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Excise tax on repurchases of stock

Tax Alert

Overview

On August 16, 2022, President Biden signed into law the Inflation Reduction Act (the "Act"). The Act included new section 4501, which imposes an excise tax of 1 percent on repurchases of stock by certain publicly traded corporations (the "Excise Tax") beginning after December 31, 2022. A prior Tax Alert (dated August 12, 2022) provided a summary discussion of the provisions of the Excise Tax.

On December 27, 2022, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service ("Service") released Notice 2023-2 (the "Notice"), which announces that Treasury and the Service intend to issue proposed Treasury regulations (such regulations, the "Proposed Regulations") addressing the application of the Excise Tax. To provide taxpayers with interim guidance until publication of the Proposed Regulations, the Notice describes certain rules and procedures that Treasury and the Service intend to include in the Proposed Regulations.

The Notice includes (i) a summary of relevant law underlying the guidance set forth in section 2 of the Notice, (ii) certain operating rules for purposes of the Excise Tax, which are set forth in section 3 of the Notice (the "Operating Rules"), (iii) anticipated rules for reporting and paying any liability for the Excise Tax, which are set forth in section 4 of the Notice (the "Procedural Rules"), (iv) anticipated applicability date for the Proposed Regulations in section 5 of the Notice, (v) a request for comments on various issues in section 6 of the Notice, and (vi) drafting and contact information in section 7 of the Notice.

Treasury and the Service anticipate that the Proposed Regulations will be consistent with the guidance provided in the Notice. The Notice is intended to provide clarity as to the calculation of the Excise Tax and the application of the Excise Tax to certain transactions and other events occurring prior to the issuance of the Proposed Regulations. As described in more detail below, until the issuance of those Proposed Regulations, taxpayers are permitted to rely on the Operating Rules.

The Excise Tax

Background, section 2 of the Notice

Section 2 of the Notice provides a summary of the statutory provisions in section 4501, which underlies the guidance set forth in the Notice, including the Operating Rules and the Procedural Rules discussed below.

Aside from summarizing the statutory provisions of section 4501, section 2.07(2) of the Notice sets forth one important clarification regarding how Treasury and the Service intend to apply the effective date for the Excise Tax. Specifically, while the Excise Tax expressly applies only to repurchases that occur after December 31, 2022, the Netting Rule (as described below) takes into account any issuances of stock during the taxable year. Accordingly, for covered corporations with taxable years that begin before January 1, 2023, and end after December 31, 2022 (*i.e.,* fiscal-year taxpayers), the fair market value (FMV) of the repurchases undertaken during such taxable year after December 31, 2022, can be reduced by the FMV of issuances of its stock during the entirety of that taxable year.

Operating Rules, section 3 of the Notice

Definitions, section 3.02 of the Notice

The Notice contains a number of terms and definitions for purposes of applying the Operating Rules. Besides terms and definitions set forth in section 4501, the Notice introduces several new terms and definitions, including:

- "acquisitive reorganization," which means a reorganization described in section 368(a)(1)(A) (including by reason of section 368(a)(2)(D) or (E)), (C), and (D) (but only if the conditions in section 354(b)(1) are met);
- "distributing corporation" and "controlled corporation," each being defined by reference to section 355(a)(1)(A);
- "employee," which means a person defined in section 3401(c) and Treas. Reg. § 31.3401(c)-1, including a former employee, of a covered corporation or specified affiliate;
- "employer-sponsored retirement plan," which means a retirement plan maintained by the covered corporation and that is qualified under section 401(a) (an ESRP), including an employee stock ownership plan described in section 4975(e)(1) (an ESOP);

> ***Observation:*** In order for a plan to be qualified under section 401(a), the plan must meet the qualification requirements set forth in section 401(a), which includes having a trust created or organized in the U.S. Thus, the definition of ESRP and ESOP does not appear to extend to non-U.S. retirement plans.

