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Report No. 1494
June 4, 2024

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Re: Report No. 1494 - Report on Proposed Regulations under Section 4501

Dear Mses. Aron-Dine and Rollinson, and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1494 of the Tax Section of the New York State Bar Association, which discusses proposed regulations under Section 4501.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully Submitted,

Jiyeon Lee-Lim
Chair

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Report No. 1494

New York State Bar Association Tax Section

Report on Proposed Regulations under Section 4501

June 4, 2024

TABLE OF CONTENTS

I. Introduction 3

II. Summary of Principal Recommendations 3

III. Background on Proposed Regulations 5

IV. Topics and Recommendations for Guidance 6

A. Revised Funding Rule 6

1. Background 6

2. Proposed Funding Rule 8

3. Targeted Anti-abuse Rule 13

4. Limitations to Scope of Funding Rule 14

5. Transition Rules 15

6. Punitive Consequences of Becoming a "Specified Affiliate" 16

B. Foreign Partnership Applicable Specified Affiliate Status 16

C. Constructive Specified Affiliate Acquisition 18

D. Stock "Issued" or "Provided" to Non-Employees of a Specified Affiliate for Netting Rule Purposes 20

E. Instruments Not in the Legal Form of Stock 23

F. Repurchases After the Cessation Date Pursuant to a Plan 27

G. Single Entity Reorganizations 29

Appendix – Prior Reports

Report No. 1494

Report on Proposed Regulations under Section 4501

I. Introduction

This Report[1] analyzes proposed regulations (REG-115710-22) (the "**Proposed Regulations**"), which provide guidance under Section 4501 of the Internal Revenue Code of 1986, as amended (the "**Code**").[2] Section 4501 imposes a new excise tax (the "**Excise Tax**") on certain repurchases of corporate stock.[3]

Part II summarizes our principal recommendations for guidance from the Department of the Treasury ("**Treasury**," including, as applicable, the Internal Revenue Service (the "**IRS**")) with respect to certain rules under the Proposed Regulations. Part III provides general background on the Excise Tax under the Code and the Proposed Regulations. Part IV then analyzes discrete rules under the Proposed Regulations and presents certain recommendations for guidance.

II. Summary of Principal Recommendations

We have focused our analysis on the most important issues we have identified in the Proposed Regulations. We provide detailed recommendations for guidance on these topics in Part IV below.

Our principal recommendations include the following:[4]

1. Final regulations should remove the Proposed Funding Rule and the Principal Purpose Standard and retain a narrow anti-abuse rule modeled after the Rebuttable Presumption. If Treasury retains the Proposed Funding Rule, final guidance should establish safe harbors that deem certain specified ordinary course intercompany transactions not to have a principal purpose of avoiding the Excise Tax.

2. In the context of a Section 4501(d) repurchase by a foreign partnership with a domestic partner, we recommend that final guidance adopt a proportionate application of the Excise Tax based on the interest of the domestic partner in the

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[1] The principal authors of this Report are William Curran, Vadim Mahmoudov, David Rievman, Michael J. Cardella, Daniel J. Bleiberg, Gianluca Darena, Constance Zhang, and Michelle Zhao. Helpful comments were received from William Alexander, Kimberly Blanchard, Robert Cassanos, Kevin Jacobs, Shane Kiggen, Jiyeon Lee-Lim, Michael Mollerus, Arvind Ravichandran, Gary Scanlon, Michael Schler, Vikram Sharma, Eric. B Sloan, Karen Gilbreath Sowell, Wade Sutton, Shun Tosaka, Gordon Warnke, and Libin Zhang. This report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] In connection with the Proposed Regulations, Treasury also issued proposed regulations (REG-118499-23) that would provide guidance regarding reporting and payment of the Excise Tax, which are not addressed in this Report.

[3] Except as otherwise indicated, all references to "**Section**," "**Treas. Reg**." and "**Prop. Treas. Reg.**" refer, respectively, to the Code, the Treasury regulations promulgated thereunder and the Proposed Regulations.

[4] Capitalized terms not defined in this Part II have the meaning ascribed to them in Parts I, III and IV.

foreign partnership and a higher *de minimis* threshold. Final guidance should also provide some clarification on how the Excise Tax would be paid if the covered purchase is made by a foreign partnership.

3. We recommend removing the *per se* rule in the Notice Funding Rule for transactions occurring before April 13, 2024.

4. Final regulations should limit the Constructive Specified Affiliate Acquisition Rule solely to transactions in which a covered corporation's acquisition of interests in a specified affiliate and such specified affiliate's prior acquisition of stock of the covered corporation are related or can reasonably be treated as related. Alternatively, we recommend increasing the *de minimis* threshold in the Constructive Specified Affiliate Acquisition Rule from 1% to 5%.

5. Final guidance should provide that the Netting Rule applies when a covered corporation issues its stock to any service provider (employee or non-employee) of a specified affiliate (or contributes or is deemed to contribute such stock to the specified affiliate for further transfer to the service provider) in connection with services performed for the specified affiliate.

6. We believe the NSI Netting Exception should be removed and that final regulations should provide that all instruments treated as equity for U.S. federal income tax purposes, whether in the legal form of stock or not, should be treated alike for purposes of the Excise Tax.

7. If Treasury does not adopt recommendation 6, the final regulations should expand the NSI Netting Exception to also apply to Preferred Equity or, as a more limited alternative, to Redeemable Preferred Equity.

8. We believe that the Cessation Date Rule Exception should only apply in cases where a covered corporation enters into a binding commitment to execute a series of steps that include a cessation date and a repurchase, where the repurchase and the cessation of publicly traded status are both parts of the same series of steps. Further, we believe that the final regulations should expand the scope of this exception to also cover issuances that occur after the cessation date as a part of a take-private plan for purposes of the Netting Rule.

9. Consistent with Prior Reports, we recommend that the final regulations exclude F Reorganizations and E Reorganizations from "economically similar" transactions entirely if no qualifying property is distributed or no exchange of stock occurs. With respect to E and F Reorganizations where non-qualifying property is distributed, final guidance should deem a repurchase to occur solely to the extent of such non-qualifying property (except to the extent such distribution of non-qualifying property is treated as a dividend under Section 356(a)).

III. Background on Proposed Regulations

The Proposed Regulations provide guidance regarding the application of the Excise Tax and generally adopt much of the interim guidance Treasury previously provided under Notice 2023-2 (the "**Notice**"). We previously discussed the Notice in the report submitted by the Tax Section to Treasury on March 20, 2023.[5] In addition, we discussed the background of Section 4501 in the report submitted by the Tax Section to Treasury on November 1, 2022.[6] This Part III provides a brief summary of the Excise Tax computation mechanism under the Proposed Regulations to set the stage for the discussion in Part IV.

Similar to the Notice, under the Proposed Regulations, the "**Excise Tax Base**" is the amount (not less than zero) determined pursuant to the following steps. First, a covered corporation[7] must determine the aggregate fair market value of the stock of the covered corporation that is repurchased by the covered corporation or acquired by a specified affiliate[8] of the covered corporation during the covered corporation taxable year (the "**Aggregate Gross Repurchase FMV**").[9] If the Aggregate Gross Repurchase FMV does not exceed $1,000,000, then a *de minimis* exception applies (the "**De Minimis Exception**") and the covered corporation is not subject to the Excise Tax.[10] After assessing the application of the De Minimis Exception and concluding it does not apply, the covered corporation reduces the Aggregate Gross Repurchase FMV by the fair market value of the stock repurchased by the covered corporation or acquired by a specified affiliate during the taxable year of the covered corporation that is subject to a "statutory exception."[11] Finally, the amount determined in the preceding step is further reduced by the fair market value of the stock of the covered corporation issued by the covered corporation, or provided by a specified affiliate of the covered corporation, during the covered corporation's taxable year in accordance with Prop. Treas. Reg. § 58.4501-4 (the "**Netting Rule**").[12]

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5 *See* NYSBA Tax Section, Report No. 1474: "Report on Notice 2023-2" (Mar. 20, 2023) (hereinafter, the "**Second Report**").

6 *See* NYSBA Tax Section, Report No. 1469: "Report on the Section 4501 Excise Tax on Repurchases of Corporate Stock" (Nov. 1, 2022) (hereinafter, the "**First Report**" and together with the Second Report, the "**Prior Reports**").

7 Under the Proposed Regulations, a "**covered corporation**" means any domestic corporation the stock of which is traded on an established securities market (within the meaning of Treas. Reg. § 1.7704-1(b)). Prop. Treas. Reg. § 58.4501-1(b)(6) and (13).

8 Under the Proposed Regulations, a "**specified affiliate**" is defined as, with respect to a corporation (i) any corporation more than 50% of the stock of which is owned (by vote or by value), directly or indirectly, by the corporation or (ii) any partnership more than 50% of the capital interests or profits interests of which is held, directly or indirectly, by the corporation. Prop. Treas. Reg. § 58.4501-1(b)(25).

9 Prop. Treas. Reg. § 58.4501-2(c)(1)(i)(A) and (B).

10 Prop. Treas. Reg. § 58.4501-2(b)(2)(i). A determination of whether the De Minimis Exception applies with regard to a taxable year is made before applying any statutory exception under Prop. Treas. Reg. § 58.4501-3 and any adjustment pursuant to the Netting Rule under Prop. Treas. Reg. § 58.4501-4. Prop. Treas. Reg. § 58.4501-2(b)(2)(ii).

11 Prop. Treas. Reg. § 58.4501-2(c)(1)(ii).

12 Prop. Treas. Reg. § 58.4501-2(c)(1)(iii). The Netting Rule is addressed in Prop. Treas. Reg. § 58.4501-4.

IV. Topics and Recommendations for Guidance

This Part IV sets forth the description of and our recommendations as to the most critical issues under the Proposed Regulations. As noted below, some of these recommendations were included in our Prior Reports. The Prior Reports continue to represent the views of the Tax Section and are hereby incorporated by reference into this Report (and are attached for ease of reference as the Appendix to this Report).

A. Revised Funding Rule

1. Background

The Proposed Regulations include meaningful changes to the application of the Excise Tax to applicable foreign corporations[13] and their applicable specified affiliates.[14] Pursuant to Section 4501(d), the acquisition of stock of an applicable foreign corporation by an applicable specified affiliate of the corporation from a person that is not the applicable foreign corporation or a specified affiliate of the corporation will be treated as a repurchase by the specified affiliate that is subject to the Excise Tax (the "**Statutory Foreign Buyback Rule**").[15] The Excise Tax does not apply if the purchasing specified affiliate is a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner).[16] Where a domestic affiliate of an applicable foreign corporation acquires stock of the applicable foreign corporation, the Statutory Foreign Buyback Rule treats the acquisition as a repurchase of stock of the domestic affiliate and the domestic affiliate as a covered corporation. The statute includes the following regulatory delegation with respect to the Statutory Foreign Buyback Rule: "The Secretary shall prescribe such regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section, including regulations and other guidance . . . (3) for the application of the rules under [Section 4501(d)]."[17]

While the statute by its terms applies only to acquisitions of applicable foreign corporation stock by a domestic subsidiary of the applicable foreign corporation,[18] the Notice greatly expanded

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[13] Under the Proposed Regulations, an "**applicable foreign corporation**" is defined as any foreign corporation the stock of which is traded on an established securities market (within the meaning of Treas. Reg. § 1.7704-1(b)). Prop. Treas. Reg. § 58.4501-7(b)(2)(ii) and (b)(13).

[14] Under the Proposed Regulations, an "**applicable specified affiliate**" is defined as a specified affiliate of an applicable foreign corporation, other than a foreign corporation or a foreign partnership. Prop. Treas. Reg. § 58.4501-7(b)(2)(iii).

[15] The statute includes a companion rule with respect to foreign corporations that were involved in inversion transactions in Section 4501(d)(2) (the "**Surrogate Foreign Corporation Buyback Rule**"). The Surrogate Foreign Corporation Buyback Rule applies to purchases by the surrogate foreign corporation, i.e., the foreign public company, of its own stock and purchases by specified affiliates (domestic and foreign) of the surrogate foreign corporation. Accordingly, the Surrogate Foreign Corporation Buyback Rule is much broader than the Statutory Foreign Buyback Rule.

[16] Section 4501(d)(1).

[17] Section 4501(f)(3).

[18] The statute also applies by its terms to acquisitions by foreign partnerships with domestic partners. Section 4501(d)(1).

the reach of the Excise Tax to non-U.S. public companies through a "funding rule." The "**Notice Funding Rule**" sets forth circumstances in which an applicable specified affiliate is treated as acquiring the stock of an applicable foreign corporation as a result of a use or deemed use of funds of the applicable specified affiliate in an acquisition of stock of an applicable foreign corporation by another entity. The Notice Funding Rule operates pursuant to a general rule and a *per se* rule. Under the general rule, an applicable specified affiliate is treated as acquiring the stock of an applicable foreign corporation if it funds by any means the acquisition or repurchase of stock of the applicable foreign corporation and such funding is undertaken for a principal purpose of avoiding the Excise Tax.[19] The *per se* rule provides that a principal purpose is deemed to exist if the applicable specified affiliate funds by any means, other than through distributions, the applicable foreign corporation or specified affiliate that is not also an applicable specified affiliate, and such funded entity acquires or repurchases stock of the applicable foreign corporation within two years of the funding.[20]

Numerous stakeholders, the Tax Section included, commented that the Notice Funding Rule was overbroad and did not appropriately target actual transactions of concern.[21] Treasury took such comments into account to some extent and developed a revised funding rule in the Proposed Regulations (the "**Proposed Funding Rule**") intended to more narrowly address acquisitions and repurchases of stock of certain foreign corporations.[22] The Proposed Funding Rule retains the general rule that an applicable specified affiliate is treated as acquiring the stock of an applicable foreign corporation to the extent it "funds by any means (including through distributions, debt, or capital contributions) directly or indirectly, a covered purchase with a principal purpose of avoiding the section 4501(d) excise tax" (such funding a "**Covered Funding**").[23] The Proposed Funding Rule defines a "principal purpose of avoiding the section 4501(d) excise tax" extremely broadly: "if a principal purpose of the covered funding is to fund, directly or indirectly, a covered purchase, then there is a principal purpose of avoiding the section 4501(d) excise tax" (the "**Principal Purpose Standard**").[24] The determination of whether a principal purpose exists will be based on all facts and circumstances.

The Proposed Regulations eliminated the *per se* rule in the Notice and added a rebuttable presumption (the "**Rebuttable Presumption**") whereby a principal purpose is presumed to exist if the applicable specified affiliate funds by any means, directly or indirectly, a "downstream relevant entity" and the funding occurs within two years of a covered purchase by or on behalf of the downstream relevant entity.[25] This presumption may be rebutted if the taxpayer demonstrates

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[19] Notice Section 3.05(2)(a)(ii).

[20] Notice Section 3.05(2)(a)(ii)(B).

[21] *See generally* Second Report, Section V.F.

[22] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 26022.

[23] Prop. Treas. Reg. § 58.4501-7(e)(1). For purposes of applying Prop. Treas. Reg. § 58.4501-7(e)(1), a "**covered purchase**" is defined as "an [applicable foreign corporation] repurchase or an acquisition of stock of an applicable foreign corporation by a relevant entity." Prop. Treas. Reg. § 58.4501-7(b)(1)(vii).

[24] Prop. Treas. Reg. § 58.4501-7(e)(1).

[25] Under the Proposed Regulations, a "**downstream relevant entity**" is defined as an entity (A) 25% or more of the stock of which is owned (by vote or value), directly or indirectly, by, individually or in the aggregate, one or more applicable specified affiliates of an applicable foreign corporation or (B) 25% or more of the capital interest or

facts and circumstances clearly establishing that there was not a principal purpose of avoiding the Excise Tax.[26] As noted in the preamble to the Proposed Regulations, the rebuttable presumption is intended to apply only to "downstream" fundings involving a covered purchase by or on behalf of a relevant entity in which one or more applicable specified affiliates have a material direct or indirect ownership interest.[27]

2. Proposed Funding Rule

While we gratefully acknowledge certain of the changes Treasury made to the Notice Funding Rule—in particular the elimination of the *per se* rule—the Proposed Funding Rule is itself a material expansion of the reach of the Statutory Foreign Buyback Rule that is not, in our view, justified by the text or policies of the statute or anti-abuse concerns. Accordingly, we recommend that Treasury eliminate the Proposed Funding Rule and replace it with a targeted anti-abuse rule that covers downstream fundings and other transactions structured to avoid the Statutory Foreign Buyback Rule.

Our perspective on the Proposed Funding Rule is grounded in the text of the statute. The Statutory Foreign Buyback Rule is narrow, clear and specific in its application. It applies "in the case of an acquisition of stock of an applicable foreign corporation by a specified affiliate of such corporation," i.e., when a domestic subsidiary acquires the stock of its foreign public parent. The statute makes no reference to an acquisition that is "funded" or made "directly or indirectly" by a specified affiliate, and Congress obviously could have included such language or written a broader rule if it intended the Excise Tax to apply to a broader range of transactions involving foreign public companies.

Indeed, Congress did target a much broader range of transactions in the Surrogate Foreign Corporation Buyback Rule, which appears directly after the Statutory Foreign Buyback Rule in Section 4501(d) and applies where the foreign public company at issue was a surrogate foreign corporation, i.e., it had participated in an applicable inversion transaction. The Surrogate Foreign Corporation Buyback Rule applies by its terms to purchases by the surrogate foreign corporation of its own stock and to purchases of the surrogate foreign corporation's stock by its specified affiliates, both domestic and foreign. The Surrogate Foreign Corporation Buyback Rule effectively subjects relevant foreign public companies to the Excise Tax to the same extent as if they had been domestic public companies subject to the general Excise Tax of Section 4501(a).

Congress thus wrote two very different rules that apply to different types of foreign public companies. However, if the Proposed Funding Rule applies, the Statutory Foreign Buyback Rule is transformed from a targeted rule to one with scope that is close to the Surrogate Foreign Corporation Buyback Rule. Under the Proposed Funding Rule, the only difference between the two regimes is that the Statutory Foreign Buyback Rule would require the additional purchases described in the Surrogate Foreign Corporation Buyback Rule to have been funded (with purpose

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profits of which is held, directly or indirectly, by, individually or in the aggregate, one or more applicable specified affiliates of an applicable foreign corporation. Prop. Treas. Reg. § 58.4501-7(b)(2)(xi).

[26] Prop. Treas. Reg. § 58.4501-7(e)(2).

[27] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 26023.

to fund) "by any means" by a domestic specified affiliate. If this were the intended scope of the Statutory Foreign Buyback Rule, the statutory scheme with two separate rules would not make sense. Instead, Congress could have drafted a single rule—the Surrogate Foreign Corporation Buyback Rule—and applied this rule to foreign public companies that were not surrogate foreign corporations where the applicable purchase was funded "by any means" by a domestic subsidiary. Congress did not take this approach and instead wrote two rules with no mention of a funding concept. We believe these legislative choices were deliberate and should be respected.

The significance of the absence of language suggesting a "funding rule" is amplified by the fact that we have been unable to identify a meaningful policy concern that animates the Proposed Funding Rule. In particular, as applied through its Principal Purpose Standard, we find unsupportable the Proposed Funding Rule's determination that longstanding corporate transactions that were effected for the purpose of funding a stock buyback prior to the enactment of the Excise Tax are somehow being undertaken to avoid the Excise Tax when effected to fund a stock buyback post-enactment. The following example is illustrative:

> Example 1: Corporation FT is an applicable foreign corporation for purposes of the Excise Tax that is the parent of a corporate group with subsidiaries around the globe. All of Corporation FT's wholly-owned subsidiaries, including Corporation US1, a domestic corporation, annually distribute all of their operating profit, less a fixed reserve, to Corporation FT pursuant to longstanding policy of the corporate group. Corporation US1's distributions are dividends for U.S. federal income tax purposes. Corporation FT has a longstanding practice of conducting annual stock buybacks. These buybacks constitute one of several material items of expense for Corporation FT, along with employee salaries, interest expense and lease payments, among others, and Corporation FT does not segregate and track the cash it receives and match it with the expenses that cash funds.[28]

Assume the express purpose of the distributions by Corporation FT's subsidiaries, including Corporation US1, was to fund Corporation FT buybacks. We do not believe Example 1 should result in a Covered Funding. The transaction by Corporation US1 is one of the most fundamental transactions a subsidiary can undertake – paying a distribution to its parent – and at its core has nothing to do with the Excise Tax (or, of course, avoiding the Excise Tax). Corporation US1, like many subsidiaries, regularly made distributions to its parent before the Excise Tax was enacted. Some of those distributions were for the purpose of funding stock buybacks both before and after the enactment of the Excise Tax. Neither before nor after such enactment did Corporation US1 consider acquiring stock of Corporation FT. We thus fail to see how a dividend that would be paid by Corporation US1 regardless of the Excise Tax out of funds that Corporation US1 never considered using to purchase Corporation FT stock could be viewed as being distributed for a

[28] Example 1 highlights the problematic nature of the Principal Purpose Standard. The distribution from Corporation US1 is viewed as a funding. As would normally be the case, Corporation US1's only "purpose" for making the distribution is to deliver cash to its shareholder, in accordance with its core function as a commercial entity. The use of the cash is a matter for the Corporation FT, the shareholder, to determine. In this sense, the Principal Purpose Standard would not be met. However, because Corporation FT may use some of the proceeds from the distribution received from Corporation US1 to fund buybacks, we would be concerned that the IRS would assert that the Principal Purpose Standard applies here. In our view, this uncertainty is inappropriate.

principal purpose of avoiding the tax that would apply if Corporation US1 acquired Corporation FT stock, which is, again, an action it had never considered undertaking. Accordingly, the Proposed Funding Rule is far too broad to serve as an anti-abuse rule for the Statutory Foreign Buyback Rule.

The breadth of the Proposed Funding Rule is particularly striking in light of the modest and targeted approach that Treasury took with respect to its guidance for other elements of the Excise Tax, closely hewing to the statute. To take but one example, Treasury declined to write regulations addressing debt-like preferred stock, including mandatorily redeemable preferred stock, notwithstanding many comments recommending such guidance and the statute's directive for Treasury to "prescribe such regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section, including regulations and other guidance . . . to address special classes of stock and preferred stock . . . ."[29] Treasury declined to provide special rules for preferred stock as a general matter because "the plain language of section 4501 repeatedly refers to 'stock' and does not, for example, refer solely to 'common stock'" and in light of administrability considerations.[30] Looking to the plain language of the statute with respect to the Statutory Foreign Buyback Rule, there is no reference to or suggestion of a funding rule. Moreover, the applicable regulatory directive merely instructs Treasury to write guidance "for the application of the rules under [Section 4501(d)]."[31] This straightforward delegation makes no mention of a funding rule or anti-abuse concerns, unlike the delegation with respect to exceptions from the Excise Tax that appears in the same subsection of the statute.[32] With no suggestion from the statute that the Statutory Foreign Buyback Rule requires an expansive regulatory regime that reaches beyond the rule itself, we recommend that Treasury apply the same disciplined adherence to the statute as it did generally in the Proposed Regulations by eliminating the Proposed Funding Rule.

While we do not think the Proposed Funding Rule is consistent with the text or policies of the statute, we are sympathetic to Treasury's desire for an anti-abuse rule to ensure Section 4501(d) applies as intended. In examining the statute to determine its intended application, we identified three policy goals that should animate any anti-abuse rule. These goals are taxing transactions where (i) assets leave the corporate solution of a domestic corporation (ii) to acquire public company stock (iii) while avoiding dividend treatment. The first of these criteria is supported by the fact that the Excise Tax applies to buybacks by domestic issuers, and, in the case of non-U.S. public companies, applies under Section 4501(d) where the non-U.S. issuer's stock is purchased by a domestic company. The second of these criteria is self-evident: the statute only applies to public companies, domestic or foreign. And the third of these criteria is supported by the exception to Excise Tax liability, where a repurchase is treated as a dividend by a domestic covered

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[29] Section 4501(f). The Proposed Regulations do include a narrow exception to the Excise Tax and the Netting Rule for redemptions or issuances of preferred stock that qualifies as additional tier 1 capital for purposes of regulatory requirements for regulated financial institutions. Prop. Treas. Reg. § 58.4501-1(b)(29)(ii).

[30] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 25983.

[31] Section 4501(f)(3).

[32] *See* Section 4501(f)(1) (directing Treasury to write regulations to "prevent the abuse of the exceptions provided by subsection (e)").

corporation.[33] The application of Section 4501(d) under the statute is consistent with these criteria. Under the Statutory Foreign Buyback Rule, the Excise Tax applies where funds leave the corporate solution of a domestic corporation to acquire the stock of a public company while being treated as a sale or exchange. We evaluate the Proposed Funding Rule against these criteria in the following examples.

First, we return to Example 1, where Corporation US1 pays a dividend to Corporation FT for purposes of funding stock buybacks by Corporation FT. The policies of Section 4501(d) are not being avoided by this transaction because the domestic funding constitutes a dividend for U.S. federal income tax purposes. As discussed above, if a U.S. publicly traded corporation itself conducted a buyback that was treated as a dividend, such buyback would not be subject to the Excise Tax.[34] We cannot see any reason why a funding by way of a dividend (with the attendant consequences, including withholding) from an applicable specified affiliate of a buyback by an applicable foreign corporation should be treated differently. In each case, assets leave domestic corporate solution through a dividend, a path that Congress has determined is not subject to the Excise Tax. And yet Corporation US1's dividend would be treated as a Covered Funding, triggering Excise Tax liability for Corporation US1 under the Proposed Funding Rule. For the reasons stated above, we think application of the Excise Tax serves no policy goal in this example and goes beyond the intended scope of the Statutory Foreign Buyback Rule.

As in Example 1, in Examples 2 through 4 below, Corporation FT is an applicable foreign corporation for purposes of the Excise Tax that is the parent of a corporate group with subsidiaries around the globe.

> Example 2: Corporation US1, a domestic corporation, loans funds on an arm's-length basis to its parent, Corporation FT, with a principal purpose (among others) of funding a repurchase by Corporation FT of its stock. The loan is due in five years and Corporation FT regularly makes payments of interest on the loan and repays the loan principal in full on the maturity date. Corporation FT has a historical practice of conducting annual stock buybacks and conducts buybacks in both the year Corporation US1 makes the loan (the "**Funding Year**") and the year Corporation FT repays the loan (the "**Repayment Year**").

Under the Proposed Funding Rule, Corporation US1's loan would be a Covered Funding, trigging Excise Tax. However, under the policy criteria discussed above, this transaction is not troubling because no value leaves domestic corporate solution—the cash loaned by Corporation US1 is replaced with a loan receivable from Corporation FT. Moreover, the loan is repaid in the Repayment Year such that over time, Corporation US1's cash position is unchanged by the loan. This transaction thus does not implicate the policies of the Statutory Foreign Buyback Rule.[35]

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[33] Section 4501(e)(6).

[34] Prop. Treas. Reg. § 58.4501-2(e)(5)(iv) and Prop. Treas. Reg. § 58.4501-3(g).

[35] In the event Treasury does not accept our recommendation to eliminate the Proposed Funding Rule and/or to provide a safe harbor for upstream loans such as the loan at issue in Example 2, Treasury should consider providing a credit in the Repayment Year against Covered Fundings in that year. However, this result, while equitable over

Example 3: In this example, the direction of the loan is reversed, with Corporation FT loaning funds on an arm's-length basis to its wholly owned subsidiary, Corporation US1, a domestic corporation. Corporation US1 regularly makes payments of principal and interest on the loan to Corporation FT. Corporation FT has a historical practice of conducting annual stock buybacks. These buybacks constitute one of several material items of expense for Corporation FT, along with employee salaries, interest expense and lease payments, among others, and Corporation FT does not segregate and track the cash it receives and match it with the expenses that cash funds.

Corporation US1's payments of interest and principal are arm's-length payments for the use of capital that do not constitute a funding under any normal use of the term. A debtor does not "fund" its creditor when it pays interest and principal on amounts it has borrowed. The interest on the loan is properly treated as interest, and the principal is a return of principal. The amounts funded to the foreign corporation are merely a market return for an amount of cash that the foreign corporation has previously provided to its domestic subsidiary.

Example 4: Corporation FT owns all the intellectual property of its corporate group. All of Corporation FT's wholly-owned subsidiaries, including Corporation US1, a domestic corporation, pay Corporation FT arm's length license fees in order to use the IP in their operations. Corporation FT has a historical practice of conducting annual stock buybacks. These buybacks constitute one of several material items of expense for Corporation FT, along with employee salaries, interest expense and lease payments, among others, and Corporation FT does not segregate and track the cash it receives and match it with the expenses that cash funds.

Example 4 raises the question of whether license fees paid by Corporation US1 to Corporation FT constitute a funding under the Proposed Funding Rule. These fees are arm's-length payments for the use of IP and should not be viewed as a funding any more than any payment pursuant to any contract would be considered a funding (e.g., rent on a lease). Moreover, this transaction is not problematic under the policy criteria discussed above because no value leaves domestic corporate solution—in this arm's length transaction, the value Corporation US1 is receiving for its cash in the form of IP is equal to the value of the cash. According to the Preamble, the changes to the Notice Funding Rule were made at least in part to narrow the scope of the rule, allowing the Excise Tax to apply to potentially concerning transactions "without ordinary course intercompany funding transactions among their corporate affiliates being inadvertently captured."[36] The fact that there is any uncertainty with respect to Example 3 and 4 speaks to the continuing over-breadth of the Proposed Funding Rule.

Yet another reason for Treasury to abandon the Proposed Funding Rule is that it could result in double taxation in circumstances where the home jurisdiction of the applicable foreign

time, would present administrative complexity. Our strong preference is the elimination of the Proposed Funding Rule altogether over the introduction of further complexity to permit it be applied with greater equity.

[36] "U.S. Department of the Treasury and IRS Release Proposed Guidance on Stock Buyback Excise Tax to Ensure Large Corporations Pay More of Their Fair Share in Taxes," U.S. Department of the Treasury, April 9, 2024 (https://home.treasury.gov/news/press-releases/jy2244).

corporation has also adopted a buyback excise tax. Following the enactment of the Excise Tax in the United States, other countries have taken steps to implement similar excise taxes within their own jurisdictions. Notably, in November 2023 Canada formally introduced a bill establishing a 2% excise tax on certain repurchases of stock of specified Canadian entities.[37] Should the Canadian stock repurchase excise tax be enacted, the current Proposed Funding Rule could treat a U.S. subsidiary as funding its Canadian parent with a principal purpose to avoid the Excise Tax while at the same time the proposed Canadian repurchase tax regime could independently levy an excise tax on the Canadian parent for repurchasing its own stock. The income tax convention between Canada and the United States also does not provide relief for stock buyback excise taxes.[38] This potential for double taxation further supports the elimination of the Proposed Funding Rule in favor of a modest anti-abuse rule tailored to address the specific concerns of the Excise Tax articulated above. We discuss our recommended contours for the anti-abuse rule immediately below.

3. Targeted Anti-abuse Rule

As discussed above, the Proposed Funding Rule should be replaced with an anti-abuse rule that targets transactions that violate the policies of the Statutory Foreign Buyback Rule. This anti-abuse rule would have two components: (i) the Rebuttable Presumption and (ii) a narrow residual rule targeted at transactions structured to achieve the same outcome as a purchase by a domestic specified affiliate of an applicable foreign corporation of such applicable foreign corporation's shares.

First, with respect to the Rebuttable Presumption, we believe such presumption, as provided in the Proposed Regulations, is an appropriately tailored part of an anti-abuse regime for the Foreign Statutory Buyback Rule. Indeed, because the Rebuttable Presumption will apply only where a subsidiary of an applicable foreign corporation acquires the stock of an applicable foreign corporation, i.e., extremely rarely, it does not present the administrative burden that would have been imposed by the Notice Funding Rule or the Proposed Funding Rule. Moreover, a "hook stock"-creating transaction that implicates the Rebuttable Presumption is unusual and unnatural enough that we do not believe corporate groups are at risk of regularly entering into these transactions inadvertently.

The Proposed Regulations set forth the following example to demonstrate how the Rebuttable Presumption would be applied:

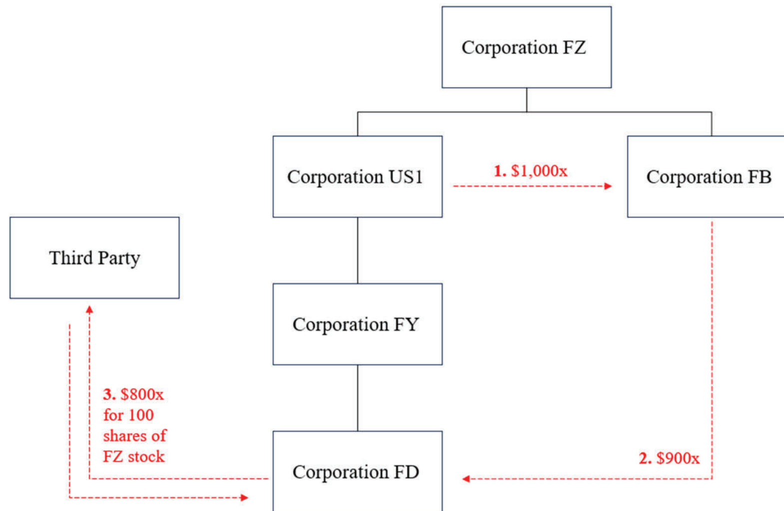
> <u>Example 5</u>:[39] Corporation FZ owns all the outstanding stock of each of Corporation US1, a domestic corporation and Corporation FB, a foreign corporation. Corporation US1 owns all the outstanding stock of Corporation FY, a foreign

[37] Bill C-59, "An Act to implement certain provisions of the fall economic statement tabled in Parliament on November 21, 2023 and certain provisions of the budget tabled in Parliament on March 28, 2023" Part II.2, "Tax on Repurchases of Equity" (November 30, 2023)(Can.). The Netherlands has also enacted a 15% dividend withholding tax on share buybacks, set to take effect on January 1, 2025. (https://www.ey.com/en_gl/tax-alerts/netherlands-passes-act-to-implement-the-2024-tax-plan-and-pillar).

[38] United States – Canada Income Tax Convention, Article XXIV "Elimination of Double Taxation" (1984).

[39] Prop. Treas. Reg. § 58.4501-7(p)(6), Ex. 6: Indirect funding subject to rebuttable presumption.

corporation. Corporation FY owns all the outstanding stock of Corporation FD, a foreign corporation. On March 1, 2024, Corporation US1 makes a loan of $1,000x to Corporation FB. On March 15, 2024, Corporation FB makes a loan of $900x to Corporation FD. On May 15, 2024, Corporation FD acquired 100 shares of the stock of Corporation FZ when the fair market value of each share is $8x. The facts and circumstances do not clearly establish that there was not a principal purpose of avoiding the Section 4501(d) excise tax.



In Example 5, a principal purpose is deemed to exist because Corporation FD is a downstream relevant entity and the March 1, 2024 loan by Corporation US1 to Corporation FB occurs within two years of a covered purchase by Corporation FD. Because the facts and circumstances do not clearly establish that there was not a principal purpose of avoiding the excise tax, the presumption is not rebutted. The March 1, 2024 loan is a Covered Funding. The acquisition of Corporation FZ stock by Corporation FD is a covered purchase. The entire amount of the covered purchase is the allocable amount and Corporation US1's Excise Tax Base is increased by $800x.

Second, our proposed anti-abuse regime also would include a focused residual rule intended to protect the Foreign Statutory Buyback Rule from being avoided through transactions other than the downstream transactions that are the subject of the Rebuttable Presumption. An example of the type of transaction that might appropriately be subject to this rule may be certain total return swaps entered into by a domestic specified affiliate with respect to the stock of its applicable foreign corporation for the purpose of economically acquiring the applicable foreign corporation's stock while avoiding the application of the Foreign Statutory Buyback Rule and the Rebuttal Presumption. For the reasons set forth above, this anti-abuse rule would not have a funding concept and would thus not apply to ordinary course intercompany transactions, including value-for-value transactions and distributions.

4. Limitations to Scope of Funding Rule

In the event that Treasury does not accept our recommendation to eliminate the Proposed Funding Rule and replace it with a narrow anti-abuse rule modeled after the Rebuttable

Presumption, we recommend that Treasury establish safe harbors that deem certain specified intercompany transactions not to have a principal purpose of avoiding the Excise Tax. We acknowledge Treasury's belief that "the elimination of the *per se* rule and the targeted nature of the rebuttable presumption appropriately address the concerns reflected in the feedback requesting…exclusion."[40] However, for the reasons previously discussed, significant over-breadth and meaningful uncertainty remains with respect to the application of the Proposed Funding Rule. Accordingly, we believe that exemptions for specified transactions would accomplish narrowing the scope of the Proposed Funding Rule and help provide the type of clarity and administrability to the application of the Section 4501(d) as the Proposed Regulations achieve with respect to most other aspects of Section 4501. Such transactions should include distributions and intra-group payments for royalties, interest, services, or inventory for an arm's-length consideration (a "quid pro quo" exception) (including the transactions covered in Examples 1, 2, 3 and 4). Given Treasury's previously mentioned comments that described Prop. Treas. Reg. § 58.4501-7(e) as a "targeted anti-abuse rule" that was not intended to encompass "ordinary course intercompany funding transactions," safe harbors for such transactions would align with Treasury's priorities.

Treasury has acknowledged the necessity for ordinary course safe harbors to a general funding rule in several analogous situations. For example, the rules governing the treatment and character of distributions of debt instruments in Treas. Reg. § 1.385-3 establish various safe harbors under which the general rule and the more targeted funding rule do not apply.[41] In the preamble to the proposed regulations, Treasury stated that the exceptions in Prop. Treas. Reg. § 1.385-3 were intended to "limit the scope of the section to transactions undertaken outside of the ordinary course of business by large taxpayers with complex organizational structures."[42] Those same policy interests would apply to the Excise Tax.

The rules on non-ordinary course distributions in connection with inversion transactions provide another example.[43] By excepting certain distributions that are not "non-ordinary course distributions" from the scope of the determination of a domestic entity's ownership fraction, Treasury recognized that ordinary course distributions do not implicate the policy concerns and should not be taken into account in making such determination.

5. Transition Rules

The Proposed Regulations provide that the *per se* rule set forth in the Notice would apply to transactions occurring before April 13, 2024 unless the covered corporation chooses to apply the Proposed Regulations retroactively.[44] Though the Proposed Regulations nominally provide taxpayers the option to apply either the Notice or the Proposed Regulations, in practice the wide reach of the Notice Funding Rule, in particular the *per se* rule, may discourage many taxpayers from electing to apply the approach set forth in the Notice. The removal of the *per se* rule from

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[40] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 26024.

[41] *See* Treas. Reg. § 1.385-3(c).

[42] *See* Internal Revenue Service, T.D. 9790, Background Part II (Oct. 13, 2016).

[43] Treas. Reg. § 1.7874-10.

[44] Prop. Treas. Reg. § 58.4501-7(r)(2), (r)(3).

the Proposed Regulations implies that Treasury agrees this rule was inappropriately broad. If so, we fail to see any reason to subject taxpayers to this rule with respect to any time periods. Accordingly, we recommend that final regulations remove the *per se* rule with respect to transactions occurring prior to April 13, 2024.

6. Punitive Consequences of Becoming a "Specified Affiliate"

The Proposed Regulations provide that, subject to an exception,[45] if (i) a corporation or a partnership becomes a specified affiliate of an applicable foreign corporation or a covered surrogate foreign corporation[46] and (ii) at the time the corporation or partnership becomes a specified affiliate, the corporation or partnership owns stock of the applicable foreign corporation or covered surrogate foreign corporation, which stock it acquired after December 31, 2022 and which represents more than 1% of the fair market value of the assets of the corporation or partnership at the time it becomes a specified affiliate, then such stock is treated as acquired by the corporation or partnership immediately after the corporation or partnership becomes a specified affiliate.[47]

For reasons discussed in more detail in Part IV.B of this Report, which addresses a similar rule, we recommend removing this new rule from the final regulations or significantly revising its scope, as discussed further below.

B. Foreign Partnership Applicable Specified Affiliate Status

The Proposed Regulations provide a *de minimis* exception for circumstances in which foreign partnerships are applicable specified affiliates for purposes of the Statutory Foreign Buyback Rule and the Proposed Funding Rule. Pursuant to the Proposed Regulations, "a foreign partnership that has one or more domestic entities as direct or indirect partners is not considered an applicable specified affiliate if the domestic entities hold, directly or indirectly, in aggregate, less than 5% of the capital interests and profits interests in the foreign partnership."[48] As the examples to the Proposed Regulations illustrate, a domestic corporation's ownership of a small portion of a foreign partnership is enough to pull the foreign partnership fully within the scope of the Excise Tax, even when such domestic nexus is a narrow slice of the whole.

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[45] The rules of Prop. Treas. Reg. § 58.4501-7(g)(3)(i) do not apply with respect to shares of stock of the applicable foreign corporation or covered surrogate foreign corporation held by the corporation or partnership described therein at the time that it becomes a specified affiliate and Section 4501(d) covered corporation identifies as previously having been subject to the rule of Prop. Treas. Reg. § 58.4501-7(g)(3)(i) when held by the corporation or partnership. Prop. Treas. Reg. § 58.4501-7(g)(3)(ii).

[46] Under the Proposed Regulations, a "**covered surrogate foreign corporation**" is defined as any surrogate foreign corporation (as determined under Section 7874(a)(2)(B) by substituting September 20, 2021 for March 4, 2003 each place it appears) the stock of which is traded on an established securities market, including any successor to the surrogate foreign corporation (as determined under Treas. Reg. § 1.7874-12(a)(10)), but only with respect to taxable years that include any portion of the applicable period with respect to such corporation under Section 7874(d)(1). Prop. Treas. Reg. § 58.4501-7(b)(2)(viii).

