Newly Proposed Regulations on Stock Buyback Excise Tax Largely Adopt Approach From Initial IRS Guidance

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On April 12, 2024, the Treasury Department (Treasury) and Internal Revenue Service (IRS) issued proposed regulations (89 FR 25980 and 89 FR 25829) on the excise tax on stock buybacks enacted as part of the Inflation Reduction Act of 2022. The excise tax generally applies to "repurchases" of stock by publicly-traded corporations after December 31, 2022. The tax imposed is generally equal to 1% of the fair market value of the repurchased stock (determined based on a "shares in, shares out" approach that nets repurchases and issuances of stock within the same taxable year). However, under President Biden's Fiscal Year 2025 Budget Proposal (FY 2025 Budget Proposal), the rate would increase to 4%.

The proposed regulations contain detailed operative rules as well as administrative rules related to the reporting and payment of the excise tax. They generally follow the approach laid out in prior interim guidance issued by Treasury and the IRS in Notice 2023-2 (Notice).[1] Both the Notice and the proposed regulations endorse a broad application of the excise tax, including (as many commentators pointed out in response to the Notice) application to types of transactions that bear little resemblance to traditional stock buyback programs that Congress appeared to target in enacting the excise tax.

The proposed regulations include a number of modifications to the rules set forth in the Notice, including changes that will come as welcome relief for publicly-traded non-U.S. companies and certain regulated financial institutions. Nevertheless, the proposed regulations continue to apply the excise tax broadly in many situations, including to certain payments of cash made in reorganizations and other M&A transactions, creating potential traps for the unwary in a variety of transactional settings.

If finalized, the proposed regulations generally would apply to repurchases of stock by a covered corporation occurring after December 31, 2022, but certain rules included in the proposed regulations that were not included in the Notice would apply only to repurchases occurring after April 12, 2024.

The following provides an overview of notable considerations with respect to the proposed regulations, including certain key changes from the rules described in the Notice.

Common M&A and corporate transactions. Notwithstanding concerns raised by commentators and stakeholders, the proposed regulations generally take the same approach as the Notice with respect to application of the excise tax to many common M&A and corporate transactions. As under the Notice, taxable transactions including "bootstrap" acquisitions and leveraged buyouts would be subject to the excise tax to the extent the consideration is funded by cash sourced from the target for U.S. federal income tax purposes (*i.e.*, cash on the target's balance sheet or a borrowing by the target or a transitory merger subsidiary that merges into the target).

This is in contrast to partially tax-free acquisitive reorganizations, in which any taxable boot, regardless of source, would be subject to the excise tax. No guidance is provided on whether the excise tax would apply to taxable boot received in a "double dummy" transaction that qualifies under the tax-free incorporation provisions in addition to one or more tax-free reorganization provisions. And, like the Notice, the proposed regulations generally do not provide relief for non-liquidating redemptions by SPACs (*e.g.*, redemptions made in connection with a de-SPAC transaction or an extension request).

[1] See our December 30, 2022, client alert "IRS Issues Initial Guidance for New Excise Tax on Stock Buybacks and Corporate Alternative Minimum Tax."

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Treatment of preferred stock. One aspect of the Notice that disappointed many commentators was the Notice's treatment of repurchases of preferred stock as fully subject to the excise tax, notwithstanding a statutory grant of rulemaking authority inviting the issuance of separate guidance on the treatment of preferred stock.

Repurchases of preferred stock are generally subject to the excise tax under the proposed regulations, as well, albeit with a limited exception for preferred stock that qualifies as "additional tier 1 capital" for purposes of regulatory requirements for certain regulated financial institutions. This is welcome guidance for the institutions entitled to that exception, which routinely use the issuance and redemption of preferred stock to comply with applicable regulatory requirements and for risk management purposes.

With respect to preferred stock not excluded from the scope of the excise tax, the proposed regulations make clear that issuances of such stock are taken into account in the "netting" calculation used to determine the excise tax base. In some cases, this could make the inclusion of preferred stock in the excise tax base beneficial for companies issuing preferred stock and redeeming common or preferred stock in the same taxable year.

"Funding" rule for non-U.S. corporations. Although generally targeted at repurchases by publicly-traded domestic corporations, the excise tax also applies to repurchases of stock of publicly-traded non-U.S. corporations in certain situations. Specifically, under the statute, a repurchase of stock of a publicly-traded non-U.S. parent corporation by its U.S. subsidiary is subject to the excise tax. The Notice included a rule that would treat a U.S. subsidiary as repurchasing stock of a publicly-traded non-U.S. parent corporation if the repurchase is funded (including by way of distributions, debt and capital contributions) with cash from the U.S. subsidiary and a principal purpose of the funding is to avoid the excise tax (the general funding rule). The Notice also provided a draconian "*per se*" rule that would deem any funding made within two years of the repurchase to have a principal purpose of avoiding the excise tax (the *per se* rule). Both the general funding rule and the *per se* rule drew heavy criticism from a wide range of stakeholders and commentators.

The proposed regulations retain the general funding rule, but would replace the broad *per se* rule from the Notice with a rebuttable presumption that certain "downstream" fundings (*i.e.*, a funding of a repurchasing non-U.S. entity in which one or more U.S. affiliates directly or indirectly own a 25% or greater interest) made within two years of a repurchase by the funded non-U.S. entity are made with a principal purpose of avoiding the excise tax. Because the rebuttable presumption would apply only to downstream fundings, whether any other funding was made with a principal purpose of avoiding the excise tax would be determined based on the facts and circumstances.

Although the replacement of the *per se* rule with a rebuttable presumption, coupled with the much narrower scope of application of the rebuttable presumption, should generally come as welcome relief to publicly-traded non-U.S. corporations, the application of a nebulous facts-and-circumstances standard without any safe harbors to fundings other than downstream fundings may still impose a significant compliance burden. Note that the proposed regulations would retain the *per se* rule from the Notice for applicable repurchases conducted after December 31, 2022, and on or before the date of issuance of the proposed regulations, unless a taxpayer chooses to consistently apply all of the provisions of the proposed regulations that relate to publicly-traded non-U.S. corporations during that period.

Acquisitions of targets holding the acquiror's stock. The proposed regulations include a provision that would treat "constructive specified affiliate acquisitions" as repurchases that are subject to the excise tax. Such acquisitions would generally include the acquisition by a corporation of a target corporation or partnership more than 1% of the value of which was attributable to acquiror stock owned by the target where the target becomes an affiliate of the acquiror following the acquisition and where such acquiror stock was acquired by the target after December 31, 2022.

In light of this rule, acquirors in M&A transactions should consider in due diligence whether a potential target owns a significant amount of acquiror stock, such that the acquisition of the target by the acquiror could implicate the excise tax even if no acquiror stock is actually repurchased. In addition, a corporation that is or may be subject to the excise tax should consider this rule in connection with the potential issuance of any "hook stock" to an entity that could later become an affiliate of such corporation.

Forfeiture or clawback of restricted stock. The proposed regulations provide that a forfeiture of restricted stock that was treated as issued for tax purposes as a result of a holder's section 83(b) election is generally treated as a repurchase of such stock on the date of forfeiture and is subject to excise tax based on the fair market value of the stock on that date. The same treatment would apply to stock that is actually vested but is required to be returned to a covered corporation pursuant to a clawback agreement. These rules will require corporations that issue compensatory grants of stock to consider the application of the excise tax even if such corporations do not conduct stock buyback programs or engage in significant M&A activity.

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