- "established securities market," which is defined by reference to Treas. Reg. § 1.7704-1(b) (and not only to section 7704(b)(1));
- "qualifying property exception" and "qualifying property repurchase," each as defined below in reference to the "Reorganization Exception";
- "split-off," which means a distribution qualifying under section 355 (including section 356) in which shareholders of the distributing corporation exchange distributing corporation stock for stock in a controlled corporation (including money and other property);
- "stock," which means any instrument issued by a corporation that is treated as stock for U.S. federal income tax purposes, regardless of whether the instrument is traded on an established securities market; and

> ***Observation:*** Notwithstanding the grant of regulatory authority in section 4501(f), Treasury and the Service have decided not to exempt the repurchase of non-traded classes of stock, including mandatorily

redeemable preferred stock (*i.e.,* the corporation does not have the option to decide whether to redeem the stock). (*see* Notice, section 3.09, *Example 1*).

- "taxable year," which is defined by reference to section 7701(a)(23) and (a)(24).

Other relevant definitions set forth in section 3.02 of the Notice not included above will be defined where relevant in the descriptions below.

Computation of the Excise Tax, section 3.03 of the Notice

Stock Repurchase Excise Tax Base

The Notice provides that the amount of the Excise Tax imposed on a covered corporation is equal to the following product:

0.01 x Stock Repurchase Excise Tax Base

"Stock Repurchase Excise Tax Base" is defined as an amount (*not less than zero*) equal to the FMV of all repurchases (as defined in section 3.04 of the Notice) of the covered corporation's stock during the taxable year (as measured and determined under section 3.06 of the Notice), subject to reduction in the following order:

- The FMV of any repurchases that are subject to one of the "Statutory Exceptions" under section 4501(e), applied in accordance with section 3.07 of the Notice (summarized below); and then
- The FMV of any stock issued by the covered corporation under the "Netting Rule" under section 4501(c), applied in accordance with section 3.08 of the Notice (summarized below).

The Notice confirms that any repurchases that occur before January 1, 2023, are excluded from the Stock Repurchase Excise Tax Base.

No carrybacks or carryforwards

If, in any taxable year, the aggregate FMV of any reductions under the Statutory Exception or the Netting Rule exceed the aggregate FMV of the repurchases during that year, such excess may not be carried to any preceding or succeeding taxable years of the covered corporation.

Separate computations

The computation of the Stock Repurchase Excise Tax Base is required to be computed separately by each covered corporation and for each taxable year of the covered corporation.

Observation: In the case of publicly traded foreign corporations, U.S. specified affiliates that acquire the foreign corporation's stock (or, pursuant to the Notice, fund certain acquisitions of the foreign corporation's stock) can be treated as separate "covered corporations" for a taxable year, thereby resulting in separate computations of the Excise Tax.

***De Minimis* Exception**

One of the Statutory Exceptions is the *De Minimis* Exception under section 4501(e)(3), which provides that the Excise Tax will not apply to stock repurchased by a covered corporation during a taxable year to the extent the aggregate FMV of the repurchases does not exceed $1,000,000. Section 3.03(2) of the Notice specifies that whether the *De Minimis* Exception applies for any taxable year is determined ***before*** applying any of the other Statutory Exceptions or the Netting Rule.

Redemptions and economically similar transactions, section 3.04 of the Notice

A "repurchase" is defined in section 4501(c)(1) to include any (i) redemption within the meaning of section 317(b), or (ii) transaction determined by the Secretary to be economically similar to a redemption of stock.

Redemptions

Under section 317(b), a redemption of stock means an acquisition by a corporation of its own stock from a shareholder in exchange for property, other than the corporation's own stock or rights to acquire such stock. The Notice provides for two limited and exclusive exceptions with respect to section 317(b) redemptions.

> ***Observation:*** Treasury and the Service appear to be defining "repurchase" as broadly as possible by not excepting any other transactions that are redemptions under general U.S. federal income tax principles. In this regard, in the buy-out context, the Notice provides that redemptions of target corporation stock funded with existing cash of a target corporation or debt of a merger subsidiary that is assumed by the target corporation, will be treated as repurchases (*see* Notice, section 3.09, *Examples 3 and 4*).

Section 304(a)(1) exception. The first exception is for the deemed redemption of acquiring corporation stock that occurs in an acquisition of stock to which section 304(a)(1) applies (*i.e.,* a brother-sister or cross-chain stock sales). This exception applies regardless of whether the deemed redemption gives rise to sale or exchange treatment under section 302(a) or to a section 301 distribution under section 302(d). As noted below, any stock of the acquiring corporation deemed issued as a result of the application of section 304(a)(1) is also disregarded in applying the Netting Rule.

