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Upcoming Proposed Regulatory Changes to Stock Buyback Excise Tax

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With another new year nearly upon us, we call attention to regulatory changes to the Stock Buyback Excise Tax that will be proposed to take effect on January 1 and the implications on more non-U.S. corporations. Specifically, we address exceptions for (i) a broad new *per se* funding rule and (ii) exceptions for dividends and reorganizations.

IRS Guidance to Stock Buyback Excise Tax to Impact More U.S. Corporations

The *Inflation Reduction Act of 2022* (Act), enacted on August 16, 2022, introduced a 1% excise tax on stock buybacks by public corporations (Excise Tax). Then on December 27, 2022, the U.S. Treasury and Internal Revenue Service released a notice (Notice) describing certain rules intended to be included in future proposed regulations on the Excise Tax. This bulletin provides an overview of some of the Notice's more surprising rules that could result in the Excise Tax being applied to public non-U.S. corporations starting in 2023.

Statutory Application of the Excise Tax to Non-U.S. Corporations

Under section 4501 of the U.S. Internal Revenue Code, the Excise Tax generally applies to repurchases of stock (or other economically similar transactions) by "Covered Corporations" (generally public U.S. corporations) and certain inverted public non-U.S. corporations. These repurchases include those by certain affiliates of such corporations ("Specified Affiliates" such as corporations and partnerships that are greater than 50% owned). Although the Excise Tax was not generally expected to be applicable to repurchases of stock by a "non-inverted" public non-U.S. corporation, if a U.S. Specified Affiliate of a public non-U.S. corporation repurchases stock of such corporation (a Specified Affiliate Repurchase), the U.S. Specified Affiliate would itself be treated as a Covered Corporation and be subject to the Excise Tax on the repurchase.

Section 4501 provides several exceptions to the Excise Tax, two of which we describe here. The first exception is for a repurchase that is treated as a dividend for U.S. federal income tax purposes (Dividend Exception). Generally, a corporation's repurchase of stock would be treated as a dividend if (i) the corporation has earnings and profits (determined for U.S. federal income tax purposes) and (ii) the repurchase does not satisfy one of the tests set out in the U.S. Internal Revenue Code to be treated as a redemption and not a dividend. For example, a redemption of stock from a large shareholder that does not significantly reduce the shareholder's percentage ownership of the vote or value of the corporation would likely be treated as a dividend. The second exception applies to the extent that a repurchase is part of a reorganization and no gain or loss is recognized on such repurchase by the shareholder by reason of the reorganization (Reorganization Exception).

Section 4501 grants broad authority to the Treasury Department to promulgate regulations implementing the Excise Tax, and the Notice is a preview of the proposed regulations to come. It is contemplated that the rules described in the Notice will generally apply to repurchases of stock (and economically similar transactions) made after December 31, 2022.

Funding Rule

Before the Notice, the Excise Tax likely would not have affected many non-U.S. corporations (other than non-U.S. corporations that engaged in "inversion" transactions) because a subsidiary would rarely repurchase public stock of its parent. The Notice would increase the incidence of the Excise Tax through a rule that would deem there to be a Specified Affiliate Repurchase subject to the tax if:

- A U.S. Specified Affiliate of a public non-U.S. corporation funds a repurchase by the corporation itself (or by a non-U.S. Specified Affiliate of the corporation); and
- The funding is undertaken for the principal purpose of avoiding the Excise Tax. For this purpose, funding could be accomplished by any means, including distributions, loans or contributions, and the total amount of deemed repurchases would be limited to the amount funded.

Crucially, the Notice also includes a *per se* rule that would deem a principal purpose of avoiding the Excise Tax to exist if a U.S. Specified Affiliate funded the public non-U.S. corporation (or a non-U.S. Specified Affiliate of the corporation) by means other than distributions, and the corporation (or such non-U.S. Specified Affiliate) repurchased stock of the corporation within two years of the funding. Although this *per se* rule would not apply to distributions, the concept of funding appears to be broadly defined; many other intercompany transactions could be captured if their effect is the funding of a public non-U.S. corporation or another non-U.S. Specified Affiliate by a U.S. subsidiary of such corporation – thus resulting in the Excise Tax applying to repurchases by the corporation or any such affiliate (to the extent of the funding). The Notice states that the funding rule generally would apply to repurchases made after December 31, 2022, that are funded on or after December 27, 2022.

Dividend Exception

The Notice would severely restrict the ability of a non-U.S. corporation to take advantage of the Dividend Exception by creating a rebuttable presumption that a repurchase is not a dividend and imposing a high bar to rebut the presumption. To rebut the presumption, a corporation must (i) provide U.S. information reporting of the repurchase as a dividend to the applicable shareholder; (ii) obtain certification from the shareholder that the repurchase was treated as a dividend (and that proper withholding was made if required), and state that it has no knowledge to indicate that the certification is incorrect; and (iii) demonstrate that the corporation has sufficient earnings and profits (determined for U.S. federal income tax purposes) to treat the repurchase as a dividend. Although a corporation may not have a significant hurdle to execute U.S. reporting, it may have difficulty obtaining certifications from shareholders regarding treatment as a dividend. In addition, even if such certifications could be obtained, the corporation may need to engage U.S. tax accountants to compute its earnings and profits in accordance with U.S. tax principles, and that could be costly and time-consuming.

Reorganization Exception

Consistent with section 4501, the Notice generally provides that the Reorganization Exception will apply if shareholders exchange shares in a corporation for consideration without gain or loss recognized for U.S. federal income tax purposes; however, the Reorganization Exception will not apply with respect to shares exchanged for any other consideration (such as cash), even though the transaction otherwise qualifies as a reorganization (e.g., where shareholders exchanged their shares in the corporation for a mix of stock of an acquirer and cash).

Conclusion

After the Act was enacted, it seemed that public non-U.S. corporations would not need to be overly concerned about the Excise Tax. The Notice has changed that in surprising and dramatic fashion by capturing repurchases funded (or *per se* funded) by U.S. subsidiaries. Public non-U.S. corporations that intend to make stock repurchases or other transactions treated as such, including certain reorganization transactions involving taxable consideration (generally, consideration other than stock) and have U.S. subsidiaries should now carefully consider whether their intercompany transactions could be caught by the Funding Rule and result in the Excise Tax being imposed on their U.S. subsidiaries. In addition, non-U.S. corporations that might be able to use the Dividend Exception should consider how they would satisfy the conditions to rebut the presumption against dividend treatment.

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