[47] Prop. Treas. Reg. § 58.4501-7(g)(3).

[48] Prop. Treas. Reg. § 58.4501-7(h)(5).

> Example 6:[49] Partnership FP is a foreign partnership in which Corporation FZ (an applicable foreign corporation), Corporation FB (a foreign corporation), and Corporation US1 (a domestic corporation) are partners. Corporation FZ owns 70% of the capital and profits interests of Partnership FP. Corporation FB owns 20% of the capital and profits interests of Partnership FP. Corporation US1 owns 10% of the capital interest and profits interests of Partnership FP. On March 1, 2024, Partnership FP purchases 100 shares of stock of Corporation FZ when the fair market value of each share is $8x.

In Example 6, Corporation US1 is a direct partner with respect to Partnership FP because Corporation US1 directly owns an interest in Partnership FP and is not a *de minimis* domestic entity partner with respect to Partnership FP. Accordingly, Partnership FP is an applicable specified affiliate of Corporation FZ because Corporation FZ owns more than 50% of the capital and profits interests of Partnership FP and Corporation US1, a domestic entity, is a direct partner of Partnership FP. Partnership FP's purchase of 100 shares of stock of Corporation FZ is a Section 4501(d)(1) repurchase. Accordingly, the Section 4501(d)(1) repurchase increases Partnership FP's Excise Tax Base for the 2024 taxable year by $800x.

As Example 6 illustrates, where a domestic corporate partner's interest in a foreign partnership exceeds the *de minimis* threshold, there is a cliff effect that may result in a relatively minimal U.S. nexus through a domestic partner being treated in the same manner as U.S. corporate status. We do not see the policy rationale for this cliff effect and thus would recommend applying the Excise Tax to foreign partnerships proportionately based on the interest of the domestic partner in the foreign partnership. That is, if a domestic corporate partner's interest in a foreign partnership exceeds the *de minimis* threshold, such foreign partnership's Excise Tax Base would then be calculated as the pro rata amount of the covered purchase that is attributable to the relevant domestic partner's ownership interests in the foreign partnership. In the case of Example 6, it would be $80x, which is $800x multiplied by Corporation US1's 10% interest in Partnership FP. This more accurately reflects the amount of the Covered Funding that is attributable to, and therefore "funded by," the U.S. partner in the partnership, and is also consistent with how the Proposed Funding Rule operates for corporate applicable specified affiliates, where the amount of the Covered Funding is the amount that was allocable to the U.S. corporate subsidiary.

In addition to the proportionate application of the rule, we believe a *de minimis* rule is also appropriate. We recommend raising the *de minimis* threshold to a more material amount such that the rule (i) would apply only to situations where the U.S. partner has a material interest in, and material influence on, the operations of a foreign partnership and (ii) is administrable. In particular, Treasury could take an approach similar to the approach set forth in the Section 721(c) regulations on the recognition of gain on certain contributions of property to partnerships with related foreign partners.[50] In the Section 721(c) regulations, nonrecognition treatment is denied to a U.S. transferor directly contributing section 721(c) property if the U.S. transferor and its related persons own 80% or more of the partnership to which the property is being contributed. Similarly,

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[49] Adapted from Prop. Treas. Reg. § 58.4501-7(p)(8), Ex. 8, "A foreign partnership that is an applicable specified affiliate."

[50] Treas. Reg. § 1.721(c)-2(b).

the final Excise Tax regulations could provide that the Excise Tax applies to a foreign partnership if its domestic direct or indirect partners, and related parties of such domestic partners, hold, directly or indirectly, in aggregate, 80% or more of the capital and profits interests in the foreign partnership. In the alternative, we believe 25% would be a reasonable *de minimis* threshold for the domestic partner itself. This threshold has been used in other areas of the Code with respect to interests in a partnership triggering the operation of general rules.[51] A third option is a 50% *de minimis* threshold, as that percentage interest not only reflects actual control by the domestic partner of the foreign partnership but is also the same percentage that is used to determine "specified affiliate" status more generally under Section 4501.[52]

The Proposed Regulations do not specify which entity will be responsible for paying the Excise Tax liability triggered by a purchase by a foreign partnership applicable specified affiliate. Presumably the liability would lie with the foreign partnership itself, as the foreign partnership is the entity whose Excise Tax Base is increased as a result of the Covered Funding. However, this approach would create burdensome administrative compliance consequences for foreign partnerships. This approach would require a partnership to track direct and indirect (requiring additional reporting by each partner) ownership by its U.S. partners over time (as fundings can occur both before and after a covered purchase), in order to be able to assess whether domestic ownership for a potential repurchase would fall outside the *de minimis* threshold. For foreign partnerships that would not otherwise file U.S. tax returns or report operations for U.S. federal income tax purposes, this introduces a significant administrative burden. Further, this entity approach to partnership liability would require a partnership to set aside funds at the entity level to pay the tax, and then determine how to allocate the liability among its partners. In order to properly allocate the liability, the partnership would need to consider how expenses are allocated in the partnership agreement and whether circumstances driving the repurchase are instructive as to which partners should properly bear the liability.[53] Final guidance should provide some clarification on how the Excise Tax would be paid if the covered purchase is made by a foreign partnership.

C. Constructive Specified Affiliate Acquisition

The Proposed Regulations provide that shares of stock of a covered corporation are treated as repurchased by the covered corporation if a corporation or partnership becomes a specified affiliate of the covered corporation and shares of the covered corporation that were acquired after December 31, 2022 represent more than 1% of the fair market value of such corporation or

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[51] *See, e.g.*, passive foreign investment company look-through rules for greater than 25%-owned partnerships pursuant to Treas. Reg. § 1.1297-2(g)(4). *See also* Section 954(c)(4).

[52] *See* Section 4501(c)(2)(B).

[53] We also note that the result in Example 6 would be inconsistent with how the Excise Tax would have operated in the absence of the partnership. If in Example 6 Corporation US1 had bought the stock of Corporation FZ, and Corporation US1 and Corporation FZ were not partners in a partnership, there would have been no Excise Tax liability because Corporation US1 is not an applicable specified affiliate of Corporation FZ (assuming Corporation US1 and Corporation FZ are unrelated).

partnership at the time that such corporation or partnership becomes a specified affiliate of the covered corporation (the "**Constructive Specified Affiliate Acquisition Rule**").[54]

We believe that the Constructive Specified Affiliate Acquisition Rule is overbroad in its proposed form, because it applies even where an entity that becomes a specified affiliate of a covered corporation acquired stock of the covered corporation in a transaction that was entirely unrelated to the transaction in which the specified affiliate becomes a specified affiliate of the covered corporation. We are concerned that the Constructive Specified Affiliate Acquisition Rule may be implicated in many ordinary merger and acquisition transactions between otherwise unrelated parties where the entity being acquired owns only a small amount of stock of the acquiror. In the form proposed, the Constructive Specified Affiliate Acquisition Rule could apply even where stock of the relevant covered corporation represented a minuscule amount of the fair market value of the assets of the entity being acquired at the time that such entity acquired the stock of the covered corporation, but fluctuations in the value of the stock of the covered corporation and the assets of such entity cause the stock of the covered corporation to represent more than 1% of the fair market value of such entity at the time that such entity becomes a Specified Affiliate of the covered corporation.

We recommend that Treasury revise the Constructive Specified Affiliate Acquisition Rule such that it encompasses only those transactions in which a covered corporation's acquisition of interests in a specified affiliate and such specified affiliate's prior acquisition of stock of the covered corporation are related or can reasonably be treated as related. A potentially instructive model for revising the rule is Treas. Reg. § 1.108-2(c), which generally treats a debtor as indirectly acquiring its own indebtedness where the holder of such indebtedness becomes related to the debtor, and such holder acquired the indebtedness in a transaction that occurred "in anticipation" of such holder becoming related to the debtor (as determined based on all relevant facts and circumstances). For purposes of this rule, any acquisition of indebtedness by a holder that occurs less than six months before such holder becomes related to the debtor is treated as having occurred in anticipation of such holder becoming related to the debtor.

The Constructive Specified Affiliate Acquisition Rule could be revised such that covered corporation stock is treated as repurchased by the covered corporation only to the extent that such stock was acquired by the specified affiliate "in anticipation" of becoming a specified affiliate, as determined based on all relevant facts and circumstances. For example, if the specified affiliate acquired stock of the covered corporation after negotiations had commenced between the specified affiliate and the covered corporation regarding an acquisition of the specified affiliate by the covered corporation, or following the entry into a binding agreement by the parties with respect to such acquisition but prior to its consummation, it may be appropriate to treat the acquisition of stock of the covered corporation by the specified affiliate as having occurred "in anticipation" of the specified affiliate becoming related to the covered corporation. By contrast, if the specified affiliate acquired stock of the covered corporation in the ordinary course of its portfolio investment activities and prior to the commencement of negotiations with the covered corporation regarding a potential acquisition of the specified affiliate by the covered corporation, it would not be appropriate to treat the acquisition of stock of the covered corporation stock by the specified

[54] Prop. Treas. Reg. § 58.4501-2(f)(3)(i).

affiliate as having occurred "in anticipation" of the specified affiliate becoming related to the covered corporation.[55]

In the alternative, if Treasury wishes to retain a mechanical rule, we believe that the 1% value threshold contained in the Constructive Specified Affiliate Acquisition Rule should be revised to be higher than 1% in order to prevent the Constructive Specified Affiliate Acquisition Rule from becoming burdensome by virtue of being potentially applicable to a significant subset of all merger and acquisition transactions. If the threshold remains as low as 1%, then covered corporations will need to analyze nearly all such transactions (as well as any other type of transaction in which an entity becomes a specified affiliate of the covered corporation) to assess the application of the Excise Tax. Accordingly, we propose that the applicable threshold be increased to 5% so that the Constructive Specified Affiliate Acquisition Rule applies where a meaningful amount of stock of the covered corporation is indirectly acquired when an entity becomes a specified affiliate of the covered corporation.[56] To be clear, this higher threshold should not apply if Treasury adopts a narrower rule that targets acquisitions of covered corporation stock made in anticipation of becoming related to the covered corporation. If the acquisition was indeed made in anticipation of becoming related, we believe no *de minimis* threshold is needed at all.

We also recommend that Treasury and the IRS clarify that the reference to "the fair market value of the assets of the corporation or partnership" in Prop. Treas. Reg. § 58.4501-2(f)(3)(i)(b) contemplates the gross assets of the corporation or partnership, rather than the assets net of liabilities of the corporation or partnership. We recommend that this provision be clarified to refer to gross assets in order to align the determination with other similar determinations elsewhere in the Code.[57]

D. Stock "Issued" or "Provided" to Non-Employees of a Specified Affiliate for Netting Rule Purposes

Under the Notice, stock issued by a covered corporation to a specified affiliate is not treated as issued for purposes of the Netting Rule.[58] We previously recommended that issuances of stock by a covered corporation to a specified affiliate should qualify for the Netting Rule to the extent the specified affiliate subsequently transfers the covered corporation stock to any party other than the covered corporation or another specified affiliate.[59] While the Proposed Regulations have largely accepted this recommendation, they provide that the Netting Rule does not apply to covered corporation stock issued by a covered corporation or provided by a specified affiliate to a

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55 *See* Treas. Reg. § 1.108-2(c)(2).

56 *See, e.g.*, Treas. Reg. § 1.382-9(d)(4).

57 *See, e.g.*, IRS Notice 88-22 (stating that regulations will be issued that will provide that the "asset test" applicable to the "passive foreign investment company" determination under Section 1297 will be applied on a gross basis without regard to any liabilities); Section 1202(d)(1) (defining "qualified small business" by reference to the "aggregate gross assets" of a corporation); Treas. Reg. § 1.897-1(o)(2)(i) (fair market value of property for purposes of FIRPTA provisions is gross value of property reduced by certain debt secured by such property).

58 Notice, Section 3.08(4)(c).

59 *See* Second Report, Section V.H.3.

non-employee of the specified affiliate as compensation for services rendered to the specified affiliate.[60] The Proposed Regulations' approach in this area can be summarized as follows:

Covered Corporation Stock:	***To:***	***Netting Rule Credit?***
Issued by Covered Corporation	Any person (other than the covered corporation or a specified affiliate of the covered corporation), even if the transfer is in connection with the performance of services for the covered corporation.	Yes.
Issued by Covered Corporation	An employee of the specified affiliate in connection with the performance of services for the specified affiliate.	Yes.
Issued by Covered Corporation	A non-employee of the specified affiliate in connection with the performance of services for the specified affiliate.	No.
Provided by Specified Affiliate	Any person (other than the covered corporation or a specified affiliate of the covered corporation) if the transfer is *not* in connection with the performance of services to the specified affiliate.	Yes.
Provided by Specified Affiliate	An employee of the specified affiliate in connection with the performance of services for the specified affiliate.	Yes.
Provided by Specified Affiliate	A non-employee of the specified affiliate in connection with the performance of services for the specified affiliate.	No.

We commend Treasury for largely adopting our proposed approach. However, we believe that denying Netting Rule credit when a specified affiliate transfers covered corporation stock to a non-employee in connection with the performance of services for the specified affiliate (or is deemed to make such a transfer under Treas. Reg. § 1.83-6(d)) is inconsistent with the letter of Section 4501(c)(3). The Proposed Regulations approach is based on the interpretation of the terms "issued" or "provided" in Section 4501(c)(3). Specifically, the preamble of the Proposed Regulations indicates that:

> "[a] stakeholder recommended that stock "issued" should be interpreted to mean covered corporation stock issued directly by the covered corporation to its employees or other service providers. In contrast, stock "provided" should be

[60] Prop. Treas. Reg. § 58.4501-4(f)(2); Prop. Treas. Reg. § 58.4501-4(b)(1)(ii). The Proposed Regulations do not impose any limitation on the issuance of covered corporation stock in connection with services performed for the covered corporation, regardless of whether the recipient is an employee or non-employee of the covered corporation. *See* Prop. Treas. Reg. § 58.4501-4(b)(1)(i).

interpreted to mean covered corporation stock transferred by a specified affiliate (which cannot issue covered corporation stock) to its employees. The Treasury Department and IRS agree with the foregoing interpretation. A specified affiliate may provide stock in the covered corporation, rather than the specified affiliate's own stock, as compensation for services provided by the specified affiliate's employees. Thus, this interpretation would not interfere with existing stock-based compensation arrangements. Moreover, because section 4501(c)(3) applies to transfers by a specified affiliate to its employees, stock provided by the specified affiliate in connection with the performance of services by its employees (but not by its non-employee service providers) would qualify for the netting rule under these proposed regulations."[61]

In other words, the Proposed Regulations interpreted the "issued or provided" language as *limiting* the general Netting Rule in Section 4501(c)(3), which requires reducing the Excise Tax Base by the fair market value of any stock issued by a covered corporation during the taxable year. We disagree with the Proposed Regulations' interpretation of Section 4501(c)(3)'s "issued or provided" language because it ignores the plain meaning of the term "including."[62] Section 4501(c)(3) states that the Excise Tax Base:

> shall be reduced by the fair market value of any stock issued by the covered corporation during the taxable year, **including** the fair market value of any stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation during the taxable year, whether or not such stock is issued or provided in response to the exercise of an option to purchase such stock.

Section 7701 of the Code states that when the term "including" is "*used in a definition contained in this title* [which includes Section 4501] *shall not be deemed to exclude other things otherwise within the meaning of the term defined.*"[63] Courts have rejected under Section 7701(c) an interpretation of the Code that ignores the term "including," and substitutes it, in effect, with the term "limited to."[64] However, the Proposed Regulations ignore the term "including" in Section 4501(c)(3) and instead interpret it as limiting the application of the Netting Rule in the context of compensatory transfers to instances where the recipient of the covered corporation stock is an employee of a specified affiliate. This is contrary to the plain meaning of the lead-in language of Section 4501(c)(3), which states that the Netting Rule applies to any stock issued by the covered

[61] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 26012-3.

[62] *See Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883) ("It is the duty of the court to give effect, if possible, to every clause and word of a statute…"); *see also Hibbs v. Winn*, 542 U.S. 88, 101 (2004) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant…") (citing 2A N. Singer, Statutes and Statutory Construction § 46.06, pp. 181-186 (rev. 6th ed. 2000)).

[63] Section 7701(c).

[64] *In re Joplin*, 882 F.2d 1507, 1511 [64 AFTR 2d 89-5543] (10th Cir. 1989).

corporation, regardless of whether the recipient is providing services to the covered corporation or a specified affiliate and regardless of whether the recipient is an employee or non-employee.

Taken to its logical conclusion, such narrow interpretation of the statutory language that follows the word "including" could also preclude applying the Netting Rule to transfers of covered corporation stock by a specified affiliate to a third-party *non*-service provider in exchange for property, since that case is not explicitly addressed in Section 4501(c)(3) either. Nevertheless, the Proposed Regulations would (we believe, correctly) give credit under the Netting Rule in such cases.[65] There is no discernible policy justification for giving credit for stock transferred to employees and *any* non-service providers, yet excluding stock transferred to non-employee service providers.

Accordingly, we recommend that the Netting Rule applies when a covered corporation issues its stock to any service provider (employee or non-employee) of a specified affiliate in connection with services performed for the specified affiliate. The result should be the same when a covered corporation issues its stock, contributes it to a specified affiliate, and the specified affiliate transfers such stock to its employee or non-employee as compensation for services rendered (or when such contribution and transfer are deemed to occur under Treas. Reg. § 1.83-6(d)). In these situations, the issuance of the covered corporation stock should qualify for the Netting Rule because Section 4501(c)(3) expressly indicates that any issuance of its stock reduces the Excise Tax Base.[66]

E. Instruments Not in the Legal Form of Stock

The Proposed Regulations include a new rule modifying the application of the Netting Rule to certain equity instruments that are not legally in the form of stock. In general, the issuance of an instrument that is not in the legal form of stock but that is treated as equity for U.S. federal income tax purposes (a "**Non-Stock Instrument**") is, under the Proposed Regulations, disregarded for purposes of the Netting Rule at the time of issuance (the "**NSI Excluded Issuance Rule**"). Accordingly, the issuance of a Non-Stock Instrument does not, without more, reduce the Excise Tax Base.[67] However, a Non-Stock Instrument is generally treated as issued for purposes of the Netting Rule when and if such Non-Stock Instrument is itself repurchased (the "**Issuance-at-Redemption Rule**" and together with the NSI Excluded Issuance Rule, the "**NSI Netting Exception**").[68] The amount reducing the Excise Tax Base under the Issuance-at-Redemption Rule is equal to the lesser of the fair market value of the Non-Stock Instrument at the time of its actual issuance, and the fair market value of the Non-Stock Instrument at the time of its redemption (the "**NSI Lesser-of Valuation Rule**").[69] Because the redemption of a Non-Stock Instrument is generally included (as an addition) to the Excise Tax base in an amount equal to the fair market

[65] Prop. Treas. Reg. § 58.4501-4(f)(2).

[66] When a covered corporation issues stock to a specified affiliate, we continue to believe that it is sensible to apply the Netting Rule only if and when that stock is transferred by the specified affiliate to a person who is not the covered corporation or a specified affiliate of that corporation.

[67] Prop. Treas. Reg. § 58.4501-4(f)(13)(i).

[68] Prop. Treas. Reg. § 58.4501-4(f)(13)(ii).

[69] Prop. Treas. Reg. § 58.4501-4(f)(13)(ii)(E).

value of the Non-Stock Instrument at the time of its redemption, the net effect of the Issuance-at-Redemption Rule and the NSI Lesser-of Valuation Rule is that the repurchase of a Non-Stock Instrument will increase the Excise Tax Base only to the extent that the instrument's fair market value at the time of the redemption exceeds its fair market value at the time of issuance.[70] Put another way, the NSI Netting Exception practically exempts Non-Stock Instruments from the Excise Tax, to the extent of their value at the time of their actual issuance, while also preventing the issuance of a Non-Stock Instrument from eroding the Excise Tax Base attributable to the repurchase of other equity instruments in the earlier year of issuance.

To avail itself of the Issuance-at-Redemption Rule, a covered corporation must comply with several timing and consistency rules. Specifically, a Non-Stock Instrument will not be treated as issued in the year of its repurchase or redemption (and hence will never reduce the Excise Tax Base) unless the redeeming covered corporation identifies the repurchase of the Non-Stock Instrument on the Excise Tax return for the taxable year in which the repurchase or acquisition occurs. Furthermore, the Issuance-at-Redemption Rule will not apply to a particular Non-Stock Instrument unless the covered corporation has reported the repurchase or acquisition of all other "comparable" Non-Stock Instruments repurchased or acquired within the preceding five taxable years in a consistent manner (the "**NSI Consistency Requirement**").[71]

No rule similar to the NSI Netting Exception was included in the Notice. In the preamble to the Proposed Regulations, Treasury indicated that the NSI Netting Exception was intended as an anti-avoidance measure preserving and protecting the Excise Tax Base. In the expressed view of Treasury, instruments that are treated as equity for U.S. federal income tax purposes but that are not in the legal form of stock (i.e., Non-Stock Instruments) could more readily be issued by a corporation as compared to instruments legally denominated as stock. Accordingly, Treasury and the Service appear concerned that a taxpayer could strategically issue Non-Stock Instruments. Absent the NSI Netting Exception, these issuances would decrease the Excise Tax Base in the year of issuance.[72] As one example of this potential abuse, the preamble to the Proposed Regulations posits that a taxpayer could write an option to purchase its stock with a deeply discounted exercise price, and take the position that such option was deemed exercised for U.S. federal income tax purposes (the "**Discounted Option Example**").[73] The option would be granted to an accommodation party, and the Notice of Proposed Rulemaking suggests that there could be a tacit understanding between the issuer and the option holder that such option would remain unexercised.

Instruments are generally characterized as debt or equity for all U.S. federal income tax purposes based primarily on their economic terms, and we do not see a compelling rationale to

[70] The actual redemption of the Non-Stock Instrument is added to the Excise Tax Base and, at the same time, under the Issuance-at-Redemption Rule, the Excise Tax Base is decreased by an amount which cannot be more than the fair market value of the Non-Stock Instrument at the time of the repurchase (under the NSI Lesser-of Valuation Rule).

[71] Under the Proposed Regulations, a "comparable Non-Stock Instrument" is a Non-Stock Instrument that has substantially similar economic terms as the Non-Stock Instrument being redeemed, regardless of whether the two instruments have the same legal form. Prop. Treas. Reg. § 58.4501-4(f)(13)(ii)(D).

[72] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 26011.

[73] *Id*.

establish a rule that uniquely applies to certain instruments based solely on their form. We believe that the NSI Netting Exception inappropriately focuses on the legal form of an instrument and elevates form over substance in a matter that creates what we believe are unintended opportunities for taxpayers to strategically choose the legal form of their equity issuances.

For example, consider a covered corporation that has not historically conducted share repurchases. If such a corporation needs or desires to *issue* equity (whether common or preferred) in any year prior to the covered corporation repurchasing stock, the NSI Netting Exception, as currently drafted, would provide an incentive for the covered corporation to issue such equity in the form of Non-Stock Instruments. Equity in form and Non-Stock Instruments would have contrasting consequences to such a taxpayer. The issuance of a Non-Stock Instrument, under the NSI Netting Exception as currently proposed, would not reduce the Excise Tax Base in the year of issuance. But that is a net favorable result to the covered corporation, as the covered corporation would have no share repurchases in that year. In a subsequent year, if such Non-Stock Instrument were to be redeemed, under the Issuance-at-Redemption Rule, the Non-Stock Instrument will be treated as both issued and redeemed, and the covered corporation may owe Excise Tax only on an amount equal to the difference, if any, between the value of the Non-Stock instrument at issuance and redemption.

By contrast, if the covered corporation issued an instrument in the legal form of stock, the repurchase of such instrument in a later year would result in Excise Tax on the full value of the stock instrument redeemed, because any issuance credit in the prior year would have expired unused under the Netting Rule. This divergent treatment could incentivize certain covered corporations to structure equity issuance in the form of a Non-Stock Instrument, purely for tax reasons. This incentive would exist regardless of the economic terms of the instrument. For example, term preferred in the form of stock would increase a taxpayer's Excise Tax liability if it were issued and redeemed in different years (and assuming insufficient other repurchases in the year of issuance). By contrast, equity economically equivalent to a term preferred instrument but in the form of, for example, a subordinated contingent principal amount note, would, under the NSI Netting Exception, only incur an Excise Tax on incremental value accretion between issuance and redemption. We do not believe there is a policy basis for this disparate treatment.

The NSI Netting Exception, could also have anomalous consequences as applied to an entity treated as a corporation for U.S. federal income tax purposes that is not organized as a corporation under U.S. federal or state law. For example, a limited liability company, limited partnership, "business trust," or non-U.S. entity may be treated as a corporation for U.S. federal income tax purposes and yet not issue any instruments that take the legal form of stock, for example, membership interests or partnership interests, such that the NSI Netting Exception could potentially apply to all instruments issued by such entity that are treated as equity for U.S. federal income tax purposes (even an instrument that bears features ordinarily associated with common stock). This would be an unusual and, we believe, unjustifiable, result that arises out of the NSI Netting Exception's reliance on form rather than substance.

Finally, we do not believe the NSI Netting Exception is necessary to combat abuses like the one identified in the Discounted Option Example. A public corporation would likely face numerous legal and non-tax impediments to engaging in a transaction described in the Discounted Option Example. In addition, we believe general U.S. tax principles and existing anti-abuse

doctrines would adequately foreclose treating a discounted option as common equity, especially when there is an arrangement or other economic compulsion preventing the option holder from ever actually exercising that right. As an initial matter, an option issued under the terms of the Discounted Option Example, if accompanied by an agreement or understanding that the option would be redeemed for the cost to the buyer, plus some interest spread, would not appear to qualify as equity for U.S. federal income tax purposes. Depending on the form that the prohibition or limitation on option exercise takes, the Discounted Option Example would be subject to attack under (i) general substance over form principles, (ii) principal/agent theories that would treat the covered corporation as the true holder of the option (and so the stock would not be treated as issued), and/or (iii) sham transaction principles.

Accordingly, we believe the NSI Netting Exception should be removed, and that all instruments treated as equity for U.S. federal income tax purposes, whether in the legal form of stock or not, should be treated alike for purposes of Section 4501.[74]

If notwithstanding the recommendation above the NSI Netting Exception is retained, we believe that it should be expanded to also apply to equity instruments, regardless of their form, that are limited and preferred as to dividends and do not participate in corporate growth to any meaningful extent, as such terms have been used and defined under Section 305 ("**Preferred Equity**"). As a more limited alternative, if it is not desired to expand the NSI Netting Exception to all Preferred Equity, we would recommend applying it to Preferred Equity that is mandatorily redeemable or redeemable by the issuer at a specified time, upon demand of the holder or at the option the issuer, if the issuer is more likely than not to exercise such option ("**Redeemable Preferred Equity**"). A taxpayer is generally able to select the form of Preferred Equity instruments to a much greater degree than it may select the legal form of common equity. Taxpayers also have some flexibility to structure financing transactions as either debt issuances or preferred equity issuances for U.S. federal income tax purposes. If the NSI Netting Exception were retained, we see no reason why the rationale for its adoption does not apply equally to issuances of Preferred Equity that are in form stock. If the NSI Netting Exception applies to Non-Stock Instruments, expanding its application to all Preferred Equity (or all Redeemable Preferred Equity) would prevent strategic issuances of Preferred Equity in the legal form of stock to erode the Excise Tax Base. Furthermore, as detailed in our Prior Reports, redemptions of Preferred Equity do not present the perceived abuses the Excise Tax was intended to prevent.[75] Additionally, applying the NSI Netting Exception to Redeemable Preferred Equity would avoid some of the unintended distortions inherent in the application of the Netting Rule on an annual basis. Accordingly, applying the Issuance-at-Redemption Rule to Preferred Equity would do no violence to the purposes of Section 4501.[76]

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[74] Treasury could consider adding a consistency requirement to the Netting Rule in order to address circumstances in which a covered corporation initially takes the position that an instrument is treated as debt but subsequently treats the instrument as equity for purposes of the Excise Tax (other than as required by the IRS) in order to claim issuance credit under the Netting Rule retroactively.

[75] *See* First Report, Section V.E.2, 3 and Second Report, Section V.C.

[76] We note that several prior recommendations to exempt or exclude certain types of preferred stock instruments from the Excise Tax were disregarded by Treasury as either inconsistent with the plain text of Section 4501 or not consistent with sound tax administration. To the extent the NSI Netting Exception, as proposed, is within the

Accordingly, we would recommend that, if the NSI Netting Exception is retained, it should apply as equally to Preferred Equity, regardless of its legal form, as it applies to all Non-Stock Instruments.

F. Repurchases After the Cessation Date Pursuant to a Plan

The Proposed Regulations generally treat a corporation as a covered corporation starting at the beginning of the date on which stock of the corporation begins to be traded on an established securities market.[77] Conversely, a covered corporation would generally cease to be treated as such at the end of the day on which stock of the covered corporation ceases to be traded on an established securities market.[78] Similar initiation and cessation date rules apply to non-stock instruments, applicable foreign corporations, and covered surrogate foreign corporations.[79] Treasury adopted bright-line rules consistent with the statutory language of Section 4501(b), which defines the term "covered corporation" to mean any "domestic corporation the stock of which is traded on an established securities market."

However, the Proposed Regulations provide an exception to the initiation and cessation date rules if a corporation "ceases to be a covered corporation pursuant to a plan that includes a repurchase," and if the corporation's cessation date precedes the date on which any repurchase undertaken pursuant to the plan occurs. In this case, the Proposed Regulations would continue to treat the corporation as "a covered corporation *with regard to each repurchase* pursuant to the plan until the end of the date on which the last such repurchase occurs" (the "**Cessation Date Rule Exception**").[80]

We are sympathetic to Treasury's concern, but believe the Cessation Date Rule Exception should be narrowly tailored to avoid targeting repurchases that are not part of the take-private transaction. The Proposed Regulations do not provide guidance on how taxpayers should determine what repurchases are included in a plan to take private a covered corporation for purposes of applying this rule. For example, a corporation might fund a take-private transaction through an issuance of mandatorily redeemable preferred stock subject to repurchases years after where redemption rights were negotiated in connection with the take-private plan. Accordingly, we believe the Cessation Date Rule Exception should be clarified to only apply in cases where a

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authority of Treasury and the IRS, we see no reason why an extension of that rule to certain instruments that are in the form of stock would not similarly be a valid exercise of regulatory authority.

[77] Prop. Treas. Reg. § 58.4501-1(b)(16); Prop. Treas. Reg. § 58.4501-2(d)(1); Prop. Treas. Reg. § 58.4501-4(b)(2).

[78] Prop. Treas. Reg. § 58.4501-1(b)(3); Prop. Treas. Reg. § 58.4501-2(d)(2)(i); Prop. Treas. Reg. § 58.4501-4(b)(2).

[79] Prop. Treas. Reg. § 58.4501-4(f)(13)(ii)(B) (with respect to non-stock instruments); Prop. Treas. Reg. § 58.4501-7(f)(2)(i) and § 58.4501-7(n) (with respect to applicable foreign corporations and covered surrogate foreign corporations).

[80] For example, the preamble to the Proposed Regulations indicates that "all repurchases of stock of a target covered corporation in an acquisitive reorganization would be subject to the stock repurchase excise tax (if no exception applied), even if the target covered corporation's stock ceased to be traded on an established securities market prior to the repurchase of the target covered corporation's stock in the acquisitive reorganization." REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 25991. *See* Prop. Treas. Reg. § 58.4501-2(d)(2)(ii); *see also* Prop. Treas. Reg. § 58.4501-7(f)(2)(ii) applying the Cessation Date Rule Exception to applicable foreign corporations and covered surrogate foreign corporations.

covered corporation enters into a binding commitment to execute a series of steps that include a cessation date and a repurchase, where the repurchase and the cessation of publicly traded status are both parts of the same series of steps and the repurchase relates to the shares outstanding at the time the plan was entered into. Further guidance would be needed to delineate cases that are in scope of this rule, and other cases that are not, as suggested in our examples below.

Furthermore, we recommend expanding the scope of this exception to also cover *issuances* that occur as a part of a take-private plan for purposes of the Netting Rule. Specifically, the Cessation Date Rule Exception only considers repurchases that occur after the cessation date as a part of a take-private plan but it does not consider the application of the Netting Rule to issuances occurring after the cessation date that are part of the same plan.[81] If Treasury believes that a corporation can remain a covered corporation after the cessation date in this context, its status as a covered corporation should count for both repurchases and issuances as the Netting Rule explicitly applies to all covered corporations.[82] There is no justification for the disparate treatment of repurchases and issuances if a plan to delist a covered corporation includes both a repurchase and an issuance occurring after the cessation date. Accordingly, we believe that if a take-private plan includes both issuances and repurchases occurring after the cessation date, both should be reflected in computing the Excise Tax Base.

> Example 7: Corporation X, listed on the NASDAQ with a market capitalization of $200x, agrees to be acquired by Y, a closely held partnership, in a transaction structured as a private subscription for $90x newly issued preferred shares of Corporation X followed by a redemption of 100% of Corporation X's common stock. On Day 1, after all regulatory closing conditions are met, Corporation X shares are delisted from NASDAQ and its shares are no longer publicly traded. On Day 2, Y contributes $90x to Corporation X for an issuance of new preferred shares and Bank lends $110x to Corporation X. On Day 3, Corporation X redeems all of its common shares for $200x.

In this case, assuming the Cessation Date Rule Exception applies, we believe both the issuance of $90x and the repurchase of $200x should be taken into account under the Netting Rule to produce an Excise Tax Base of $110x.[83] This would produce the same result that would have applied if the cessation date had not preceded the closing of the transaction and all steps had occurred on Day 1.

> Example 8: Same facts as Example 7, but assume $110x is funded through an issuance of senior preferred stock instead of Bank debt. The senior preferred stock is mandatorily redeemable after five (5) years. On the fifth anniversary of Day 2, when Corporation X is still a private company, the senior preferred stock is redeemed.

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[81] *See* Prop. Treas. Reg. § 58.4501-2(d)(2)(ii) treating a corporation as a covered corporation solely "with regard to each repurchase pursuant to the plan".

[82] Section 4501(c)(3).

[83] Notably, this transaction could also be structured as (or deemed to be) a direct purchase of $90x shares by Y from the existing public holders of common stock, with the only repurchase being funded by $110x of Bank debt. *See, e.g.*, *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970).

We believe the final regulations should clarify that the redemption of senior preferred stock in Example 8 is not subject to the Excise Tax under the Cessation Date Rule Exception. The "plan that includes a repurchase" should be the take-private transaction that resulted in a repurchase of the common stock on Day 3. This transaction would have occurred (and indeed did occur) regardless of whether the new senior preferred stock would be ultimately redeemed. The language of the Cessation Date Rule Exception should not extend to cover a subsequent redemption of stock that was issued as part of the take-private transaction.

> Example 9: Corporation X, a covered corporation, has an outstanding class of preferred stock that was issued in 2020 and is mandatorily redeemable in 2025. In order to avoid incurring the Excise Tax, Corporation X delists and has a cessation date in 2024.

In Example 9, the Cessation Date Rule Exception should not apply to the preferred stock, which was issued long before the cessation date in an unrelated transaction. Although on the cessation date the preferred stock is subject to a pre-existing binding commitment by Corporation X to repurchase it at maturity, its repurchase would have occurred regardless of Corporation X delisting. Accordingly, this repurchase should not be viewed as part of the same "plan" with the cessation date.[84] Taxpayers should be able to cease being publicly traded in order to eliminate Excise Tax liabilities prospectively with respect to future repurchases.

G. Single Entity Reorganizations

Under the Proposed Regulations, reorganizations under Section 368(a)(1)(F) (an "**F Reorganization**") and Section 368(a)(1)(E) (an "**E Reorganization**") are treated as economically similar transactions in the same manner as other reorganizations. Accordingly, a corporation in an E or F Reorganization is deemed to engage in a repurchase to the extent of the fair market value of the shares exchanged by its shareholders in the transaction.[85] However, the fair market value of the repurchased shares that are exchanged for qualifying property reduces the corporation's Excise Tax Base under the reorganization exception.[86] As a result, the recapitalizing or transferor corporation is subject to the Excise Tax only to the extent of the fair market value of its shares that are repurchased with non-qualifying property.[87] Treasury indicated that subjecting E and F Reorganizations to the same treatment as the other types of reorganizations promotes uniformity and administrability in the enforcement of the Excise Tax, but solicited further comments on E and F Reorganizations.[88]

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[84] *See, e.g.*, Treas. Reg. § 1.355-7(b)(4)(vi) (non-plan factor if distribution would have occurred at the same time and in the same form regardless of the acquisition).

[85] Prop. Treas. Reg. § 58.4501-2(e)(4)(ii) and (iii).

[86] Prop. Treas. Reg. § 58.4501-2(c)(1)(ii) and Prop. Treas. Reg. § 58.4501-3(c)(2).

[87] The Proposed Regulations use the term "**non-qualifying property**" to refer to "property that is not permitted to be received under section 354 or 355 of the Code without the recognition of gain or loss". REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 25988.

[88] REG-115710-22, Federal Register Vol 89, No. 72, April 12, 2024, at 26000-1.

We continue to believe that E and F Reorganizations should generally never give rise to a repurchase, except in cases where shareholders receive non-qualifying property.[89] At a minimum, the Proposed Regulations should be clarified as to whether all E and F Reorganizations are covered, or only those in which an "exchange" occurs. The Proposed Regulations state that "an exchange by transferor corporation shareholders of … stock pursuant to the plan of reorganization is a repurchase."[90] However, that begs the question of whether an "exchange" must be deemed to occur in every E or F Reorganization.

> Example 10: Corporation X has 200 shares of common stock outstanding. Corporation X engages in a two-for-one stock split, pursuant to which 100 shares remain outstanding but pro rata ownership remains the same.

> Example 11: Corporation X is a State A corporation. In order to reorganize under the laws of State B, Corporation X forms Corporation Y (a State B corporation) and merges into Corporation Y in a transaction that qualifies as an F reorganization ("**Corporation X Redomiciliation**"). On the date of the Corporation X Redomiciliation, all X shareholders exchange all of their Corporation X stock for Corporation Y stock as part of the Corporation X Redomiciliation.

The transactions in Examples 10 and 11 qualify as an E Reorganization and an F Reorganization, respectively.[91] Although Corporation X's capital structure has changed to some degree, no Corporation X shareholder has been diluted and each Corporation X shareholder has the exact same proportionate claim on Corporation X's assets before and after the transaction. These transactions are also not Section 317(b) redemptions.[92] Given the lack of dilution or change in proportionate ownership, we continue to believe it would be inappropriate to treat these transactions as economically similar to a repurchase, which could have the effect of using up the annual De Minimis Exception that could have applied to unrelated actual stock repurchases during the same year.[93]

We believe that a repurchase should only be deemed to occur in E and F Reorganizations to the extent non-qualifying property is distributed. For federal income tax purposes, a distribution of non-qualifying property is generally treated as a "separate transaction" from the E or F Reorganization.[94] As such, the non-qualifying property distribution should be analyzed under Section 301 and/or Section 302 for purposes of the Excise Tax, like any other stand-alone distribution or exchange.

> Example 12: Corporation X has 10,000 shares of common stock outstanding, each worth $200, and no other outstanding equity. Corporation X exchanges its old

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[89] *See* First Report, Section V.F.(b).(i).

[90] Prop. Treas. Reg. § 58.4501-2(e)(4)(ii) and (iii).

[91] *See* Prop. Treas. Reg. § 58.4501-5(b), Ex. 9 and Ex. 10.

[92] *See* Section 317(b).

[93] *See* First Report, Section V.F.(b).(i).

[94] Treas. Reg. § 1.301-1(j); Treas. Reg. § 1.368-2(m)(3)(iii); *see Bazley v. Commissioner*, 331 U.S. 737 (1947).

common stock for 9,000 shares of new common stock (each worth $200) and $200,000 of cash.[95] The $200,000 of cash is distributed non-pro rata, such that some Corporation X shareholders receive only new common stock for their old common stock while others receive a mix of new common stock and cash. The receipt of non-qualifying property is treated as a separate transaction under the principles of Treas. Reg. § 1.301-1(j).

Example 13: The facts are the same as in Example 11, except that Corporation X has 10,000 shares of common stock outstanding, each worth $200, and no other outstanding equity. Shareholder A owns 1,000 shares of Corporation X's outstanding common stock. In the Corporation X Redomiciliation, Shareholder A transfers all its Corporation X stock to Corporation X in exchange for $200,000 of cash, which is treated for federal income tax purposes as an unrelated, separate transaction from the Corporation X Redomiciliation to which Section 302(a) applies.[96] The remaining Corporation X shareholders exchange their Corporation X stock for Corporation Y stock as part of the Corporation X Redomiciliation.

As recommended above, we believe the stock-for-stock exchanges in Examples 12 and 13 should not be treated as repurchases. Under the Proposed Regulations, in each case, the entire exchange would be treated as (i) a transaction economically similar to a repurchase that increases the Excise Tax Base by $2,000,000, followed by (ii) a $1,800,000 reduction of the Excise Tax Base because the 80 shares repurchased by Corporation X constitute qualifying property under the reorganization exception. The repurchase of 20 shares of Corporation X in both Examples would increase the Excise Tax Base by $200,000. However, the De Minimis Exception would be unavailable because in each of these Examples Corporation X is deemed to exchange all of its shares, producing a repurchase of $2,000,000.[97] Therefore, Corporation X would have an Excise Tax Base of $200,000 in both cases.