> ***Observation:*** It would appear that deemed redemptions pursuant to acquisitions of stock to which section 304(a)(2) apply (*i.e.*, parent-subsidiary stock sales) are not excepted from the definition of repurchase; however, such transactions may be largely subject to the Excise Tax through its application to acquisitions of stock by specified affiliates (as described below).

Cash-in-lieu-of-fractional-shares exception. The second exception is for certain transactions in which cash may be received in lieu of fractional shares. Specifically, the exception applies only if the payment occurs as part of (i) a reorganization under section 368(a), (ii) distribution to which section 355 applies, or (iii) the settlement of an option or similar financial instrument (*e.g.,* on conversion of convertible debt). Moreover, the cash payment must meet the following additional conditions:

- The cash payment cannot be separately bargained-for consideration (that is, the cash is a mere mechanical rounding off of shares to be issued);
- The cash payment is solely for administrative convenience; and
- The cash payment to any one shareholder does not exceed the value of one full share of the stock of the covered corporation.

Correspondingly, as discussed below, any deemed issuance of fractional shares would not be taken into account for purposes of the Netting Rule.

> ***Observation:*** Given the scope of this exception, and depending upon the source of funding for the cash payment, other situations may still be subject to the Excise Tax. For example, a taxable acquisition where the consideration is stock of the covered corporation and the covered corporation funds the cash in lieu of fractional shares would not appear to be excepted. Separately, if the fractional shares are aggregated and sold in

the market (with the proceeds going to shareholders), then there should be no deemed redemption and the Excise Tax ought not apply.

Economically Similar Transactions

Under the Notice, Treasury and the Service have identified the following *non-exclusive* list of transactions that they intend to treat as "Economically Similar Transactions" under section 4501(c)(1)(B), and therefore as repurchases in applying the Excise Tax (to the extent the relevant corporation is a covered corporation or a covered foreign surrogate corporation):

- Acquisitive reorganizations (as defined above) are treated as repurchases by the target corporation of its stock from the target corporation shareholders in exchange for the reorganization consideration (*see* below for an exception and coordination with the Netting Rule);
- Recapitalizations under section 368(a)(1)(E) (a "Recapitalization") are treated as repurchases by the corporation undertaking the recapitalization (*see* below for an exception and coordination with the Netting Rule);
- Reorganizations under section 368(a)(1)(F) (an "F reorganization") are treated as repurchases by the transferor corporation of its stock from the transferor corporation shareholders (as defined in Treas. Reg. § 1.368-2(m)(1)) in exchange for resulting corporation stock (*see* below for an exception and coordination with the Netting Rule);
- Split-offs (as defined above) are treated as repurchases by the distributing corporation of its stock from the distributing corporation shareholders in exchange for controlled corporation stock (and any cash or other property); and

Observation: Similar to the limited exceptions to repurchase described above, Treasury and the Service appear to be adopting a broad view with respect to economically similar transactions, which include transactions that are more transformative and less frequent than open-market share repurchase programs and similar transactions.

The Notice is adopting a specific construct for reorganizations, treating the section 361(c) distribution and/or section 354 exchange by the target corporation, recapitalizing corporation, transferor corporation, or distributing corporation as undertaking the "repurchase," and therefore not applying other U.S. federal income tax constructs. For example, the Notice did not adopt a the construct set forth by the Supreme Court in *Clark v. Commissioner* (489 U.S. 726 (1989)) for purposes of determining dividend treatment under section 356(a)(2), whereby the acquiring corporation is deemed to issue stock and then redeem such stock in exchange for any cash or other boot.

Thus, a reorganization under section 368(a)(1)(B), which only has a section 354 exchange by the target shareholders directly with the acquiring corporation, or its parent corporation, should not give rise to a repurchase for purposes of the Excise Tax.

