example 1: No "Downstream Relevant Entity"



In Example 2, FC2 and FC3 are downstream relevant entities. If these entities acquire stock in the foreign parent and their respective US owners provide funding within two years before or after the acquisition, the rebuttable presumption will apply.

Example 2: FC2 and FC3 are "Downstream Relevant Entities"



Downstream Relevant Entity

Downstream Relevant Entity

Under the proposed regulations, payments by an applicable specified affiliate (e.g., US Entity 1, US Entity 2, or US Entity 3 in Example 2) to its publicly traded non-US parent or to brother-sister entities in the ordinary course of business, such as payments for inventory, services, royalties, or interest or as a reimbursement for stock-based compensation, generally should not be captured, provided there was no principal purpose of avoiding the excise tax. In most cases, if the transfer pricing is appropriate, the principal purpose of intercompany payments for commercial transactions is to obtain the goods, services, or access to property or capital that the commercial transaction involves. Unfortunately, Treasury and the IRS rejected comments from taxpayers suggesting that arm's length payments for ordinary business transactions should be out of scope, but they did not explain their rationale for rejecting these comments. Moreover, Treasury and the IRS declined to adopt comments from taxpayers suggesting that the regulations adopt a "the principal purpose" (rather than "a principal purpose") standard, raising at least the possibility that the IRS might assert a payment has multiple principal purposes. It would be helpful if the final regulations confirmed that where a transaction is undertaken for business reasons in the ordinary course, and the transfer pricing complies with section 482, the transaction should not be treated as having a principal purpose of avoiding the excise tax.

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The funding rule and rebuttable presumption still add considerable uncertainty, dispute risk, and compliance burdens for foreign multinationals with inbound US operations. The fact that the IRS could potentially attempt to apply the excise tax to arm's length transactions in the ordinary course of business and to distributions from US members of a foreign parented group magnify these concerns. Considering these rules, taxpayers would be well advised to document their purpose with respect to any transactions that the IRS could view as a funding by a US affiliate. Where the presumption applies, taxpayers will be required to do so affirmatively to rebut the presumption. Moreover, Treasury and the IRS did not provide any specific guidance on what constitutes a "principal purpose." The approach in the proposed regulations could also require taxpayers to trace multiple intercompany transactions to ensure that there is no indirect funding that implicates the rules. Again, there is no guidance on what constitutes an "indirect" funding. Companies with complex intercompany flows, or with cash pooling arrangements, may face difficulties under these rules. Finally, the rebuttable presumption potentially applies to purchases either by or on behalf of a downstream relevant entity. The preamble indicates that purchases "on behalf of" a downstream relevant entity would include purchases by an agent or nominee for the account of the downstream relevant entity, suggesting a relatively narrow scope. Unfortunately, the proposed regulations do not expressly define the term. Given the many open questions regarding the scope of the funding rule, it would be helpful if the final regulations addressed these uncertainties.

Exceptions

The general exceptions to section 4501, discussed above, may provide some relief for inbound companies. Consistent with the statute, in the context of repurchase within the scope of section 4501(d), the netting rule (which allows companies subject to the excise tax to reduce the amount of the excise tax by the fair market value of shares issued in that year, including to its employees) is limited to shares issued to the applicable specified affiliate's employees. In addition, the proposed regulations introduce a specific section 4501(d) *de minimis* exception. Under this exception, the excise tax does not apply if, during the year, the aggregate fair market value of all section 4501(d)(1) repurchases for all applicable specified affiliates or all section 4501(d)(2) repurchases, as applicable, does not exceed USD 1,000,000. This exception applies before any of the statutory exceptions or the netting rule.

Application of the Funding Rule

The proposed regulations provide detailed guidance on a number of technical issues relating to the excise tax under section 4501(d)(1).

Among other key points, the proposed regulations clarify that generally, if an applicable specified affiliate acquires stock of its foreign parent (i.e., of the applicable foreign corporation), the acquisition is treated as occurring on the date on which ownership of the stock transfers for US tax purposes. In the case of a deemed acquisition because of the funding rule, the deemed acquisition is treated as occurring on the later of (1) the date of the covered purchase or (2) the date of the covered funding. This approach mitigates the need to amend prior year returns to reflect later fundings.

The proposed regulations also discuss how to allocate one or more covered fundings to one or more covered repurchases. In general, the proposed regulations treat a covered purchase as coming first from covered fundings. In other words, even if other sources of funding are available, the covered funding takes priority. This rule would be less concerning if the regulations at least acknowledged that establishing that there are other sources of funding is powerful evidence that there was no principal purpose of avoiding the excise tax. Where there are multiple covered purchases and/or multiple covered fundings, broadly, the proposed regulations adopt a "first in, first out" approach. If there is more than one covered funding, the oldest covered funding is allocated first. If there are multiple covered purchases, then amounts from covered fundings are allocated first to the oldest covered purchases.

Procedural considerations

Under the proposed regulations, any taxpayer treated as making a repurchase that is subject to the excise tax after 31 December 2022, must file an excise tax return on Form 720 (Quarterly Federal Excise Tax Return), attaching Form 7208 (Excise Tax on Repurchase of Corporate Stock). Consistent with the Notice, the proposed regulations provide that the taxpayer must file the return and pay the tax shown on the return once a year, by the due date of the Form 720 for the first full calendar quarter after the taxpayer's taxable year. For example, a calendar year taxpayer must file by 30 April of the following calendar year.

Under a transition rule, for any taxable year ending after 31 December 2022, and on or before the effective date of the final regulations, the return must be filed by the due date of the Form 720 for the first full calendar quarter after the final regulations are published in the Federal Register. The taxpayer must attach separate Forms 7208 for each taxable year covered by this transition rule.

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In a case involving the rebuttable presumption, the taxpayer must attach a separate statement to the return that discloses the covered fundings and covered purchases at issue, as well as facts to rebut the presumption that the covered fundings had a principal purpose of avoiding the excise tax under section 4501(d).

Effective date

In general, the funding rule and the rebuttable presumption will apply to repurchases occurring on or after 13 April 2024, and to all fundings on or after 27 December 2022, in taxable years ending after 27 December 2022.

For transactions after 31 December 2022, but before 13 April 2024, the proposed regulations would generally apply the rules of Notice 2023-2, including the *per se* rule. Instead of applying the rules of the Notice, taxpayers may elect to apply the proposed regulations, if all of the taxpayer's applicable specified affiliates are potentially subject to the section 4501(d)(1) excise tax with respect to the same publicly traded foreign corporation consistently apply the rules.

The above summary is only a high-level overview of key points affecting non-US multinationals. The regulations are quite lengthy and provide detailed guidance on a number of technical points beyond what is addressed here. Treasury and the IRS have requested comments on all aspects of the proposed regulations. Inbound companies should review the proposed regulations and consider submitting comments to Treasury and the IRS on any issues of concern.

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