The only effect of treating each of these reorganizations as a repurchase followed by an offsetting exception is to prevent the application of the De Minimis Exception to the smaller cash redemption, which occurs simultaneously with the reorganization. Therefore, we continue to recommend that a repurchase should be deemed to occur in E and F Reorganizations solely to the extent that qualifying property is distributed to shareholders in exchange for stock. We also continue to recommend that the distribution of non-qualifying property should be separately analyzed under Section 301 and/or Section 302 for purposes of the Excise Tax, consistent with general principles of tax law.

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[95] Assume that the old common stock and new common stock have formal terms that differ to a material enough degree for the exchange to be treated as an E Reorganization, but without diluting or altering the Corporation X shareholders' proportionate equity interests in Corporation X. *See, e.g.*, Section 368(a)(1)(E); Rev. Rul. 69-407, 1969-2 C.B. 50 (exchange of $150 par value common for $100 par value old common stock, and of $87.50 par value common stock for old $100 par value common treated as a E Reorganization); Rev. Rul. 54-482, 1954-2 C.B. 148 (exchange of no par value common stock for new $1 par value common stock treated as a E Reorganization), amplified, Rev. Rul. 86-25, 1986-1 C.B. 202.

[96] *See* Treas. Reg. § 1.368-2(m)(3)(iii) and -2(m)(4) Ex. 2.

[97] Prop. Treas. Reg. § 58.4501-2(e)(4)(ii) and (iii); Prop. Treas. Reg. § 58.4501-5(b), Ex. 9 and Ex. 10.

Finally, we recommend that final regulations clarify that the Excise Tax does not apply to E Reorganizations where there is no exchange of the covered corporation stock, e.g., a recapitalization solely with respect to debt securities.[98]

In sum, we recommend that the final regulations (i) exclude F Reorganizations and E Reorganizations from "economically similar" transactions entirely if no qualifying property is distributed, (ii) with respect to E and F Reorganizations where non-qualifying property is distributed, a repurchase should be deemed to occur solely to the extent of such non-qualifying property (except to the extent such distribution of non-qualifying property is treated as a dividend under Section 356(a)), and (iii) clarify that an E Reorganization not involving an exchange of stock is not a repurchase or an economically similar transaction.

[98] Prop. Treas. Reg. § 58.4501-2(e)(4)(ii) states that "[i]n the case of an E reorganization in which the recapitalizing corporation is a covered corporation, the exchange by the recapitalizing corporation shareholders <u>of their recapitalizing corporation stock</u> pursuant to the plan of reorganization is a repurchase by the recapitalizing corporation." (emphasis added). We believe the intended result is that debt-for-debt exchanges are not within the scope of this rule precisely because there is no exchange of "stock," but a clarification would be helpful.

Appendix – Prior Reports

Report No. 1474

New York State Bar Association Tax Section

Report on Notice 2023-2

March 20, 2023

TABLE OF CONTENTS

I. Introduction **1**
II. Summary of Principal Recommendations **1**
III. Background on the Notice **3**
A. Mechanical Approach to Calculating Excise Tax Base 3
B. Scope of "Repurchases" 4
1. Section 317(b) Redemptions 4
2. Repurchases "Economically Similar" to Section 317(b) Redemptions 4
C. Taxable Acquisitions 6
D. Foreign Corporations 6
E. Preferred Stock 7
F. Liquidations 7
IV. Principles and Considerations for Excise Tax Guidance **8**
V. Topics and Recommendations for Guidance **9**
A. Framework of the Excise Tax 9
B. Scope of Section 317(b) Redemptions 11
C. Preferred Stock 12
D. M&A Transactions 13
1. Taxable Acquisitions 14
2. Tax-Free Transactions 15
i. The Acquisitive Reorganization Exception 15
I. "Economically Similar" 16
II. Statutory Reorganization Exception 18
ii. The Source Rule 22
iii. The Reverse Triangular Merger Exception 24
E. Distressed Companies 26
F. Foreign Corporations 28
1. Replacement of the Funding Rule 28
2. Considerations If the Funding Rule Is Retained 31
G. Liquidation 34
H. Other Issues 36
1. Transitional Rules 36
2. Covered Corporation Status 36
3. Netting Rule for Specified Affiliates 36

Appendix - Prior Report

Report on Notice 2023-2

I. Introduction

This Report[1] analyzes Notice 2023-2 (the "**Notice**"), which provides preliminary guidance on Section 4501 of the Internal Revenue Code of 1986, as amended (the "**Code**"). Section 4501 imposes a new excise tax (the "**Excise Tax**") on certain repurchases of corporate stock.[2]

Part II summarizes our principal recommendations for guidance from the Department of the Treasury ("**Treasury**," including, as applicable, the Internal Revenue Service (the "**IRS**")) with respect to the elements of Section 4501 addressed by the Notice. Part III provides background on the aspects of Section 4501 and the Notice for which we provide recommendations in Part V. Part IV describes the policy considerations that guided our approach to developing recommendations for Treasury guidance. Part V then analyzes and presents certain recommendations for guidance with respect to Section 4501 and the Notice.

II. Summary of Principal Recommendations

We first must express our gratitude to Treasury for issuing a comprehensive piece of guidance in a short time frame. The Notice provided helpful and timely guidance with respect to a number of the key issues presented by Section 4501. We think that the approach taken by the Notice on some topics merits further consideration, and we also believe that additional guidance is necessary in a number of other areas. In order to provide Treasury with as much time as possible to consider the recommendations of this Report prior to the publication of future guidance, we have focused our analysis on the most important issues we have identified in Section 4501 and the Notice. We provide detailed recommendations for guidance on these topics in Part V below, some of which include recommendations set forth in the report submitted by the Tax Section to Treasury on November 1, 2022.[3]

Our principal recommendations include the following:

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[1] The principal authors of this Report are William Curran, Constance Zhang and Michelle Zhao. Helpful comments were received from William Alexander, Robert Cassanos, Jason R. Factor, Lawrence M. Garett, Edward E. Gonzalez, Adam Kool, Stephen B. Land, Jiyeon Lee-Lim, John Lutz, Vadim Mahmoudov, Stephen Massed, Michael Mollerus, Richard M. Nugent, Deborah L. Paul, David Rievman, David M. Schizer, Michael Schler, David Schnabel, Karen G. Sowell, Joseph Tootle, Shun Tosaka, Philip Wagman, Gordon Warnke, Thomas Wood, Sara Zablotney and Libin Zhang. This Report reflects solely the views of the Tax Section (the "**Tax Section**") of the New York State Bar Association ("**NYSBA**") and not those of NYSBA's Executive Committee or its House of Delegates.

[2] Except as otherwise indicated, all references to "**Section**," "**Treas. Reg**." and "**Notice Section**" refer, respectively, to the Code, the Treasury regulations promulgated thereunder and the Notice.

[3] NYSBA Tax Section, Report No. 1469: "Report on the Section 4501 Excise Tax on Repurchases of Corporate Stock" (Nov. 1, 2022) (hereinafter, the "**Prior Report**").

1. Treasury should consider calculating the Excise Tax Base (as defined below) for Tax-Free Transactions (as defined below) solely by reference to the amount of applicable corporate stock that is exchanged for "boot" in such transactions.

2. Guidance should confirm that for purposes of the Excise Tax, Section 317(b) Redemptions (as defined below) include only transactions described in Part I of Subchapter C of the Code ("**Subchapter C**").

3. Guidance should exclude redemptions of Straight Preferred Stock (as defined below) from the scope of the Excise Tax.

4. Consistent with the Prior Report, we believe that both taxable and nontaxable merger and acquisition ("**M&A**") transactions between unrelated parties should be excluded from the Excise Tax.

5. In the event Treasury does not adopt recommendation 4, future regulations should adopt the bright-line rules set forth by the Notice with respect to the application of the Excise Tax to Taxable Acquisitions (as defined below).

6. In the event Treasury does not adopt recommendation 4, Treasury should reconsider its approach to the application of the Excise Tax to Tax-Free Transactions. We set forth three possible approaches below:

    a. Exclude Acquisitive Reorganizations (as defined below) from the scope of the Excise Tax;

    b. Establish a "sourcing" rule to determine whether Acquisitive Reorganizations are subject to the Excise Tax; or

    c. Exclude Reverse Triangular Mergers (as defined below) from the scope of the Excise Tax (either generally or at a minimum to the extent that boot is sourced from the acquiring corporation).

7. Guidance should generally exclude distressed companies from the scope of the Excise Tax.

8. Instead of adopting the Funding Rule, guidance should provide that Section 4501(d)(1) applies to purchases of stock of an applicable foreign corporation by a specified affiliate that is (i) a U.S. corporation, (ii) a CFC (as defined below), or (iii) a partnership in which a U.S. corporation owns an interest (either directly or through a CFC).

9. If Treasury does not adopt recommendation 8, then the *per se* element of the Funding Rule should be removed and exceptions for ordinary course transactions (such as cash pooling) should be provided.

III. Background on the Notice

The Notice provides guidance on the application of Section 4501. The Prior Report describes the background of Section 4501.

A. Mechanical Approach to Calculating Excise Tax Base

Under the Notice, the "**Excise Tax Base**" is the amount determined pursuant to the following steps. First, a covered corporation[4] must determine the aggregate fair market value of all repurchases of the covered corporation's stock by the corporation during its taxable year (the "**Aggregate Gross Repurchase FMV**").[5] If the Aggregate Gross Repurchase FMV does not exceed $1,000,000, then a de minimis exception applies (the "**De Minimis Exception**") and the covered corporation is not subject to the Excise Tax.[6] After assessing the application of the De Minimis Exception and concluding it does not apply, the corporation reduces the Aggregate Gross Repurchase FMV by the fair market value of the stock it repurchased in its taxable year that is subject to a "statutory exception."[7] Finally, the amount determined in the preceding step is further reduced by the fair market value of the stock of the covered corporation issued or provided by the corporation during the taxable year (the "**Netting Rule**"), which includes, for this purpose, any stock (i) issued or provided to employees of the covered corporation or employees of a specified affiliate of the covered corporation (whether or not the stock is issued or provided in response to the exercise of an option to purchase the stock) or (ii) issued by the covered corporation to persons other than persons described in (i) during the same taxable year.[8] However, certain issuances, such as a distribution by a covered corporation of its own stock to its shareholders, or an issuance by a covered corporation to a specified affiliate of the covered corporation (the "**Specified Affiliate Exception**"), are disregarded for purposes of the Netting Rule.[9]

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[4] For purposes of the Excise Tax, a "**covered corporation**" means any domestic corporation the stock of which is traded on an established securities market (within the meaning of Section 7704(b)(1)). Section 4501(b).

[5] Notice Section 3.03(3)(a)(i).

[6] Notice Section 3.03(2).

[7] Notice Sections 3.03(3)(a)(ii), 3.07. The statutory exceptions include (i) the Qualifying Property Exception (as defined below), (ii) repurchased stock that is contributed to an employer-sponsored retirement plan, (iii) stock that is repurchased by a dealer in securities (within the meaning of Section 475(c)(1)), (iv) stock that is repurchased by a RIC or REIT and (v) a repurchase that is treated as a distribution of a dividend under Section 301(c)(1) or Section 356(a)(2).

[8] Notice Sections 3.03(a)(iii), 3.08.

[9] Notice Section 3.08(4). The other exceptions are (i) issuances that are part of a transaction to which the Qualifying Property Exception applies, (ii) deemed issuances under Section 304(a)(1), (iii) deemed issuances of a fractional share, (iv) issuances by a covered corporation that is a dealer in securities in the ordinary course of the dealer's business of dealing in securities and (v) issuances by the target corporation in a Reverse Triangular Merger.

B. Scope of "Repurchases"

Only stock that is considered "repurchased" as defined in Section 4501 is subject to the Excise Tax. For purposes of Section 4501, a "repurchase" means (a) a redemption within the meaning of Section 317(b) with regard to the stock of a covered corporation (a "**Section 317(b) Redemption**"), and (b) any transaction determined by the Secretary of the Treasury (the "**Secretary**") to be economically similar to a Section 317(b) Redemption (an "**Economically Similar Transaction**").[10]

1. Section 317(b) Redemptions

Section 317(b) provides that, for the purposes of Sections 301-318, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired or held as treasury stock.[11] The Notice indicates that a Section 317(b) Redemption includes straightforward repurchases of a corporation's own common stock as well as transactions that have been deemed to be Section 317(b) Redemptions, such as certain forms of so-called "bootstrap acquisitions," discussed below in Part III.C.[12] The Notice sets forth an exclusive list of transactions that are treated as Section 317(b) Redemptions, but that are not repurchases for purposes of Section 4501.[13]

2. Repurchases "Economically Similar" to Section 317(b) Redemptions

Section 4501 provides that the Excise Tax will apply to any transaction determined by the Secretary to be economically similar to a Section 317(b) Redemption.[14] The Notice sets forth what it means to be "economically similar" by providing (i) an exclusive list of transactions that are Economically Similar Transactions and (ii) a nonexclusive list of transactions that are not Economically Similar Transactions ("**Non-Economically Similar Transactions**").

The Economically Similar Transactions are:[15]

1. In an Acquisitive Reorganization, the exchange by the target corporation ("**Target**") shareholders of their Target stock is treated as a repurchase by Target. "**Acquisitive Reorganizations**" are transactions that qualify as a reorganization under (i) Section 368(a)(1)(A) (an "**A Reorganization**"), including by reason of Section 368(a)(2)(D) (a "**Forward Triangular Merger**") or Section 368(a)(2)(E) (a "**Reverse Triangular**

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[10] Section 4501(b).

[11] Section 317(b).

[12] *See* Notice Sections 3.09(3), 3.09(4).

[13] Notice Section 3.04(3). This list consists of (i) an acquisition of stock under Section 304(a)(1) and (ii) a payment by a covered corporation of cash in lieu of fractional shares.

[14] Section 4501(c)(1)(B).

[15] Notice Section 3.04(4)(a).

Merger"), (ii) Section 368(a)(1)(C) (a "**C Reorganization**"), or (iii) Section 368(a)(1)(D), if it satisfies the requirements of Section 354(b)(1) (a "**D Reorganization**");[16]

2. In a reorganization under Section 368(a)(1)(E) (an "**E Reorganization**"), the exchange by the recapitalizing corporation shareholders of their recapitalizing corporation stock is treated as a repurchase by the recapitalizing corporation;[17]

3. In a reorganization under Section 368(a)(1)(F) (an "**F Reorganization**"), the exchange by the shareholders of the "transferor corporation" (within the meaning of Treas. Reg. 1.368-2(m)(1)) of their transferor corporation stock is treated as a repurchase by the transferor corporation;[18]

4. In a split-off, the exchange by the distributing corporation shareholders of their distributing corporation stock for controlled corporation stock and any consideration provided in the split-off (subsections (1)-(4) collectively, "**Tax-Free Transactions**");[19] and

5. In a complete liquidation to which both Section 331 and Section 332 apply, each distribution to which Section 331 (but not Section 332) applies is treated as a repurchase by the liquidating corporation.[20]

Tax-Free Transactions are taken into account in the determination of the Excise Tax Base by first including in the Aggregate Gross Repurchase FMV the stock deemed repurchased as set forth above. This amount is then reduced by the fair market value of any repurchased stock that is subject to a statutory exception, including the Qualifying Property Exception. The "**Qualifying Property Exception**" reduces the Aggregate Gross Repurchase FMV by the amount of stock repurchased by a covered corporation to the extent such repurchase is for property permitted to be received without the recognition of gain or loss under Section 354 or Section 355 in (i) a repurchase by a Target as part of an Acquisitive Reorganization, (ii) a repurchase by a covered corporation or a covered surrogate foreign corporation[21] as part of an E Reorganization, (iii) a

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[16] Notice Sections 3.02(1), 3.04(4)(a)(i). In this Report, "**Acquiror**" is the corporation that acquires Target in an Acquisitive Reorganization or other M&A transaction.

[17] Notice Section 3.04(4)(a)(ii).

[18] Notice Section 3.04(4)(a)(iii).

[19] Notice Section 3.04(4)(a)(iv).

[20] Notice Section 3.04(4)(a)(v).

[21] A "**covered surrogate foreign corporation**" is defined in Notice Section 3.04(2)(b) to mean any surrogate foreign corporation (as determined under Section 7874(a)(2)(B) by substituting "September 20, 2021" for "March 4, 2003" each place it appears) the stock of which is traded on an established securities market, but only with respect to taxable years that include any portion of the applicable period with respect to such corporation under Section 7874(d)(1).

repurchase by a transferor corporation as part of an F Reorganization and (iv) a repurchase by a distributing corporation as part of a split-off (whether or not part of a D Reorganization).[22]

The effect of the Qualifying Property Exception is that stock consideration transferred or distributed to covered corporation shareholders in a Tax-Free Transaction generally is included in and then removed from the Excise Tax Base. Thus, Tax-Free Transactions generally increase the Excise Tax Base to the extent of taxable boot (i.e., cash or other non-stock consideration) that is paid in the reorganization.[23]

C. Taxable Acquisitions

The Notice limits the application of the Excise Tax with respect to corporate acquisitions that do not constitute Acquisitive Reorganizations ("**Taxable Acquisitions**") to Section 317(b) Redemptions (i.e., transactions that would be treated as Section 317(b) Redemptions under current law). Thus, in the case of Taxable Acquisitions, Section 317(b) Redemptions would include transactions where a target corporation pays to the selling shareholders a portion of the purchase consideration using its own cash reserves or a borrowing pursuant to a reverse subsidiary merger structure for which it becomes the obligor for income tax purposes pursuant to the merger, i.e., certain forms of a so-called "bootstrap acquisition."[24]

D. Foreign Corporations

Section 4501(d)(1) provides that in the case of an acquisition of stock of an applicable foreign corporation – defined to mean a foreign corporation the stock of which is traded on an established securities market (within the meaning of Section 7704(b)(1)) – by a "specified affiliate" of the corporation from a person that is not the applicable foreign corporation or a specified affiliate of the corporation, such repurchase will be subject to the Excise Tax.[25] However, the Excise Tax does not apply if the purchasing specified affiliate is a foreign corporation or foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner).[26] This rule operates by treating the acquisition of the stock of an applicable foreign corporation by an affiliate that is a domestic entity as a repurchase of stock of a covered corporation by such covered corporation.

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[22] Notice Section 3.07(2).

[23] Notice Section 3.09(6).

[24] *See Zenz v. Quinlivan*, 213 F.2d 916 (6th Cir. 1954); Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 75-447, 1975-2 C.B. 113. *See also* Notice Section 3.09(3), 3.09(4).

[25] Section 4501(d)(1).

[26] *Id*.

In addition, the Notice provides that, for purposes of applying Section 4501(d)(1), a repurchase is deemed to occur if an applicable specified affiliate[27] funds by any means (including through distributions, debt or capital contributions) an acquisition or repurchase of stock of an applicable foreign corporation (or a specified affiliate that is not an applicable specified affiliate) and such funding is undertaken for a principal purpose of avoiding the Excise Tax (the "**Funding Rule**").[28] The Funding Rule contains a *per se* rule whereby a principal purpose of avoiding the Excise Tax is deemed to exist if the acquisition or repurchase by the funded entity occurs within two years of the funding (other than a funding through distributions).[29] This means that an acquisition preceding the funding would also be captured by the Funding Rule. The application of the *per se* rule is not rebuttable.

E. Preferred Stock

Notwithstanding the directive in Section 4501(f)(2) for the Secretary to provide guidance "to address special classes of stock and preferred stock," the Notice does not provide any guidance with respect to preferred stock, including any exception for the redemption of any type of preferred stock from the Excise Tax.[30] Instead, the Notice treats preferred stock, including mandatorily redeemable preferred stock, of a covered corporation as subject to the Excise Tax. The Notice requests comments as to whether there should be special rules for redeemable preferred stock or certain other special classes of stock or debt.[31]

F. Liquidations

As noted above, the Notice provides a nonexclusive list of transactions that are not Economically Similar Transactions, including distributions in complete liquidation of a corporation under Section 331 *or* Section 332(a) (but not a complete liquidation to which both Sections 331 and 332 apply).[32] Further, the Notice specifies that if a covered corporation completely liquidates and dissolves (within the meaning of Treas. Reg. 1.331-1(d)(1)(ii)) during a taxable year, no distribution made during that taxable year is a repurchase.[33]

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[27] The Notice uses the defined term "**applicable specified affiliate**" to refer to such specified affiliates of an applicable foreign corporation other than foreign corporations or foreign partnerships (unless such a partnership has a domestic entity as a direct or indirect partner). Notice Section 3.02(4).

[28] Notice Section 3.05(2)(a)(ii). The fair market value of stock that is treated as acquired by the applicable specified affiliate is limited to the amount funded by the applicable specified affiliate.

[29] Notice Section 3.05(2)(a)(ii)(B).

[30] Notice Section 3.09(1).

[31] Notice Section 6.01(1).

[32] Notice Section 3.04(4)(b)(i)(A). This nonexclusive list also includes a distribution under Section 355 that is not a split-off. Since this is a *nonexclusive* list of transactions that are not Economically Similar Transactions, and because the Notice otherwise contained exclusive lists, taxpayers presumably can treat other similar transactions as not economically similar to a repurchase.

[33] Notice Section 3.04(4)(b)(i)(B).

IV. Principles and Considerations for Excise Tax Guidance

In developing our recommendations, we have been guided by three principles. First, guidance must be faithful to the text of the statute. Second, consistent with the statute's direction that Treasury provide "regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section," our recommendations seek to further the purposes of the Excise Tax. These two principles intersect, as we begin with the statutory language of Section 4501 in attempting to discern its relevant purposes and policies.[34] Section 4501 provides that the Excise Tax shall apply to (i) repurchases that are redemptions within the meaning of Section 317(b) and (ii) repurchases that are *economically* similar to Section 317(b).[35] Our recommendations for guidance are informed by our focus on the meaning of "economically similar." In particular, we examine how the Notice interprets, and how the features of certain transactions deviate from, this term.

In addition, we have looked more broadly for the policies behind the statute. As described in further detail in the Prior Report, the Excise Tax is intended to address certain perceived non-tax abuses in conventional stock repurchases, including the use of repurchases to recapture value and improve financial metrics without investing in business operations and generating economic growth.[36] Yet, rather than an outright prohibition on stock repurchases, Congress intended to utilize the Excise Tax to raise substantial revenue.[37] As such, in determining whether a particular transaction should fall within the scope of the Excise Tax, we have considered whether that transaction has the same non-tax implications as the intended target of the policy considerations that apparently gave rise to the Excise Tax. This consideration also reinforces our focus on "economically similar" transactions and, in particular, on treating economically similar transactions in a similar manner, as such transactions are more likely to share the same non-tax implications.

Third, we believe guidance should reflect the fact that Section 4501 is imposing an excise tax, not an income tax. Due to its nature as a transaction-based tax, an excise tax exists apart from, and is directed to purposes distinct from those of, the income tax provisions of the Code. Excise taxes in general are primarily intended to raise revenue.[38] Historically, they have been

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[34] Treasury officials have embraced this approach in public statements regarding the Notice. *See* Colin Campbell, Jr., Daniel Hemel, Vadim Mahmoudov, Sophie Staples and David M. Rievman, panelists. Panel discussion. New York State Bar Association Annual Meeting 2023. Jan. 19, 2023. Hilton Midtown, New York.

[35] Sections 4501(c)(1)(A), 4501(c)(1)(B).

[36] *See* Prior Report, pages 12-16.

[37] *Id*.

[38] Joseph J. Thorndike, *Tax History: Don't Believe the Hype: Excise Taxes Are About Revenue*, 2015 TNT 8-2 (Jan. 13, 2015); *see also*, George Hass, *Tax Revision Studies: Excise Taxes*, Staff Memo, Division of Tax Research, Treasury Department (Sept. 1937) ("The history of excise taxation in the United States is largely the history of emergency Federal financing. Excise taxes have been collected almost without exception during every critical period in American Federal finance.").

imposed to fund wars and address financial shortfalls.[39] Another purpose of excise taxes is to prevent behavior that is deemed socially undesirable by increasing the cost of engaging in such behavior.[40] The revenue raising and regulating functions, which often coexist, make excise taxes distinct from income taxes. To serve these purposes, the imposition of excise taxes should not be ambiguous. Accordingly, the rules under the Excise Tax should be simple, administrable and clearly defined by Treasury regulations in as bright-line a manner as possible. Specifically, the regulations should clearly define the rules governing the Excise Tax, target discrete "behaviors" and provide that any transaction that is not expressly defined as a repurchase under Section 4501(c)(1) is not subject to the Excise Tax. Treasury appears to have embraced the value of clarity, simplicity and administrability with respect to the Excise Tax.[41] Without clear and administrable rules, there would be significant compliance burdens associated with Section 4501 that undermine its purpose as an excise, rather than income, tax.

V. Topics and Recommendations for Guidance

Our recommendations as to the most critical issues under Section 4501 and the Notice are set forth in this Part V. As noted below, several of these recommendations were included in the Prior Report. The Prior Report continues to represent the views of the Tax Section and is hereby incorporated by reference into this Report (and is attached for ease of reference as the Appendix to this Report).

A. Framework of the Excise Tax

The mechanical framework of Section 4501 operates by first including all stock related to a "repurchase" transaction – defined expansively to include both Section 317(b) Redemptions and transactions that are economically similar to Section 317(b) Redemptions – in the base of the Excise Tax calculation and then applying broad exclusions to shrink that base.[42] By virtue of this sweeping approach to the inclusion and subsequent exclusion, Section 4501 places a compliance burden on taxpayers that are covered corporations, insofar as they must consider the application of the Excise Tax whenever they engage in any transaction involving the deemed exchange of corporate shares, regardless of whether such transaction resembles, in any respect, a Section 317(b) Redemption. For example, a covered corporation that changes the par value of its shares (an E Reorganization) would presumably be required to make a filing that first includes in its calculation of the Aggregate Gross Repurchase FMV all of its outstanding shares and then

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[39] *See* George Haas, *Tax Revision Studies: Excise Taxes*, Staff Memo, Division of Tax Research, Treasury Department (Sept. 1937) (detailing the varied history of U.S. excise taxes, including those imposed on liquor and tobacco, bankers, broker, and theater proprietors to raise revenue during wartime).

[40] *See* Todd Nesbit and Adam Hoffer, *For Your Own Good: Taxes, Paternalism, and Fiscal Discrimination in the Twenty-First Century* (2017).

[41] *See* supra note 34 (a representative from the Treasury noting the importance of administrability to the operation of the Excise Tax); Chandra Wallace, *Clarity is Paramount for Buyback Tax Guidance, Government Says*. Tax Notes (Mar. 8, 2023). We note that, with a few exceptions that are discussed in this Report, the Notice effectively provides for simple and clear rules.

[42] As noted above, the list of transactions that are not Economically Similar Transactions is a nonexclusive list.

removes all of these outstanding shares from the Excise Tax Base under the Qualifying Property Exception. On net, this E Reorganization would not affect the covered corporation's Excise Tax Base in any respect, but the reporting requirement would create a trap for the unwary. This violates the principles of simplicity and administrability.

In addition, the mechanical approach of the Notice renders as arbitrary the application of the De Minimis Exception. Because the determination of whether the De Minimis Exception applies is based on the Aggregate Gross Repurchase FMV, the occurrence of a transaction that bears no economic similarity to a Section 317(b) Redemption could determine whether the Excise Tax applies or not.

> **Example 1**. A covered corporation with a calendar taxable year changes the par value of its shares on March 15, 2023, when the shares are worth $1 billion. On November 1, 2023, the corporation redeems shares worth $500,000 in a transaction described in Section 302(a).

The change in par value constitutes an E Reorganization, which is an Economically Similar Transaction. Thus, the corporation is presumably treated as repurchasing all of its shares in exchange for new shares, even though Section 317(b) expressly does not apply when the redeeming corporation is using its own stock in the transaction.[43] While this deemed repurchase would be excluded from the Excise Tax Base because of the Qualifying Property Exception, the De Minimis Exception would not apply and thus the corporation would owe Excise Tax in the amount of $5,000. If the corporation had not undertaken the E Reorganization, it would not have owed any Excise Tax (nor had to make any related filings).

In order to simplify the application of the Excise Tax and make it more administrable for taxpayers and the IRS, we recommend that the Excise Tax Base be determined after the application of the statutory exceptions are taken into account, which in the case of Tax-Free Transactions would mean the determination is made solely by reference to the stock that is exchanged for boot. This would simplify compliance and remove the arbitrariness currently associated with the De Minimis Exception. In addition, it would eliminate the need for taxpayers that are covered corporations to address certain questions that result from the Notice's current approach. For example, when applying the Notice to an F Reorganization, the Aggregate Gross Repurchase FMV includes the shares exchanged by the transferor corporation's shareholders for their transferee corporation shares, i.e., all of the shares of the transferor corporation. However, it is not always clear whether a transaction that constitutes an F Reorganization (e.g., a change of a corporation's name) gives rise to the deemed exchanges of shares contemplated by the Notice. As a result of the breadth of Section 368(a)(1)(F), taxpayers would need to make determinations that otherwise are often irrelevant in order to determine whether a particular F Reorganization must be reported as a repurchase for purposes of Excise Tax compliance and determine the

[43] Section 317(a) provides that "for purposes of this part, the term "property" means money, securities, and any other property; except that **such term does not include stock in the corporation making the distribution (or rights to acquire such stock)**" (emphasis added). Section 317(b) provides that "for purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."

Aggregate Gross Repurchase FMV and whether it exhausts the De Minimis Exception. This additional compliance burden would not further the purpose of the Excise Tax.[44]

B. Scope of Section 317(b) Redemptions

While the scope of Economically Similar Transactions is admirably clear in the Notice, additional guidance as it relates to Section 317(b) Redemptions would be useful. In particular, it is possible that a transaction that is not an Economically Similar Transaction but that does, at least in form, arguably involve the acquisition of stock by a corporation in exchange for property (e.g., certain reorganizations within the meaning of Section 368(a)(1)(G) ("**G Reorganizations**")) could be viewed as Section 317(b) Redemptions.[45] In addition, certain transactions that are specifically excluded from the list of Economically Similar Transactions, such as distributions in complete liquidation of a corporation under Section 331, arguably involve the acquisition of stock by a corporation in exchange for property and therefore could be viewed as Section 317(b) Redemptions.[46]

We interpret the structure of the Notice to address these uncertainties. In particular, we believe the fact that the Notice has addressed reorganizations and liquidations as Economically Similar Transactions or Non-Economically Similar Transactions reflects a conclusion by Treasury that for purposes of the Excise Tax, consistent with the text of Section 317(b),[47] Section 317(b) Redemptions are limited to transactions described in Part I of Subchapter C (distributions by corporations)[48] and therefore transactions described in Part II (corporate

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[44] Section 4501(e)(1) (the "**Statutory Reorganization Exception**") provides that Section 4501(a) shall not apply "to the extent that the repurchase is part of a reorganization (within the meaning of Section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 by reason of such reorganization." We do not think this statutory language requires a conclusion that in a Tax-Free Reorganization, stock of the acquiring corporation must be included in the Aggregate Gross Repurchase FMV, and then at a later step in the calculations removed from the Excise Tax Base. Rather, this exception can reasonably be applied by completely excluding stock of the acquiring corporation from all calculations required by the statute. The Statutory Reorganization Exception is discussed below in Part V.D.2.i.II of this Report.

[45] Because Treasury apparently concluded that Acquisitive Reorganizations are not Section 317(b) Redemptions (or it would not have included them as Economically Similar Transactions) and because the formal mechanics of G Reorganizations that give them arguable similarity to Section 317(b) Redemptions are identical to those of Acquisitive Reorganizations, we interpret the fact that G Reorganizations are not included as Economically Similar Transactions to reflect a conclusion by the Treasury that G Reorganizations are outside the scope of the Excise Tax. Direct guidance on this point would be welcome nonetheless.

[46] Because a "repurchase" is defined to include (i) a Section 317(b) Redemption and (ii) any transaction determined by the Secretary to be economically similar to a Section 317(b) Redemption, the fact that a transaction is not described under (ii) does not foreclose the possibility that such transaction is a Section 317(b) Redemption. Nonetheless, we think the correct reading of the Notice is to conclude that if a transaction is not economically similar to a Section 317(b) Redemption, it is also not a Section 317(b) Redemption. To conclude otherwise would be to conclude that there is a Section 317(b) Redemption that does not resemble itself in economic terms, which is an absurd result.

[47] Section 317(b) ("For purposes of this part…").

[48] Sections 301-318.

liquidations)[49] and Part III (corporate organizations and reorganizations)[50] of Subchapter C may be treated as repurchases within the scope of the Excise Tax only if and to the extent they constitute Economically Similar Transactions. However, we think clear guidance reflecting this conclusion would provide helpful clarity with respect to the scope of the Excise Tax.

C. Preferred Stock

With respect to preferred stock, the Tax Section continues to endorse the recommendations in the Prior Report, particularly with respect to "preferred stock" within the meaning of Section 1504(a)(4) (but without regard to the requirements of Section 1504(a)(4)(A) and (C)) ("**Straight Preferred Stock**").[51] The Notice treats redemptions of preferred stock as subject to the Excise Tax.[52] However, it is the Tax Section's belief that redemptions of Straight Preferred Stock should be exempted from the scope of the Excise Tax. To the extent such redemptions are exempted from the scope of the Excise Tax, we would recommend that issuances of Straight Preferred Stock be similarly excluded for purposes of the Netting Rule.

The Prior Report details how preferred stock resembles debt in many substantive respects. Straight Preferred Stock typically has a fixed or limited dividend yield and does not participate in the economic growth of the issuer.[53] Further, upon a redemption of Straight Preferred Stock, the earnings-per-share of shareholders of common stock is increased only to the extent the issuer no longer has an obligation to pay a future dividend.[54] In these ways, Straight Preferred Stock functions as a debt-like instrument, and the redemption of Straight Preferred Stock resembles the repayment of an issuance of debt. Indeed, many companies view Straight Preferred Stock and debt as financing alternatives, with considerations such as the regulatory capital credit that Straight Preferred Stock sometimes provides driving their financing decisions.

Under the Notice, however, the Excise Tax would treat these economically similar instruments differently in ways that could arbitrarily favor the government or taxpayers. For example, a covered corporation seeking funding for a buyback of its common stock could raise the funds through an issuance of Straight Preferred Stock, which would offset the repurchased common stock under the Netting Rule and thereby reduce the covered corporation's Excise Tax liability.[55] Debt funding for the same buyback would not produce a Netting Rule benefit. Accordingly, these two transactions, both of which appear to implicate the policies of the Excise Tax, would have different results under the Excise Tax. As discussed in the Prior Report, a

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[49] Sections 331-346.

[50] Sections 351-368.

[51] *See* Prior Report, pages 34-38.

[52] Notice Section 3.09(1).

[53] *See* Prior Report, page 34.

[54] *See id*.

[55] Notice Sections 3.03(a)(iii), 3.08.

covered corporation seeking funding for purposes other than stock buybacks might choose to issue debt rather than Straight Preferred Stock because the ultimate redemption of the Straight Preferred Stock would trigger the Excise Tax (which could be mitigated under the Netting Rule if the redemption of the Straight Preferred Stock were funded by an issuance of new Straight Preferred Stock).[56] In light of Congress's invitation to Treasury to address preferred stock, the fact that Straight Preferred Stock does not appear to raise the policy issues underlying Section 4501 and the arbitrary results discussed here, we believe that Straight Preferred Stock should be exempted from the scope of the Excise Tax.

D. M&A Transactions

As discussed in detail in the Prior Report, we believe that Taxable Acquisitions, including bootstrap acquisitions, and Acquisitive Reorganizations, other than single company reorganizations, downstream reorganizations, and reorganizations between corporations under common control, should be outside the scope of the Excise Tax.[57] Consistent with the Prior Report, we thus recommend that Treasury provide guidance which excepts from the Excise Tax taxable and nontaxable M&A transactions between unrelated parties (an "**M&A Exception**"). We believe that an M&A Exception is appropriate because M&A transactions do not bear the traditional hallmarks of conventional, often opportunistic stock repurchase transactions and programs that, based on all available information with respect to the policies of the Excise Tax, were the intended target of the Excise Tax.[58] That is, M&A transactions are not single company, downstream, or related party transactions that distribute corporate value to shareholders in exchange for the surrender of corporate stock. They instead generally are transformative transactions involving two or more unrelated corporations that are heavily negotiated and have real world consequences significantly beyond the opportunistic transfer of corporate value to shareholders (e.g., from the target's perspective, they frequently involve the relinquishment of corporate control).

Our view is in part informed by the fact that attempting to apply the Excise Tax to M&A transactions creates problematic line-drawing exercises, several of which are present in the Notice, that are hard to justify under Section 4501. For example, and as discussed in greater detail below, the Notice excludes from the Excise Tax Taxable Acquisitions that do not involve the use of target funds. This exclusion is required by the statute because these transactions (i.e., taxable acquisitions funded by the acquiror) are neither Section 317(b) Redemptions nor "economically similar" to Section 317(b) Redemptions under any reasonable interpretation of the phrase. However, the Notice subjects Acquisitive Reorganizations to the Excise Tax on the view that they are "economically similar" to Section 317(b) Redemptions, even though Acquisitive Reorganizations are arguably more economically similar – and in some cases are economically identical to – Taxable Acquisitions that are outside the scope of the Excise Tax. In the absence of plain language requiring otherwise, we believe that Section 4501 should be interpreted in a

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[56] As noted in the Prior Report, this creates yet another incentive that weighs in favor of the issuance of debt instead of equity. *See* Prior Report page 35 and footnote 145.

[57] *See* Prior Report, pages 49-56 (Acquisitive Reorganizations) and pages 59-60 (Taxable Acquisitions).

[58] *See id*.

manner that treats similarly situated parties similarly and avoids inconsistent results. If the statute was intended to subject a broad range of M&A transactions to the Excise Tax, it could have done so in plain language with a specific reference to M&A, rather than relying on an expansive reading of "economically similar."[59]

1. Taxable Acquisitions

While we continue to favor an exception from the Excise Tax for Taxable Acquisitions between unrelated parties, if Treasury nevertheless concludes that Taxable Acquisitions are subject to the Excise Tax, we agree with the approach under the Notice to treat a Taxable Acquisition as a Section 317(b) Redemption only to the extent a portion of the purchase price is sourced from Target, whether as an upfront payment to Target shareholders out of Target cash or as the result of Target inheriting an obligation incurred by a merger subsidiary in a reverse subsidiary merger.[60] With respect to financing involving debt obligations, it is the Tax Section's view that the question of payment sourcing for purposes of the Excise Tax should, as provided in the Notice, be guided by the same rules that apply to determine the identity of the borrower for U.S. federal income tax purposes.

The following examples illustrate how the Excise Tax applies to common Taxable Acquisition forms.[61]

> **Example 2**: Acquiror, a public company, acquires all of the outstanding stock of Target, a public company (Target Stock Acquisition). To effectuate the Target Stock Acquisition: (i) Acquiror directly borrows $50x from an unaffiliated lender and contributes the $50x of borrowed funds and $50x of cash on hand to a newly formed corporation (Merger Sub); and (ii) Merger Sub merges into Target, with Target surviving the merger (Merger). At the time of the Merger the stock of Target has an aggregate fair market value of $100x. In the Merger, Target's shareholders exchange all their Target stock for Merger Sub's $100x of cash.

[59] *See Tandy Leather Co. v. United States*, 347 F.2d 693 (1965) ("The burden in such a case is always on the collector to show, in justification of his levy and collection of an excise tax, that the statute plainly and clearly lays the tax; that, in short, the fundamental rule is that taxes to be collectible must be clearly laid.").

[60] Notice Section 3.09(3) (concluding Target is treated as if it redeemed a portion of Target's outstanding stock as a result of directly funding a corresponding portion of the consideration received by its shareholders in exchange for such stock); Notice Section 3.09(4) (concluding Target is treated as if it redeemed a portion of Target's outstanding stock as a result of assuming a loan, the proceeds of which were used to redeem a corresponding amount of Target's outstanding stock from its shareholders). The Notice's approach to Taxable Acquisitions is informed by the existing rules in Subchapter C in determining which party to a transaction is treated as funding a transaction for purposes of the Excise Tax. Because these principles are based on an economic substance-over-form analysis, we find them to be a reasonable source of authority to guide the application of the Excise Tax (unlike the rules relying on fictional formal constructs that appear to provide the basis for the treatment of Acquisitive Reorganizations, discussed below).

[61] *See* Notice Sections 3.09(3) and (4) (Examples 3 and 4).

The Merger is funded by Acquiror and is treated as a purchase of the Target stock by Acquiror. The Target Stock Acquisition is not within the scope of the Excise Tax.

> **Example 3**: The facts are the same as in Example 2, except that Acquiror has an equity value of $50x as a result of a capital contribution from investors and no operations of its own and the Acquiror loan provides for a guarantee from Target upon the consummation of the Merger.

The Merger is funded by Acquiror, as Acquiror is the borrower. The fact that Target provides a guarantee does not result in Target being treated as the borrower under general federal income tax principles.[62] Neither the Target Stock Acquisition nor the Merger is within the scope of the Excise Tax.

> **Example 4**: The facts are the same as in Example 2 above, except that following the Target Stock Acquisition, Target assumes the debt from Acquiror.

General tax principles, including the step transaction doctrine, would determine whether the borrowing and subsequent pushdown should be viewed together as an integrated borrowing by Target and redemption of Target stock with the proceeds thereof, in which case the transaction would be subject to the Excise Tax, or as separate (albeit potentially related) transactions not involving a redemption of Target stock, in which case the transaction would not be subject to the Excise Tax.