- Moreover, as described below, to the extent an acquisitive reorganization, a Recapitalization, an F reorganization, or a split-off (whether or not part of a qualifying reorganization under section 368(a)(1)(D)) involves consideration permitted to be received tax-free under section 354 or 355, such "repurchases" generally will be exempt from the Excise Tax. A liquidation in which (i) a corporate shareholder receives liquidating distributions to which section 332(a) applies (the "Majority Shareholder"), and (ii) one or more shareholders that receive liquidating distributions to which section 331 applies (the "Minority Shareholders"), is only subject to the Excise Tax with respect to liquidating distributions made to the Minority Shareholders ("Majority-Minority Liquidations").

Observation: With respect to Majority-Minority Liquidations, presumably other exceptions may be applied to the extent the Excise Tax might otherwise apply to distributions to the Minority Shareholders, such as if the liquidating distribution under section 331 also qualifies under section 354 as part of a section 368(a) reorganization, or the liquidating distribution is taxable as a dividend under sections 301 and 316 or 356(a)(2).

Further, in the case of multiple corporations in a consolidated group that own stock in the covered corporation and would qualify under section 332(a) solely by virtue of the application of Treas. Reg. § 1.1502-34, it is not clear under the Notice if the exception may still apply to a Majority Shareholder in a Majority-Minority Liquidation (*see* Notice, section 3.09, *Example 17*, referring to the application of section 337(c)).

Other transactions that are specifically identified as *not* Economically Similar Transactions, and therefore are not considered repurchases, include:

- Complete liquidations to which only either section 332 or section 331 applies, but, in the case of a complete liquidation to which section 331 applies, only with respect to liquidating distributions that occur in the liquidating corporation's final tax year; and
- Distributions of a controlled corporation by a distributing corporation qualifying under section 355 that are not split-offs (*e.g.*, pro rata spin-offs).

Observation: Based on the section 331 liquidation exception, a liquidation of a "special purpose acquisition company" or SPAC following the termination of its defined acquisition period (*e.g.*, 18-24 months) does not appear to be subject to the Excise Tax so long as all liquidating distributions and the liquidation are completed within the same taxable year.

Specified affiliates, applicable foreign corporations, and covered surrogate corporations, section 3.05 of the Notice

The Notice largely redescribes the definitions in and operation of the Excise Tax under section 4501(d) to both applicable foreign corporations (as defined in section 4501(d)(3)(A)) and covered surrogate foreign corporations (as defined in section 4501(d)(3)(B)).

The Notice, however, introduces one significant non-statutory operating rule for applicable foreign corporations dealing with cases in which the applicable specified affiliate (in general, a domestic specified affiliate) "funds" repurchases by the applicable foreign corporation or a foreign specified affiliate. Specifically, an applicable specified affiliate will be subject to the Excise Tax if (i) it funds the repurchase of an applicable foreign corporation's stock, and (ii) such funding is undertaken for a principal purpose of avoiding the Excise Tax. A funding can be provided by any means, including through distributions, debt, or capital contributions. However, the Stock Repurchase Excise Tax Base cannot exceed the amount funded by the applicable specified affiliate.

Moreover, a principal purpose will be presumed to exist (the "*Per Se* Rule") if the applicable specified affiliate provides funding to the applicable foreign corporation or a foreign specified affiliate, *other than by means of a distribution*, and the repurchase or acquisition of the applicable foreign corporation's stock occurs within two years after the funding.

Observation: The *Per Se* Rule could potentially put at risk ordinary course reimbursement arrangements for stock-based compensation provided by publicly traded foreign corporations to employees of their applicable specified affiliates, which would not otherwise appear to be subject to the general anti-abuse rule above.

Although the applicable specified affiliate may generally be permitted to reduce the Stock Repurchase Excise Tax Base for the FMV of stock issued to its employees, because of the timing and measurement rules for determining FMV and the two-year window in which a funding may be linked with a repurchase, the FMV of the stock repurchased may not be "zeroed" out by the FMV of such stock issuances in the case of ordinary course reimbursement arrangements.

Timing and FMV, section 3.06 of the Notice

The time at which stock is treated as repurchased under the Excise Tax generally is the time at which ownership of such stock transfers for U.S. federal income tax purposes to the covered corporation or the relevant specified affiliate. For Economically Similar Transactions, stock is treated as repurchased at the time the shareholders of the covered corporation or covered surrogate foreign corporation exchange their stock in either of the foregoing.

