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IRS Proposes to Limit Application of Funding Rule on Stock Buyback Excise Tax

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In prior bulletins from February 2023 and December 2022, we described a notice from the Internal Revenue Service (IRS) that outlined the rules that the IRS intended to issue with respect to the 1% stock buyback excise tax. This tax generally applies to the repurchase of stock of a public U.S. corporation (or its affiliates) and stock of a non-U.S. public corporation if the repurchase is made or funded by certain U.S. affiliates of the non-U.S. public corporation.[1]

In those earlier bulletins, we called attention to the "funding rule" in the IRS notice, under which this tax would apply to a repurchase of stock of a non-U.S. public corporation if the repurchase is funded by a U.S. affiliate (by any means, including through distributions, debt or capital contributions) and a principal purpose of the funding was to avoid this tax. The notice also deemed such a principal purpose to exist (with no exceptions) if a repurchase occurred within two years of a U.S. affiliate funding (other than through distributions[2]) a non-U.S. affiliate of the non-U.S. public corporation (a "per se" rule).

After receiving numerous comments on the overreach of this rule, the IRS issued proposed regulations that, among other things, would soften the funding rule in two ways.[3] First, the per se element would be removed, and instead the proposed regulations would create a rebuttable presumption that the funding was used to repurchase stock. Second, this presumption would apply only to the funding of a "downstream" non-U.S. entity, directly or indirectly. A downstream entity would include only a non-U.S. entity that is at least 25% owned by U.S. affiliates of the non-U.S. public corporation (affiliation has a 50% threshold).[4]

Other than these two changes, the presumption would apply under the same circumstances as the per se rule and would be rebuttable only if facts and circumstances clearly established that there was no principal purpose of avoiding the excise tax (and, if a principal purpose of the funding were to fund a repurchase, there would also be a principal purpose of avoiding the excise tax).

Notably, even if a taxpayer takes the position that the presumption is rebutted with respect to a funding within two years of a repurchase, the U.S. affiliate that funded the non-U.S. public corporation must file a statement with the IRS disclosing the funding and repurchase, as well as the facts that rebut the presumption.

Commentators, U.S. law firms, law societies and others have spoken out against the funding rule, whether in its entirety or aspects thereof. In addition, these regulations are only proposed, not final, and it is possible that the rule might be further limited when final regulations are issued. Davies will be sure to publish an update at that time.

[1] In this situation, the U.S. affiliate is subject to the excise tax, not the non-U.S. corporation.

[2] The exclusion of distributions from the funding rule may be an indication that the IRS believed that it would be clear whether a direct funding via distribution had a principal purpose of avoiding the excise tax; it was therefore unnecessary to apply a per se rule to distributions. There may be a similar reason why the proposed regulations discussed in this bulletin apply the presumption only to downstream funding.

[3] The per se rule would continue to apply to repurchases that occurred prior to April 13, 2024 (the date on which the proposed regulations were issued).

[4] One helpful example in the proposed regulations of an indirect funding that is subject to the presumption: (1) A direct U.S. subsidiary of non-U.S. public corporation makes a loan to a direct non-U.S. subsidiary of the public corporation. (2) The direct non-U.S. subsidiary makes a loan to a non-U.S. entity that is 25% owned by the U.S. subsidiary. (3) The 25% owned non-U.S. entity purchases stock of public corporation from its shareholders.

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