2. Tax-Free Transactions

If Treasury does not adopt an M&A Exception covering both taxable and nontaxable M&A transactions as recommended above, then we propose that Treasury at a minimum reconsider its approach to the application of the Excise Tax to Tax-Free Transactions. We describe three alternative approaches for Treasury's consideration: (i) the Acquisitive Reorganization Exception approach, (ii) the Source Rule approach, or (iii) the Reverse Triangular Merger Exception approach (each as defined below). The discussion that follows outlines and considers the strengths of each approach along with countervailing considerations.

i. The Acquisitive Reorganization Exception

Under the "**Acquisitive Reorganization Exception**," Acquisitive Reorganizations would not be subject to the Excise Tax regardless of the source of the consideration, except for

[62] *Compare* Example 3 *with Plantation Patterns, Inc. v. Comm'r*, 462 F.2d 712 (5th Cir. 1972) (holding that debt issued by a thinly capitalized corporation and guaranteed by the corporation's shareholder should properly be treated as debt of the shareholder, as the corporation lacked adequate capitalization to borrow on its own merit, such that the shareholder-guarantor was the true obligor on the loan). Unlike the fact pattern in *Plantation Patterns*, the guarantee in Example 3 serves to give the lender a more direct claim to the operating assets and cash flows of Target and does not make Target, a wholly-owned subsidiary of Acquiror, the true obligor on the loan. In a fact pattern where Target is a holding company, the guarantee would not have a meaningful effect on the credit profile of the loan.

transactions involving the receipt of boot where Target controls Acquiror (or vice versa).[63] In analyzing the case for an Acquisitive Reorganization Exception, two key elements of the statute should be considered: (i) the phrase "economically similar" and (ii) the exception for repurchases that are a part of a reorganization as set forth in Section 4501(e)(1) (the "**Statutory Reorganization Exception**"). We address each of these elements in turn.

I. "Economically Similar"

As indicated above, our interpretation of the Notice is that a shareholder's receipt of consideration in an Acquisitive Reorganization is not a Section 317(b) Redemption. This approach fits with the basic structure of Subchapter C: Section 317(b) Redemptions are, by their terms, limited to transactions occurring under Part I of Subchapter C. As a result, for the Excise Tax to apply, a Target shareholder's receipt of boot taxed under Section 356 would need to be "economically similar" to a Section 317(b) Redemption.[64]

This phrase is not defined or further qualified in the statute, nor is it elaborated on in the Notice.[65] The fact that "economically similar" can be construed to have straightforward meaning, indicates that a plain reading is the correct one.[66] A straightforward reading of "economically similar" is similar in terms of economics or with respect to the effect a transaction has on the interests of Target, Acquiror and the shareholders of both Target and Acquiror.

As an economic matter, in an Acquisitive Reorganization Target shareholders are selling Target to Acquiror; the basic economic nature of the transaction is a two-company acquisitive transaction. A Section 317(b) Redemption, on the other hand, is a transaction in which a single corporation acquires its own stock from its shareholders. On its face, the economic structure and result of a Section 317(b) Redemption appears not to be similar to that of a sale of one corporation to another.

Indeed, an Acquisitive Reorganization may be economically virtually identical to a taxable M&A transaction involving stock as acquisition currency or a Section 351 transaction, as

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[63] For a discussion of potential anti-abuse rules for situations involving the receipt of boot in such Tax-Free Transactions, *see* Prior Report pages 52-54 and 56.

[64] This is in contrast to a bootstrap Taxable Acquisition, in which payments of consideration to the Target's shareholders sourced from its assets would be Section 317(b) Redemptions; thus, such payments would be subject to Excise Tax, unless an M&A Exception is adopted.

[65] Other regulations and notices released by Treasury that contain the phrase "economically similar" are similarly silent on a precise definition of the phrase. *See, e.g.*, Final and Temporary Regulations under Section 385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness, T.D. 9790, 81 Fed. Reg. 72858 (October 21, 2016); Notice 2002-36, I.R.B. 2002-22, 4 (June 3, 2002) ("As a policy matter, the Service and the Treasury are concerned whenever significantly different tax results obtain for *economically similar* financial instruments…") (emphasis added). We are not aware of any tax principles or authorities that guide the interpretation of this phrase.

[66] *See generally, e.g.*, *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) (reasoning that if the meaning of statute is not ambiguous or silent, then it must be given effect); *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) ("Because the Code's plain text permits the taxpayer here to receive these benefits, we need not address this policy concern.").

illustrated in Examples 5 through 8 below. Yet the Notice looks at that Acquisitive Reorganization and the Taxable Acquisition or Section 351 transaction and treats one as economically similar to a Section 317(b) Redemption and the other as not. This is an incongruous approach to the application of Section 4501.

An argument could be made against the Acquisitive Reorganization Exception, by focusing on A Reorganizations, Forward Triangular Mergers, C Reorganizations and D Reorganizations (collectively, "**Acquisitive Asset Reorganizations**"). These transactions involve exchanges that could be viewed as "economically similar" to Section 317(b) Redemptions under an application of Subchapter C fictions. That is, Subchapter C creates the fiction that Acquisitive Asset Reorganizations are two-step transactions, with Target treated as (i) transferring all or a portion of its assets to Acquiror in exchange for Acquiror stock and/or boot, then (ii) making a liquidating distribution to its shareholders in exchange for their Target stock (a "**Deemed Liquidating Distribution**").[67]

While one could argue that the receipt of boot in a Deemed Liquidating Distribution resembles a Section 317(b) Redemption – that is, Target is deemed to acquire its stock from a shareholder in exchange for property, and the property is typically not treated as a dividend under Section 356[68] – a Deemed Liquidating Distribution exists as a fictional, rather than an economic, matter.[69] It can be questioned whether that fictional similarity should be viewed as enough to satisfy the statute's standard of "economically similar."

Moreover, if an Acquisitive Asset Reorganization is treated in accordance with its fictive form under Subchapter C, it nevertheless is not clear that the Excise Tax should apply. As discussed above, an Acquisitive Asset Reorganization is deemed to consist of two steps: the transfer of Target's assets to Acquiror in exchange for Acquiror stock and/or boot and a Deemed Liquidating Distribution.[70] Under the Notice, distributions by a covered corporation in complete liquidation are not Economically Similar Transactions and thus are not subject to the Excise

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[67] *See, e.g.*, Section 361 (gain or loss recognition of Target is based on (i) the exchange of all or a portion of its property for consideration from Acquiror, and (ii) the subsequent distribution of such consideration and any retained Target assets); Boris L. Bittker & James S. Eustice, Federal Income Taxation of Corporations & Shareholders, ¶ 12.21[1] (7th ed. 2000 & Supp. 2020-3) (describing this construct for A Reorganizations).

[68] *See Commissioner v. Clark*, 489 U.S. 726 (1989). As we noted in the Prior Report, whether the receipt of boot is taxed to the shareholder as a dividend or as "gain from the exchange of property" (i.e., in the manner of a redemption) depends on whether the boot has the effect of the distribution of a dividend. The Supreme Court held in *Clark* that the receipt of boot in a Deemed Liquidating Distribution involving previously unrelated corporations does not typically qualify for dividend treatment.

[69] We note that certain Acquisitive Asset Reorganizations involve an actual liquidating distribution by Target and this form is contemplated in the case of C Reorganizations under Section 368(a)(2)(G). However, as an economic matter, Target is distributing in liquidation property it received from Acquiror and with respect to which Target has only transitory ownership –Target is acting as a conduit for Acquiror. Accordingly, as an economic matter, an actual liquidating distribution in an Acquisitive Asset Reorganization is not more similar to a Section 317(b) Redemption than a Deemed Liquidating Distribution.

[70] *Compare* Rev. Rul. 69-6, 1969-1 C.B. 104 (treating a taxable merger as consisting of these two deemed transactions).

Tax.[71] It can be asked why a Deemed Liquidating Distribution, where Target distributes assets received from Acquiror that Target held or was deemed to hold only momentarily, gives rise to an Economically Similar Transaction, while an actual liquidating distribution by a covered corporation, using its own funds, does not. Moreover, a deemed liquidating distribution to a Target shareholder in an acquisition structured as a forward merger would not be subject to Excise Tax if the merger was a taxable transaction.[72]

A further possible argument against the Acquisitive Reorganization Exception arises out of a revenue ruling that applies Section 302 to a target corporation shareholder in an A Reorganization that receives only cash with respect to its target shares. In Revenue Ruling 74-515,[73] the target corporation had common and preferred shares outstanding and the parties agreed that the target common shares would be exchanged solely for acquiror common shares whereas the preferred shares would be exchanged solely for cash. The IRS ruled that the receipt of cash by a target shareholder that held only preferred shares was a distribution in exchange for its stock pursuant to Section 302, whereas the receipt of cash by a target shareholder that held preferred and common shares was treated as boot taxable pursuant to Section 356(a)(1). Therefore, with respect to a shareholder that receives, in an Acquisitive Reorganization, solely consideration that is not eligible for deferral under Section 354(a), this ruling appears consistent with the IRS's view of the treatment of boot under the Notice. Moreover, one could argue that receipt of some stock of the acquiring corporation, in addition to boot, does not meaningfully alter the economic consequences of the receipt of boot – in either case, cash or other property is leaving corporate solution in exchange for surrender of corporate stock.

On the other hand, the IRS's position in this ruling as to the application of Section 302 to a particular subset of shareholders in Acquisitive Reorganizations arguably does not speak to the question of whether Acquisitive Reorganizations generally are "economically similar" to Section 317(b) Redemptions. It could be argued that the focus of the ruling is on drawing a technical distinction under Subchapter C between shareholders who receive both stock and boot and those who receive only boot, rather than on conducting an economic analysis of the overall transaction, and that the overall character of an Acquisitive Reorganization is sufficiently different from a typical redemption so that the Excise Tax should not apply.

II. Statutory Reorganization Exception

Adopting the Acquisitive Reorganization Exception requires the conclusion that the existence of the Statutory Reorganization Exception is an insufficient justification for the drafting of a rule treating all boot in an Acquisitive Reorganization as economically equivalent to a redemption. While a statute should be interpreted to give all words meaning,[74] the statutory

[71] *See* Notice 3.04(4)(b)(i)(A).

[72] *See* Rev. Rul. 69-6 (treating such a deemed liquidating distribution as taxable under Section 331).

[73] 1974-2 C.B. 515.

[74] *See Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883) ("It is the duty of the court to give effect, if possible, to every clause and word of a statute…"); *see also Hibbs v. Winn*, 542 U.S. 88, 101 (2004) ("A statute should be (….continued)

text providing for the Statutory Reorganization Exception may be given meaning by applying it to reorganizations that unambiguously resemble Section 317(b) Redemptions. For example, an E Reorganization involving an actual or deemed exchange of a corporation's outstanding stock for other, newly issued stock (an "**Equity Recapitalization**") is economically similar to a Section 317(b) Redemption to the extent there is boot.[75] Accordingly, these transactions are properly within the scope of "economically similar" transactions. Any stock issued in an Equity Recapitalization involving boot would qualify for the Statutory Reorganization Exception.

Moreover, a split-off with boot as consideration is economically similar to a Section 317(b) Redemption. In a split-off, the parent corporation (the "**Parent**") distributes the stock of a subsidiary to certain shareholders of Parent in exchange for their stock of Parent. In the case where a shareholder of Parent receives boot in the split-off in addition to subsidiary shares, the split-off transaction is economically similar to a Section 317(b) Redemption to the extent of the boot. These transactions should be within the scope of "economically similar" and the exchange of subsidiary stock for Parent stock should qualify for the Statutory Reorganization Exception.

It is, however, possible to take a broader view of the Statutory Reorganization Exception and to interpret the exception as evidence of Congressional intent that all boot received in a reorganization should be considered economically equivalent to a redemption. According to this way of thinking, Congress would have written the exception in a different way if it intended for the exception to be relevant only in the narrow cases not subject to the Acquisitive Reorganization Exception (i.e., single company and downstream reorganizations, as well as split-offs with boot and reorganizations between related corporations).

Ultimately, since Section 4501 does not mention reorganizations in its operative provision at all, but rather only in an exception which is itself not entirely clear in its drafting, the statute presents interpretative challenges. The question of interpretation reduces to whether Congress intended to (i) subject boot in all Acquisitive Reorganizations to the Excise Tax through the words "economically similar," notwithstanding that reorganizations and M&A transactions are not mentioned in the operative rule in the statute, or (ii) provide an exception for reorganizations that has application in a narrow range of cases (such as Equity Recapitalizations and split-offs as described above), with boot in Acquisitive Reorganizations not generally being subject to the Excise Tax.

(continued….)

construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant…") (citing 2A N. Singer, Statutes and Statutory Construction §46.06, pp. 181-186 (rev. 6th ed. 2000)).

[75] Indeed, Example 3 of Treas. Reg. 1.354-1(d) acknowledges the potential application of Section 302 to a single-company exchange of stock for securities.

One meaningful strength of the latter approach, is that it mitigates the inconsistent treatment of taxable versus tax-free transactions and certain other arbitrary results that do not further a discernable policy purpose, as illustrated by the following examples.[76]

> **Example 5**: In a $20 billion transaction, Acquiror, a public corporation, acquires Target, another public corporation, by having its wholly-owned Subsidiary merge with and into Target, with Target surviving in a Reverse Triangular Merger. Alternatively, the transaction could be structured as a merger of Target with and into Subsidiary, with Subsidiary surviving in a Forward Triangular Merger. Target shareholders receive consideration in the form of $2 billion in cash from Acquiror and $18 billion in stock of Acquiror.

Under the Notice, because Acquiror and Target are each a covered corporation, (i) the exchange by Target shareholders of their Target stock for the consideration is a repurchase by Target because an Acquisitive Reorganization is an Economically Similar Transaction, (ii) Target's Excise Tax Base is initially increased by $20 billion on account of the Acquisitive Reorganization, (iii) under the Qualifying Property Exception, Target's Excise Tax Base is reduced by the $18 billion of Acquiror stock to $2 billion and (iv) Acquiror's transfer of Acquiror stock is not an issuance for purposes of the Netting Rule, because (A) the stock of Acquiror constitutes property permitted to be received under Section 354 without the recognition of gain, (B) Acquiror stock is used by a covered corporation (i.e., Target) to repurchase its stock in a transaction that is a repurchase under Notice Section 3.04(4)(a)(i) and (C) the repurchase is not included in Target's Excise Tax Base because that repurchase meets the Qualifying Property Exception.[77] The transaction results in an Excise Tax to Target of $20 million.

> **Example 6**: The facts are the same as in Example 5, except that after the merger of the Subsidiary with Target, Target discontinued its business in such a manner that violated the continuity of business enterprise requirement.[78] Accordingly, the transaction does not qualify as a reorganization under Section 368.

Because the transaction in Example 6 is not an Economically Similar Transaction, it is not subject to the Excise Tax under the Notice (even though the applicability of the continuity of business enterprise rules is in no way relevant to the economic similarity or dissimilarity of the transaction to a Section 317(b) Redemption). Acquiror's Excise Tax Base is reduced by the aggregate fair market value of the Acquiror stock issued to Target shareholders under the Netting Rule.

> **Example 7:** The facts are the same as in Example 5, except that the transaction is effected through a double-dummy structure. Acquiror forms a wholly-owned

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[76] Proponents of the former approach to interpreting the statute might argue these types of inconsistent results are simply a byproduct of the statute Congress enacted, notwithstanding the difficulty of finding a policy justification for them.

[77] Notice Section 3.08(4)(d).

[78] Treas. Reg. 1.368-1(d).

corporate subsidiary, New Acquiror, which in turn forms two wholly-owned corporate subsidiaries, Merger Sub 1 and Merger Sub 2. Pursuant to an integrated plan, (i) Acquiror merges with Merger Sub 1, with Acquiror surviving, and all of Acquiror's shares are converted into New Acquiror shares under state law (First Merger), and (ii) Target merges with Merger Sub 2, with Target surviving, and Target's shares are converted into $18 billion of New Acquiror shares and $2 billion of cash (Second Merger). Alternatively, these mergers might be structured so that Merger Sub 1 and Merger Sub 2, rather than Acquiror and Target, survive (i.e., as Forward Triangular Mergers rather than Reverse Triangular Mergers).

Because each of the two transactions set forth in Example 7 constitutes an Acquisitive Reorganization, each is an Economically Similar Transaction under the Notice. The First Merger qualifies in its entirety for the Qualifying Property Exception and thus would not affect the Excise Tax Base of Target (but would affect the De Minimis Exception). The Second Merger would be treated in the same manner as in Example 5.

Example 8: The facts are the same as in Example 7, except that Target has a class of non-voting preferred stock worth $40,000. Merger Sub 2 merges with and into Target in the Second Merger, and this non-voting preferred stock is not affected by the merger. The First Merger is treated in the same manner as in Example 7. However, the Second Merger does not qualify as a Reverse Triangular Merger because Target shareholders did not exchange Target stock constituting control of Target (within the meaning of Section 368(c)) for New Acquiror voting shares. The two mergers, taken together, would qualify for Section 351 and, accordingly, Target shareholders would generally be subject to current income taxation only on the cash portion of the merger consideration, just as in Examples 5 and 7. However, in this case, because the Second Merger does not constitute an Economically Similar Transaction, no Excise Tax would result and the $18 billion of New Acquiror stock issued in the merger would be available to offset stock buybacks by New Acquiror.

Examples 5 through 8 are economically virtually indistinguishable. They differ only in respects that, while critical to the application of Subchapter C, do not appear relevant to the policies of the Excise Tax. It is not clear why some of these economically identical transactions should be viewed as "economically similar" to a Section 317(b) Redemption while others should not. Excluding all Acquisitive Reorganizations from the Excise Tax arguably would be faithful to the text of the statute while also eliminating arbitrary distinctions between transactional forms. While similar consistency between Acquisitive Reorganizations and Taxable Acquisitions could be achieved through the Source Rule, as discussed below, the Acquisitive Reorganization Exception avoids the need to address sourcing while upholding the policies of the Excise Tax and fostering simplicity and administrability. As an anti-avoidance measure, we recommend the approach proposed in the Prior Report whereby a "repurchase" would include the receipt of boot by shareholders in an Acquisitive Reorganization where Target controls Acquiror (or vice versa) prior to the Acquisitive Reorganization. In addition, as discussed in the Prior Report, an anti-

avoidance rule for cases where Target and Acquiror are under common control also could be considered.[79]

ii. The Source Rule

As an alternative to the Acquisitive Reorganization Exception, Treasury guidance could instead provide that the Excise Tax applies to Acquisitive Reorganizations only to the extent the consideration is cash (or other boot) that is sourced from Target (the "**Source Rule**" approach).[80]

The Source Rule is based on Section 4501's foundational principle that a corporation's redemption of its own stock should be subject to the Excise Tax. To the extent consideration in any purchase of Target's stock is attributable to a third party (i.e., Acquiror), such a transaction does not represent Target's redemption of its own stock and should not in principle be within the scope of the Excise Tax. The Source Rule accordingly draws a bright line: to the extent Target provided the consideration, that amount is taxed; to the extent Target did not provide the consideration, then we look no further to trace the cash. Without this bright line, the inquiry into the source of the cash becomes unmanageable. Moreover, this approach is consistent with the treatment of Taxable Acquisitions under the Excise Tax. Part V.D.1 above sets forth examples of the application of the Source Rule in the context of Taxable Acquisitions.

Under the Notice, Taxable Acquisitions are treated more favorably than Acquisitive Reorganizations, insofar as all boot in an Acquisitive Reorganization, irrespective of the source of such boot, is subject to the Excise Tax, whereas the Excise Tax applies to a Taxable Acquisition only to the extent the consideration is sourced from Target.

> **Example 9**: Acquiror wholly owns Subsidiary, a private corporation. In a transaction that qualifies as a Forward Triangular Merger, Target, a public corporation, merges with and into Subsidiary, with Subsidiary surviving. Target shareholders receive 40% of the consideration in the form of Acquiror stock and the remaining 60% in the form of cash, for a total consideration of $20 billion.

On these facts, pursuant to the Notice, the exchange by Target shareholders of their Target stock for the consideration is a repurchase by Target because a Forward Triangular Merger is an Economically Similar Transaction. Target's Aggregate Gross Repurchase FMV with respect to this transaction is $20 billion. Pursuant to the Qualifying Property Exception, the fair market value of the Target stock exchanged by Target shareholders for Acquiror stock (i.e., $8 billion) is a qualifying property repurchase, which reduces the Excise Tax Base to $12 billion ($20 billion repurchase - $8 billion Qualifying Property Exception = $12 billion). The Excise

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[79] S*ee* Prior Report pages 52-54 and 56 for a discussion of the so-called "Downstream Reorg Exception" and "Acquisitive Reorg Brother-Sister Exception."

[80] For purposes of the Source Rule, we believe that in a Forward Triangular Merger or Reverse Triangular Merger, to the extent Acquiror's merger subsidiary is a shell which borrows to pay a portion of the consideration, that portion of the consideration should be considered to be sourced from Target.

Tax amounts to $120 million. In addition, Acquiror's transfer of Acquiror stock to Target is not an issuance for purposes of the Netting Rule.[81]

> **Example 10**: Acquiror wholly owns Subsidiary. In a Taxable Acquisition, Subsidiary merges with and into Target, a public corporation, with Target surviving. Target shareholders receive 40% of the consideration in the form of Acquiror stock and the remaining 60% in the form of cash from Acquiror, for a total consideration of $20 billion.

On these facts, pursuant to the Notice, there is no repurchase within the meaning of Section 4501 because this is a Taxable Acquisition with Acquiror's cash being used to pay the consideration, so the Excise Tax does not apply. Under the Netting Rule, Acquiror's Excise Tax Base for that taxable year, if applicable, is reduced by the aggregate fair market value of Acquiror stock issued to Target shareholders (i.e., $8 billion).

The above two examples demonstrate the inconsistent treatment of two transactions that economically are very similar – in both cases, Acquiror purchases Target in exchange for the same amount of stock and cash consideration. It can be argued there is not a compelling reason for the Excise Tax to draw distinctions in the first instance that are based on income tax principles. Moreover, this distinction may create incentives at the margins to structure transactions as Taxable Acquisitions to avoid the Excise Tax.

The Source Rule approach would eliminate this distinction. Under this approach, to the extent the cash consideration in Example 9 is sourced from Acquiror, then the cash is not subject to Section 4501, and no Excise Tax would apply to the transaction. However, to the extent the cash consideration is sourced from Target, the Excise Tax would apply.

The Source Rule, however, can be seen to raise questions of administrability. In particular, the fungible nature of cash and the fact that target and acquiror operations often are integrated following a tax-free reorganization may present challenges. These difficulties are arguably compounded where a target operating corporation is merged directly into an acquiring operating corporation (although other forms of post-merger integration may present similar challenges).

These challenges, though, are not meaningfully different from other issues that exist and have been addressed in longstanding guidance under the corporate reorganization regime. For example, a version of the source rule is used to determine whether a target corporation's distribution of funds to its shareholders prior to a reorganization under Section 368(a)(1)(B) (a "**B Reorganization**" and, together with a Reverse Triangular Merger, an "**Acquisitive Stock Reorganization**") gives rise to boot.[82] In such cases, the source rule "stems from the view that

[81] Notice Section 3.08(4)(d).

[82] *See generally*, NYSBA Tax Section, Report No. 1158: "Report on Distributions in Connection with Acquisitions" (June 18, 2008) (hereinafter, the "**Source Rule Report**"); *see also* Source Rule Report, footnote 3 (describing the numerous authorities concluding that redemption of stock using cash sourced at target does not impact B Reorganization qualification but that cash sourced from acquiror would lead to boot that affects B Reorganization qualification); Rev. Rul. 68-285, 1968-1 C.B. 147 (redemption of dissenters using cash sourced at target was (….continued)

Sections 354, 356, 361 and 368 are organized around a single concept of boot as property that comes from Acquiror. This framework aims at taxing boot once, either at the corporate level or the shareholder level."[83] Additionally, Treasury regulations with respect to Reverse Triangular Mergers include a source rule for purposes of differentiating between the consideration used to acquire control (within the meaning of Section 368(c)) of the target corporation and the base for the "substantially all" test. Under these rules, funds sourced from the target corporation are taken into account for purposes of the "substantially all" test but not for purposes of measuring the acquisition of control.[84] Accordingly, there is precedent for administering a source rule effectively in the context of reorganizations.

A further possible challenge to the application of the Source Rule in the case of Acquisitive Asset Reorganizations is that in light of the applicability of Section 381 to asset reorganizations, such reorganizations should be conceptually analogized to single company reorganizations (i.e., effectively treating the acquiring and target corporations as a single corporation). Under this construct, whether boot is funded by the acquiring corporation or by the target corporation is not a significant differentiating factor. In either case, the net effect is the use of corporate value to repurchase corporate stock.

This position, however, could be seen as inappropriately blurring the distinctions between single company reorganizations and Acquisitive Reorganizations. For example, Acquisitive Reorganizations are subject to the continuity of interest and continuity of business enterprise tests, whereas single-company reorganizations are not, because of the need to ensure that reorganization policies are being upheld where two separate business with different shareholder bases are being combined.[85] The fact that Section 381 results in a carryover of tax attributes of a target corporation to an acquiror corporation arguably does not alter the fundamental economic nature of an Acquisitive Reorganization as the combination of two unrelated companies.

iii. The Reverse Triangular Merger Exception

A third approach is for Acquisitive Reorganizations to be subject to the Excise Tax, with an exception for Reverse Triangular Mergers (the "**Reverse Triangular Merger Exception**" approach). If Treasury were to continue to conclude that Acquisitive Reorganizations are within the scope of Section 4501, this approach would exclude Reverse Triangular Mergers from the application of the Excise Tax either entirely or in part through a limited application of the Source Rule (if Treasury does not adopt the Source Rule generally).

(continued….)

consistent with B Reorganization treatment, but the reorganization would fail if the acquiror paid the dissenters or reimbursed the target for such payment); Rev. Rul. 68-435, 1968-2 C.B. 155 (a dividend paid by target "from its own funds" to mirror a dividend paid by the acquiror that target shareholders would have received if the acquisition had not been delayed did not affect B Reorganization qualification).

[83] *See* Source Rule Report at page 16.

[84] *See* Treas. Reg. 1.368-2(j)(3)(iii), Treas. Reg. 1.368-2(j)(6), Example 3.

[85] *See* Treas. Reg. 1.368-2(m)(2).

Subchapter C principles do not treat the target corporation in an Acquisitive Stock Reorganization as having made a Deemed Liquidating Distribution. Accordingly, a Reverse Triangular Merger, like a B Reorganization, does not, under the applicable Subchapter C fiction, include any redemption by Target of its own shares. Moreover, a Reverse Triangular Merger is similar in economic effect to a B Reorganization – Acquiror purchases Target with consideration consisting largely or solely of Acquiror stock, and after the transaction, Target continues its corporate existence as a subsidiary of Acquiror. Thus, a Reverse Triangular Merger is the acquisition of Target shares by another party, not a deemed repurchase by Target of its own stock.

Nonetheless, the Notice does not treat the two types of Acquisitive Stock Reorganizations as economically similar, which creates tax consequences disconnected from the economic substance of the transaction.

> **Example 11**: The facts are the same as the Reverse Triangular Merger in Example 5, except that Target shareholders receive all of the voting stock of Acquiror in exchange for $20 billion of Target stock in a transaction that qualifies as a B Reorganization.

Compare the results under Example 11 with the Reverse Triangular Merger in Example 5: there, Target has an Excise Tax in the amount of $20 million and Acquiror's transfer of Acquiror stock to Target does not reduce Acquiror's Excise Tax Base because it is not an issuance for purposes of the Netting Rule; on the other hand, in Example 11, there is no Excise Tax because a B Reorganization is not an Economically Similar Transaction and Acquiror's transfer of Acquiror stock, which is an issuance for purposes of the Netting Rule, reduces its own Excise Tax Base for that taxable year by $20 billion.

We note that Reverse Triangular Mergers can include transactions in which Target stock is acquired by Target using its own funds in a manner that resembles a bootstrap Taxable Acquisition. For example, a Target with common and non-voting preferred stock outstanding could use its own cash to acquire the preferred stock as part of a transaction in which Acquiror acquires the common stock in exchange for Acquiror voting shares.[86] The preferred stock would not be treated as outstanding for purposes of testing whether control (for purposes of Section 368(c)) is acquired by Acquiror, and the Target funds used to acquire the preferred stock would be taken into account for purposes of the "substantially all" test of Treas. Reg 1.368-2(j)(iii). In light of the similarity between this Target-funded acquisition and the Taxable Acquisitions that the Notice treats as Section 317(b) Redemptions, it would be reasonable to treat Target stock acquired with Target funds in Reverse Triangular Mergers as subject to the Excise Tax under a modified version of the Source Rule.[87] Alternatively, because the "substantially all" test places

[86] *See* Treas. Reg. 1.368-2(j)(6), Example 3.

[87] This assumes that our recommendations for an M&A Exception (Part V.D), an Acquisitive Reorganization Exception (Part V.D.2.i) and the application of a Source Rule generally to Acquisitive Reorganizations (Part V.D.2.ii) have not been accepted.

strict limits on the amount of Target funds that may be used in a Reverse Triangular Merger, it would also be reasonable, and administratively simpler, to exclude Reverse Triangular Mergers from the Excise Tax altogether.

E. Distressed Companies

In the absence of further guidance in the Notice, and in response to the Notice's request for comments on whether special rules should be provided for bankrupt or troubled companies, the Tax Section recommends that distressed corporations should generally not be subject to the Excise Tax. We would look to provisions of the Bankruptcy Code and Section 108(a) for purposes of framing this exemption and therefore would exempt from the Excise Tax repurchases by covered corporations in a Title 11 case or in cases when the covered corporation is insolvent (the "**Distress Exception**").[88]

From a policy perspective, a distressed corporation undergoing reorganization is facing a number of difficult decisions regarding capitalization and value. Uncertainty surrounding the potential application of the Excise Tax would further burden decision-making and would give corporations an incremental incentive to reject otherwise equitable restructuring plans to the extent such plans would implicate the Excise Tax. In addition, as a matter of good policy, we believe that such periods of financial distress are not proper times in a company's life cycle for the government to be raising revenue. Moreover, as a practical matter, it is unlikely that an Excise Tax on distressed corporations would generate much revenue in the first instance.

In addition to the policies of Section 108,[89] the Distress Exception finds support in an analogous provision of the Bankruptcy Code. Section 1146(a) of the Bankruptcy Code provides that the issuance, transfer, or exchange of a security under a plan of reorganization may not be taxed under any law imposing a stamp tax or similar tax.[90] In the words of one bankruptcy court, "Congress enacted this provision to facilitate reorganization under a confirmed plan by giving debtors tax relief from certain transfer taxes."[91] In so exempting such transactions from tax, the

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[88] Although Section 108 is an income tax provision rather than an excise tax provision, we believe that, as an existing Code provision that addresses the taxation of distressed companies, it is a logical source for guidance for distressed companies regarding the Excise Tax. Moreover, as discussed below, Section 108's policies are not driven by income tax considerations but rather by concern for the economic health of a struggling enterprise, and we believe these same policies should be considered with respect to the application of the Excise Tax to a distressed corporation.

In view of the relevant policy goals, Treasury could consider expanding the Distress Exception beyond Title 11, to also cover "similar cases" within the meaning of Sections 368(a)(1)(G) and 368(a)(3)(A) and (D).

[89] H. Rept. No. 96-833, 96th Cong., 2nd Sess. (March 19, 1980) ("To preserve the debtor's 'fresh start' after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability . . . The committee believes that these attribute-reduction provisions of the bill give flexibility to the debtor to account for a debt discharge amount in a manner most favorable to the debtor's tax situation.").

[90] 11 U.S.C. §1146(a).

[91] *See In re Kerner Printing Co.*, 188 B.R. 121, 124 (Bankr. S.D.N.Y. 1995) (citations omitted); *see also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 281 (1977).

provision "reduces the obligations encumbering the property, thereby making a greater portion of the sale proceeds available to creditors and affords debtor a quick and efficient means of distributing and discharging its obligations under the plan."[92] To do otherwise may defeat these purposes and, in the words of another bankruptcy court, "circumvent the intent of the Bankruptcy Code."[93] The same logic applies to the Excise Tax, which, as an excise tax, resembles stamp and transfer taxes in its narrow and targeted scope. Exempting corporations that are undergoing plans of reorganization either in court or through out-of-court workouts would give such corporations the greatest means to discharge their obligations and emerge from reorganization in a position of relative strength.

The Distress Exception has the most relevant application in Title 11 cases where a corporation exchanges its equity for other property. It is possible, however, that such an exchange may occur in the out-of-court context as well.[94] When a corporation is undergoing restructuring out of court, we believe an equitable, and administrable, approach would be for the Distress Exception to apply if the corporation is insolvent (within the meaning of Section 108) immediately prior to the relevant transaction that would have been within the scope of the Excise Tax absent the exception. This proposed timing for testing would allow a corporation to look back and properly evaluate its status after a period of remove, as the Excise Tax is reportable and payable at the end of the first full quarter following the close of the taxpayer's relevant taxable year.[95]

We also note that the Notice specifically does not include G Reorganizations in its exclusive list of Economically Similar Transactions.[96] We assume this was intended to provide some relief to distressed corporations and this could be made clear by either (i) the adoption of the Distress Exception or (ii) the adoption of our recommendation above to clarify that Section 317(b) Redemptions include only transactions described in Part I of Subchapter C.

Finally, we note that corporations that are undergoing plans of reorganization in bankruptcy or out-of-court debt workouts may exchange debt for other property, such as new debt or equity in a restructured corporation. The Prior Report describes why the treatment of such exchanges is not entirely clear for purposes of the Excise Tax.[97] As indicated in that report, we recommend these exchanges not be subjected to the Excise Tax: this result could be achieved by application of the Distress Exception, in the case of debt classified as stock for U.S. federal income tax purposes, and by a straightforward reading of Section 4501 as applying only to equity, in the case of debt respected as such for income tax purposes.

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[92] *In re Kerner Printing Co.*, 188 B.R. 121, 124.

[93] *See CCA P'ship v. Dir. of Revenue (In re CCA P'ship)*, 70 B.R. 696, 698 (Bankr. D. Del. 1987).

[94] The proposed exception would apply, for example, where as part of an out-of-court workout an insolvent corporation repurchases some of its stock in exchange for contingent value rights or other property.

[95] Notice Section 4.

[96] Notice Section 3.04(4)(a).

[97] *See* Prior Report, page 41.

F. Foreign Corporations

1. Replacement of the Funding Rule

We recommend that guidance eliminate the Funding Rule and, instead, provide that Section 4501(d)(1) applies only when there is a repurchase of stock of an applicable foreign corporation by a specified affiliate that is (i) a domestic corporation, (ii) a CFC (as defined below) or (iii) an entity treated as a partnership, to the extent owned by a domestic corporation or a CFC.

As discussed above, the Notice in general provides bright-line rules that are intended to be easily administered by the IRS and readily complied with by taxpayers. We commend Treasury for this approach and, as discussed above, think it is appropriate in light of Section 4501's nature as an excise tax. A significant exception to Treasury's general approach is the Funding Rule. The Funding Rule, and in particular its *per se* element, breaks from the Notice's general approach of favoring clarity and administrability and instead creates a regime of substantial complexity. This is somewhat puzzling because the Funding Rule is aimed only at the application of the Excise Tax to foreign corporations, and foreign corporations do not appear to play a key role in the policies motivating Section 4501.

The statutory provision which the Funding Rule apparently is designed to implement, Section 4501(d)(1), by its terms appears to have a clearly delineated application. It is implicated "[i]n the case of an acquisition of stock of an applicable foreign corporation" by certain specified affiliates that have a U.S. connection. Section 4501 does not provide a definition of "acquisition," but the word appears to have a fairly straightforward meaning.[98] In the context of Section 4501, it calls to mind Section 317(b), which defines a redemption as a transaction in which a corporation "acquires" its stock from a shareholder in exchange for property.[99] In addition, Section 4501(c)(2)(A), which addresses acquisitions by subsidiaries of (domestic) covered corporations, provides that "[t]he acquisition of stock of a covered corporation" by a specified affiliate, from a person other than the covered corporation or a specified affiliate, is treated as a repurchase for purposes of Section 4501. There is no indication that "acquisition" in Section 4501(c)(2)(A) is intended to have a special meaning, or one that is different than in the similarly phrased provision in Section 4501(d)(1).[100]

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[98] *See generally Frontier Chevrolet Co. v. Comm'r*, 116 T.C. 289 (2001), *aff'd* 329 F.3d 1131 (9th Cir. 2003) ("The term 'acquisition' is defined as 'The gaining of possession or control over something' and 'Something acquired'. Black's Law Dictionary 24 (7th ed. 1999). The term 'redemption' is defined as 'The act or an instance of reclaiming or regaining possession by paying a specific price.' *Id*. at 1282. Redemption, in the context of securities, is defined as 'The reacquisition of a security by the issuer.' [citing to Section 317].")

[99] *See, e.g., H.J. Heinz Co. v. United States*, 99 AFTR.2d 2007-2940 (76 Fed. Cl. 570) (2007) (construing Section 317(b) and citing *Frontier Chevrolet*).

[100] We also note that Section 4501(d)(2) refers to "an acquisition of stock of a covered surrogate foreign corporation by a specified affiliate of such corporation." There is not an indication that "acquisition" has a different meaning here than in Sections 4501(c)(2)(A) or 4501(d)(1). In addition, a comparison of the structure of Section 4501(d)(1) and 4501(d)(2) is instructive. The latter provision applies to a foreign publicly-traded parent that is a surrogate foreign corporation under Section 7874(a)(2)(B), during the 10-year period after it has completed an inversion
(….continued)

Section 4501(d)(1) thus by its terms appears to cover a specific, clearly articulated type of transaction – an acquisition of stock of a foreign parent by a U.S.-connected affiliate (i.e., a transaction which results in such affiliate owning such stock). Further, there does not appear to be a policy reason for rules that extend significantly beyond this type of transaction, in order to implement the purposes of Section 4501(d)(1). As noted above, the Excise Tax generally appears to be intended to address perceived abuses resulting from stock repurchases, including the use of repurchases to improve financial metrics and stock performance in lieu of investing in a U.S. corporation's business operations and generating economic growth. In addition, repurchases generally enable assets to leave U.S. corporate solution in a manner that results in less shareholder-level tax than would a *pro rata* dividend, including in the cross-border context. That is, a repurchase generally results in (i) no U.S. withholding tax for foreign shareholders, (ii) the use by shareholders subject to U.S. taxation of their basis in the repurchased shares, and (iii) the non-realization of income by shareholders not participating in the repurchase.[101] In this respect, Congress may have concluded that where a publicly traded foreign corporation has a U.S. corporate subsidiary, an acquisition of the stock of the foreign parent corporation by its U.S. subsidiary potentially effects these results because cash of that subsidiary leaves U.S. corporate solution and is used to repurchase the stock of its publicly traded parent, without the United States having the opportunity to impose shareholder-level tax on a dividend from the U.S. corporation.[102] The Tax Section is not aware of other potential concerns that explain Section 4501(d)(1).

The Funding Rule, however, goes far beyond the transaction referenced in Section 4501(d)(1) to sweep into the purview of the Excise Tax a variety of intercompany transactions between the foreign parent (or its foreign subsidiaries) and the U.S. subsidiary even though the U.S. subsidiary itself never acquires, directly or indirectly, the stock of the foreign parent. Moreover, the compliance burden imposed by the Funding Rule appears to be disproportionate to any possible policy concern. Under the Funding Rule, one would have to trace through the structure and intercompany activities of an entire foreign-parented group, however large, in order to determine whether and to what extent a repurchase by the foreign parent or a foreign subsidiary is funded by a U.S. subsidiary rather than by assets or cash flow of foreign members of the group.[103] We believe that administering the Funding Rule will often be highly difficult, particularly in light of the fungibility of cash. Moreover, in our experience, it is unusual for a U.S. subsidiary to acquire stock of a foreign publicly traded parent from third-party shareholders

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transaction. In the case of such a parent, Congress provided that an acquisition of parent stock by the parent or <u>any</u> specified affiliate – foreign or U.S. – would be subject to Excise Tax. By contrast, in the case of all other foreign publicly-traded parent corporations, Congress decided in Section 4501(d)(1) to take a different approach, providing that only an acquisition of parent stock by applicable specified affiliates would result in Excise Tax.

[101] *See* Prior Report, footnotes 83-85.

[102] By comparison, Section 4501(d)(1) does not apply when an applicable foreign corporation owns (directly or through a disregarded entity) a U.S. branch and uses cash from that branch to repurchase its stock. In such cases, it often would be difficult to withdraw cash from the branch to use in this manner, without being subject to branch profits tax under Section 884.

[103] *See* Example 12 below.

of the parent, the transaction described in Section 4501(d)(1). It seems questionable to adopt a rule like the Funding Rule which, rather than operating as an anti-avoidance rule to prevent the Excise Tax from being circumvented in these few transactions, in effect becomes the primary operative rule, with far-reaching effect.

As noted above, particularly in the case of an excise tax, clear and straightforward rules are important. If Section 4501(d)(1) and its reference to an "acquisition" are construed in a straightforward manner, as referring to a transaction in which a U.S. corporate subsidiary acquires ownership of stock of the foreign parent, directly or through ownership of a lower-tier entity (as described below), this approach would provide an administrable rule that is consistent with the Source Rule.[104]

Where an applicable foreign corporation owns a U.S. corporate specified affiliate that, in turn, owns[105] over 50% of the stock of a foreign corporation that is a specified affiliate (such foreign specified affiliate, a "**CFC**"), we recommend that Treasury provide in guidance that Section 4501(d)(1) will apply whenever there is a purchase of stock of an applicable foreign corporation by such CFC. We believe a purchase by a CFC could be seen as an indirect purchase by the U.S. corporate specified affiliate (to the extent that a portion of the value of such U.S. specified affiliate corresponds to its ownership of the CFC), which would raise the same policy concerns discussed above.