The FMV of the repurchased stock is the "market price" of the stock on the date of the repurchase, regardless of how much consideration may be paid for the stock. Two different rules are provided depending on whether the stock repurchased is traded on an established securities market.

Traded on an established securities market

Taxpayers must apply one of four "acceptable methods" for determining the market price of stock that is traded on an established securities market. The Notice provides that stock is treated as traded on an established securities market if any stock of the same class is so traded, even if the particular shares of stock repurchased are privately held and not traded on an established securities market. The acceptable methods are:

- The daily volume-weighted average price as determined on the date the stock is repurchased;
- The closing price on the date the stock is repurchased;
- The average of the high and low prices on the date the stock is repurchased; or
- The trading price at the time the stock is repurchased.

If the repurchase date is not a trading day, whichever of the above methods is selected by the taxpayer must be applied using the most recent preceding trading day.

Furthermore, taxpayers are bound to consistently use one of the above methods for all repurchases occurring during the taxable year, as well as for determining the market price of stock issued during the same taxable year for purposes of the Netting Rule (as described below). However, it would appear that taxpayers are free to change the method used from taxable year to taxable year.

Not traded on an established securities market

If stock is not traded on an established securities market, then the market price is determined under the principles of Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(*1*). That provision generally provides that the taxpayer may determine the FMV of stock using a reasonable application of a reasonable valuation method.

Statutory Exceptions, section 3.07 of the Notice

As described above, the Stock Repurchase Excise Tax Base is first reduced by the amount of any repurchases that qualify for one of several Statutory Exceptions.

Reorganizations and split-offs

The first of the Statutory Exceptions is under section 4501(e)(1) for repurchases that occur as part of a section 368(a) reorganization. As mentioned above, the Notice earlier provides in section 3.04(4)(a) that in an acquisitive reorganization, a Recapitalization, an F Reorganization, or a split-off (whether or not part of a section 368(a)(1)(D) reorganization), if the target corporation, transferor corporation, or distributing corporation, as applicable, is a covered corporation or covered surrogate foreign corporation, then such corporation is generally treated as undertaking a repurchase of stock held by its shareholders (and thus increasing the Stock Repurchase Excise Tax Base).

Under this Statutory Exception, the Notice specifies that the Stock Repurchase Excise Tax Base is reduced to the extent that the repurchase is made with consideration permitted to be received under sections 354 or 355 without the recognition of gain or loss (referred to as "qualifying property repurchases").

> ***Observation:*** The Notice clarifies that the Statutory Exception for reorganizations and split-offs is only to the extent of the qualifying property repurchases—conversely, the Excise Tax applies only to the extent the consideration issued in the reorganization or split-off is subject to tax under section 356(a)(1). Thus, cash or other boot in an acquisitive reorganization or split-off will result in a repurchase by the target corporation or distributing corporation, respectively, that is subject to the Excise Tax (*see* Notice, section 3.09, *Examples 6, 8, 9-14, and 19*).
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> Boot may include, for example, non-qualified preferred stock. Furthermore, it does not appear that a transaction is excepted under this rule if a shareholder recognizes no gain under section 356(a)(1) because the shareholder has no gain in the target corporation or distributing corporation stock.
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> Given the focus of the Excise Tax is on cash or other boot, the *Clark* approach described above generally would not have resulted in any Excise Tax liability in respect of acquisitive reorganizations due to the offsetting issuance and redemption of acquiring corporation stock.

Employee stock retirement plan contributions

The second Statutory exception is for any repurchased stock (or an amount of other stock equal to the FMV of the repurchased stock) that is contributed to an ESRP that is qualified under section 401, including an ESOP described in section 4975(e)(1).

The amount of the reduction to the Stock Repurchase Excise Tax Base depends on whether stock of the repurchased class or stock of a different class is contributed to the ESRP.

> ***Observation:*** The Notice does not define what may constitute a separate class of stock, and so presumably has its ordinary meaning and also does not include any rules coordinating the application of the two computations where more than one class is repurchased and/or more than one class is contributed.

If stock of the same class is contributed to the ESRP, then the reduction to the Stock Repurchase Excise Tax Base for any taxable year is equal to the lesser of:

- The aggregate FMV of the stock repurchased, *divided* by the number of shares repurchased, and *multiplied* by the number of shares contributed; and
- The aggregate FMV of the stock of all stock of the same class that was repurchased.

If stock of a different class is contributed to the ESRP, then the reduction to the Stock Repurchase Excise Tax Base for the taxable year is equal to the FMV of the stock contributed to the ESRP, *at the time of such contribution*, but limited to aggregate FMV of the other class of stock that was repurchased during the taxable year.

Generally, only contributions made during or on account of a taxable year can reduce the Stock Repurchase Excise Tax Base for that taxable year. However, the Notice permits taxpayers to retroactively reduce the Stock Repurchase Excise Tax Base for an immediately preceding taxable year if a contribution is made:

- to an ESRP by the filing deadline for Form 720, *Quarterly Federal Excise Tax Return*, (the deadline for filing and payment is described below) for that preceding taxable year, and
- on account of that preceding taxable year under section 404(a)(6) (*i.e.*, an income tax deduction is claimed by the taxpayer for that contribution for that prior taxable year).

> ***Observation:*** As a general rule, a sponsor of an ESRP, including an ESOP, can take an income tax deduction for the contribution in the taxable year when the contribution is paid to the plan, under the rules of section 404(a). Section 404(a)(6) provides that a contribution made after the end of the taxable year can be deducted on the preceding year's return if the contribution is on account of the prior year and is actually contributed no later than the due date, with extensions for filing the tax return for that taxable year. Thus, for a calendar year corporate taxpayer the deadline for making a contribution to claim a prior year's deduction is October 15 of the following year. The contribution deadline for claiming a reduction in the Stock Repurchase Excise Tax Base for the prior year will fall prior to the extended return deadline.

To the extent a reduction in the Stock Repurchase Excise Tax Base is claimed under this second Statutory Exception, no reduction may also be claimed under the Netting Rule relating to the issuance or provision of stock to employees (*i.e.,* no double benefit).

> ***Observation:*** Although the Netting Rule limits adjustments for stock issued or provided only to employees of domestic subsidiaries of publicly traded foreign corporations, this Statutory Exception does not appear to be so limited, and there does not appear to be any limitation in either case for publicly traded domestic corporations.

Dealer repurchases

Under the Notice, the Statutory Exception for repurchases undertaken by a covered corporation (or an applicable acquiror) that is a dealer in securities (within the meaning of section 475(c)(1)) is only available if the dealer:

- acquires the stock in the ordinary course of the dealer's business of dealing in securities;
- accounts for the stock as securities held primarily for sale to customers in the ordinary course of its business;
- disposes of the stock within a time period that is consistent with the holding of the stock for sale to customers in its ordinary course of business (taking into account the terms of the stock and the conditions and practices prevailing in the markets for similar stock during the period in which the stock is held); and
- does not transfer the stock to an applicable acquiror (if the dealer is a covered corporation) or does not transfer the stock to the covered corporation or another applicable acquiror (if the dealer is an applicable

acquiror), other than in a transfer to a dealer that also satisfies the requirements of this Statutory Exception.

For purposes of the above, "applicable acquiror" means a specified affiliate with respect to a covered corporation (within the meaning of section 4501(c)(2), an applicable specified affiliate with respect to an applicable foreign corporation (within the meaning of section 4501(d)(1)), a covered surrogate foreign corporation or a specified affiliate of a covered surrogate foreign corporation (with respect to a repurchase or acquisition under section 4501(d)(2)).

Regulated investment companies (RICs) and real estate investment trusts (REITs)

A repurchase by a covered corporation that is a RIC or a REIT is a reduction for purposes of computing the Stock Repurchase Excise Tax Base.

> ***Observation:*** While RICs and REITs generally should be exempt from substantive Excise Tax liability under this Statutory Exception, it is unclear under the Notice whether RICs and REITs may still be subject to the annual reporting on Form 720, discussed below.

Dividend-equivalent redemptions

The Stock Repurchase Excise Tax Base is also reduced to the extent the repurchase is treated as a distribution of a dividend under sections 301(c)(1) or 356(a)(2).

Under the Notice, a redemption under section 302 or an exchange under section 356 that is treated as a repurchase is presumed not to be a dividend and therefore ineligible for the exception.