In addition to CFCs, guidance should also provide that Section 4501(d)(1) applies to an acquisition of applicable foreign parent stock by a specified affiliate treated as a partnership, to the extent the partnership is owned by a domestic corporation. It is difficult to identify a reason relevant to the apparent purposes of Section 4501 for the Excise Tax to apply when a partnership (domestic or foreign) that is a specified affiliate of an applicable foreign corporation acquires stock of the foreign corporation, except in a case where a domestic corporation is treated for U.S. federal income tax purposes as a partner in that partnership. In such a case, the partnership's use of its assets in this manner could be seen as, indirectly, use of the U.S. corporate partner's assets, which raises the same policy considerations as discussed above. This logic would seem to apply to the extent of the percentage of partnership assets used to repurchase stock of the applicable foreign corporation that corresponds to the domestic corporate partner's percentage capital interest in the partnership.[106] The same approach could be extended to a partnership in which a

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[104] We note that there is an equitable argument for expanding the Netting Rule such that issuances of equity by a specified affiliate that is a U.S. corporation that would be taken into account under the Netting Rule if issued by a covered corporation should reduce the Excise Tax base that results from a repurchase by such entity (or by a member of the same consolidated group as such entity). While this rule strikes us as appealing in that it is equitable, we acknowledge it would create further complexity.

A narrower variation on such a rule would be to apply the Netting Rule when the U.S. specified affiliate (or, if it is a member of a consolidated group, a member of the consolidated group) uses stock of the foreign parent as consideration to pay for property or services in a transaction described in Treas. Reg. 1.1032-3. Such a rule would be in keeping with the approach taken by Congress in Sections 4501(d)(1)(C) and 4501(d)(2)(C).

[105] This is intended to refer to ownership under Section 958(a), and not Section 958(b).

[106] It would be appropriate for guidance to require a minimum percentage ownership of a partnership by U.S. corporations that must be met in order for the Excise Tax to apply.

CFC of a U.S. corporate specified affiliate owns an interest. By comparison, to the extent a foreign corporation (other than such a CFC) is a partner in the partnership, it is difficult to discern what purpose would be served by imposing the Excise Tax on the use of the foreign corporation's share of partnership assets to acquire stock of the applicable foreign corporation.[107]

If, after providing guidance under Section 4501(d)(1) to include acquisitions by CFCs and partnerships as and to the extent described above, Treasury believes a purpose-based anti-abuse rule is still necessary in order to backstop Section 4501(d)(1), that rule should be drafted in a manner that is clearer and more precisely targeted than the Funding Rule. In our view, such a rule should apply only to transactions with a view to avoiding Section 4501(d)(1) that achieve the economic effect of an acquisition by a U.S. corporate specified affiliate of stock of the foreign parent corporation, i.e., where the U.S. corporate specified affiliate ends up owning, either directly or else indirectly through a CFC (or, as described above, a partnership) an economic interest in stock of the foreign parent corporation.

2. Considerations If the Funding Rule Is Retained

If, contrary to our recommendation, the Funding Rule is retained, then there should not be a *per se* rule that the Excise Tax is automatically imposed if an acquisition or repurchase by a funded entity occurs within two years of the funding (other than a funding through distributions). The *per se* rule as currently drafted is overbroad and applies to transactions that in no way evidence a purpose of avoiding the Excise Tax – the *per se* rule does not require any temporal or actual connection between the cash or other property a foreign parent receives and cash or other property that is used in the repurchase. As a result, cash or other property transferred under arm's-length transactions and transactions occurring in the ordinary course of business (e.g., inventory sales, licenses) could possibly be subject to the *per se* rule. Such a broadly applied rule might regularly subject a corporation to the Excise Tax as a result of engaging in its normal business operations.

The following example shows some of the issues raised by the *per se* element of the Funding Rule:

> **Example 12**: Corporation X is an applicable foreign corporation. Corporation X has a U.S. subsidiary, Corporation Y, indirectly owned through five intermediate non-U.S. entities. At the start of year 1, Corporation X repurchases $1.1 million of its stock. In June of year 2, Corporation Y extends a $10 million loan to its direct parent, Corporation B. Later in year 2, Corporation B generates significant profits and distributes a cash dividend of $3 million up the chain to Corporation A, the direct subsidiary of Corporation X, and Corporation A extends a loan in the

[107] The Notice requests comments on circumstances in which a foreign partnership is an applicable specified affiliate with a domestic entity as a direct or indirect partner. In these cases, we think the domestic direct or indirect partner should be the entity that is required to file Form 720 and pay any Excise Tax. This approach would facilitate compliance and avoid burdening foreign entities with U.S. tax obligations that would be difficult to enforce. We think the same approach could apply when the partnership is domestic.

amount of $1.5 million to Corporation X. In year 3, Corporation X repays the $10 million loan it owes to Corporation Y.

In this example, there is a funding (other than a funding through distributions) to Corporation X that occurs within two years of a repurchase by Corporation X. Because cash is fungible, it would be difficult to establish that this funding is not a funding by an applicable specified affiliate (i.e., Corporation Y) as a loan to Corporation B, then a cash dividend up the chain of ownership, and lastly as a loan to Corporation X (and indeed, the Notice does not specify how to determine funding). Under the terms of the Notice and the *per se* element of the Funding Rule, it appears Section 4501 may apply to treat the stock that is repurchased by Corporation X as having been acquired by Corporation Y, and such acquisition would be subject to the Excise Tax. This would be the case even though there is no connection between the cash that originated in Corporation Y and the cash used to purchase the Corporation X stock. In addition, under the Notice, Excise Tax for year 1 will be due by April 30 of year 2.[108] The Notice does not provide rules explaining whether Corporation Y's Excise Tax is due at that time (on the theory that the relevant acquisition of Corporation X stock occurred in year 1)[109] or, instead, is due on April 30 of year 3 (on the theory that Corporation X's funding occurs in year 2, and such funding is a necessary element for a repurchase to be considered to have occurred under the Funding Rule). If the Excise Tax is due for year 2 (rather than year 1), it is not clear whether the Excise Tax is computed based on the fair market value on the date of the funding in year 2, rather than on the date when the stock was repurchased in year 1. Moreover, when the $10 million loan from Corporation Y to Corporation B is repaid, Corporation Y will have the same amount of cash as it did before the start of year 1, but will have paid an Excise Tax nonetheless. Although this arbitrary result could be mitigated by a refund or credit to the extent the loan that triggered the application of the Excise Tax is repaid, this would only serve to further complicate the administration of the Excise Tax. In sum, for clarity and administrability, guidance should eliminate the *per se* element of the Funding Rule.[110]

In addition, if Treasury retains the Funding Rule, we recommend that guidance provide explicit exceptions for transactions that do not implicate the policies of the Excise Tax, including payments of interest or principal on debt instruments issued by an applicable specified affiliate, payments in respect of arm's-length and ordinary course commercial transactions that involve applicable specified affiliates[111] and cash pooling transactions.[112] Furthermore, the Funding Rule

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[108] Notice Section 4.

[109] *See* Notice Section 3.06(1)(a). In Example 12, the funding transactions occur after the due date for Corporation X's Excise Tax return for year 1, with the result that it may be impossible for Corporation X to determine by such due date that Excise Tax will be owed for year 1.

[110] If, contrary to this recommendation, there continues to be a *per se* rule, then arguably the Netting Rule should be broadened to include any issuance of stock by an applicable specified affiliate that engages in a funding.

[111] Treasury has provided exceptions for transactions in the ordinary course of business in other circumstances involving the use of domestic assets by foreign corporations. *See, e.g.*, Treas. Reg. 1.956-2(b) (providing a list of exceptions for what constitutes "United States property" under Section 956(a)). *See also* Treas. Reg. 1.385-3(b)(3)(vii)(B) (providing an exception, from the recasting of a debt instrument into equity under certain conditions, for certain ordinary course loans). We reference the regulations under Section 956 and Section 385 not because we think those sections are appropriate places from which to develop a framework for the regulations implementing

(….continued)

should be drafted in a manner that acknowledges that if an applicable foreign corporation has material sources of funds other than funding transactions by its U.S. subsidiary, it is fair to view its repurchase of stock as attributable at least in part to those other sources of funds.[113]

Cash pooling provides an additional useful illustration of the over-breadth of the Funding Rule without adequate exceptions, particularly if the Funding Rule continues to have a *per se* element. Cash pooling is a cash management arrangement that allows multinational corporate groups to maximize the use of internal funds through centralizing such funds at one designated entity (such entity, the "**Cash Pool Vehicle**"). Cash pooling generally involves excess cash from each company within a corporate group being physically "swept" into a Cash Pool Vehicle on a regular basis (e.g., on a daily basis at close of business). The sweeps typically take the form of loans from operating entities that generate the cash to a holding company that acts as the Cash Pool Vehicle.[114]

If the Cash Pool Vehicle is an applicable foreign corporation, then all funds that are swept up from U.S. subsidiaries to the Cash Pool Vehicle in the ordinary course of business could potentially be viewed as funding an acquisition by the Cash Pool Vehicle (or, possibly, by a foreign affiliate that receives funds from the Cash Pool Vehicle) of the foreign parent's stock, for purposes of the Funding Rule. This would potentially mean that every foreign-parented multinational group with U.S. subsidiaries and a Cash Pool Vehicle in a regular cash pooling arrangement would routinely attract the Excise Tax. Moreover, as noted above, the Notice has no rules for how to measure funding and when to test funding, such that it would be impossible for multinational groups to set up monitoring systems.

(continued….)

Section 4501(d)(1). Indeed, those sections are supported by complex rules (and then exceptions to these rules), bringing significant compliance burdens and enforcement challenges that we think would not be well placed for an excise tax. It would, in our view, be anomalous if Section 4501(d)(1), an ancillary part of Section 4501, was supported by a rule with the potential sweeping breadth of the Funding Rule, necessitating a series of exceptions for ordinary course transactions not implicating the policies behind the Excise Tax, and resulting in the most complex set of regulations issued under Section 4501. However, if Treasury were to proceed with the Funding Rule and, in particular, one with a *per se* element then we think that adequate exceptions, such as those provided in the regulations under Section 956 and Section 385, would be critical to making it workable.

[112] Treasury has in other circumstances provided special rules to address the issues raised by cash pooling arrangements. *See, e.g.*, Treas. Reg. 1.385-3(b)(3)(vii)(A)(1) (providing an exception from the recasting of a debt instrument into equity under certain conditions for certain short-term funding arrangements, including between expanded group members).

[113] A highly simplistic rule might be that if the applicable foreign corporation's investment in U.S. subsidiaries represents a minority of the applicable foreign corporation's assets, then the applicable foreign corporation's repurchase is deemed to be funded first from sources other than U.S. subsidiaries' funding transactions.

[114] *See* OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration ¶10.113, (Revised 2022).

G. Liquidation

We agree with the Notice's treatment of distributions in complete liquidation of a corporation under Section 331 *or* Section 332(a) as transactions that are not economically similar to a Section 317(b) Redemption. As noted in the Prior Report, liquidations under Sections 331 and 332(a) are economically different in kind from redemptions by corporations that continue to exist after the redemption – these liquidations are not a return of capital from an ongoing venture and there is no policy concern that such liquidations artificially inflate financial metrics when the corporation ceases to exist.[115]

While we think the Notice, taken together with existing law, is reasonably clear in this area, we understand that some questions have arisen as to the meaning of "complete liquidation" because the exception in the Notice in relevant part turns on qualification for Section 331, and Section 331 requires a "complete liquidation." In particular, some have questioned whether this exemption will apply when there are multiple classes of stock and not all classes receive consideration in exchange for their shares.[116]

The source of this question is Section 346. Section 346 provides that "a distribution shall be treated as a complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan."[117] We interpret the text of Section 346 as describing a transaction type that qualifies as a complete liquidation, not as providing the sole type of transaction that may qualify. We note in particular that Section 346 includes no language limiting complete liquidations to those described in Section 346. Our interpretation finds support in the legislative history to Section 346, which provides that the section was intended to expand the scope of a "complete liquidation" and narrow that of a "partial liquidation" in order to address a specific loophole.[118]

Consistent with our interpretation, the Treasury does not look to Section 346 for a definition of "complete liquidation" for purposes of Section 331. In proposed regulations issued on so-called "no net value" transfers ("**No Net Value Proposed Regulations**"), Treasury distinguishes between the treatment of a subsidiary liquidation under Section 332 when the subsidiary does not have enough assets to make a distribution on each class of its stock and its

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[115] *See* Prior Report, page 63.

[116] This issue could have relevance, for example, for liquidating SPACs with multiple classes of stock. *See also* Section 4501(f), which contemplates special treatment for "special classes of stock."

[117] Section 346(a).

[118] *See* 128 Cong. Rec. 8965 (May 6, 1982) (describing a situation whereby in a partial liquidation of an acquired corporation, the acquiror corporation was able to receive stepped-up basis in certain of the acquired corporation's assets, providing an opportunity to gain new depreciation deductions, while deferring tax on recapture gains and other taxable items by postponing complete liquidation of the acquired corporation); *see also* S. Rept. No. 97-494, Vol. 1, 97th Cong., 2nd Sess. (July 12, 1982) ("The partial liquidation rules allow unwarranted selectivity when one corporation has acquired control of another. A stepped-up basis for selected assets with little or no tax consequences can be combined with a continuation of the acquired entity, provided a distribution of the selected assets satisfies the corporate contraction standard.").

view with respect to the same fact pattern under Section 331.[119] The No Net Value Proposed Regulations incorporated the holdings of *Commissioner v. Spaulding Bakeries, Inc.* and *H.K. Porter Co., Inc. and Subsidiaries*, providing that Section 332 applies only when the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidation corporation.[120] Importantly, the No Net Value Proposed Regulations further stated that if Section 332 does not apply because a liquidating distribution is not made on each class of stock, Section 331 may apply with respect to the stock that receives partial payment.[121] In other words, Treasury believed that Section 331 applied to the liquidating distribution on the preferred stock, notwithstanding that no distribution on the common stock was made. Although the No Net Value Proposed Regulations were withdrawn in 2017, Treasury stated that *Spaulding* and *H.K. Porter*, among other authorities, continued to reflect the Treasury's position with respect to Section 332.[122]

The courts similarly do not take Section 346 as the source for defining a "complete liquidation" for purposes of Section 331. Instead, they refer to a three-factor test developed through case law:[123] (i) there must be a manifest intention to liquidate, (ii) there must be a continuing purpose to terminate corporate affairs and (iii) the corporation's activities must be directed to such termination.[124]

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[119] *See* Prop. Treas. Reg. 1.332-2, 26 CFR Part 1, REG-163314-03, "Transactions Involving Transfer of No Net Value" (March 10, 2005).

[120] *See id.* at 19 ("The proposed regulations clarify that section 332 applies only to those cases in which the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation, an interpretation consistent with the Second Circuit's holding in *Spaulding Bakeries* and the Tax Court's holding in *H. K. Porter*."). *See also* 252 F.2d 693 (2d Cir. 1958), aff'g 27 T.C. 684 (1957); 87 T.C. 689 (1986).

[121] *See id.* ("The proposed regulations also confirm that when the liquidation fails to qualify under section 332 because the recipient corporation did not receive at least partial payment for each class of stock but did receive at least partial payment for at least one class of stock, the transaction may qualify as a corporate reorganization under section 368."). The No Net Value Proposed Regulations also provided an example where Parent owns all the outstanding preferred and common stock of Sub. The fair market value of Sub's assets exceeds the amount of its liabilities but does not exceed the liquidation preference on Sub's preferred stock. Parent receives partial payment for its Sub preferred stock but receives nothing for its Sub common stock. The example concludes that (i) Section 332 does not apply because the distribution is not with respect to each class of Sub's stock, (ii) Parent is entitled to a worthless security deduction for its Sub common stock, and (iii) if the transaction does not qualify as a reorganization, Parent will recognize gain or loss on its Sub preferred stock under Section 331.

[122] *See* 82 FR 32281, REG-139633-08, "Transactions Involving the Transfer of No Net Value," (July 13, 2017) ("With respect to section 332, the holdings of *H.K. Porter Co.* v. *Commissioner,* 87 T.C. 689 (1986), *Spaulding Bakeries Inc.* v. *Commissioner,* 27 T.C. 684 (1957), *aff'd,* 252 F.2d 293 (2d Cir., 1958), *H.G. Hill Stores, Inc.* v. *Commissioner,* 44 B.T.A. 1182 (1941) . . . continue to reflect the position of the Treasury Department and the IRS."). Treasury also affirmed the view that a complete liquidation under Section 331 does not require a distribution with respect to each class of shares in Chief Counsel Advice 200706011.

[123] *See Earle E. Murphy v. Commissioner*, T.C. Memo 1996-59.

[124] *See Maguire v. Commissioner*, 50 T.C. 130 (1968); *see also*, Bittker & Eustice, *supra* note 67, ¶ 10.10[2] ("The Tax Court, however, generally applies a three-pronged test").

Accordingly, and notwithstanding that we think the Notice and current law adequately address this issue, guidance would be welcome in this area to confirm that the exception to the Excise Tax for Section 331 transactions does not require each class of shares to receive consideration in the liquidation.

H. Other Issues

1. Transitional Rules

The Tax Section continues to endorse the recommendations in the Prior Report with respect to transitional guidance.[125]

2. Covered Corporation Status

The Notice requests comments on when a corporation should be treated as becoming or ceasing to be a covered corporation.[126] We believe that the determination of a corporation's status as a "covered corporation" should be made immediately prior to a repurchase transaction, such that a public company in a going private transaction will be a covered corporation, but a private company that becomes public pursuant to the transaction is not a covered corporation. Similarly, the Excise Tax Base of a corporation that becomes a covered corporation during its taxable year (for example, as a result of an initial public offering) should be increased only for Section 317(b) Redemptions and Economically Similar Transactions occurring on or after the date such corporation becomes a covered corporation. As a matter of symmetry, only stock issued by a corporation on or after the date that it becomes a covered corporation should count as issued during such covered corporation's taxable year for purposes of applying the Netting Rule. Finally, consistent with the income tax treatment of a foreign corporation that domesticates in an F Reorganization, further guidance should clarify that such a corporation is not a domestic corporation for purposes of Section 4501 until the day after such reorganization occurs.[127] This is an important clarification for foreign SPACs, which typically domesticate in connection with combining with a domestic business. As with the Source Rule, clear guidance is paramount with respect to these matters.

3. Netting Rule for Specified Affiliates

As discussed above, the Notice added the Specified Affiliate Exception to the Netting Rule. The Specified Affiliate Exception provides that stock issued by a covered corporation to a specified affiliate is not treated as issued. The Netting Rule, as set forth in Section 4501, does not include such an exception; rather, Section 4501 simply provides that the Excise Tax Base is "reduced by the fair market value of any stock issued by the covered corporation during the taxable year."[128]

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[125] *See* Prior Report, pages 66-68.

[126] Notice Section 6.02(2).

[127] Treas. Reg. 1.367(b)-2(f)(4).

[128] Section 4501(c)(3).

The Specified Affiliate Exception was presumably intended as an anti-abuse rule to prevent covered corporations from eroding their Excise Tax Base by creating hook stock through issuances to affiliates. This is a sensible rule. However, the Specified Affiliate Exception is inconsistent with Section 4501 and creates inappropriate results when stock of the covered corporation that is issued to a specified affiliate is used by the specified affiliate in a third-party transaction.

> **Example 13**: Acquiror is a covered corporation that repurchases its own stock with a fair market value of $2 million. In the same taxable year, Acquiror purchases a piece of land in exchange for stock of Acquiror with a fair market value of $2 million.

> **Example 14**: The facts are the same as in Example 13, except that the land is purchased instead by Acquiror's subsidiary in exchange for Acquiror stock with a fair market value of $2 million.

> **Example 15**: The facts are the same as in Example 13, except that, after Acquiror purchases the land with Acquiror stock, it contributes the land to its subsidiary.

In Example 13, the issuance of Acquiror stock with a fair market value of $2 million is an issuance for purposes of the Netting Rule, which reduces Acquiror's Excise Tax Base to $0. Acquiror has no Excise Tax liability for the taxable year. In Example 14, however, the issuance of Acquiror stock may not be an issuance for purposes of the Netting Rule under the Specified Affiliate Exception.[129] Acquiror's Excise Tax Base is $2 million and its Excise Tax liability for that taxable year is $20,000 ($2 million × 1% = $20,000). The results in Example 15 are the same as in Example 13.

We do not believe that Congress intended the result in Example 14, which is inconsistent with Section 4501 and its policies, because the covered corporation stock has been issued and is no longer in the hands of the specified affiliate. Moreover, we do not believe a taxpayer should be forced to undertake the approach of Example 15 in order to achieve a result that is consistent with the policies of Section 4501. Accordingly, we recommend that Treasury clarify that the Specified Affiliate Exception to the Netting Rule applies only to the extent the covered corporation stock is held by the specified affiliate.

[129] Notice Section 3.08(4)(c) ("Stock issued by a covered corporation to a specified affiliate of the covered corporation is not treated as issued.").

Appendix – Prior Report

Report No. 1469

New York State Bar Association Tax Section

Report on the Section 4501 Excise Tax on Repurchases of Corporate Stock

November 1, 2022

TABLE OF CONTENTS

I. Introduction **1**
II. Summary of Principal Recommendations **1**
III. Background on Section 4501 ..... **3**
A. Basic Rule: “Repurchases” by “Covered Corporations” 3
B. “Special Rules” for Certain Foreign Corporations 5
1. Applicable Foreign Corporations 5
2. Covered Surrogate Foreign Corporations 6
C. The Netting Rule and the Modified Netting Rules 7
D. Repurchases Excluded from the Excise Tax 8
1. Reorganization Exception 8
2. Employee Plan Exception 8
3. De Minimis Exception 9
4. Dealer Exception 9
5. RIC and REIT Exception 9
6. Dividend Exception 9
E. Treasury’s Authority for Regulations and Other Guidance 10
F. Procedural Rules for the Excise Tax 10
1. Tax Returns and Payment 10
2. Tax Controversy Matters 11
(a) IRS Appeals 11
(b) Litigation Procedure 11
(c) Statute of Limitations 12
IV. Policy Background for the Excise Tax **12**
V. Potential Topics and Recommendations for Treasury Guidance **16**
A. Principles for Excise Tax Guidance 16
B. General Netting Rule Guidance 18
1. Instrument Type Matching Principle 19
2. Certain Stock Issuances and Exchanges in Respect of Existing Equity 19
3. When a Covered Instrument Is Treated as Issued; Coordination with the Employee Plan Exception 21
4. Application of the Netting Rule to 2022-2023 Fiscal Year Taxpayers 22
C. General Exclusion for Pro Rata Transactions 23
D. Section 301 Distributions; Section 302(d) Redemptions; Related Substantiation Issues 24
1. Actual Section 301(c)(2)-(3) Distributions 24
2. Deemed Section 301(c)(2)-(3) Distributions 25
3. Substantiating Qualification for the Dividend Exception 25
E. Treatment of Specific Types of Instruments 26
1. Stock Options, Warrants, and Other Option-Like Instruments 26
(a) Threshold Treatment of Option Contracts for Excise Tax Purposes 27
(b) Physical and Net Cash Settlement of Option Contracts 28

(i) Physical Settlement of Option Contracts 28
(ii) Net Cash Settlement of Option Contracts 30
2. Straight Preferred Stock 34
3. Convertible and Other Participating Preferred Stock 36
4. Tracking Stock 38
5. Convertible Debt 39
6. Distressed Debt 41
F. Extraordinary Transactions 42
1. Reorganizations 42
(a) Scope of the Reorganization Exception 42
(i) General Scope of the Reorganization Exception 42
(ii) The Reorganization Exception for Section 355 Transactions 45
(b) How the Excise Tax Applies to Reorganizations to the Extent Not Eligible for the Reorganization Exception 47
(i) Boot in Equity Recapitalizations 48
(ii) Boot in Acquisitive Asset Reorganizations 49
(iii) Boot in Acquisitive Stock Reorganizations 55
(iv) Boot in Divisive D Reorganizations and Other Section 355 Transactions 56
(v) Straight Preferred Stock Other Than NQPS in Reorganizations 57
2. Cash in Lieu of Fractional Shares in a Reorganization 58
(a) Basic Background 58
(b) Recommended Approach 58
3. Taxable Acquisitions 59
(a) Bootstrap Acquisitions 59
(b) Section 304(a)(1) Transactions 60
4. Section 331 Liquidations 62
5. Partial Liquidations 63
6. Considerations for SPACs 64
G. Other Issues 66
1. Effective Date and Transition Relief 66
(a) Accelerated Share Repurchases 66
(b) Transitional Guidance 67
2. "Stock of Which Is Traded on an Established Securities Market" for Section 4501(b) 68
3. Valuation for Purposes of Section 4501(a) and the Netting Rule 69
(a) In General 69
(b) Publicly Traded Stock 70
(c) Privately Owned Stock 70
(d) Alternative Annual Valuation Convention 71
4. Certain Issues Under Section 4501(d) 71
(a) Domestic Partners of Foreign Partnerships that Are Specified Affiliates 72

(b) Treatment of Surrogate Foreign Corporations that Are Domestic Under Section 7874(b)....................72
(c) Modified Netting Rule for Applicable Foreign Corporations........73
(d) Modified Netting Rule for Covered Surrogate Foreign Corporations....................73
(e) SFC Related-Party Acquisitions....................74
5. The Employee Plan Exception....................75
6. Overall Ordering Rule for the Netting Rule and Section 4501(e) Exceptions....................76
7. Procedural Issues....................77

Report No. 1469

Report on the Section 4501 Excise Tax on Repurchases of Corporate Stock

I. Introduction

This Report[1] analyzes section 4501(a), which was enacted as part of the law commonly known as the "Inflation Reduction Act of 2022."[2] Section 4501(a) imposes a new excise tax (the "**Excise Tax**") on certain repurchases of corporate stock.[3]

Part II summarizes our principal recommendations for guidance from the Department of the Treasury ("**Treasury**," including, as applicable, the Internal Revenue Service (the "**IRS**")) with respect to the Excise Tax. Part III provides background on section 4501 and related procedural rules, and Part IV describes the policy considerations that appear to have motivated the Excise Tax, based on the statute and legislative history. Part V then analyzes potential topics for Treasury guidance related to the Excise Tax; presents different approaches that Treasury guidance could take in certain areas; and offers our recommended approaches.

II. Summary of Principal Recommendations

Section 4501 presents numerous important issues that will need to be addressed by Treasury guidance. As a general matter, we recommend that more immediate guidance—which could take the form of an IRS Notice ideally issued before the effective date for the Excise Tax, as well as other IRS Notices in the near future—address the most pressing issues that are most critical to the efficient functioning of U.S. capital markets. Those issues include the treatment of various forms of preferred stock, equity-linked financial instruments such as options and convertible debt, acquisitive and divisive reorganizations and various other M&A transactions, and section 331 liquidations, as well as potential transition relief.

We provide recommendations for guidance on these and other topics in Part V below. In particular, we provide recommendations for anti-avoidance rules; for various types of distributions, redemptions, extraordinary transactions, and financial instruments to which we

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1 The principal authors of this Report are Vadim Mahmoudov, David Rievman, Thomas Wood, David Berke, and Gianluca Darena. Substantial research and drafting assistance was provided by Ana Maganto Ramirez and Caitlin Hird. Helpful comments were received from William Alexander, Lee Allison, Daniel Altman, Eric Behl-Remijan, Kimberly Blanchard, Bora Bozkurt, Robert Cassanos, Olivia Coates, Tijana Dvornic, Jason Factor, Edward Gonzalez, Martin Hamilton, Kevin Jacobs, Shane Kiggen, Adam Kool, Stephen Land, Jiyeon Lee-Lim, Jeffrey Maddrey, David Miller, Richard Nugent, Deborah Paul, Andrew Park, Yaron Reich, Rachel Reisberg, Stuart Rosow, Michael Schler, David Schnabel, Jodi Schwartz, Karen Gilbreath Sowell, Linda Swartz, Joseph Tootle, Shun Tosaka, Philip Wagman, Gordon Warnke, Sara Zablotney, and Libin Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

2 H.R. 5376, An Act To Provide for Reconciliation Pursuant To Title II of S. Con. Res. 14 [hereinafter Inflation Reduction Act of 2022], section 10201 (2022).

3 Except as otherwise indicated, all references to "section" and "Treas. Reg." refer, respectively, to the Internal Revenue Code of 1986, as amended (the "**Code**"), and the Treasury Regulations promulgated thereunder.

believe the Excise Tax should and should not apply; and for other key statutory concepts that we believe warrant guidance or clarification. Our principal recommendations include the following:

1. Guidance should impose limits on the scope of the "netting rule" in section 4501(c)(3), in particular to address potential strategies involving actual or deemed issuances of stock that could otherwise reduce or eliminate Excise Tax liability with relative ease.[4]

2. Guidance should confirm that the Excise Tax does not apply to non-redemptive distributions under section 301(c)(2)-(3).[5]

3. Guidance should exclude 100% pro rata redemptions from the scope of the Excise Tax, and should also specify the circumstances in which section 302(d) redemptions that are not 100% pro rata do or do not constitute repurchases.[6]

4. Guidance should clarify how the Excise Tax applies to options. As a general matter, unexercised options should not be treated as "stock" for purposes of the Excise Tax.[7]

5. Guidance should exclude redemptions of Straight Preferred Stock (as defined below) from the scope of the Excise Tax, but should *not* exclude participating preferred stock (including convertible preferred stock).[8]

6. Guidance should clarify that, in general, convertible debt and distressed debt are not "stock" subject to the Excise Tax.[9]

7. Guidance should clarify the scope of the "reorganization exception" in section 4501(e)(1). Guidance should also provide that payments ineligible for the reorganization exception that are made in acquisitive and divisive reorganizations and in certain other M&A transactions should not be subject to the Excise Tax, except in certain circumstances as appropriate to prevent avoidance.[10]

8. Guidance should generally exclude section 331 liquidations and certain partial liquidations from the scope of the Excise Tax.[11]

9. We do not recommend a blanket exemption for redemptions by special purpose acquisition companies ("**SPACs**"), but Treasury could consider rules for applying the

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[4] *See infra* Part V.B.

[5] *See infra* Part V.D.1.

[6] *See infra* Part V.C & V.D.2.

[7] *See infra* Part V.E.1.

[8] *See infra* Part V.E.2-3.

[9] *See infra* Part V.E.5-6.

[10] *See infra* Part V.F.1-3.

[11] *See infra* Part V.F.4-5.

Excise Tax to certain SPAC-specific situations in light of the particular characteristics of SPACs.[12]

10. Guidance should clarify how the effective date for the Excise Tax relates to accelerated share repurchase programs, and transitional guidance should be considered for certain instruments issued, entities formed, and transactions agreed to prior to the enactment of the Excise Tax.[13]

11. Guidance should clarify the scope of "covered corporations" subject to the Excise Tax and the valuation principles that apply for determining the base of the Excise Tax.[14]

12. Guidance should clarify how the Excise Tax applies to foreign corporations under section 4501(d).[15]

13. Guidance should clarify how to apply the Excise Tax exception for contributions to employee plans under section 4501(e)(2).[16]

14. Guidance should provide an overall "ordering rule" for computing liability for the Excise Tax.[17]

15. Guidance should address key procedural issues for tax return filing and tax payment with respect to the Excise Tax.[18]

A substantial majority of the Executive Committee of the NYSBA Tax Section supports recommendations 3 and 7. However, the concept of a stock "repurchase" could be construed more broadly than is reflected in these two recommendations based on a different interpretive approach. Recommendations 3 and 7 are based on a somewhat narrower interpretive approach to section 4501 that places more emphasis on its underlying policies and purposes.[19]

III. Background on Section 4501

A. *Basic Rule: "Repurchases" by "Covered Corporations"*

Section 4501(a) imposes an excise tax on certain corporations in an amount equal to "1 percent of the fair market value of any stock of the corporation which is repurchased by such

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[12] *See infra* Part V.F.6.

[13] *See infra* Part V.G.1.

[14] *See infra* Part V.G.2-3.

[15] *See infra* Part V.G.4.

[16] *See infra* Part V.G.5.

[17] *See infra* Part V.G.6.

[18] *See infra* Part V.G.7.

[19] For a discussion of these two interpretive approaches, see *infra* Part V.A.

corporation during the taxable year."[20] The Excise Tax is non-deductible for federal income tax purposes.[21] It applies to "repurchases" that occur after December 31, 2022.[22]

Specifically, the Excise Tax applies to a "repurchase" by a "covered corporation"—defined as a "domestic corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1))"[23]—of the covered corporation's stock. The Excise Tax also applies to an acquisition of the covered corporation's stock by a "specified affiliate" of the covered corporation, from a person *other than* the covered corporation or another specified affiliate.[24]

For this purpose, a "specified affiliate" is defined, with respect to a covered corporation, as:

> (i) any corporation more than 50 percent of the stock of which is owned (by vote or by value), directly or indirectly, by such corporation, and (ii) any partnership more than 50 percent of the capital interests or profits interests of which is held, directly or indirectly, by such corporation.[25]

Thus, a covered corporation's "specified affiliates" are corporations and partnerships directly or indirectly controlled by the covered corporation, with "control" generally defined as equity ownership of greater than 50 percent.[26]

A "repurchase" is defined as: (i) a redemption (within the meaning of section 317(b)) of stock of a covered corporation (a "**Section 317(b) Redemption**"), and (ii) any transaction "determined by the Secretary to be economically similar" to a Section 317(b) Redemption.[27]

Section 317(b), in turn, defines a redemption "[f]or purposes of this part" (i.e., for purposes of sections 301-318) as a transaction in which a "corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired,

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[20] Section 4501(a).

[21] Inflation Reduction Act of 2022, section 10201(b) (2022) (providing that "[p]aragraph (6) of section 275(a) is amended by inserting '37,' before '41'," thereby making the Excise Tax non-deductible for federal income tax purposes). *See* section 275(a) ("No deduction shall be allowed for the following taxes . . . .").

[22] Inflation Reduction Act of 2022, section 10201(d) ("The amendments made by this section shall apply to repurchases (within the meaning of section 4501(c) of the Internal Revenue Code of 1986, as added by this section) of stock after December 31, 2022.").

[23] Section 4501(b).

[24] Section 4501(c)(2)(A).

[25] Section 4501(c)(2)(B).

[26] As measured "by vote or by value" for corporate specified affiliates and by reference to "capital interests or profits interests" for partnership specified affiliates. Section 4501(c)(2)(B).

The Excise Tax also applies to repurchases of stock of foreign corporations in certain circumstances, as described in Part III.B below.

[27] Section 4501(c)(1).

or held as treasury stock."[28] The second prong of the "repurchase" definition provides Treasury with authority to define "repurchase" to include transactions that Treasury determines to be "economically similar" to Section 317(b) Redemptions of the stock of a covered corporation.[29]

When a specified affiliate acquires stock of a related covered corporation, that acquisition is *not*, in form, a Section 317(b) Redemption, which requires the acquiring corporation to acquire "its [own] stock" in exchange for property.[30] Accordingly, to apply the Excise Tax to such acquisitions by specified affiliates, section 4501(c)(2)(A) provides:

> The acquisition of stock of a covered corporation by a specified affiliate of such covered corporation, from a person who is not the covered corporation or a specified affiliate of such covered corporation, shall be treated as a repurchase of the stock of the covered corporation by such covered corporation.[31]

Thus, the specified affiliate's "acquisition" of the covered corporation's stock is *deemed* to be a repurchase by the covered corporation. Although the term "acquisition" is not defined in the statute, it presumably refers to a specified affiliate's receipt of the covered corporation's stock in a transaction that, if the specified affiliate were the covered corporation, would constitute a "repurchase" by the covered corporation within the meaning of section 4501(c)(2). In this Report, we refer to the entities that can repurchase or acquire stock in a manner that triggers potential Excise Tax liability collectively as "**Applicable Entities**."

B. *"Special Rules" for Certain Foreign Corporations*

Section 4501(d) provides two sets of rules for applying the Excise Tax to stock repurchases or acquisitions by or on behalf of certain foreign corporations: (i) "applicable foreign corporations" and (ii) "covered surrogate foreign corporations."

1. *Applicable Foreign Corporations*

First, the Excise Tax can apply when a specified affiliate of an applicable foreign corporation acquires stock of the applicable foreign corporation "from a person who is not the applicable foreign corporation or a specified affiliate of such applicable foreign corporation."[32] An applicable foreign corporation is a "foreign corporation the stock of which is traded on an

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[28] Section 317(b). For purposes of this definition, "property" is defined as all property other than "stock in the corporation making the [redemption] (or rights to acquire such stock)." Section 317(a).

[29] The term "economically similar" is used elsewhere in the Code and Treasury Regulations, but as a general matter, we do not view those other uses as helpful to interpreting the appropriate application of the concept for the Excise Tax. *See, e.g.*, section 470(f)(3) (definition of "lender"); Treas. Reg. 1.199A-5(b)(2)(vii) (services performed in the field of consulting); Temp. Treas. Reg. 1.448-1T(e)(4)(iv) (same); Treas. Reg. 1.482-9(h) (unspecified methods in connection with controlled services transactions).

[30] Section 317(b). *But see* section 304(a)(2).

[31] Section 4501(c)(2)(A).

[32] Section 4501(d)(1).

established securities market (within the meaning of section 7704(b)(1))"[33]—in other words, the foreign equivalent of a covered corporation.

The Excise Tax does not apply to a specified affiliate's acquisition of an applicable foreign corporation's stock if the specified affiliate is "a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner)."[34] In other words, for an applicable foreign corporation, the Excise Tax can generally apply only if a specified affiliate treated as a *domestic* entity repurchases the applicable foreign corporation's stock. When such a domestic specified affiliate acquires the applicable foreign corporation's stock in this manner, section 4501(d)(1) treats that acquisition as a repurchase by a covered corporation by providing that:

- The specified affiliate is "treated as a covered corporation with respect to such acquisition";
- The acquisition is "treated as a repurchase of stock of a covered corporation by such covered corporation"; and
- The netting rule of section 4501(c)(3) (the "**Netting Rule**") is applied on a modified basis, as discussed further below.[35]

2. *Covered Surrogate Foreign Corporations*

Second, the Excise Tax can apply when a "covered surrogate foreign corporation" or its specified affiliate repurchases or acquires stock of the covered surrogate foreign corporation.[36] For this purpose, a "covered surrogate foreign corporation" is defined as:

> [A]ny surrogate foreign corporation (as determined under section 7874(a)(2)(B) by substituting 'September 20, 2021' for 'March 4, 2003' each place it appears) the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)), but only with respect to taxable years which include any portion of the applicable period with respect to such corporation under section 7874(d)(1).[37]

Thus, a "covered surrogate foreign corporation" is an acquiring foreign corporation in a transaction described in section 7874(a)(2)(B) (a "**Section 7874(a)(2)(B) Transaction**") that occurs after September 20, 2021 if: (i) the foreign corporation's stock is traded on an established securities market, and (ii) the stock repurchase or acquisition in question occurs during a taxable

[33] Section 4501(d)(3)(A).

[34] Section 4501(d)(1).

[35] Section 4501(d)(1)(A)-(C).

[36] Section 4501(d)(2).

[37] Section 4501(d)(3)(B).

year that falls within the "applicable period" that ends ten years after the last date properties are acquired as part of the Section 7874(a)(2)(B) Transaction.[38]

For a "covered surrogate foreign corporation," section 4501(d)(2) causes repurchases or acquisitions by the covered surrogate foreign corporation or its specified affiliates to be subject to the Excise Tax by providing that:

- The expatriated entity—i.e., the acquired domestic corporation or partnership in the Section 7874(a)(2)(B) Transaction—with respect to such covered surrogate foreign corporation is "treated as a covered corporation with respect to such repurchase or acquisition";
- A repurchase or acquisition by the covered surrogate foreign corporation or its specified affiliate of the covered surrogate foreign corporation's stock is "treated as a repurchase of stock of a covered corporation by such covered corporation" (i.e., as if the expatriated entity, as a covered corporation, had repurchased its own stock); and
- The Netting Rule is applied on a modified basis, as discussed further below.[39]

C. *The Netting Rule and the Modified Netting Rules*

Under the Netting Rule of section 4501(c)(3), the Excise Tax is applied to a *net*, rather than gross, measure of stock repurchases during each taxable year.[40] Specifically, section 4501(c)(3) provides:

> The amount taken into account under [section 4501(a)] with respect to any stock repurchased by a covered corporation [i.e., the value of stock repurchases subject to the Excise Tax] shall be reduced by the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation during the taxable year, whether or not such stock is issued or provided in response to the exercise of an option to purchase such stock.

Thus, to determine the tax base for the Excise Tax, the fair market value of stock *issuances* by a covered corporation are generally netted against the fair market value of its stock *repurchases* during the taxable year. For this purpose, stock issuances include the provision of stock as part of employee compensation programs for employees of the covered corporation or its specified affiliates. The statute does not specify how to determine the fair market value of stock issued and stock repurchased.

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38 Section 7874(d)(1)(B).

39 Section 4501(d)(2)(A)-(C).

40 Section 4501(c)(3).

For applicable foreign corporations and covered surrogate foreign corporations, as noted above, section 4501 modifies the Netting Rule in certain respects.[41] For acquisitions of an applicable foreign corporation's stock by a specified affiliate, netting is only available for "stock issued or provided by such specified affiliate to employees of the specified affiliate."[42] For repurchases or acquisitions of stock of a covered surrogate foreign corporation, netting is only available for "stock issued or provided by [the] expatriated entity to employees of the expatriated entity."[43]

D. *Repurchases Excluded from the Excise Tax*

Certain transactions—even if otherwise treated as "repurchases" within the meaning of section 4501(c)—are excluded, in whole or in part, from the base of the Excise Tax under section 4501(e) (the "**Section 4501(e) Exceptions**"). These six exceptions are described below.