A taxpayer may rebut the foregoing presumption under the Notice only if the taxpayer satisfies all of the following requirements (referred to as "establishing with sufficient evidence" in the Notice):

- provides information reporting to the redeemed shareholder that the repurchase constitutes a dividend (*e.g.*, on Form 1099-DIV);
- obtains certification from the shareholder that the shareholder is treating the repurchase as a dividend under either sections 302(d) and 316 or under section 356(a)(2), including evidence that applicable withholding occurred, if required;
- has no knowledge of facts that would indicate that the certification is incorrect; and
- demonstrates that the taxpayer has sufficient earnings and profits to treat the excepted amount of the distribution or boot as a dividend under section 316 or section 356(a)(2).

> ***Observation:*** With respect to a section 301 distribution under section 302(d), to the extent there are insufficient earnings and profits (*i.e.,* a section 301(c)(2) return of basis and potentially section 301(c)(3) gain), the repurchase apparently would still be treated as a repurchase that does not qualify for the exception.
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> In addition, the amount and sourcing of earnings and profits under section 301 for a particular shareholder may differ from the amount and sourcing of earnings and profits under section 356(a)(2) for a shareholder, and so the availability of the exception in mergers and acquisitions may depend upon how the merger or acquisition is structured.

Netting Rule, section 3.08 of the Notice

General rule

Consistent with section 4501(c)(3), the Notice permits taxpayers to reduce the Stock Repurchase Excise Tax Base for a taxable year (after applying any available reductions under the Statutory Exceptions) by the FMV of the stock of the covered corporation that is:

- issued or provided to employees of the covered corporation or a specified affiliate of the covered corporation; or
- issued by the covered corporation to persons other than employees described above.

> ***Observation:*** The Netting Rule does not appear to permit any reduction for stock issued by specified affiliates to persons other than employees. Thus, for example, certain "triangular" acquisitions of property or stock, such as those that do not qualify as a section 368(a) reorganization, where the consideration is stock of the covered corporation, do not appear to result in a reduction under the Netting Rule.
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> In addition, as described below, stock issued by the covered corporation to a specified affiliate does not count as issued for purposes of the Netting Rule.

In general, stock will be treated as issued or provided by the covered corporation when ownership of such stock transfers for U.S. federal income tax purposes.

FMV

Except for stock-based compensation, discussed below, the rules that apply for determining the FMV of stock issued under the Netting Rule in section 3.08(5) of the Notice are the same as those for determining the FMV of repurchased stock under section 3.06 of the Notice (*i.e.*, market price determination), including the duty to use a consistent methodology for a taxable year for purposes of determining the market price of stock traded on an established securities market.

Disregarded issuances

The Notice provides the following list of stock issuances that are not taken into account as issuances of stock under the Netting Rule:

- Distributions of stock by a covered corporation with respect to its stock (*e.g.,* stock dividends under section 305);
- Stock issued by the covered corporation to a specified affiliate;
- Stock issued in an acquisitive reorganization, a Recapitalization, an F Reorganization, or a split-off, to the extent it is a qualifying property repurchase under section 3.04(4)(a) of the Notice and is not included in the applicable Stock Repurchase Excise Tax Base (*i.e.*, as described above, the stock issued is transferred to the shareholder of a covered corporation in a nonrecognition transaction under section 354 or 355);

> ***Observation:*** Because the qualifying property repurchase is limited to repurchases of a covered corporation's stock under section 3.04(4)(a) of the Notice, it is not clear if a taxpayer would be given credit under the Netting Rule if the stock were issued to acquire other property, such as securities of the covered corporation in an exchange to which section 354 applies.
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> In addition, it would appear that stock issued by an acquiring corporation in a reorganization under section 368(a)(1)(B) would be taken into account under the Netting Rule because an acquisitive reorganization is not defined to include a section 368(a)(1)(B) reorganization and there is no repurchase by the target corporation.