1. *Reorganization Exception*

A repurchase is not subject to the Excise Tax "to the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 by reason of such reorganization" (the "**Reorganization Exception**").[44] By its terms, the Reorganization Exception applies only to the extent that two requirements are met: (i) the repurchase is "part of" a section 368(a) reorganization, and (ii) the shareholder from whom the stock is repurchased recognizes no gain or loss on the repurchase. As described further below, an exchanging shareholder generally does not recognize loss in a reorganization exchange, including with respect to any "other property" (i.e., "boot") received in the exchange.[45] Further, whether and to what extent a particular shareholder recognizes gain on the receipt of boot in a reorganization generally depends on that shareholder's amount of built-in gain (if any) in the stock that it surrenders in the exchange.

2. *Employee Plan Exception*

A repurchase is not subject to the Excise Tax "in any case in which the stock repurchased is, or an amount of stock equal to the value of the stock repurchased is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan" (such plans, collectively, "**Employee Plans**," and such exception, the "**Employee Plan Exception**").[46] While the Netting Rule, by its terms, eliminates stock issuances to employees from the Excise Tax's tax base, the Employee Plan Exception appears to have the additional effect of excluding stock "contributed to" an Employee Plan even if that stock is not properly treated as "issued" within the meaning of the Netting Rule. Another distinction is that the Employee Plan Exception

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[41] Section 4501(d)(1)(C), (2)(C).

[42] Section 4501(d)(1)(C).

[43] Section 4501(d)(2)(C).

[44] Section 4501(e)(1).

[45] *See* section 356(c).

[46] Section 4501(e)(2).

excludes the particular *shares* of repurchased stock contributed to an Employee Plan from the base of the Excise Tax. This treatment contrasts with the Netting Rule, which appears to net the fair market value of issued stock against the fair market value of repurchased stock, rather than netting the number of shares issued against the number of shares repurchased.

3. *De Minimis Exception*

If "the total value of the stock repurchased during the taxable year does not exceed $1,000,000," then the Excise Tax does not apply to such repurchases (the "**De Minimis Exception**").[47] Although the statute does not explicitly state whether this exception is applied on an "aggregate" or entity-by-entity basis, it presumably takes into account *all* stock of the relevant covered corporation, applicable foreign corporation, or covered surrogate foreign corporation that is treated as "repurchased" during the taxable year, whether repurchased by that corporation or acquired by a specified affiliate. The statute also does not explicitly state whether the $1 million threshold is measured before or after application of the Netting Rule and the other Section 4501(e) Exceptions.

4. *Dealer Exception*

Repurchases are to be excluded from the Excise Tax "under regulations prescribed by the Secretary, in cases in which the repurchase is by a dealer in securities in the ordinary course of business" (the "**Dealer Exception**").[48] In other words, Congress did not intend the Excise Tax to apply to repurchases by a dealer as part of the dealer's ordinary-course dealing activity (e.g., a dealer making a market in its own stock as a bona-fide broker-dealer).

5. *RIC and REIT Exception*

The Excise Tax does not apply "to repurchases by a regulated investment company (as defined in section 851) or a real estate investment trust."[49]

6. *Dividend Exception*

The Excise Tax does not apply "to the extent that the repurchase is treated as a dividend for purposes of this title" (the "**Dividend Exception**").[50] For example, section 302(d) treats a redemption of stock that does not qualify for "sale or exchange" treatment under section 302(a) as "a distribution of property to which section 301 applies." Such a section 302(d) redemption is thus treated as a dividend to the extent treated as made from the distributing corporation's earnings and profits ("**E&P**").[51] By its terms, the Dividend Exception does not apply to any portion of a section 302(d) redemption that is not treated as a dividend (i.e., any portion treated

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[47] Section 4501(e)(3).

[48] Section 4501(e)(4).

[49] Section 4501(e)(5).

[50] Section 4501(e)(6).

[51] *See* section 301(c); section 316.

as a recovery of basis under section 301(c)(2) or that results in gain to the shareholder under section 301(c)(3)).

E. *Treasury's Authority for Regulations and Other Guidance*

Section 4501(f) provides that:

> The Secretary shall prescribe such regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section, including regulations and other guidance—(1) to prevent the abuse of the exceptions provided by [section 4501(e)], (2) to address special classes of stock and preferred stock, and (3) for the application of the rules under [section 4501(d)].

Statutory grants of authority to carry out the "purposes" of a Code section, as found in section 4501(f), are understood to be "broad."[52]

In addition, as noted above, Treasury has authority to determine transactions "economically similar" to Section 317(b) Redemptions that are to be treated as "repurchases,"[53] as well as regulatory authority to define the scope of the Dealer Exception.[54] Further, as described below, Treasury also has more general regulatory authority under the Code to prescribe reporting and payment requirements with respect to the Excise Tax.[55]

We believe that these various delegations of regulatory authority are broad enough to encompass the recommendations that we make in Part V below.

F. *Procedural Rules for the Excise Tax*

1. *Tax Returns and Payment*

The Excise Tax is not part of the federal income tax governed by Subtitle A of the Code. Rather, the Excise Tax is a "miscellaneous excise tax" included under Subtitle D of the Code.[56]

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52 *See, e.g.*, H. R. Rep. No. 100-795, at 54 (1988) (stating that the Treasury Department has, under section 382(m), "broad regulatory authority to prescribe any regulations necessary or appropriate to carry out the purposes of the loss limitation provisions"); *id.* at 326 (describing the similarly worded grant of regulatory authority in section 148(i) as "broad regulatory authority"); Staff of the Joint Comm. on Taxation, 109th Cong. 2d Sess., Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, 369 (JCX-38-06) (Comm. Print Aug. 3, 2006) (stating that the similarly worded grant of regulatory authority in section 529(f) "grants the Secretary broad regulatory authority"). *Cf. Chamber of Commerce vs. IRS*, 122 A.F.T.R. 2d 2017-5967 (W. D. Tex. 2017) ("[Section 7874(g)] uses terms granting broad authority to the Secretary of the Treasury for example: 'such regulations as may be appropriate' and 'such regulations as are necessary to carry out this section.'").

53 Section 4501(c)(1)(B).

54 Section 4501(e)(4). Treasury also has its more general regulatory authority pursuant to section 7805(a).

55 *See infra* Part III.F.

56 Certain other excise taxes in Subtitle D and also Subtitle E are, by statute, treated as part of the federal income tax for these procedural purposes, but there is no such treatment for the Excise Tax. *E.g.*, section 4999(c)(2) (providing that the excise tax on "excess parachute payments" is "treated as a tax imposed by subtitle A" for

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As a result, there are *not* general rules that, by default, determine the specific timing and nature of tax returns that must be filed with respect to the Excise Tax. Rather, as part of more general grants of regulatory authority, the Code delegates authority to Treasury to issue specific regulations prescribing the tax returns and other information statements required for the Excise Tax;[57] the time for filing such returns or statements, including the time allowed for filing extensions (if any);[58] and the time periods that such returns or statements cover.[59] Absent regulatory guidance pursuant to this authority, payment of the Excise Tax would be due at the time that a tax return with respect to the Excise Tax is required to be filed,[60] and no withholding or estimated payments would be required to be made with respect to the Excise Tax.[61]

2. ***Tax Controversy Matters***

(a) ***IRS Appeals***

The IRS Independent Office of Appeals ("**IRS Appeals**") has jurisdiction to hear disputes relating to excise taxes imposed by Subchapter D of the Code.[62] Accordingly, because the Excise Tax is imposed pursuant to Subchapter D, taxpayers presumably should be able to attempt to resolve Excise Tax disputes with IRS Appeals.[63]

(b) ***Litigation Procedure***

As is the case for most excise taxes, a taxpayer will *not* receive a statutory notice of deficiency with respect to a purported underpayment of the Excise Tax.[64] The Tax Court's

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purposes of Subtitle F's procedural rules); section 5881(e) (providing the same for the excise tax on "greenmail" in Subtitle E).

[57] *See* section 6001; section 6011(a).

[58] Section 6071(a); section 6081(a).

[59] Section 6101.

[60] Section 6151(a); section 6151(c).

[61] *See* section 6302(a) ("If the mode or time for collecting any tax is not provided for by this title, the Secretary may establish the same by regulations."). Pursuant to this grant of authority, Treas. Reg. 40.6302(c)-1(a) requires semi-monthly deposits of certain excise taxes, but does not apply to the Excise Tax. *See* Treas. Reg. 40.0-1(a) (stating that the excise tax procedural regulations in 26 CFR Part 40 only apply to "the excise taxes imposed by chapters 31, 32, 33, 34, 36, 38, 39, and 49").

[62] *See* Prop. Treas. Reg. 301.7803-2(b)(2) (defining "Federal tax controversy" for IRS Appeals purposes to include excise taxes); Prop. Treas. Reg. 301.7803-2(c)(4) (excluding certain excise taxes *other than* the Excise Tax from IRS Appeals); Treas. Reg. 601.106(a)(1)(ii)(b) (explaining that IRS Appeals may determine cases related to "certain Federal excise tax liability"); Treas. Reg. 601.106(a)(3) (stating that excise taxes imposed by Subtitle E are not reviewable by IRS Appeals); *see also* Prop. Treas. Reg. 601.106(a)(3)(iii), (a)(4)(v) (same).

[63] *See also* section 7803(e)(4) ("The resolution process described in [section 7803(e)(3), which provides that IRS Appeals' function is 'to resolve Federal tax controversies'] shall be generally available to all taxpayers.").

[64] Section 6212(a) provides for the issuance of a notice of deficiency only in respect of "any tax imposed by subtitle A or B or chapter 41, 42, 43, or 44." The Excise Tax is in Chapter 37. *See also* section 6211 (defining the concept of a "deficiency").

deficiency jurisdiction extends only to cases where such a notice of deficiency is issued.[65] Thus, the Tax Court does *not* have jurisdiction to hear Excise Tax cases. Rather, taxpayers judicially challenging an Excise Tax liability will have to pay the assessed tax;[66] file a refund claim with the IRS;[67] and wait for six months (or until the IRS renders a decision on the refund claim, if earlier).[68] As with income tax refund claims, if the six-month period expires without the IRS granting the refund or if the IRS disallows the claim, the taxpayer can then file suit for a refund in federal district court or in the Court of Federal Claims.[69]

(c) *Statute of Limitations*

The general three-year statute of limitations for assessment—running from the later of the due date for the relevant tax return and the date that tax return is actually filed—applies to excise taxes, including the Excise Tax.[70] For purposes of starting the limitations period, an Excise Tax return is considered filed for *all* amounts of Excise Tax owed for a given period if the filed Excise Tax return reports a specified amount of Excise Tax liability, even if the return reports no Excise Tax liability.[71] A six-year, instead of three-year, statute of limitations applies to the Excise Tax if the Excise Tax return for the period omits an amount of such tax properly includible that exceeds 25% of the amount reported.[72]

IV. Policy Background for the Excise Tax

No congressional committee or conference reports address section 4501. However, certain statements made with respect to a substantially similar predecessor version of section

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[65] *See* section 6213(a); Tax Court Rule 13 (stating that the Tax Court's jurisdiction generally depends on the issuance of "a notice of deficiency in income, gift, or estate tax or, in the taxes under Code Chapter 41, 42, 43, or 44 . . . , or in any other taxes which are the subject of the issuance of a notice of deficiency"); *Flora v. United States*, 362 U.S. 145, 175 n.38 (1960) ("[T]he Tax Court has no jurisdiction over excise tax cases.").

[66] It is somewhat unclear whether a taxpayer may pay only the Excise Tax due on a particular repurchase and sue for a refund of that amount, or if a taxpayer must instead pay their full Excise Tax liability for the year prior to filing suit for a refund. *See Flora*, 362 U.S. at 175 n.38 ("[E]xcise tax assessments may be divisible into a tax on each transaction or event, so that the full-payment rule would probably require no more than payment of a small amount."); *Dixon v. Commissioner*, 141 T.C. 173, 188 (2013) ("[A] well-established exception" to this full-payment rule exists with respect to 'divisible taxes.'"), *action on decision* 2014-001 (Sept. 3, 2014); *United States ex rel. Perler v. Papandon*, 331 F.3d 52, 54 n.1 (2d Cir. 2003) (noting that the government conceded that taxpayers had satisfied the full payment rule by paying gasoline taxes owed on six particular transactions, even though the amount paid was "a tiny fraction of the full assessment" of taxpayers' gasoline tax liability).

[67] *See* section 7422(a).

[68] *See* section 6532(a).

[69] *See* 28 U.S.C. section 1346(a)(1) (federal district courts); 28 U.S.C. section 1491(a)(1) (Court of Federal Claims); *see also Flora* at 163 ("[T]here is one tribunal for prepayment litigation[—the Tax Court—]and another[—the district courts and Court of Federal Claims—]for postpayment litigation . . . .").

[70] Section 6501(a), (b)(1).

[71] Section 6501(b)(4). Accordingly, subject to the publication of applicable forms and promulgation of applicable procedures, corporations potentially subject to the Excise Tax but that do not believe they actually owe Excise Tax for a given period may be incentivized to file zero-liability Excise Tax returns to commence the statute of limitations period.

[72] Section 6501(e)(3).

4501 that was proposed in 2021,[73] as well as with respect to the enacted version of section 4501, demonstrate the policy considerations that apparently motivated the Excise Tax. These policy considerations can, in turn, inform how Treasury resolves Excise Tax issues that require guidance.

The Excise Tax is apparently intended to discourage publicly traded corporations from repurchasing stock instead of investing in their business operations and thereby generating economic growth and job creation.[74] In relevant House and Senate debates, discussions focused on the perception that companies implement stock repurchase programs in order to opportunistically drive up their stock price, enrich wealthy shareholders and corporate insiders, and increase the value of executives' compensation packages.[75] These discussions also cited statistics on the volume of stock repurchases after the enactment of the Tax Cuts and Jobs Act in 2017, and claimed that section 4501 would temper that increased volume of stock repurchases in recent years.[76] As far as we have been able to identify, these congressional debates and other

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[73] Draft of Stock Buyback Accountability Act of 2021, section 4501(d)(1) (Sept. 10, 2021); Stock Buyback Accountability Act of 2021, S.2758, 117th Cong. section 4501(d)(1) (Sept. 20, 2021); Build Back Better Act, H.R. 5376, 117th Cong. section 138102(a) (Rules Comm. Print Nov. 3, 2021).

[74] *See, e.g.*, Press Release, *Brown, Wyden Unveil Major New Legislation to Tax Stock Buybacks* (Sept. 10, 2021), https://www.brown.senate.gov/newsroom/press/release/brown-wyden-tax-stock-buybacks ("Stock buybacks are currently heavily favored by the tax code . . . ."); *id.* ("Large corporations buy back stock using the capital that could be used to make investments, create new jobs, and raise wages . . . . Stock buybacks also provide a tax arbitrage opportunity for wealthy shareholders, as a means to delay and potentially fully-avoid tax on their share of corporate gains."); Cong. Rsch. Serv., IF11960, *An Excise Tax on Stock Repurchases and Tax Advantages of Buybacks Over Dividends* (Aug. 10, 2022), https://crsreports.congress.gov/product/pdf/download/IF/IF11960/IF11960.pdf/.

[75] *E.g.*, 167 Cong. Rec. S6451 (daily ed. Sept. 13, 2021) (Senator Brown introducing S. 2758, which was the predecessor to section 4501: "Stocks can account for as much as half of an executive's compensation package. Corporations, therefore, juice those stock prices by repurchasing their own stock, what we call stock buybacks. Here is how it works. There are a finite number of company shares at any given time. Purchasing shares will decrease the number of shares available to investors and therefore drive up the price and the value of the remaining shares."); 168 Cong. Rec. S4169 (daily ed. Aug. 6, 2022) (statement of Senator Merkley: "Let's understand what stock buybacks are. First of all, a president of a company works to get a board, and that board is compensated, and then that board makes lots of decisions about, well, the welfare of the top executives. They set the salaries for the top executives, and then they give them stock options. Now, if you have a stock option and then your company buys back stock, every share gets more valuable; you make a massive amount of money. This is a corrupt system. It does nothing to further the investment of the company and the productivity of America. It does nothing to increase the R&D—research and development—that goes into new products.").

[76] 168 Cong. Rec. H7703 (daily ed. Aug. 12, 2022) (statement of Rep. Bonamici: "After the Republicans' 2017 tax bill was signed into law, corporations spent more than $1 trillion on stock buybacks in 2018. The Inflation Reduction Act will help correct the missed opportunities of the so-called Tax Cuts and Jobs Act by establishing a tax on stock buybacks."); 168 Cong. Rec. S4069 (daily ed. Aug. 6, 2022) (statement of Senator Wyden: "We also paid for the legislation in an important way that was proposed by our colleague from Ohio, Senator Brown, that I was proud to join him on, and that is a 1-percent tax on stock buybacks. Corporations have spent trillions of dollars on stock buybacks in recent years, a huge windfall for corporate executives and wealthy shareholder. It set a record in 2018, broke it again in 2021 right in the middle of a global pandemic, and I just noticed the profits of some of the biggest oil companies here in the last few weeks, again, they are kind of leading the league in stock buybacks."); 167 Cong. Rec. S6452 (daily ed. Sept. 13, 2021) (Senator Brown introducing S. 2758, which was the predecessor to section 4501: "In 2018, the largest U.S. companies spent more than $800 billion in stock buybacks, a 50-percent increase from the previous year, a 50-percent increase because they got

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legislative history focused exclusively on conventional stock repurchases as the target for the Excise Tax.

Thus, at least certain members of Congress perceived non-tax abuses in conventional stock repurchases, and apparently enacted the Excise Tax in order to disincentivize conventional stock repurchases (and thereby indirectly address those perceived non-tax abuses). But in contrast to certain non-tax legislative proposals that had been proposed with respect to stock repurchases,[77] the Excise Tax is apparently not intended as a prohibitive measure, but rather is intended and expected to raise substantial tax revenue from continuing stock repurchase activity.[78] This revenue-raising goal also contrasts with, for example, Congress' apparent goal in enacting the 50% excise tax on so-called "greenmail" payments in the 1980s.[79] That excise tax was apparently intended to stop or dramatically reduce greenmail activity subject to the tax, rather than raise revenue.[80]

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that largesse from the Federal Treasury."); 168 Cong. Rec. S3795 (daily ed. Aug. 1, 2022) (statement of Senator Schumer: "They promised [the TCJA] would unleash a tsunami of economic activity. Instead, it led to record corporate stock buybacks, benefiting the wealthy and nobody else.").

[77] *E.g.*, H.R. 6339, 116th Cong. (2020) (proposed legislation "[t]o temporarily ban stock buybacks until the impact of COVID-19 on the American financial system has ended"); Reward Work Act, S. 2605, 115th Cong. section 2(b) (2018) ("Notwithstanding any other provision of law, no issuer may purchase an equity security of the issuer on a national securities exchange.").

[78] *See, e.g.*, Staff of the Joint Comm. on Taxation, 117th Cong., 2d Sess., Estimated Budget Effects of the Revenue Provisions of Title I – Committee on Finance, of an Amendment in the Nature of a Substitute to H.R. 5376, "An Act To Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14," As Passed by the Senate on August 7, 2022, and Scheduled for Consideration by the House of Representatives on August 12, 2022 (Aug. 9, 2022) (estimating approximately $73.69 billion of tax revenue from the Excise Tax through 2031); Laura Davison, *Buyback Tax at 1% Is Too Small to Matter as CEOs Reward Holders*, Bloomberg Tax (Oct. 3, 2022), https://news.bloomberglaw.com/daily-tax-report/buyback-tax-at-1-is-too-small-to-matter-as-ceos-reward-holders (quoting Senator Wyden: "Our goal wasn't to end stock buybacks all together—the stock buyback tax simply tries to reduce this preferential tax treatment in order to level the playing field and encourage more investment in workers").

[79] Section 5881.

[80] Jonathan Barry Forman, *Ways and Means Examines Tax Aspects of Mergers*, 27 Tax Notes Fed. (TA) 121 (Apr. 8, 1985) (describing congressional intent to limit hostile takeovers and stop greenmail); H.R. Rep. No. 100-391, pt. 2, at 1086 (1987) ("The committee believes that corporate acquisitions that lack the consent of the acquired corporation are detrimental to the general economy as well as to the welfare of the acquired corporation's employees and community. The committee therefore believes it is appropriate not only to remove tax incentives for corporate acquisitions, but to create tax disincentives for such acquisitions. In addition, the committee believes that taxpayers should be discouraged from realizing short-term profits by acquiring stock in a public tender offer and later being redeemed by the corporation in an effort by the corporation to avert the hostile takeover.").

The Inflation Reduction Act of 2022 also included an excise tax on manufacturers, producers, or importers of pharmaceuticals that fail to enter into negotiated drug pricing agreements with the federal government. This pharmaceutical excise tax, similar to the excise tax on greenmail, was apparently intended to stop certain behavior and not meant as a revenue raiser. *See* Joint Committee on Taxation, JCX-43-19, *Description of the Revenue Provisions of H.R. 3, the "Lower Drug Costs Now Act of 2019,"* 11 (Oct. 18, 2019) (estimating no revenue gain from the pharmaceutical excise tax); *Inflation Reduction Act Considerations for Pharma Companies*, PwC (Aug. 2022) (observing that the pharmaceutical excise tax is not expected to have a revenue

(cont'd)

Critics of share buybacks note that conventional stock repurchases tend to increase the demand for a company's stock and can also improve the financial metrics on which equity investors and analysts focus (such as earnings per share ("**EPS**")) without any material change in the company's overall corporate structure or its underlying business operations, which may lead to an enhanced market valuation for the company's stock.[81] Any resulting increase in the stock price will generally benefit shareholders who do not sell their shares and increase the value of stock options and other equity awards, which typically do not participate in dividends. These features of conventional stock repurchases are central to their perceived non-tax abuses, as identified by Congress. Notably, these features are not present in non-redemptive and pro rata distributions and many of the other transactions discussed in Part V of this Report.

Consistent with the notion that the Excise Tax is aimed at conventional stock repurchases and similar transactions of a non-pro rata nature, the Excise Tax does *not* apply to non-redemptive distributions (or other amounts treated as dividends under the Code, per the Dividend Exception), which are the other common means for corporations to return earnings to shareholders.[82] In distinguishing stock repurchases from non-redemptive distributions for purposes of the Excise Tax, it appears that Congress also took note of some of the perceived income tax advantages of stock repurchases relative to dividends. Those advantages can include: (i) more efficient basis recovery for U.S. selling shareholders,[83] (ii) inapplicability of U.S. withholding tax for non-U.S. selling shareholders,[84] (iii) income tax deferral (or elimination if held until a basis step-up at death) for non-selling shareholders whose ownership interests accrete over time,[85] and (iv) the ability to offset capital losses against capital gains.

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impact), https://www.pwc.com/us/en/services/tax/library/inflation-reduction-act-considerations-for-pharma-companies.html.

[81] *See, e.g.*, Cong. Rsch. Serv., IF11960, *An Excise Tax on Stock Repurchases and Tax Advantages of Buybacks Over Dividends* (Aug. 10, 2022), https://crsreports.congress.gov/product/pdf/download/IF/IF11960/IF11960.pdf/. Of course, the converse is also true: a share repurchase at a price above intrinsic value can dilute the equity of the remaining shareholders as well.

[82] *See* section 4501(e)(6).

[83] A U.S. selling shareholder is taxed on its net gain in the redeemed stock for a Section 317(b) Redemption taxed as a sale or exchange under section 302(a) (i.e., amount realized minus the shareholder's full basis in the redeemed stock). By contrast, a U.S. shareholder can only recover basis in a section 301 distribution, or Section 317(b) Redemption taxed as a section 301 distribution under section 302(d), after the corporation has distributed all of its E&P.

[84] For a Section 317(b) Redemption taxed as a sale or exchange under section 302(a), a non-U.S. selling shareholder's gain is not generally subject to U.S. withholding tax. By contrast, U.S. withholding tax is generally imposed on a dividend to a non-U.S. shareholder, except as otherwise reduced by an applicable tax treaty. Section 881(a)(1); section 1441(b).

[85] *E.g.*, Cong. Rsch. Serv., IF11960, *An Excise Tax on Stock Repurchases and Tax Advantages of Buybacks Over Dividends* (Aug. 10, 2022), https://crsreports.congress.gov/product/pdf/download/IF/IF11960/IF11960.pdf/; 168 Cong. Rec. S4211 (daily ed. Aug. 6, 2022) (statement of Senator Cardin: "The third provision is a 1 percent excise tax on stock buybacks. Corporations can choose to distribute profits either by issuing dividends or buying back shares of stock, which inflates stock prices. Stock buybacks are taxed at a lower rate than dividends and create profit gaming opportunities for companies, which have been abused over time.").

As noted above, the Excise Tax does not apply to the fair market value of stock repurchases to the extent of the fair market value of stock issuances during the taxable year under the Netting Rule.[86] The Netting Rule indicates Congress' judgment that stock repurchases that merely offset the dilution to shareholders that would otherwise result from equity compensation or other share issuance transactions do not have the negative policy implications that motivated the Excise Tax.

V. Potential Topics and Recommendations for Treasury Guidance

A. *Principles for Excise Tax Guidance*

Section 4501 presents numerous important issues that will need to be addressed by Treasury guidance. Many of these issues involve transactions that are important to capital formation. We believe that leaving these issues unresolved could pose risks to the efficient operation of U.S. capital markets, as could a failure to address key areas where the Excise Tax potentially applies (or does not apply) in a manner that may conflict with sound public policy or apparent congressional intent.

More generally, we believe that certain key principles should inform how Treasury approaches guidance for the Excise Tax. As noted above, we recommend that more immediate guidance—which could take the form of an IRS Notice ideally issued before the effective date for the Excise Tax, as well as other IRS Notices in the near future—address the most pressing issues that are most critical to the efficient functioning of U.S. capital markets. Those issues include the treatment of various forms of preferred stock, equity-linked financial instruments such as options and convertible debt, acquisitive and divisive reorganizations and various other M&A transactions, and section 331 liquidations, as well as potential transition relief.

Second, guidance should provide clarity about the classes of transactions to which the Excise Tax does and does not apply. For a transaction-based tax, the rules governing the Excise Tax—and in particular, the definition of "repurchase"—should be clearly defined by regulations in as bright-line a manner as possible, and in a manner that is consistent with congressional intent. These regulations could generally provide that any transaction not expressly defined as a repurchase in section 4501 or Treasury Regulations thereunder is not subject to the Excise Tax.[87] Accordingly, any transaction that is not a Section 317(b) Redemption and is not designated as "economically similar" to a Section 317(b) Redemption should generally not be subject to the Excise Tax.[88]

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[86] Section 4501(c)(3); *see infra* Part III.C.

[87] *Cf.* Treas. Reg. 1.245A(e)-1(b)(2) ("No other amount received by a United States shareholder from a CFC is a hybrid dividend for purposes of section 245A."); Treas. Reg. 1.267A-1(b) ("This paragraph (b) sets forth the exclusive circumstances in which a deduction is disallowed under section 267A.").

[88] *See* section 4501(c)(1). We recommend below that Treasury guidance provide that certain transactions not be categorized as "economically similar" to a Section 317(b) Redemption. Treasury guidance could accomplish that result by making its list of "economically similar" transactions exclusive by its terms (and then not including those transactions on the list). An IRS Notice explaining anticipated future guidance, but not providing a comprehensive or exclusive list of "economically similar" transactions, could note certain transactions that are expected to be excluded from that eventual exclusive list.

Third, in certain instances, the appropriate guidance on a given topic depends on how one views and weighs the statutory language and apparent policy goals of the Excise Tax. In terms of policy goals, one could argue that the legislative history to section 4501, although somewhat limited, evidences a strong and even exclusive focus on conventional stock repurchase programs. Accordingly, one could argue that guidance should thus refine the statutory concepts in order to focus section 4501 on conventional stock repurchases, and to cover other transactions that are "economically similar" to such conventional stock repurchases as a tailored anti-avoidance measure.

Somewhat in tension with that approach, one could instead focus on how the actual language of section 4501 interrelates with certain concepts and principles from Subchapter C of the Code (e.g., the definition of "repurchase" in section 4501(c)(1) by cross-reference to section 317(b)). These cross-referenced aspects of Subchapter C have a rich and complicated background, and a stronger focus on applying these Subchapter C principles in Excise Tax guidance would generally broaden the scope of the Excise Tax significantly beyond conventional stock repurchases—for example, by potentially applying the Excise Tax to distributions in section 331 liquidations and to deemed redemptions in certain M&A transactions and reorganizations. But this focus on Subchapter C principles would also, at least in certain respects described below, create material administrative difficulties and would impose the Excise Tax in instances that do not otherwise seem to implicate the apparent policy concerns underlying section 4501.

Lastly, one's view of guidance on certain topics could also be colored by whether one views the Excise Tax's overall policy goal as disincentivizing conventional stock repurchase transactions specifically, or as more generally encouraging corporate retention and re-investment of earnings, as opposed to any form of distribution.

A substantial majority of the Executive Committee of the NYSBA Tax Section believes that guidance should generally focus section 4501 on conventional stock buyback programs and similar repurchases based on the policy background and legislative history described above. As part of this view, we believe that the definition of "repurchase"—and in particular, its cross-reference to section 317(b)—should be refined through guidance so that it excludes transactions that are entirely unlike conventional stock repurchases, such as redemptions of non-participating, non-convertible preferred stock, distributions in section 331 liquidations and certain partial liquidations, as well as payments of boot to shareholders in many acquisitive reorganizations and M&A transactions. But at the same time, guidance should also include anti-avoidance measures—particularly as relates to the Netting Rule—to address potential strategies that could otherwise reduce or eliminate Excise Tax liability with relative ease, which would contravene that same policy background and legislative history. This Report's recommendations generally reflect this predominant view.

A minority of the Executive Committee of the NYSBA Tax Section supports a broader interpretation of the concept of a repurchase, particularly given the lack of formal legislative history for section 4501 on which to base these policy judgments. In particular, this minority view would interpret the concept of a Section 317(b) Redemption in what these members characterize as a more literal manner, particularly as relates to aspects of M&A transactions that are (or have historically been treated as) Section 317(b) Redemptions in light of traditional

Subchapter C authorities. However, the members in this minority view still support limits on the concept of a repurchase—for example, to exclude section 331 liquidations—in order to ensure that the statute is not applied literally in cases where doing so would not seem to advance any discernable potentially relevant policy. Likewise, they also support other recommended guidance to exclude certain instruments and transactions from the scope of the Excise Tax, such as tax-free Split-Offs (as defined below) and redemptions of non-participating, non-convertible preferred stock. Thus, the different views between the substantial majority and the minority are generally a matter of degree on certain topics (chiefly, payments to shareholders in acquisitive reorganizations and M&A transactions).

As reflected in the recommendations made in this Report, we believe that certain principles should guide how Treasury approaches guidance on relevant issues. In particular, in assessing how a particular type of transaction should be treated for purposes of the Excise Tax, we believe that Treasury should consider and evaluate: (i) whether the transaction bears the salient features of a conventional stock repurchase (i.e., an opportunistic, elective, and non-pro rata "cashing-out" of some, but not all, of the corporation's shareholders using proceeds sourced from the corporation or its specified affiliates); (ii) whether the transaction reduces the number of shares outstanding and results in a corresponding enhancement (or the potential for an enhancement) in EPS or other financial metrics for the shares that remain outstanding in a manner akin to a conventional stock repurchase; (iii) whether the transaction has one or more of the identified income tax advantages associated with stock repurchases relative to non-redemptive distributions; and (iv) whether the transaction is treated as a Section 317(b) Redemption under traditional Subchapter C principles.

With these points in mind, we turn to specific issues that require Treasury guidance. This Report primarily focuses on critical and threshold guidance issues; it is not comprehensive as to all issues that require guidance.[89]

B. *General Netting Rule Guidance*

As a threshold matter, we recommend that Treasury guidance address or reflect certain key concepts for the application of the Netting Rule:

- A "matching principle" that, where the acquisition or redemption of a particular type or class of instrument does or does not constitute a "repurchase,"[90] the issuance of that same type or class of instrument also should or should not constitute an issuance.[91]

- Exclusions from the definition of "issuance" for: (i) distributions of equity in respect of existing equity under section 305(a), and (ii) Stock-for-Stock Exchanges (as defined below).

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89 As one example, this Report does not address guidance under the Dealer Exception.

90 Section 4501(c)(1).

91 Section 4501(c)(3).

- A clarification of when stock is treated as issued for purposes of the Netting Rule, and coordination of that concept with the Employee Plan Exception.

- Clarification of how the Netting Rule applies to fiscal year taxpayers for their fiscal years beginning in 2022 and ending in 2023.

1. *Instrument Type Matching Principle*

We recommend that, where the acquisition or redemption of a particular type or class of instrument does or does not constitute a "repurchase,"[92] the issuance of that same type or class of instrument also should or should not constitute an issuance (the "**Instrument Type Matching Principle**").[93] In other words, any regulatory expansion of or limitation on the scope of "repurchase" with respect to types or classes of instruments—including those limitations that we recommend below, if adopted—should apply in equal measure to the scope of "issuance." In this Report, we refer generally to types or classes of instruments the acquisition or redemption of which constitutes a repurchase as "**Covered Instruments**."

For example, we recommend below that Treasury guidance provide that an acquisition or redemption of stock that is generally: (i) limited and preferred as to dividends and not participating in corporate growth to any significant extent within the meaning of section 1504(a)(4)(B), and (ii) not convertible into another class of stock within the meaning of section 1504(a)(4)(D) ("**Straight Preferred Stock**") does not constitute a "repurchase" subject to the Excise Tax (i.e., that Straight Preferred Stock is not a Covered Instrument).[94] If Treasury guidance adopted that recommendation, then under the Instrument Type Matching Principle, the issuance of Straight Preferred Stock likewise would not constitute an "issuance" for Netting Rule purposes. As described above, the Netting Rule appears to reflect a policy judgment that repurchases that are merely anti-dilutive relative to issuances in the same taxable year do not have the negative policy implications that warrant the Excise Tax.[95] We believe that this policy judgment is best implemented by matching the scope of potentially taxable repurchases and nettable issuances in this manner.[96]

2. *Certain Stock Issuances and Exchanges in Respect of Existing Equity*

We further recommend that certain stock distributions and exchanges in respect of existing equity of a covered corporation be excluded from the definition of "issuance" for

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92 Section 4501(c)(1).

93 Section 4501(c)(3).

94 *See infra* Part V.E.2.

95 *See supra* Part IV.

96 To be clear, the Instrument Type Matching Principle does *not* mean that issuances of an instrument of a type or class that is generally within the Excise Tax's scope are excluded from the Netting Rule merely because other repurchases of the same type or class of instrument were excluded from the base of the Excise Tax under one of the Section 4501(e) Exceptions. Section 4501(e) is clear that repurchases qualifying for its exceptions remain "repurchases" within the general meaning of section 4501(c)(1). In turn, the issuance of stock of the same type or class as that repurchased in a transaction that qualifies for a Section 4501(e) Exception should also remain an "issuance" under section 4501(c)(3).

purposes of the Netting Rule.[97] Specifically, we recommend that the definition of "issuance" exclude: (i) a non-dilutive, tax-free distribution of stock that constitutes a Covered Instrument ("**Covered Stock**") with respect to a corporation's existing Covered Stock within the meaning of section 305(a), and (ii) stock splits, reverse stock splits, and other actual or deemed exchanges of newly issued Covered Stock for a corporation's existing Covered Stock in a non-dilutive, tax-free recapitalization within the meaning of section 368(a)(1)(E) (a "**Recapitalization**"), a transaction described in section 1036 (a "**Section 1036 Transaction**"), or a reorganization within the meaning of section 368(a)(1)(F) (an "**F Reorganization**," and such Recapitalizations, Section 1036 Transactions, and F Reorganizations, collectively, "**Stock-for-Stock Exchanges**").

Absent these types of exclusions, these transactions that are otherwise realization events (and therefore stock issuances) for federal income tax purposes—but that have no meaningful dilutive effect with respect to the covered corporation's equity capital—would allow covered corporations to use the Netting Rule to avoid the Excise Tax with relative ease.

> **Example 1**: *Section 305(a) stock distribution*. Corp X[98] has 100 shares of common stock outstanding and no other outstanding equity. Corp X distributes five shares of common stock with respect to each existing share of common stock in a section 305(a) stock distribution.

In this transaction, Corp X has issued 500 shares. But although Corp X's raw outstanding share count has increased by 500, no Corp X shareholder has been diluted; each Corp X shareholder has the exact same proportionate claim on Corp X's assets before and after the reverse stock split. Given that lack of dilution or change in proportionate ownership, we believe that it would be inappropriate to treat this section 305(a) transaction as an "issuance" for purposes of the Netting Rule.

A Stock-for-Stock Exchange can have substantially the same result.

> **Example 2**: *Recapitalization as a Stock-for-Stock Exchange*. Corp X has 100 shares of common stock outstanding and no other outstanding equity. Corp X exchanges its common stock (the "**Old Stock**") for new common stock (the "**New Stock**"). The Old Stock and New Stock have formal terms that differ to a material enough degree for the exchange to be treated as an equity Recapitalization for federal income tax purposes,[99] but without diluting or altering the Corp X shareholders' proportionate equity interests in Corp X.

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[97] *Cf.* Rev. Rul. 72-57, 1972-1 C.B. 103 (treating a stock split as a recapitalization), *modified*, Rev. Rul. 78-351, 1978-2 C.B. 148.

[98] For all examples in this Report, Corp X is a covered corporation, and no Section 4501(e) Exceptions apply unless otherwise stated.

[99] *See, e.g.*, section 368(a)(1)(E); Rev. Rul. 69-407, 1969-2 C.B. 50 (exchange of $150 par value common for $100 par value old common stock, and of $87.50 par value common stock for old $100 par value common treated as a Recapitalization); Rev. Rul. 54-482, 1954-2 C.B. 148 (exchange of no par value common stock for new $1 par value common stock treated as a Recapitalization), *amplified*, Rev. Rul. 86-25, 1986-1 C.B. 202; Boris L. Bittker & James S. Eustice, *Federal Income Taxation of Corporations & Shareholders* ¶ 12.27[2][a]

(cont'd)

In this Stock-for-Stock Exchange, Corp X's acquisition of the Old Stock is *not* a repurchase for Excise Tax purposes because this stock-for-stock exchange is not a Section 317(b) Redemption.[100] But absent Treasury guidance to the contrary, Corp X's issuance of the New Stock would appear to be an "issuance" for Excise Tax purposes.

We note that these types of section 305(a) stock distributions and Stock-for-Stock Exchanges may not be the only types of transactions that could improperly inflate a covered corporation's issuances for purposes of the Netting Rule. Accordingly, we encourage Treasury to consider whether guidance should exclude other similar transactions that do not dilute or otherwise alter the proportionate interests of any shareholders from the definition of "issuance."

We do not believe, however, that distributions of Covered Stock to which section 305(b) applies should be excluded from the definition of "issuance" because such distributions: (i) are generally non-pro rata transactions that materially change the shareholders' proportionate interests in the distributing corporation, and (ii) are taxable to shareholders who receive the distributed stock as if they received cash or other property in a distribution and used that cash or property to purchase the stock from the distributing corporation.[101] Similarly, we do not believe that issuances of Covered Stock in exchange for debt or Straight Preferred Stock should be excluded from the definition of "issuance" because such issuances would generally change the shareholders' proportionate interests in the distributing corporation.

3. *When a Covered Instrument Is Treated as Issued; Coordination with the Employee Plan Exception*

Section 4501 does not specify when stock is treated as issued for purposes of the Netting Rule. We recommend that Treasury guidance clarify that stock is generally treated as issued for purposes of the Netting Rule when tax ownership of the stock transfers from the Applicable Entity to the recipient of the stock (and not, for example, when the stock is treated as issued for corporate law or financial statement purposes, if different from the time at which tax ownership transfers). We recommend that this guidance apply to compensatory awards of restricted stock granted to employees and other service providers that are subject to section 83 (i.e., such restricted stock should be treated as issued only if and when the shares become substantially vested, unless the recipient makes a section 83(b) election upon grant).[102] Similarly, the stock underlying a warrant, convertible debt, or similar equity-linked financial instrument would generally be treated as issued only if and when the shares are transferred (or deemed transferred)

(7th ed. 2000 & Supp. 2022-2) ("Although the regulations are concerned mainly with exchanges of preferred stock for common stock, and vice versa, an exchange of common for common or preferred for preferred could equally well qualify as a recapitalization.").

The Old Stock and New Stock could actually be exchanged in form, or could be deemed exchanged as a result of a modification of the terms of stock (e.g., through an amendment of Corp X's certificate of incorporation).

[100] *See* section 317(a).

[101] Deemed section 305(b) distributions pursuant to section 305(c) would also need to be considered.

[102] *See* Treas. Reg. 1.83-1(a)(1)(ii) ("Until such property becomes substantially vested the transferor shall be regarded as the owner of such property . . . .").

to the holder upon exercise or settlement.[103] On the other hand, stock would presumably not be treated as issued for purposes of the Netting Rule if merely transferred to a direct or indirect wholly-owned subsidiary of the covered corporation, without a subsequent transfer of the stock by the subsidiary to a non-subsidiary during the taxable year.[104]

We further recommend that this guidance coordinate the treatment of stock provided as employee compensation: (i) as issued under the Netting Rule, and (ii) as contributed to an Employee Plan under the Employee Plan Exception.[105] There is a potential for double-counting subtractions from the Excise Tax base where unissued stock that has been repurchased is contributed to an Employee Plan, and that same stock is also either currently or later treated as issued to an employee for Netting Rule purposes. We recommend that, to the extent repurchased stock is contributed to an Employee Plan and offsets the Excise Tax base pursuant to the Employee Plan Exception, a current or later issuance of that same stock be disregarded for purposes of the Netting Rule.

4. *Application of the Netting Rule to 2022-2023 Fiscal Year Taxpayers*

The effective date for the Excise Tax provides that it shall apply "to repurchases . . . of stock after December 31, 2022."[106] In turn, the Netting Rule reduces the repurchases taken into account under section 4501(a) "by the fair market value of any stock issued by the covered corporation *during the taxable year*."[107] Based on the plain language of these provisions, a taxpayer that has a non-calendar year as its taxable year may apparently, in the first fiscal year to which the Excise Tax applies, net all issuances during the fiscal year against repurchases during the 2023 portion of the fiscal year.

> **Example 3**: *Application of Netting Rule to Fiscal Year Taxpayer in 2022-2023*. Corp X has a fiscal year for federal income tax purposes that ends March 31. From April 1, 2022 through December 31, 2022 (the "**2022 Period**"), Corp X repurchases $30 of stock and issues $40 of stock. From January 1, 2023 through March 31, 2023 (the "**2023 Period**"), Corp X repurchases $55 of stock and issues $10 of stock.

The Excise Tax applies only to Corp X's repurchases during the 2023 Period (i.e., the $55 of stock repurchased from January 1, 2023 through March 31, 2023). But the Netting Rule

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[103] For more detailed discussion of Option Contracts (as defined below) and convertible debt, see *infra* Part V.E.1 & 5.

[104] A mere transfer of stock to a wholly-owned subsidiary would not dilute the proportionate interests of existing shareholders, much like the Stock-for-Stock Exchanges and section 305(a) stock distributions described above. *See supra* Part V.B.2. Guidance could also clarify whether or not transfers to *non*-wholly-owned Specified Affiliates, without a subsequent transfer to another person, constitute issuances for purposes of the Netting Rule. For instance, those transfers could be treated as issuances to the extent of minority ownership of the Specified Affiliate (i.e., to the extent that the transfer is dilutive), or could instead be excluded entirely from the definition of issuance in order to establish a simpler, bright-line rule.

[105] For other recommendations related to the Employee Plan exception, see *infra* Part V.G.5.

[106] Inflation Reduction Act of 2022, section 10201(d).

[107] Section 4501(c)(3) (emphasis added).

apparently applies to any issuances by Corp X "during the taxable year."[108] During the taxable year, Corp X issued $50 of stock in total ($40 during the 2022 Period plus $10 during the 2023 Period). Accordingly, Corp X has $5 of repurchases subject to the Excise Tax ($55 of gross repurchases minus $50 of issuances).

It could be argued that taxpayers should not be able to offset gross issuances during the 2022 Period of a fiscal year against repurchases during the 2023 Period of a fiscal year. Accordingly, Treasury could consider a transition rule for 2022-2023 fiscal years. This rule could provide that a fiscal year taxpayer may only use *net* issuances—i.e., issuances net of redemptions—from the 2022 Period for purposes of the Netting Rule. Under this rule, Corp X would be treated as having issued $10 of stock during the 2022 Period ($40 of issuances minus $30 of redemptions during that period). Accordingly, Corp X would have $35 of repurchases, instead of $5, subject to the Excise Tax ($55 of repurchases minus $20 of issuances). To the extent that Treasury issues this type of transition rule, we believe it is important that notice of the rule be given prior to the Excise Tax's effective date in order to avoid a retroactive change in the apparent statutory treatment of fiscal year taxpayers.

C. *General Exclusion for Pro Rata Transactions*

We recommend that the definition of "repurchase" exclude distributions—both redemptive and non-redemptive—that are made to all shareholders of a covered corporation on a 100% pro rata basis (a "**100% Pro Rata Distribution**," and such recommendation, the "**Pro Rata Exclusion Principle**"). We do not believe that 100% Pro Rata Distributions implicate most of the policy considerations behind the Excise Tax. It is true that a shareholder can potentially obtain sale or exchange treatment for a 100% Pro Rata Distribution by taking actions independent from the distributing corporation.[109] But we believe that, where a covered corporation makes a 100% Pro Rata Distribution, the corporate-level Excise Tax analysis should not be impacted by such independent shareholder actions.[110]

If Treasury guidance adopted this recommendation, such guidance would have to consider the treatment of covered corporations with multiple outstanding types of Covered Instruments (i.e., how to determine whether a redemptive or non-redemptive distribution is a 100% Pro Rata Distribution for a more complicated capital structure), and may also consider the impact of 100% Pro Rata Distributions on non-Covered Instruments, such as options or convertible debt, to the extent such non-Covered Instruments thereby accrete their proportionate interest in the covered corporation.

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[108] Section 4501(c)(3).

[109] *See, e.g.*, *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 75-447, 1975-2 C.B. 113.

[110] The Pro Rata Exclusion Principle, if accepted, would be relevant to numerous topics discussed below. *See infra* Parts V.D.2 & V.E.1 & 3-4. If desired, this rule could be subject to an anti-abuse rule that could apply where, for example, the corporation works with a third party to provide shareholder liquidity or otherwise to facilitate shareholder-level transactions that defeat dividend equivalence.

D. *Section 301 Distributions; Section 302(d) Redemptions; Related Substantiation Issues*

Under the Dividend Exception, the Excise Tax does not apply "to the extent that the repurchase is treated as a dividend for purposes of this title."[111] The amount of a distribution "which is a dividend" for purposes of the Code is the portion of a distribution that is made out of a corporation's current or accumulated E&P.[112] Therefore, while it is clear that Congress intended to exempt from the Excise Tax the portion of a distribution that constitutes a "dividend" under section 301(c)(1), it is arguably unclear whether Congress intended the Excise Tax to apply to the portion of a distribution that is treated as a return of basis under section 301(c)(2) or gain from the sale or exchange under section 301(c)(3). A similar issue arises when: (i) a redemption is treated as a distribution of property to which section 301 applies under section 302(d) (i.e., the redemption does not qualify for sale or exchange treatment under section 302(a)), but (ii) there is insufficient E&P to treat this deemed section 301 distribution as a dividend. We discuss actual and deemed section 301(c)(2)-(3) distributions in turn. Then, we discuss substantiation for dividend treatment of a section 302(d) redemption.

1. *Actual Section 301(c)(2)-(3) Distributions*

An actual distribution of property governed by section 301(a) is not a Section 317(b) Redemption because the distributing corporation does not acquire its stock from its shareholders.[113] Thus, the portions of an actual distribution governed by section 301(c)(2)-(3) could be subject to the Excise Tax only to the extent that such portions are "economically similar" to a Section 317(b) Redemption.[114] We believe that the portions of a section 301(a) distribution to which section 301(c)(2)-(3) would apply are generally not, by their nature, economically similar to a Section 317(b) Redemption of the type targeted by the Excise Tax. In particular, no portion of a distribution governed by section 301(a) bears relevant economic similarities to a Section 317(b) Redemption nor implicates the policy concerns that prompted the enactment of the Excise Tax. For example, a section 301(a) distribution does not reduce a shareholder's proportionate interest in the distributing corporation as it does not result in a reduction of the number of shares owned by such shareholder.[115] As such, shareholders not receiving the distribution do not accrete their interests in the corporation's assets or earnings, and no corresponding increase in the corporation's EPS occurs. Lastly, return of basis and exchange treatment only arise after the corporation has distributed all of its E&P as taxable dividends, so that section 301(c) distributions do not generally provide the immediate basis recovery that has historically made section 302(a) redemptions relatively more tax-efficient.

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[111] Section 4501(e)(6).

[112] Section 301(c)(1); section 316.

[113] Section 301(a).

[114] Section 4501(c)(1)(B).

[115] *See, e.g.*, *United States v. Davis*, 397 U.S. 301 (1970) (a redemption is not essentially equivalent to a dividend if it results in a meaningful reduction of the shareholder's proportionate interest in a corporation); *see also Schmidt v. Commissioner*, 55 T.C. 335 (1970) (holding that a Section 317(b) Redemption requires a corporation to acquire beneficial ownership of the shares).

For these reasons, we recommend that Treasury clarify in guidance that the portion of a distribution treated as a return of basis or gain from sale or exchange under section 301(c)(2) and (3), respectively, is not economically similar to a Section 317(b) Redemption.

2. *Deemed Section 301(c)(2)-(3) Distributions*

Section 302(d) provides that if a Section 317(b) Redemption does not qualify for sale or exchange treatment under section 302(a), the redemption is deemed to be a distribution of property to which section 301 applies. That redemption remains a "repurchase" for purposes of the Excise Tax. It is clear that the portion of a section 302(d) redemption that is treated as a dividend under section 301(c)(1) is exempted from the Excise Tax under the Dividend Exception. However, it is not clear whether the portion of this deemed distribution that is treated as a return of basis or as gain from a sale or exchange should fall within the scope of the Excise Tax as a policy matter.

On one hand, any Section 317(b) Redemption (unlike a "true" dividend) reduces a company's outstanding shares and may increase a company's EPS, and therefore could raise some of the policy concerns described above. On the other hand, Congress expressly made the dividend portion of a section 302(d) redemption exempt from the Excise Tax, and it is not clear why these concerns should apply with greater force to the non-dividend portion of a section 302(d) redemption.

Consistent with the Pro Rata Exclusion Principle, we recommend that Treasury issue guidance excluding redemptions from the definition of "repurchase" if the redemption is a 100% Pro Rata Distribution. Such redemptions do not reduce any redeemed shareholder's proportionate interest in the corporation, and therefore are more akin to an actual section 301 distribution than a typical stock repurchase. To the extent a particular shareholder might qualify for section 302(a) sale or exchange treatment in a 100% Pro Rata Distribution, that treatment would be solely attributable to the shareholder's own independent actions (i.e., a secondary market disposition of shares before or after the redemption). For these reasons, we believe that an appropriate general principle is that section 302(d) redemptions that are 100% Pro Rata Distributions—whether or not the redemption is demonstrated to qualify under section 302(d) as to particular shareholders, and whether or not treated as out of E&P—should not be subject to the Excise Tax.[116] With respect to redemptions that are not 100% pro rata, guidance could confirm that section 302(d) redemptions are repurchases to the extent subject to section 301(c)(2)-(3).

3. *Substantiating Qualification for the Dividend Exception*

With respect to the Dividend Exception, a covered corporation is unlikely to know definitively whether a Section 317(b) Redemption is properly treated as a dividend with respect to a given shareholder. In the case of ordinary open market stock repurchases, the purchasing corporation generally does not (and cannot) know the identity of the selling shareholder. Even in situations where the purchasing corporation can ascertain the identity of the selling shareholder,

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[116] *Cf.* section 1059(e)(1)(A)(ii) (potentially treating as an extraordinary dividend a redemption of stock "which is not pro rata as to all shareholders").

the purchasing corporation may still not be able to determine with certainty whether the repurchase is properly treated as a sale or exchange under section 302(a) or as a section 301 distribution under section 302(d), as that determination turns on shareholder-specific facts that may not be available to the corporation. Importantly, other share disposition and acquisition transactions undertaken by the redeemed shareholder separately from the Section 317(b) Redemption (and not involving the covered corporation or any Applicable Entity) could impact the appropriate treatment.[117]

Accordingly, we recommend that Treasury guidance provide a safe harbor that an Applicable Entity can satisfy to demonstrate that a Section 317(b) Redemption qualifies for the Dividend Exception. If Treasury adopts the Pro Rata Exclusion Principle, this safe harbor would generally be relevant only to Section 317(b) Redemptions that are not completely pro rata but that might still qualify under section 302(d) as to particular shareholders.

Specifically, we recommend that guidance provide a safe harbor that the Dividend Exception will apply to a Section 317(b) Redemption if the covered corporation:

- Provides information reporting, as applicable, to the redeemed shareholder, providing that the Section 317(b) Redemption constitutes a dividend;
- Obtains certification from the shareholder that the Section 317(b) Redemption constitutes a section 302(d) redemption;[118]
- Has no knowledge of facts that would indicate that such certification is incorrect; and
- Demonstrates that it has sufficient E&P to treat the deemed section 301 distribution as a dividend.

E. *Treatment of Specific Types of Instruments*

The following sections discuss the applicability of the Excise Tax to selected types or classes of instruments.

1. *Stock Options, Warrants, and Other Option-Like Instruments*

Public corporations often use call options as part of compensation programs for employees and frequently issue warrants, put options, or other instruments that include rights to acquire the issuer's stock in connection with stock and bond offerings to enhance the appeal of the instruments offered. These stock options, warrants, and other instruments—contracts that

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[117] *See, e.g.*, *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 75-447, 1975-2 C.B. 113.

[118] In the context of withholding obligations under section 1441, the IRS allows taxpayers to follow a similar certification procedure to determine whether a foreign shareholder is entitled to sale or exchange treatment under section 302(a). *See* Notice of Proposed Rulemaking, *Withholding Procedures Under Section 1441 for Certain Distributions to Which Section 302 Applies*, 72 Fed. Reg. 58,781 (Oct. 17, 2007). That guidance could be used as a model for shareholder certifications regarding section 302(d) redemption treatment for purposes of the Dividend Exception.

give one of the parties the right to buy or sell the covered corporation's stock at a specified price by a specified date (collectively, "**Option Contracts**")—generally have the same treatment under established federal income tax principles.[119]

(a) *Threshold Treatment of Option Contracts for Excise Tax Purposes*

A settlement of certain Option Contracts can have some accretive effects and increase certain EPS metrics.[120] Thus, a threshold question is whether a purchase of an Option Contract by a covered corporation should be treated as a redemption of the underlying stock and thus as a Covered Instrument for Excise Tax purposes. For federal income tax purposes, the grant of an Option Contract is generally not treated as the delivery of the underlying stock.[121] Consistent with that basic principle, we believe that Treasury should not consider a purchase of an Option Contract by a covered corporation as a redemption of the underlying stock for Excise Tax purposes. An Option Contract is economically distinct from stock because typically the Option Contract only provides for a measure of either upside or downside participation, and only does so for a limited period of time. Unlike stock, an Option Contract generally does not represent an ownership interest in the issuer because it does not convey voting rights or participation in dividends. Further, the Excise Tax's legislative history demonstrates that Congress at one point considered, but ultimately rejected, the idea of the Excise Tax applying to Option Contracts in the same manner as stock. Specifically, an earlier version of the Excise Tax statute required that the "acquisition by a corporation of the right to acquire its stock" be treated as a Section 317(b) Redemption.[122] However, this language was removed from subsequent drafts, and does not appear in the final statutory text. This evolution in the statutory language suggests that Congress deliberately decided not to apply the Excise Tax to Option Contracts in the same manner as stock.

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119 *See* Rev. Rul. 78-182, 1978-1 C.B. 265.

120 An extinguishment of a call Option Contract reduces the number of shares *potentially* outstanding because the optionee surrenders its right to purchase shares from the covered corporation. Also, diluted EPS is increased when a call Option Contract is cancelled because the denominator of the diluted EPS formula is decreased. The same is not necessarily true for the cancellation of a put Option Contract. The denominator of the basic EPS formula should be unaffected by the cancellation of an Option Contract.

121 Rev. Rul. 78-182; *see also* Rev. Rul. 58-234, 1958-1 C.B. 279, *clarified*, Rev. Rul. 68-151, 1968-1 C.B. 363; *Commissioner v. LoBue*, 351 U.S. 243 (1956) (option subject to taxation on exercise date, not grant date, where strike price represented 25% of the fair market value of the underlying shares on the date of grant); *Victorson v. Commissioner*, 326 F.2d 264 (2d Cir. 1964) (99.8% in-the-money option taxable in year of exercise); *Simmons v. Commissioner*, 23 T.C.M. (CCH) 1423 (1964) (option to purchase stock worth $1 per share for $.001 not considered grant of the underlying stock). *But see infra* V.E.1(b)(ii)(1)(B) for a discussion of deep-in-the-money Option Contracts.

122 Stock Buyback Accountability Act of 2021, S. 2758, 117th Cong. section 4501(c)(B)(i) (Sept. 20, 2021). *See also* U.S. Senate Committee on Finance, *Wyden Stock Buyback Legislation Passes Senate* (Aug. 7, 2022) ("A modified version of the Stock Buyback Accountability Act was included in the Inflation Reduction Act."), https://www.finance.senate.gov/chairmans-news/wyden-stock-buyback-legislation-passes-senate.

Accordingly, we believe that an Option Contract is sufficiently dissimilar from stock so as not to be treated as stock for Excise Tax purposes as a general matter, and the legislative history supports this conclusion.

(b) *Physical and Net Cash Settlement of Option Contracts*

Even if an Option Contract is not generally treated as a Covered Instrument, a remaining question is whether settling Option Contracts in certain circumstances should be subject to the Excise Tax and/or give rise to a stock issuance for purposes of the Netting Rule. There are four basic option transactions that a covered corporation can enter into with respect to its own stock: (1) issue a call Option Contract; (2) issue a put Option Contract; (3) purchase a call Option Contract; or (4) purchase a put Option Contract. Each of these alternatives can involve either physical settlement or cash settlement.

(i) *Physical Settlement of Option Contracts*

(1) *Call Option Contracts*

In a physical settlement of a call Option Contract, the optionor transfers the underlying stock to the optionee in exchange for the sum of the option premium and the strike price.

When a covered corporation is the optionor in a call Option Contract and the Option Contract is physically settled, the Excise Tax has no application because the covered corporation only issues stock and does not engage in a Section 317(b) Redemption or an economically similar transaction. To the extent that a covered corporation issues stock in connection with the physical settlement of a call Option Contract such issuance should be counted as an issuance for purposes of the Netting Rule because section 4501(c)(3) expressly includes "stock issued or provided in response to the exercise of an option to purchase."[123] However, the amount taken into account under the Netting Rule should be clarified.

> **Example 4**: *Physical settlement of a call option where the covered corporation is the optionor*. Corp X issues an option that entitles the optionee to buy 100 shares of Corp X stock at a strike price of $100 ($1 per share) to Corp X for a limited time. Corp X stock is trading at $1 per share on the grant date, and the terms of the option require physical settlement. On the date that the option is exercised, Corp X stock is trading at $1.30 per share. To settle the option, the optionee pays Corp X $100 and Corp X issues 100 shares of Corp X.

In this scenario, the plain language of the Netting Rule requires taking into account the "the fair market value of any stock issued by the covered corporation during the taxable year."[124]

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[123] Essentially the same analysis applies for net cashless exercise, where the amount of shares actually issued is limited to the in-the-money spread value of the option. Net cashless excise could be viewed as either: (i) the issuance of the gross number of shares owed under the option, followed by a redemption of shares equal in value to the strike price, or (ii) the net issuance of shares equal to the spread value. In either case, no Excise Tax liability would accrue, and the net amount of shares actually issued would count as a net issuance for purposes of the Netting Rule.

[124] Section 4501(c)(3).

Therefore, the amount of the issuance for purposes of the Netting Rule should be $130—the fair market value of the issued stock on the exercise date—and not $100—the strike price the optionee paid pursuant to the call Option Contract.

Conversely, a Section 317(b) Redemption occurs when a covered corporation is the optionee of a call Option Contract with respect to its own stock that is physically settled.

> **Example 5**: *Physical settlement of a call option where the covered corporation is the optionee*. Two unrelated parties enter into a call option with respect to Corp X shares under which the optionee is entitled to purchase 100 shares of Corp X stock from the optionor at a strike price of $100 ($1 per share) for a limited time. Corp X shares trade at $1 per share on the grant date, and the terms of the option require physical settlement. On a subsequent date, Corp X purchases the call option from the optionee and exercises the call option when Corp X stock trades at $1.30 per share. To settle the option, the optionor delivers to Corp X 100 shares of Corp X stock and Corp X pays $100 to the optionor.

While it is clear that Corp X engaged in a Section 317(b) Redemption, it is not entirely clear what the appropriate Excise Tax base should be for this transaction. One could argue that the value of the repurchase should be $100 because that is the strike price paid by Corp X under the option. We believe, however, that the appropriate Excise Tax base should be $130—the "fair market value" of the repurchased stock on the exercise date.[125]

In addition to being faithful to the language of the statute, consistent use of fair market value as in the above two Examples should generally produce symmetric results for purposes of the Netting Rule and measuring the Excise Tax base.[126]

(2) *Put Option Contracts*

In a physical settlement of a put Option Contract the optionor purchases the underlying stock from the optionee in exchange for the strike price net of the option premium. When a covered corporation physically settles a put Option Contract, it generally engages in a Section 317(b) Redemption subject to the Excise Tax. Once again, the appropriate Excise Tax base should be clarified.

> **Example 6**: *Physical settlement of a put option where the covered corporation is the optionor*. Corp X issues an option that entitles the optionee to sell 100 shares of Corp X stock at a strike price of $100 ($1 per share) to Corp X for a limited time. Corp X stock is trading at $1 per share on the grant date, and the terms of the option require physical settlement. On the date that the option is exercised, Corp X stock is trading at $0.70 per share. To settle the option, Corp X purchases from the optionee 100 shares of Corp X stock for $100.

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[125] Section 4501(c)(3).

[126] *See infra* Part V.G.3.

Consistent with our approach in Example 5, we believe that the appropriate Excise Tax base in this transaction is $70—the fair market value of the repurchased stock on the exercise date—and not $100—the strike price paid under the put Option Contract. In this case, the premium paid by Corp X in excess of the trading value of Corp. X stock, or $30, represents the amount paid by the covered corporation for a property right separate from the stock being repurchased.[127] This amount is akin to a liability of the covered corporation arising from the pricing of the Option Contract, and should not be considered attributable to the "fair market value of the stock repurchased" for purposes of the Excise Tax.[128]

Under the Netting Rule, an issuance should result when a covered corporation purchases a put Option Contract with respect to its own stock and physically settles it.

> **Example 7**: *Physical settlement of a put option where the covered corporation is the optionee*. Two unrelated parties enter into a put option with respect to Corp X shares under which the optionee is entitled to sell 100 shares of Corp X stock to the optionor at a strike price of $100 ($1 per share) for a limited time. Corp X shares trade at $1 per share on the grant date, and the terms of the option require physical settlement. On a subsequent date, Corp X purchases the put option from the optionee and elects to exercise the put option when Corp X stock trades at $0.70 per share. To settle the option, Corp X issues 100 shares of Corp X stock to the optionor, and the optionor pays $100 to Corp X.

Consistent with our approach in Example 4, we believe that the amount of the issuance counted under the Netting Rule should be $70—the fair market value of the issued stock on the exercise date—and not $100—the price the optionor paid to settle the put Option Contract.

(ii) *Net Cash Settlement of Option Contracts*

Option Contracts may provide for discretionary or mandatory cash settlement on exercise. In these transactions, the issuing corporation pays the holder of the instrument cash equal to the intrinsic value of the Option Contract. Generally, Treasury has treated a cash settlement of an Option Contract as a sale or exchange of the option.[129] Thus, cash settlement of an Option Contract should not qualify as a Section 317(b) Redemption because it generally does not involve the acquisition of stock as discussed above. However, net cash settlement of an Option Contract could arguably be considered as functionally equivalent to a repurchase by the issuer of the underlying stock. Therefore, the question is whether, and to what extent, the net

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[127] *See* Rev. Rul. 70-108, 1970-1 C.B. 78 (finding that rights to purchase additional shares constitute separate property from the underlying shares).

[128] The same issue arises any time that a covered corporation redeems its stock and pays a premium over the market price.

[129] *See, e.g.*, section 1243(c)(2); Rev. Rul. 88-31, 1988-1 C.B. 302 (providing that the net cash settlement of a price-protection contingent value right is treated as a cash settlement of a put option subject to section 1234(c)(2)), *modified*, Ann. 88-86, 1988-20 I.R.B. 50. Also, the preamble to the final noncompensatory partnership option regulations states that "[t]he Treasury Department and the IRS believe that the cash settlement of a noncompensatory option should be treated as a sale or exchange of the option and taxed under section 1234." T.D. 9612, 2013-13 I.R.B. 678, *clarified*, Ann. 2013-28, 2013-17 I.R.B. 982, *and* Ann. 2013-35, 2013-27 I.R.B. 46.

cash settlement of an Option Contract could be subject to the Excise Tax because it arguably involves a transaction economically similar to a Section 317(b) Redemption.

(1) *Call Option Contracts*

(A) *General Approach*

Unless the instrument is treated as constructively exercised at the time of the grant under general tax principles, we believe that a net cash settlement of a call Option Contract should either: (i) be treated as a deemed issuance of stock followed by an immediate repurchase of the same stock (which should result in zero Excise Tax due under the Netting Rule, as discussed below), or (ii) be disregarded for purposes of the Excise Tax.

> **Example 8**: *Net cash settlement of a call option where the covered corporation is the optionor*. Corp X issues an option that entitles the optionee to purchase 100 shares of Corp X stock at a strike price of $100 ($1 per share) for a limited time. Corp X shares trade at $1 per share on the grant date, and the terms of the option require net cash settlement. On the date that the option is exercised, Corp X stock trades at $1.30 per share. To settle the option, Corp X pays the optionee $30, the intrinsic value of the option.[130] This net cash payment of $30 is equivalent in effect to the optionee paying $100 to exercise the option; Corp X issuing 100 shares to the optionee; and Corp X immediately redeeming those 100 shares for $130.[131]

For purposes of the Excise Tax, we believe that it is necessary to recognize both the deemed issuance of 100 shares *and* the deemed redemption of 100 shares of equal value that are reflected in this net settlement.[132] Thus, the transaction should not result in any Excise Tax liability because the $130 deemed repurchase is reduced to zero due to a simultaneous $130 deemed issuance. Alternatively, the same result would be reached if net cash settlements of Option Contracts are disregarded for purposes of the Excise Tax.

One could argue that the example above should produce a net redemption of $30, since the holder only "contributed" value of $100 and extracted value of $130 from the corporation. We believe that approach would conflict with the plain language of the Netting Rule. Under the Netting Rule, the repurchase amount on which the Excise Tax is imposed is expressly reduced by "the fair market value of any stock issued by the covered corporation during the taxable year."[133]

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[130] ($1.30 market price per share - $1 strike price per share) * 100 shares = $30.

[131] $130 repurchase price paid by Corp X - $100 exercise price paid by the optionee = $30 net cash payment to the optionee.

[132] In several contexts, deemed Section 317(b) Redemptions occur (or could be arguably viewed as occurring) under Subchapter C or other tax principles. Such a deemed Section 317(b) Redemption could, depending on the context and in the absence of regulatory relief, arguably be subject to the Excise Tax. But often, as here, that deemed Section 317(b) Redemption would necessarily be immediately preceded by a deemed *issuance* of a corresponding amount of stock. In these circumstances (including for net cash settlement of Option Contracts), we recommend that *both* the deemed issuance and deemed Section 317(b) Redemption must be considered in applying the Excise Tax—either by netting the repurchase and offsetting issuance to zero under the Netting Rule or disregarding both to the same effect.

[133] Section 4501(c)(3).

This means that the Netting Rule should only consider the fair market value of the stock issued, without regard to the fair market value contributed in exchange for such stock. In other words, there is no requirement that the issuance by a covered corporation is made in exchange for a contribution of property of equal value, and the Netting Rule's reference to stock issued to employees likewise suggests that no cash or other property of equal value is required to be transferred to the corporation in order for the fair market value of such stock to be counted as an issuance. Furthermore, in certain cases, the holder may well be considered to have contributed to Corp X "value" of $130. Specifically, the holder paid a strike price of $100, while the remainder may reflect other value (e.g., services performed for Corp X in the case of a compensatory Option Contract, a lower interest rate in the case of a warrant issued to a lender as part of a financing package, or the payment of an option premium in cash at the time of grant) that the holder conveyed to Corp X to induce it to issue the Option Contract.

(B) *Deep-in-the-Money Call Option Contracts*

We believe that the Excise Tax should apply to the net cash settlement of deep-in-the-money Option Contracts that are treated as ownership of the underlying stock as of the date of the grant for federal income tax purposes.[134]

> **Example 9**: *Net cash settlement of a deep-in-the-money call option*. Corp X issues an option that entitles the optionee to purchase 100 shares of Corp X stock at a strike price of $100 ($1 per share) for a limited period of time. On the grant date, Corp X stock trades at $4 per share, and the terms of the option allow for net cash settlement. On the date the option is exercised, shares of Corp X stock trade at $6 per share. When the optionee exercises the option, Corp X elects to settle the option by paying the optionee $500, the intrinsic value of the option, to settle the option.[135]

Under federal income tax principles, the option could be treated as issuance of 100 shares of Corp X stock with a fair market value of $400 as of the date of grant.[136] If the grant and the net cash settlement both occur during the same taxable year, the transactions should be treated as an issuance on the grant date of 100 shares of Corp X stock with a fair market value of $400, and a repurchase on the exercise date by Corp X of 100 shares with a fair market value of $600. Therefore, there is a net repurchase amount of $200 to which the Excise Tax should apply, subject to further netting if Corp X makes additional issuances during the year. If the grant and the net cash settlement occur during different taxable years, the fair market value of the issuance of $400 should count as an issuance in the year of grant for purposes of the Netting Rule, and the fair market value of the repurchase of $600 should count as a repurchase in the year of exercise.

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[134] Certain deep-in-the-money stock options are treated as exercised, and the underlying stock delivered, upon the grant of an option for federal income tax purposes. *See* Rev. Rul. 82-150, 1982-2 C.B. 110 (non-compensatory option recharacterized to purchase of underlying stock where option premium represented 70% of the fair market value of the shares on the grant date); *Morrison v. Commissioner*, 59 T.C. 248 (1972) (option to acquire stock worth $300 at grant for $1 was the substantial equivalent of the stock itself), *acq*. 1973-2 C.B. 3.

[135] ($6 market price per share - $1 strike price per share) * 100 shares = $500.

[136] *See supra* note 134.

(C) *Section 305(a) Distribution of Call Option Contracts*

Another exception to our recommended approach to net cash settlement of call Option Contracts may be warranted if a covered corporation issues an Option Contract in a section 305(a) distribution. Specifically, in order to prevent avoidance of our recommended treatment of section 305(a) distributions of stock,[137] where the call options were previously distributed as warrants or similar stock rights in a section 305(a) distribution ("**Section 305(a) Warrants**"), the fair market value of the issuance upon a later physical settlement (or of the deemed issuance upon a later net cash settlement) for purposes of the Netting Rule should be limited to the *strike price* of the Section 305(a) Warrants.

> **Example 10**: *Net cash settlement of Section 305(a) Warrants*. The facts are the same as Example 8, except that Corp X issued Section 305(a) Warrants. To settle the Section 305(a) Warrants, Corp X elects to net cash settle by paying the holder $30.[138]

Under our recommended general approach, upon the net cash settlement of the Section 305(a) Warrants, there would be a deemed issuance of 100 shares of Corp X worth $130, immediately followed by a redemption of 100 of Corp X shares worth $130, resulting in zero net issuance. (Or, alternatively, the net cash settlement would simply be disregarded for Excise Tax purposes.) But where the call options are Section 305(a) Warrants, the intrinsic value of the Section 305(a) Warrants (i.e., the spread value) does not represent, in a substantive sense, an issuance upon exercise because the Section 305(a) Warrants were distributed pro rata with respect to common stock for no consideration. In other words, for purposes of the Netting Rule, the intrinsic value of the Section 305(a) Warrants is analogous to stock distributed in a section 305(a) distribution and so should be disregarded for purposes of applying the Netting Rule. Accordingly, under our proposed approach for Section 305(a) Warrants, because the strike price for 100 shares is $100 in Example 10, the net repurchase amount for Example 10 should be $30.[139]

For the same reasons, to the extent that Section 305(a) Warrants are physically settled, the amount issued for purposes of the Netting Rule should also be limited to the strike price.

(2) *Put Option Contracts*

Similar issues arise when a covered corporation issues a put Option Contract that is net cash settled. For example:

> **Example 11**: *Net cash settlement of a put option where the covered corporation is the optionor*. Corp X issues an option that entitles the optionee to sell Corp X 100 shares of Corp X stock at a strike price of $100 ($1 per share) for a limited time.

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[137] *See supra* Part V.B.2.

[138] ($1.30 market price per share - $1 strike price per share) * 100 shares = $30.

[139] $130 gross repurchase - $100 gross issuance (equal to strike price because Option Contracts are Section 305(a) Warrants) = $30 net repurchase.

Corp X stock is trading at $1 per share on the grant date, and the terms of the option require net cash settlement. On the date that the option is exercised, Corp X stock is trading at $0.70 per share. To settle the option, Corp X pays the optionee $30.[140]

As discussed above for physical settlements, we believe that the $30 that Corp X pays in the net cash settlement of the put option, which represents the excess of the strike price over the fair market value of the referenced stock, should not be a repurchase subject to the Excise Tax because it represents payment for property that is separate from the referenced stock.

2. *Straight Preferred Stock*

Public corporations, particularly in certain regulated industries, frequently issue preferred stock.[141] There can be strong non-tax incentives for financial institutions, insurance companies, and other finance companies to issue preferred stock because it can potentially help satisfy regulatory capital requirements. A redemption of preferred stock is generally a Section 317(b) Redemption.[142] Therefore, absent regulatory relief, a redemption of preferred stock by a covered corporation would apparently constitute a repurchase subject to the Excise Tax.

We believe that redemptions of Straight Preferred Stock— "preferred stock" within the meaning of section 1504(a)(4) (but without regard to the requirements of section 1504(a)(4)(A) and (C))—do not present the policy concerns that prompted the enactment of the Excise Tax.[143] Specifically, redemptions of Straight Preferred Stock are not the type of opportunistic stock repurchases that motivated the Excise Tax. Rather, because preferred stock generally has a fixed or limited dividend yield and does not otherwise significantly participate in corporate growth, Straight Preferred Stock redemptions are akin to repaying a class of debt. When Straight Preferred Stock is redeemed, common shareholders experience financial accretion and an increase in EPS solely to the extent the covered corporation does not have to pay the stated dividend in the future, similar to what happens when a class of debt is repaid.[144] Further, if

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[140] ($1 strike price per share - $0.7 market price per share) * 100 shares = $30.

[141] The aggregate outstanding amount of all preferred stock listed on Bloomberg's database as of October 3, 2022, is approximately $2 trillion.

[142] *See* Rev. Rul. 66-37, 1966-1 C.B. 209 (holding that a redemption of preferred stock in exchange for cash was a Section 317(b) Redemption).

[143] This section only addresses "preferred stock" within the meaning of section 1504(a)(4) (but without regard to the requirements in section 1504(a)(4)(A) and (C)). Section 1504(a)(4)(A) requires that stock be non-voting, and section 1504(a)(4)(C) requires that stock have redemption and liquidation rights that do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium). We do not believe these characteristics are relevant to the treatment of stock as Straight Preferred Stock for Excise Tax purposes. Participating preferred stock and convertible preferred stock are discussed *infra* in Part V.E.3.

[144] Under ASC 260, basic EPS is the quotient obtained by dividing: (i) the income available to a parent company's common stockholders, and (ii) the weighted average number of common shares outstanding. The computation of diluted EPS is similar to the computation of basic EPS, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares (i.e., shares issuable pursuant to securities or other contracts that may entitle its holder to obtain common stock during the reporting period or after the end of the reporting period) had been issued. A redemption of Straight Preferred Stock does not affect the denominator of the basic or diluted EPS formula because Straight Preferred Stock is disregarded for purposes of computing the EPS denominator under both metrics. Therefore,

(cont'd)

Straight Preferred Stock were subject to the Excise Tax, that would likely incentivize public corporations to increase their leverage by issuing debt in lieu of Straight Preferred Stock to avoid the Excise Tax. This tax incentive would add to the existing tax incentives to issue debt instead of equity, and would run contrary to the non-tax regulatory preference for Straight Preferred Stock as a funding source for regulated financial entities.[145]

We also considered whether to recommend instead that the definition of "preferred stock" in Treasury Regulation section 1.305-5(a) apply for Excise Tax purposes. Ultimately, we view a definition of preferred stock that is based on section 1504(a)(4)(B) and (D) as providing the better definition in this policy context. Section 1504(a)(4)(B)'s definition includes the same core economic concept of preferred stock as in Treasury Regulation section 1.305-5(a) as "limited and preferred as to dividends" and "not participat[ing] in corporate growth to any significant extent." But, unlike Treasury Regulation section 1.305-5(a), section 1504(a)(4)(D) takes the conversion feature into account. We view the additional requirement in section 1504(a)(4)(D) as relevant for Excise Tax purposes because it results in both participating and convertible preferred stock not being treated as preferred stock, and being treated in the same manner, for purposes of the Excise Tax.[146]

Consistent with the above considerations, Congress recognized that Straight Preferred Stock may require special treatment for purposes of the Excise Tax and directed Treasury to issue "regulations and other guidance . . . to address special classes of stock *and preferred stock*."[147]

Accordingly, we recommend that Treasury issue guidance exempting redemptions of Straight Preferred Stock from the scope of the Excise Tax (i.e., Straight Preferred Stock should not be a Covered Instrument). To the extent redemptions of Straight Preferred Stock are excluded from the Excise Tax, we also recommend that any issuance of Straight Preferred Stock

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Straight Preferred Stock redemptions do not involve the type of undesirable EPS manipulation that the Excise Tax is meant to curtail. However, a redemption of Straight Preferred Stock might increase the EPS of a corporation due to a reduction of preferred dividends payable, similar to a reduction of interest payable resulting from the repayment of debt.

[145] The Code generally favors debt over equity because interest on debt can be deductible against corporate income while returns to equity (in the form of dividends or share appreciation) are not. *See, e.g.*, Robert C. Pozen & Lucas W. Goodman, *Capping the Deductibility of Corporate Interest Expense*, 137 Tax Notes Fed. (TA) 1207 (Dec. 10, 2012); *see also* Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, Int'l Monetary Fund, IMF Staff Discussion Note (May 3, 2011).

[146] Using the definition of preferred stock in Treasury Regulation section 1.305-5(a) as the basis of the definition of preferred stock for Excise Tax purposes would yield opposite results for economically similar instruments. In particular, non-convertible participating preferred stock would be subject to the Excise Tax because it is not preferred stock under Treasury Regulation section 1.305-5(a), while convertible preferred stock would be exempted from the Excise Tax if it otherwise qualifies as preferred stock under Treas. Reg. 1.305-5(a). *See* Treas. Reg. 1.305-5(a) ("The determination of whether stock is preferred for purposes of section 305 shall be made without regard to any right to convert such stock into another class of stock of the corporation."). An alternative way to define Straight Preferred Stock, one that is equivalent to the definition proposed in this Report, would be to cross-reference the definition of preferred stock in Treasury Regulation section 1.305-5(a) without regard to the sentence ignoring conversion features.

[147] Section 4501(f)(2) (emphasis added).

be excluded from the Netting Rule in accordance with the Instrument Type Matching Principle.[148]

Further, to the extent that Treasury guidance provides that Straight Preferred Stock is not a Covered Instrument (e.g., common stock), an exchange of an outstanding Covered Instrument for Straight Preferred Stock should be defined as "economically similar" to a Section 317(b) Redemption.[149] This guidance would be necessary because Straight Preferred Stock is not "property" under section 317(a) to the issuing corporation, so this exchange would not be a Section 317(b) Redemption.[150] It is also appropriate because the recommendation that Straight Preferred Stock not be a Covered Instrument is based at least in part on its debt-like nature.

3. *Convertible and Other Participating Preferred Stock*

Preferred stock with certain dividend or liquidation participation rights can be treated in the same manner as common stock because those features allow the stock to participate in corporate growth to a significant extent (such participating stock, "**Participating Preferred Stock**").[151] Also, preferred stock without other participation features might be convertible into the issuer's common stock at the holder's option ("**Convertible Preferred Stock**").

A covered corporation's redemption of its common stock is clearly a Section 317(b) Redemption. Like a redemption of common stock, a redemption of Participating Preferred Stock or Convertible Preferred Stock results in non-redeemed shareholders accreting their interests in the corporation's assets or earnings because the redeemed Participating Preferred Stock or Convertible Preferred Stock holders cease to share in future corporate growth. Further, like a redemption of common stock, a redemption of Participating Preferred Stock is likely to increase a covered corporation's EPS.[152] Accordingly, a sensible approach would be to subject redemptions of Participating Preferred Stock and Convertible Preferred Stock to the Excise

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[148] Consistent with this concept, deemed issuances of Straight Preferred Stock as a result of the accrual of redemption premium under section 305(c) and Treasury Regulation section 1.305-5(b) also should not count as issuances for purposes of the Netting Rule.

[149] *See* section 4501(c)(1)(B). For a similar principle in the context of the Reorganization Exception, see *infra* Part V.F.1(b)(v).

[150] This "economically similar" recommendation would also generally apply to any other types or classes of stock within the meaning of section 317(a) that are not treated as Covered Instruments.

[151] Participating Preferred Stock includes, *inter alia*, preferred stock that provides for either an additional participating feature (i.e., in addition to its stated dividend rate and base liquidation preference, the stock also participates on an as-converted basis with the issuer's common stock in the event that the issuer pays a dividend on the common stock or the issuer liquidates), or a "greater of" participation feature (i.e., the holder is entitled to receive the greater of: (i) its base liquidation preference, or (ii) the amount the holder would receive if the preferred stock were converted into common). For an in-depth discussion of when preferred stock is treated as common stock for federal income tax purposes, *see* Peter A. Furci & David H. Schnabel, *Convertible Preferred Stock Investments by Private Funds: A Practical Guide to Tax Structuring*, PLI Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (2d ed., 2022).

[152] Under ASC 260, an entity with multiple classes of common stock or participating securities is required to apply the two-class method to compute EPS. Accordingly, a redemption of Participating Preferred Stock would likely increase EPS by reducing the EPS denominator.