- Deemed issuances under section 304(a)(1) (coordinating with the exception for deemed repurchases under section 3.04(3)(a) of the Notice);
- Deemed issuances of a fractional share (coordinating with the exception for deemed repurchases of fractional shares under section 3.04(3)(b) of the Notice);
- Issuances by dealers if issued or used to satisfy obligations to customers in the ordinary course of the dealer's business (coordinating with the Statutory Exception for dealers, as described in section 3.07(4) of the Notice); and
- Any stock issued by a target corporation to the merging corporation in a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

Special rules for stock-based compensation

Under the Notice, stock issued or provided to employees of a covered corporation or a specified affiliate as compensation for services includes transfers of stock in connection with the performance of services described in section 83, or pursuant to the exercise of a nonstatutory stock option, or pursuant to an option described in section 421.

Stock will be treated as issued or provided to an employee pursuant to a restricted stock award (RSA) or restricted stock unit (RSU) under the Netting Rule at the time when the employee is treated as the beneficial owner of such stock for U.S. federal income tax purposes. Generally, an employee will be treated as a beneficial owner of the stock underlying an RSA when the stock is transferred to the employee and substantially vested under Treas. Reg. § 1.83-1(b). An employee will be treated as the owner of the stock underlying an RSU when the corporation or specified affiliate initiates payment. With respect to an RSA, however, if an election is made under section 83(b) by the employee to include an amount in income at grant, then the stock is treated as issued on the transfer date.

The stock transferred to an employee pursuant to the exercise of an option or a stock appreciation right is treated as issued or provided to the employee on the date the employee exercises the option or the stock appreciation right.

In many situations, the exercise price of an option and/or taxes associated with stock-based compensation are paid with stock. The Notice specifically addresses these situations. In particular, stock withheld by a covered corporation or a specified affiliate to satisfy the exercise price of an option (a net exercise) or withheld to cover a withholding obligation under section 3402 or section 3102 is not treated as issued or provided to the employee. Thus, there is no deemed repurchase of the shares used for these purposes. However, if a third party advances or pays the amount required to cover the exercise price of an option or a withholding obligation (*i.e.*, a "sell-to-cover" transaction), then the full amount of the stock transferred generally will be treated as issued or provided to the employee.

The FMV of stock issued or provided to an employee for purposes of the Netting Rule is determined under section 83 on the date the stock is treated as issued or provided to the employee under the foregoing rules.

Procedural Rules, section 4 of the Notice

Reporting

The Excise Tax is anticipated to be reported on Form 720, which will be accompanied by an additional to-be-created form that is intended to aid taxpayers with the computation of the Excise Tax and which taxpayers will be required to attach to Form 720.

Although Form 720 generally is required to be filed quarterly for other excise taxes, Treasury and the Service expect that the Excise Tax will be reported only once for each taxable year on the last day of the first full quarter following the close of that taxable year. The Notice contains the following example: a taxpayer with a taxable year ending on December 31, 2023, would report its stock repurchase excise tax on the Form 720 for the first quarter of 2024, due on April 30, 2024.

> ***Observation:*** Accordingly, consistent with the statutory construction of the Excise Tax, the amount of the Excise Tax will be computed, reported, and paid on an annual basis.

Payment

Under the Proposed Regulations, the deadline for payment of the Excise Tax is expected to be the same as the filing deadline for the Form 720 (in the above example, on April 30, 2024), and no extensions will be permitted for reporting or paying the Excise Tax.

Applicability dates and reliance, section 5 of the Notice

The Proposed Regulations are anticipated to apply rules consistent with the Operating Rules described in section 3 of the Notice (i) to repurchases of stock of a covered corporation made after December 31, 2022, and (ii) to issuances of stock made during a taxable year ending after December 31, 2022.

It is anticipated that the Proposed Regulations will provide that rules consistent with the funding rule (including the *Per Se* Rule) described above and set forth in section 3.05(2)(a)(ii) of the Notice will apply to repurchases and acquisitions of stock after December 31, 2022, that are funded on or after the date of public release of the Notice.

Until the date of the issuance of the Proposed Regulations, taxpayers are permitted to rely on the Operating Rules set forth in section 3 of the Notice.

Request for comments, section 6 of the Notice

The Notice requests comments with respect to the rules set forth in the Notice as well as for rules not included in the Notice. The Notice also sets forth specific questions for which Treasury and the Service request comments, including in respect of questions that are anticipated to be addressed in the Proposed Regulations.