Tax—i.e., to treat them as Covered Instruments—because such redemptions have similar effects as common stock redemptions for Excise Tax purposes.

An alternative approach would be to bifurcate a redemption of Participating Preferred Stock or Convertible Preferred Stock into a redemption of Straight Preferred Stock and common stock.[153] For example:

> **Example 12**: *Bifurcation approach*. At the beginning of Year 1, Corp X issues convertible preferred stock with an issue price of $100, a 1:1 conversion ratio, and an annual fixed dividend sufficient for the preferred stock to trade at par. The preferred stock is convertible into Corp X's common stock at the holder's option; the terms of the option allow for cash settlement at Corp X's option; and Corp X common stock trades at $100 per share on the issue date. At the end of Year 1, when Corp X common stock trades at $130 per share and the convertible preferred stock has a liquidation preference of $100, the holder elects to convert the preferred stock, and Corp X cash settles that conversion for $130.[154]

Under this approach, the amount of the redemption attributable to the base liquidation preference, or $100, would be excluded from the scope of the Excise Tax because it is economically equivalent to a redemption of Straight Preferred Stock. The amount of the redemption attributable to the conversion features, or $30, would be subject to the Excise Tax on the theory that this portion of the redemption is equivalent to a redemption of common stock. While this approach has the merit of targeting the application of the Excise Tax to the portion of the redemption that arguably raises relevant policy concerns, it would also introduce considerable complexity in the administration of the Excise Tax.

Therefore, we believe that the more bright-line rule is preferable, and we recommend that Participating Preferred Stock and Convertible Preferred Stock be treated as Covered Instruments in their entirety because a redemption of Participating Preferred Stock or Convertible Preferred Stock is generally more equivalent to a redemption of common stock than a repayment of debt or a redemption of Straight Preferred Stock.[155] Accordingly, issuances of Participating Preferred Stock and Convertible Preferred Stock should also count for purposes of the Netting Rule, consistent with the Instrument Type Matching Principle. Moreover, like other types of Stock-for-Stock Exchanges, a conversion of Convertible Preferred Stock into common stock should not be treated as an issuance for purposes of the Netting Rule.[156]

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[153] *Cf*. Treas. Reg. 1.1275-4(b)(4)(i) (analogous rules for determining the "comparable yield" of a contingent payment debt instrument). We do not recommend the bifurcation approach for Participating Preferred Stock or Convertible Preferred Stock (as defined below), but if it were adopted, one would need to consider how to apply bifurcation for Netting Rule purposes in light of the Instrument Type Matching Principle.

[154] Assume that the $130 redemption amount paid by Corp X represents the sum of the liquidation preference ($100) and the intrinsic value of the conversion feature ($30).

[155] Accordingly, if Treasury guidance adopted our recommendation for 100% Pro Rata Distributions, Treasury guidance may need to consider the treatment of Participating Preferred Stock and Convertible Preferred Stock in that context. *See supra* Part V.C.

[156] *See supra* Part V.B.2.

Some members of the Executive Committee of the NYSBA Tax Section expressed concern that a covered corporation could issue Participating Preferred Stock or Convertible Preferred Stock with participation or conversion features that are deeply out of the money or illusory—i.e., an instrument that is *de facto* Straight Preferred Stock. In that case, absent guidance to the contrary, the issuance would count immediately for purposes of the Netting Rule. A redemption of such an instrument would, of course, be subject to the Excise Tax, but this event may not occur for many years, in the case of redeemable preferred stock with a long term to the optional or mandatory redemption date or "perpetual" preferred stock with no stated redemption date. Treasury could consider an anti-avoidance rule that would suspend "issuance credit" for *de facto* Straight Preferred Stock until the year of redemption, or could instead address this issue within the framework of existing preferred stock authorities (i.e., by treating such stock as Straight Preferred Stock).[157]

4. ***Tracking Stock***

In general, tracking stock is a special class of common stock of a parent corporation that is linked, usually in multiple respects, to the performance of a division of the parent or a subsidiary.[158] This is generally accomplished by providing special dividend rights that are determined by reference to the earnings of the tracked division or subsidiary. Corporations issue tracking stock for various non-tax reasons, chiefly to allow investors to own separate classes of securities linked to the performance of distinct businesses operating within the same corporate umbrella, without the corporation losing ownership and control of either business. This allows capital markets to price more accurately the value of those respective businesses.[159]

Although the tax treatment of tracking stock is not always entirely clear, taxpayers generally treat tracking stock as stock of the issuing corporation rather than stock of the tracked subsidiary, and the IRS has generally not challenged that treatment.[160] Further, tracking stock is generally treated as common stock for federal income tax purposes because it participates in corporate growth.[161] Therefore, a redemption by a covered corporation of its tracking stock

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[157] *Cf.* Treas. Reg. 1.305-5(a) ("[A] right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock."); *Gerdau MacSteel, Inc. v. Commissioner*, 139 T.C. 67 (2012).

[158] Comm. On Corps. & Comm. On Reorganizations, NYSBA Tax Section, *Report Regarding "Tracking Stock" Arrangements*, 43 Tax. L. Rev. 51, 58 (1987).

[159] *See generally* James L. Dahlberg & Jay D. Perry, *Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions*, 78 Taxes 18, 24 (2000). Other reasons for issuing tracking stock include using tracking stock as currency to fund acquisitions, as a defensive measure in response to hostile takeover attempts, and as a mean of funding employee incentive programs. *Id*.

[160] The IRS will not rule on whether tracking stock is treated as stock of the issuer. Rev. Proc. 2022-3, 2022-1 IRB 144, § 3.01, *modified*, Rev. Proc. 2022-32, 2022-30 I.R.B. 101. In Private Letter Ruling 8817007 (Aug. 12, 1987), the IRS ruled favorably on a merger which provided for the issuance of tracking stock. The IRS later withdrew this ruling in Private Letter Ruling 8844038 (Aug. 8, 1988). However, several taxpayers have received private rulings relating to tracking stock where the taxpayers made representations that the tracking stock qualified as stock of the issuer. *See* P.L.R. 200229015 (Apr. 10, 2002); P.L.R. 200212012 (Dec. 17, 2001); P.L.R. 200131003 (Apr. 10, 2001); P.L.R. 9826030 (Mar. 27, 1998); PLR 9802048 (July 11, 1997); P.L.R. 9637043 (June 17, 1996); PLR 9625038 (Mar. 25, 1996); P.L.R. 9624049 (Dec. 27, 1995).

[161] *See* Treas. Reg. 1.305-5(a).

would apparently constitute a Section 317(b) Redemption, and thus a repurchase within the scope of the Excise Tax.

Where a covered corporation redeems a portion (but less than all) of a class of tracking stock, such a redemption bears the hallmarks of the conventional stock repurchases that Congress apparently intended to target with the Excise Tax. Specifically, a redemption of a portion of a class of tracking stock results in an accretion of the remaining tracking stock holders' interests in the tracked business. Further, a redemption of a portion of a class of tracking stock should increase the EPS of the remaining outstanding tracking stock within that class, akin to a redemption of regular common stock.[162] Accordingly, we recommend that redemptions of a portion (but less than all) of a class of tracking stock be treated as repurchases of a Covered Instrument because such redemptions are substantially equivalent to conventional common stock repurchases.

It is less clear whether a complete redemption of an *entire class* of tracking stock should fall within the scope of the Excise Tax. Such a redemption may be considered a Section 317(b) Redemption because the issuing corporation purchases its stock from its shareholders in exchange for property. However, we believe an exemption may be warranted with respect to a redemption of an entire class of tracking stock occurring in connection with the disposition of the underlying tracked business, whether in a taxable transaction (e.g., a sale of the tracked business and a redemption of the tracking stock with the proceeds of such sale) or in connection with a tax-free Split-Off (as defined below), notwithstanding the general market practice of treating tracking stock as stock of the issuing corporation. As discussed below, a Split-Off that qualifies for tax free-treatment should fall within the Reorganization Exception. More fundamentally, a redemption of an entire class of tracking stock in connection with a disposition of the tracked business is the equivalent of a distribution in partial liquidation, which, as explained below, should also generally be outside the scope of the Excise Tax. Importantly, a complete redemption of a class of tracking stock that results from a disposition of the tracked business generally does not accrete the interests of the corporation's remaining shareholders in the corporation's remaining assets that were not tracked by the redeemed class before the redemption.

5. ***Convertible Debt***

Public corporations also routinely issue convertible debt.[163] Generally, convertible debt is a single debt instrument—with a fixed principal amount, a fixed yield payable at fixed intervals, and a fixed maturity upon which the principal is repaid in cash—that also allows the holder to

[162] For financial accounting purposes, the issuance of tracking stock results in the creation of two classes of common stock of the consolidated entity. Subsequent to the issuance of tracking stock, EPS should be calculated separately for the residual group and for the tracking group using the two-class method provided by ASC 260. For the period that includes the tracking stock issuance, EPS is presented for the entity's single stock up to the date of issuance of tracking stock and for the tracking group stock and residual group stock for the period such stocks were outstanding. EPS of one class of stock should not be presented alone or within the separate financial statements of the referenced business because those businesses did not issue the security. *See* Ernst & Young, *Financial Reporting Developments – Earnings Per Share*, section 5.3.8 (Sept. 2022), https://www.ey.com/en_us/assurance/accountinglink/financial-reporting-developments---earnings-per-share0.

[163] The aggregate outstanding amount of all convertible debt listed on Bloomberg's database as of October 3, 2022, is approximately $717 billion.

convert the instrument into a fixed amount of the issuer's stock. Therefore, similar to Convertible Preferred Stock, a stock option is embedded in a convertible debt instrument. A holder of convertible debt has some of the upside potential in the issuer's stock price, while the debt component protects the holder's principal from downward movement in the stock's price.

Assuming that the convertible debt is treated as indebtedness for federal income tax purposes, the retirement of a convertible debt instrument for cash is not a Section 317(b) Redemption, which only encompasses redemptions of *stock*. Thus, the Excise Tax could only apply to convertible debt redemptions if they are treated as "economically similar" to stock redemptions.[164]

We believe, however, that a redemption of a convertible debt instrument should not generally be treated as economically similar to a Section 317(b) Redemption because the instrument is debt. In particular, a redemption of convertible debt is not commonly treated as a Section 317(b) Redemption for federal income tax purposes.[165] Further, a redemption of convertible debt is not the same as a conventional stock repurchase because a convertible debt redemption does not result in a reduction of the number of shares outstanding.[166] Finally, nothing in the legislative history suggests that Congress intended the Excise Tax to apply to convertible debt. Therefore, we recommend that convertible debt not be treated as a Covered Instrument.

Issuers frequently have the option, if and when debtholders elect to convert, to retire the debt with an amount of cash equal to the value of the reference shares at that time. Such transactions are equivalent to cash settlements of Option Contracts. Therefore, assuming that a debtholder is not treated as the tax owner of the underlying stock as of the date of the debt issuance, we believe that the Excise Tax (including the Netting Rule) should apply to such redemptions (if at all) in the same manner as the settlement of Option Contracts discussed above.[167]

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[164] Section 4501(c)(1)(B).

[165] The application of section 249 to a redemption of a convertible debt instrument does not affect our view. Section 249 denies a deduction for the premium paid in a repurchase of convertible debt to the extent the premium exceeds a "normal call premium," but section 249 does not reclassify the instrument as equity. Section 249(a).

[166] However, a redemption of convertible debt is likely to increase diluted EPS because such a redemption might reduce the number of securities counted for purposes of the diluted EPS denominator.

[167] *See supra* Part V.E.1. In the case of a combination settlement, these principles would apply to the extent of cash settlement.

Like a taxpayer who purchases a stock option is generally not treated as the tax owner of the stock underlying the option, the holder of convertible debt is generally not treated as the tax owner of the stock underlying the conversion feature. However, in certain circumstances, the debtholder is treated as the tax owner of the underlying stock. *See* Rev. Rul. 82-150, 1982-2 C.B. 110 (purchase of deep-in-the-money option treated as acquisition of underlying stock for former foreign personal holding company purposes); Rev. Rul. 83-98, 1983-2 C.B. 40 (holding that adjustable rate convertible notes ("ARCNs") should be treated as stock "[b]ecause of the very high probability that all of the ARCN's issued will be converted into stock"); *cf.* Rev. Rul. 2003-97, 2003-2 C.B. 380 ("If the characterization of an instrument or a transaction for federal income tax purposes either depends on, or could be affected by, the existence of a person's legal right or option to elect a certain course of

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6. ***Distressed Debt***

When financial conditions deteriorate, corporations enter into plans of reorganization in bankruptcy or engage in out-of-court debt workouts. In these transactions, a distressed corporation may exchange its debt for other property, including new debt or equity of the issuing corporation. While a redemption of a covered corporation's instrument properly classified as debt is clearly outside the scope of the Excise Tax as a general matter, certain authorities have treated distressed debt as stock for purposes of other provisions of the Code.[168] Thus, it is arguably not entirely clear whether payments in respect of distressed debt treated as stock for certain tax purposes should be considered a Section 317(b) Redemption or an economically similar transaction for purposes of the Excise Tax.

Based on the policy considerations that motivated the Excise Tax, we believe that payments with respect to distressed debt, including under a plan of reorganization in bankruptcy and out-of-court workouts, generally should not be considered a Section 317(b) Redemption or transaction economically similar for Excise Tax purposes.[169] These transactions do not have the characteristics of conventional stock repurchases. Specifically, there is no reduction of the number of shares outstanding because distressed debt that constituted debt for federal income tax purposes at issuance generally continues to be treated as such,[170] except for the limited purposes of applying certain provisions of the Code. Also, the retirement of outstanding debt does not affect the EPS in the same way as a conventional stock repurchase.[171] Finally, it would be contrary to sound public policy to impose the Excise Tax on distressed corporations. For these reasons, we believe distressed debt should not be treated as a Covered Instrument.

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action, the tax consequences often depend on whether the exercise (or non-exercise) of the right or option is economically compelled based on all the facts and circumstances.").

[168] *See Helvering v. Ala. Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas. Reg. 1.368-1(e)(6) (treating creditors as stockholders for purposes of the continuity of proprietary interest test); *Helvering v. Cement Investors, Inc.*, 316 U.S. 527 (1942) (bondholders of a bankrupt corporation were treated as the equitable owners of its assets and were regarded as the transferors of assets under the predecessor to section 351); *Overland Corp. v. Commissioner*, 42 T.C. 26 (1964) (bondholders and creditors of a bankrupt corporation were treated as the equitable owners of its assets and were regarded as transferors under the predecessor to section 351), *nonacq*., 1966-2 C.B. 8.

[169] Further, transactions that qualify as "G Reorganizations" under section 368(a)(1)(G) should fall within the purview of the Reorganization Exception.

[170] *See, e.g.*, Treas. Reg. 1.1001-3(f)(7)(ii)(A) ("Except as provided in paragraph (f)(7)(ii)(B) of this section, in making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account.").

[171] We acknowledge that an exchange of debt for new debt or equity might increase the EPS of the distressed corporation due to a reduction of indebtedness. However, these transactions do not involve the perceived type of undesirable EPS manipulation tactics that the Excise Tax was meant to curtail.

F. *Extraordinary Transactions*

1. *Reorganizations*

There are numerous ambiguities regarding whether and how the Excise Tax applies to reorganizations under section 368(a) and to certain section 355 transactions. First, we analyze the scope of the Reorganization Exception, which removes certain exchanges in a reorganization from the scope of the Excise Tax. Second, we consider the circumstances in which, to the extent that the Reorganization Exception does not apply, exchanges in a reorganization should be treated as "repurchases" subject to the Excise Tax.

(a) *Scope of the Reorganization Exception*

(i) *General Scope of the Reorganization Exception*

By its terms, the Reorganization Exception in section 4501(e)(1) applies only to the extent that two requirements are met: (i) the repurchase is part of a reorganization within the meaning of section 368(a), and (ii) the shareholder recognizes no gain or loss on the repurchase under chapter 1 of the Code (i.e., for federal income tax purposes).

As a threshold matter, we do *not* interpret section 4501(e)(1) to mean that *any* amount of recognition in a reorganization renders the Reorganization Exception wholly inapplicable to the entire transaction. To the contrary, the plain language—specifically, the use of "to the extent," which is read most naturally to modify both elements of the Reorganization Exception—indicates the exception: (i) applies separately for each "repurchase" of stock that is effected as part of a reorganization,[172] and (ii) applies to each such repurchase to the extent that the repurchase satisfies both of the exception's requirements. Thus, the applicability of the Reorganization Exception should be determined with respect to each share (or fraction of a share) that is "repurchased" as part of a reorganization in an exchange described in section 354, 355, or 356.

In terms of how the Reorganization Exception's two elements are applied to each repurchase, the statutory language of section 4501(e)(1) presents analytical difficulty that we recommend be addressed in Treasury guidance. Specifically, with respect to the "no gain or loss" recognition requirement, an exchanging shareholder generally does not recognize loss in a reorganization exchange, including with respect to any "other property" (i.e., "boot") received in the exchange.[173] Further, whether and to what extent a particular shareholder recognizes gain on the receipt of boot in a reorganization depends on the amount of the shareholder's built-in gain

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[172] *Cf.* Rev. Rul. 56-521, 1956-2 C.B. 174 (holding that a purported redemption of the stock from three shareholders constituted a redemption as to two such shareholders and a distribution taxable as a dividend to the extent of E&P as to the other shareholder); *Tiffany v. Commissioner*, 16 T.C. 1443 (1951) (holding that a redemption that effectively extinguished the taxpayer's interest in a corporation was not essentially equivalent to a dividend while acknowledging a separate Tax Court decision that held the redemption was a dividend distribution as to another shareholder), *acq.* 1957-2 C.B. 7.

[173] *See* section 356(c).

(if any) in the stock that the shareholder surrenders in the exchange.[174] Applicable Entities will generally not know whether and to what extent the thousands of shareholders have built-in gain or loss in their surrendered stock. Put differently, the "no gain or loss" element of the exception, if interpreted literally, could be un-administrable with respect to recognized gain and largely a nullity with respect to recognized loss.

To give effect to the Reorganization Exception in an administrable manner, we recommend that Treasury guidance follow one of two approaches: the Type of Consideration approach or the G/L Presumption approach (each as defined below). We believe that the Type of Consideration approach is superior from a policy perspective, but is less faithful to the plain language of the Reorganization Exception. By contrast, the G/L Presumption approach is inferior as a policy matter, but gives fuller effect to the statutory language. We recommend the Type of Consideration approach if Treasury concludes that it has regulatory authority to support it, and recommend the G/L Presumption if Treasury reaches the opposite conclusion.

Type of Consideration: Treasury guidance could provide that the applicability of the Reorganization Exception is determined based solely on the type of consideration received in exchange for each share (or fraction of a share), regardless of the shareholder's recognized gain or loss with respect to that share (or fraction of a share) (the "**Type of Consideration**" approach). Under this approach, the Reorganization Exception would be available to the extent that stock is exchanged in a reorganization for consideration that is permitted to be received without the recognition of gain or loss under section 354 or 355 ("**Qualifying Consideration**"), but would *not* apply to the extent that stock is exchanged for "other property" (i.e., "boot"). Under this approach, shareholder-level gain or loss recognition would not be considered; if a shareholder receives boot, the Reorganization Exception would not apply even if the shareholder has no gain or loss recognition with respect to that receipt of boot. Conversely, the Type of Consideration approach would disregard any gain recognized by the shareholder with respect to the receipt of Qualifying Consideration (e.g., gain recognized by U.S. shareholders under section 367(a) in certain outbound reorganizations or gain recognized by non-U.S. shareholders under section 897 in certain reorganizations involving U.S. real property holding corporations).

From a policy perspective, the Type of Consideration approach is consistent with the notion that the Reorganization Exception should be available to the extent shareholders' interests in the enterprise are preserved in modified corporate form, but not to the extent shareholders are "cashed out" in the transaction with boot.[175] We believe that it is anomalous from a policy perspective that shareholder-level gain or loss would be relevant to whether the Reorganization Exception applies, particularly in light of the general statutory definition of "repurchase," which

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[174] *See* section 356(a).

[175] This policy-driven approach is consistent with the approach Treasury has taken in other similar contexts. For example, focusing on the character of the consideration received and ignoring nonrecognition of loss under section 356(c) would parallel Treasury's approach in proposed Treasury Regulations under section 355(b)(2)(C) and (D). *See* Prop. Treas. Reg. 1.355-3(b)(4)(iii)(A); Wayne T. Murray, *The Gregory Rules of Section 355*, 481 (Apr. 2021) ("Loss is treated as recognized under the Proposal even if no loss is recognized under section 351(b). No comment is made regarding nonrecognition under section 356(c), 361(b)(1)(A), or 361(b)(2), but we understand that the reference to section 351(b) is intended to serve as a stand-in for these other, similar provisions. Section 351(b) is only one example of a tainted loss." (footnote omitted)).

encompasses any Section 317(b) Redemption regardless of whether the shareholder recognizes gain or loss. But by the same token, this approach would fail to give full effect to the statutory "no gain or loss" concept given that shareholder-level gain or loss recognition would not be considered.[176]

G/L Presumption: If Treasury concludes that it does not have regulatory authority to promulgate the Type of Consideration approach, Treasury guidance could instead provide a different approach. Under this alternative, as with the Type of Consideration approach, the Reorganization Exception would be available to the extent that stock is exchanged in a reorganization for Qualifying Consideration. To the extent that stock is exchanged for boot, all shareholders would be presumed to recognize gain or loss to the full extent of boot received in a reorganization for Excise Tax purposes (the "**G/L Presumption**") and so would be presumed ineligible for the Reorganization Exception. An Applicable Entity could, however, rebut the G/L Presumption to the extent that the Applicable Entity could demonstrate that its shareholders' recognized gain or loss (or lack thereof) in the reorganization.[177] If an Applicable Entity could not obtain those records for one or more shareholders, then the Reorganization Exception would only apply for such shareholder or shareholders to the extent that they receive Qualifying Consideration (and would not apply to the receipt of boot), regardless of actual shareholder-level gain or loss. The G/L Presumption thus would give effect to the "no gain or loss" concept, but in a relatively administrable manner that would put the burden on the Applicable Entity to prove whether and to what extent gain or loss is recognized.

The potential for different outcomes under the Type of Consideration and G/L Presumption approaches is illustrated below.

> **Example 13**: *Application of the Reorganization Exception*. Corp X has 100 shares of common stock outstanding and no other outstanding equity. In a reorganization within the meaning of section 368(a) with respect to Corp X, one Corp X shareholder (Shareholder A) exchanges its common stock solely for Qualifying Consideration;[178] another shareholder (Shareholder B) exchanges its Corp X

[176] The statutory language evolved—through different iterations of proposed predecessor versions of section 4501—to refer specifically to shareholder-level gain or loss recognition. *See* Draft of Stock Buyback Accountability Act of 2021, section 4501(d)(1) (Sept. 10, 2021); Stock Buyback Accountability Act of 2021, S. 2758, 117th Cong. section 4501(d)(1) (Sept. 20, 2021); Build Back Better Act, H.R. 5376, 117th Cong. section 138102(a) (Rules Comm. Print Nov. 3, 2021).

[177] Gain recognition would presumably include gain recognized by the shareholder under any Code provision, even if the gain is recognized with respect to the receipt of Qualifying Consideration—for example, gain recognized by U.S. shareholders under section 367(a) in certain outbound reorganizations or gain recognized by non-U.S. shareholders under section 897 in certain reorganizations involving U.S. real property holding corporations.

Treasury guidance could also address acceptable allocations of Qualifying Consideration and boot, although allocations may be difficult in public company reorganizations. *Cf.* Treas. Reg. 1.356-1(b) (respecting allocations for section 356 purposes if "economically reasonable").

[178] Shareholder A recognizes no gain or loss under section 354(a)(1).

common stock solely for cash;[179] and a third (Shareholder C) exchanges its Corp X common stock for a 50/50 mix of Qualifying Consideration and cash.[180]

On these facts, under the Type of Consideration approach, the Reorganization Exception would apply to exclude the Shareholder A exchange from the base of the Excise Tax; would not apply to the Shareholder B exchange regardless of Shareholder B's recognized gain or loss; and would apply to the Shareholder C exchange to the extent that Shareholder C received Qualifying Consideration and would not apply to the extent that Shareholder C received boot. By contrast, under the G/L Presumption approach, the Reorganization Exception would still apply to exclude the Shareholder A exchange from the base of the Excise Tax; would not apply to the Shareholder B exchange *except to the extent that the G/L Presumption is rebutted*; and would apply to the Shareholder C exchange to the extent that Shareholder C received Qualifying Consideration and would not apply to the extent that Shareholder C received boot *(except to the extent that the G/L Presumption is rebutted)*.

It could be viewed as inappropriate as a policy matter, for instance, that Shareholder B in Example 13 is entirely cashed-out in the reorganization, but under the G/L Presumption approach, no Excise Tax liability could accrue with respect to the Shareholder B exchange to the extent that the G/L Presumption is rebutted. This type of seemingly unwarranted outcome is the basis for our preference for the Type of Consideration approach.

(ii) *The Reorganization Exception for Section 355 Transactions*

In a tax-free spin-off that qualifies under section 355 (a "**Spin-Off**"), a parent corporation ("**Parent**") distributes the stock of a subsidiary ("**Subsidiary**") pro rata to all shareholders of Parent. A Spin-Off does not generally involve an exchange of Subsidiary's stock for Parent stock and so does not constitute a Section 317(b) Redemption. Further, Spin-Offs do not otherwise implicate the policies motivating the Excise Tax, both given the non-redemptive, pro rata nature of a Spin-Off and for all the same reasons described below with respect to tax-free split-off transactions that qualify under section 355 ("**Split-Offs**"). Accordingly, it is clear that the Excise Tax does not and should not apply with respect to tax-free Spin-Offs.

In a Split-Off, Parent distributes the stock of Subsidiary to certain shareholders of Parent (the "**Redeemed Shareholders**") in exchange for a portion of Parent's outstanding stock.[181] This exchange by Parent of Subsidiary stock for Parent stock in the Split-Off is tax-free to the Redeemed Shareholders.[182] Nevertheless, a Split-Off is literally a Section 317(b) Redemption because it involves an acquisition of Parent stock in exchange for Subsidiary stock, which is section 317(a) property from Parent's perspective. Thus, absent application of the

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[179] Shareholder B is taxed under either section 302 or section 1001. *See* Treas. Reg. 1.354-1(d), Exs. 3 & 4; Martin D. Ginsburg, Jack S. Levin & Donald E. Rocap, *Mergers, Acquisitions & Buyouts* ¶ 604.1.1 (June 2022 ed.).

[180] Shareholder C recognizes gain (but not loss) in its surrendered Corp X shares to the extent of boot received under section 356(a)(1).

[181] *See* section 355(a)(2)(B); Rev. Rul. 77-20, 1977-1 C.B. 91.

[182] Section 355(a)(1).

Reorganization Exception or regulatory relief, a Split-Off could constitute a repurchase that is potentially subject to the Excise Tax.[183]

The Reorganization Exception provides that the Excise Tax shall not apply "to the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholders under chapter 1 by reason of such reorganization."[184] Split-Offs are usually structured as reorganizations described in section 368(a)(1)(D) ("**D Reorganizations**"). But even in the case of such divisive D Reorganizations, the tax-free treatment to the Redeemed Shareholders results from section 355(a)(1), which, strictly speaking, can apply even if the Split-Off is *not* part of a "reorganization (within the meaning of section 368(a))."[185] Although section 355(a)(1) technically operates independently from section 368(a)—the reorganization provision referenced by the Reorganization Exception—section 355 transactions often are considered together with the Code's reorganization provisions and usually occur in tandem with divisive D Reorganizations in the public company context.

Except to the extent Parent pays boot to the redeemed shareholders, a Split-Off bears none of the hallmarks of conventional stock repurchases that Congress apparently intended to target with the Excise Tax—i.e., opportunistic stock repurchases that distribute cash to shareholders and accrete ownership to non-selling shareholders. Instead, in a Split-Off, all of the business' cash and assets *remain* in corporate solution in Parent and Subsidiary. Parent and Subsidiary can invest their cash in their respective businesses, and if either Parent or Subsidiary instead used their cash to repurchase stock, those repurchases would be subject to the Excise Tax. Moreover, a Split-Off without boot: (i) does not generally reduce the number of shares outstanding or enhance EPS as between Parent and Subsidiary in a manner relevant to the Excise Tax, and (ii) receives favorable tax treatment for reasons unrelated to the income tax advantages associated with stock repurchases relative to non-redemptive distributions. Section 355 strictly polices the types of corporate separation transactions that can qualify for tax-free treatment, including by requiring a bona-fide, non-tax business purpose for the Split-Off,[186] and active, historic business operations at both Parent and Subsidiary.[187] Thus, in a Split-Off, as with any section 355 transaction, Parent and Subsidiary have been separated because bona-fide business reasons demonstrate that Parent and Subsidiary are better operated separately for non-tax reasons.

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[183] It could be argued that a Split-Off is not technically a Section 317(b) Redemption for the same reasons as section 331 liquidations. *See infra* Part V.F.4.

[184] Section 4501(e)(1).

[185] Section 4501(e)(1).

[186] *See, e.g.*, Treas. Reg. 1.355-2(b)(1) ("Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. . . . The principal reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms.").

[187] Section 355(b); Treas. Reg. 1.355-3.

Further, as noted above, a Spin-Off where all Parent shareholders receive a pro rata distribution of Subsidiary stock is clearly not subject to the Excise Tax. We have not identified a policy reason to discourage Split-Offs relative to other forms of section 355 transactions, all of which involve separating corporate business operations for bona-fide business reasons.[188]

Even if a section 355 transaction is not effected as part of a "reorganization (within the meaning of section 368(a))" as described in the Reorganization Exception,[189] that is a technical distinction in terminology under the Code that has nothing to do with the Excise Tax's policies. The Reorganization Exception reflects a policy judgment that these types of corporate transactions that Subchapter C of the Code treats as tax-free should not be subject to the Excise Tax even if those transactions have a redemption component. This policy judgment applies with equal force to all tax-free section 355 transactions. Accordingly, we recommend that Treasury guidance define the Reorganization Exception to cover all section 355 transactions, including Split-Offs, whether or not technically part of a divisive D Reorganization.

(b) *How the Excise Tax Applies to Reorganizations to the Extent Not Eligible for the Reorganization Exception*

The inapplicability of the Reorganization Exception to an exchange in a reorganization (e.g., an exchange of stock for boot) does not necessarily mean that the exchange is a "repurchase" for Excise Tax purposes.[190] In other words, even if the Reorganization Exception is unavailable for a particular exchange in a reorganization, there must still be a determination of whether that exchange can and should be treated as a "repurchase" for Excise Tax purposes.

We recommend that Treasury issue guidance defining "repurchase": (i) to exclude certain exchanges pursuant to reorganizations that do not implicate the policies of the Excise Tax as outside the scope of the statute, even if those exchanges could arguably be viewed as Section 317(b) Redemptions (or as arguably "economically similar" to such redemptions) under a technical application of traditional Subchapter C principles, and (ii) to include certain exchanges pursuant to reorganizations that *do* implicate the policies of the Excise Tax. Specifically, we recommend that "repurchase" be defined: (i) to *include* exchanges of stock for boot in an Equity Recapitalization, (ii) to *exclude* exchanges of a covered corporation's stock for boot pursuant to an Acquisitive Asset Reorganization or an Acquisitive Stock Reorganization (each as defined below), except in specified circumstances, and (iii) to *include* exchanges of stock for boot in Split-Offs. Alternatively, Treasury guidance could apply the Pro Rata Exclusion Principle to exchanges in a reorganization not eligible for the Reorganization Exception (i.e., to the extent that boot is distributed 100% pro rata to all Target shareholders).

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[188] In addition to Spin-Offs and Split-Offs, the other less common form of section 355 transaction is a "split-up" transaction (a "**Split-Up**") in which Parent distributes the stock it holds in two or more subsidiaries in complete liquidation. Bittker & Eustice, *supra* note 99, ¶ 11.01[1][d]. *See infra* notes 233 & 235.

[189] This would generally be the case only if Subsidiary is an existing subsidiary of Parent that does not receive additional assets from Parent in connection with the separation transaction.

[190] *See infra* note 257 discussing whether exchanges pursuant to reorganizations can be Section 317(b) Redemptions.

(i) *Boot in Equity Recapitalizations*

(1) *Basics of Recapitalizations*

Reorganizations include Recapitalizations.[191] Although not expressly defined in the Code or Treasury Regulations, the Supreme Court has stated that a Recapitalization involves a "reshuffling of a capital structure, within the framework of an existing corporation."[192] It is generally understood that a transaction qualifying as a Recapitalization must involve a change or changes to the capital structure of a single corporation.[193]

A debt Recapitalization ("**Debt Recapitalization**")—an actual or deemed exchange of a corporation's outstanding debt securities for other, newly issued debt securities, or an actual or deemed exchange of a corporation's outstanding debt securities for newly issued stock—would not generally be subject to the Excise Tax, whether or not involving boot, because no existing corporate stock is being exchanged, redeemed, or treated as exchanged or redeemed.[194] An equity Recapitalization (an "**Equity Recapitalization**") with no boot—i.e., an actual or deemed exchange of a corporation's outstanding stock for other, newly issued stock—is not a Section 317(b) Redemption and would generally qualify for the Reorganization Exception even if treated as involving a repurchase.[195] Thus, for Excise Tax purposes, the potentially relevant form of Recapitalization is an Equity Recapitalization with boot.

To the extent that the boot distribution is treated as a "separate transaction" from the Equity Recapitalization for federal income tax purposes, the boot distribution would also presumably be analyzed under section 301 and/or section 302 for purposes of the Excise Tax, like any other standalone distribution or exchange.[196]

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[191] Section 368(a)(1)(E).

[192] *Helvering v. Sw. Consol. Corp.*, 315 U.S. 194, 202 (1942).

[193] *See, e.g.*, Rev. Rul. 2003-19, 2003-1 C.B. 468 ("*Because Stock Company is the same corporation as Mutual Company under State Y law*, the conversion from a mutual insurance company to a stock insurance company is a reorganization under § 368(a)(1)(E)." (emphasis added)); Rev. Rul. 2003-48, 2003-1 C.B. 863 ("*Because Stock Bank is a continuation of State Y Mutual Bank under State Y law*, the conversion from State Y Mutual Bank to Stock Bank qualifies as a reorganization under § 368(a)(1)(E) as well as a reorganization under § 368(a)(1)(F)." (emphasis added)); Bittker & Eustice, *supra* note 99, ¶ 12.27[1]; Ginsburg, Levin & Rocap, *supra* note 179, ¶ 601.3 n.9.

[194] An issuance of stock in a Debt Recapitalization should generally constitute an issuance for purposes of the Netting Rule.

[195] We recommend above that an Equity Recapitalization that is a Stock-for-Stock Exchange not be treated as an issuance for Excise Tax purposes. *See supra* Part V.B.2.

Note, however, the treatment of certain non-NQPS, non-Covered Instrument stock issued in reorganizations, including Equity Recapitalizations. *See infra* Part V.F.1(b)(v).

[196] Treas. Reg. 1.301-1(j); Treas. Reg. 1.368-2(m)(3)(iii); *see Bazley v. Commissioner*, 331 U.S. 737 (1947). This "separate transaction" treatment should generally apply to all boot in an F Reorganizations.

(2) *Recommended Approach*

We recommend that Treasury guidance define "repurchase" to include the receipt of boot in an Equity Recapitalization when that receipt of boot is not treated as a separate transaction under Subchapter C principles.[197] Such an Equity Recapitalization with boot can be nearly indistinguishable in its result from a conventional stock repurchase.

> **Example 14**: *Equity Recapitalization with boot*. Corp X has 100 shares of common stock outstanding each worth $1 and no other outstanding equity. Corp X exchanges this Old Stock for 80 shares of New Stock each worth $1 and $20 of cash.[198] The $20 of cash is distributed non-pro rata, such that some Corp X shareholders receive only New Stock for their Old Stock while others receive a mix of New Stock and cash. This receipt of boot is not treated as a separate transaction under the principles of Treasury Regulation section 1.301-1(j).

In this Equity Recapitalization, Corp X's acquisition of Old Stock in exchange for New Stock is *not* a "repurchase" for Excise Tax purposes because this stock-for-stock exchange is not a Section 317(b) Redemption.[199] But we believe that the exchange of Old Stock for cash should be treated as a repurchase because that exchange is the same in substance as Corp X redeeming 20 common shares for $20.

(ii) *Boot in Acquisitive Asset Reorganizations*

(1) *Basics of Acquisitive Asset Reorganizations*

Under traditional Subchapter C principles, acquisitive asset reorganizations—a reorganization described in section 368(a)(1)(A) (an "**A Reorganization**") not involving section 368(a)(2)(E),[200] a reorganization described in section 368(a)(1)(C) (a "**C Reorganization**"),[201] an acquisitive D Reorganization,[202] (collectively, "**Acquisitive Asset Reorganizations**")—are

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[197] Only, of course, if the Old Stock in the Recapitalization is treated as stock (i.e., a Covered Instrument) for purposes of the repurchase definition. For example, under our recommended approach for Straight Preferred Stock, a payment of boot in respect of Straight Preferred Stock in a Recapitalization (or any other form of reorganization) would not be treated as a repurchase.

To the extent that the receipt of boot *is* treated as a separate transaction, that separate transaction should be analyzed independently for Excise Tax purposes.

[198] The Old Stock and New Stock have formal terms that differ to a material enough degree for the exchange to be treated as an equity Recapitalization, but without diluting or altering the Corp X shareholders' proportionate equity interests in Corp X. *See supra* note 99.

[199] *See* section 317(a).

[200] A statutory merger of Target into Acquiror where the Qualifying Consideration is either Acquiror stock or stock of a corporation in control of Acquiror. *See* section 368(a)(2)(D).

[201] An acquisition by Acquiror of substantially all of Target's assets where the Qualifying Consideration is voting stock of Acquiror or a corporation in control of Acquiror.

[202] A transfer by Target of all or part of its assets to a corporation controlled by Target or its shareholders.

treated as two-step transactions.[203] First, the target corporation ("**Target**") is treated as transferring all or a portion of its assets to the acquiring corporation ("**Acquiror**") in exchange for, as applicable, Acquiror stock[204] and/or boot (collectively, the "**Asset Reorg Consideration**"). Second, Target is treated as making a liquidating distribution (the "**Deemed Liquidating Distribution**") to its shareholders and/or security holders in exchange for their Target stock of both the Asset Reorg Consideration and any retained Target assets not transferred or deemed transferred to Acquiror in the first step.[205]

For federal income tax purposes, whether the receipt of boot is taxed to the shareholder as a dividend or as "gain from the exchange of property"—i.e., in the manner of a section 302(a) redemption—depends on whether the receipt of boot "has the effect of the distribution of a dividend."[206] As the Supreme Court held in *Commissioner v. Clark*,[207] this test is applied by hypothesizing that: (i) the shareholder first received only Qualifying Consideration (i.e., Acquiror stock) in the reorganization, and then (ii) Acquiror redeemed the Qualifying Consideration in exchange for boot (to the extent of boot actually received in the reorganization).[208] This hypothetical "post-reorganization" redemption is then analyzed under section 302(b) prinicples to determine whether it is properly treated as a section 302(a)-type exchange or a section 302(d)-type distribution, with that characterization then applying to the boot received in the reorganization. In a typical reorganization involving previously unrelated corporations, the *Clark* test generally results in section 302(a)-type exchange treatment for boot in a reorganization.[209] Accordingly, at least under *Clark*, the receipt of boot in the Deemed

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[203] *See, e.g.*, section 361 (governing gain or loss recognition for Target based on: (i) the exchange of all or a portion of its property for the acquiror consideration, and (ii) the subsequent distribution of the acquiror consideration and any retained target assets); section 368(a)(1)(C), (a)(2)(G) (generally describing this two-step construct for C Reorganizations); section 368(a)(1)(D) (generally describing this two-step construct for D Reorganizations); Bittker & Eustice, *supra* note 99, ¶ 12.21[1] (describing this construct for A Reorganizations).

An acquisitive reorganization described in section 368(a)(1)(G) (a "**G Reorganization**") not involving section 368(a)(2)(E) is also an Acquisitive Asset Reorganization. In a G Reorganization, the prior equity holders are typically wiped-out or substantially diluted, with creditors receiving stock of the new corporation in respect of their debt claims against the old corporation. These distributions in respect of debt would not generally constitute Section 317(b) Redemptions even if boot is paid. In the narrow case where prior equity holders receive boot in a G Reorganization's Liquidating Distribution, the general principles articulated in this Part should apply.

[204] Or stock of a corporation in control of Acquiror, in the case of an A Reorganization described in section 368(a)(2)(D) or a "triangular" C Reorganization.

[205] To the extent a Deemed Liquidating Distribution is made to security holders (i.e., with respect to debt or other obligations), that distribution would not and should not constitute a "repurchase" for Excise Tax purposes, even if the Applicable Entity is in a distressed financial state. *See supra* Part V.E.6.

[206] Section 356(a)(2).

[207] 489 U.S. 726, 736 (1989).

[208] *See also* Rul. 93-61, 1993-2 C.B. 118.

[209] Bittker & Eustice, *supra* note 99, ¶ 12.14[2][c] ("Thus, the Supreme Court in *Clark* went a long way toward the other end of the spectrum from *Bedford* by imposing virtually an automatic-capital-gain finding in the case of boot paid in a typical two-party acquisitive reorganization transaction . . . ." (footnote omitted)).

Liquidating Distribution would not typically qualify for the dividend exception of section 4501(e)(6).

(2) *Recommended Approach*

The receipt of boot in the Deemed Liquidating Distribution could be viewed as a Section 317(b) Redemption subject to the Excise Tax. It can at least be argued that the Deemed Liquidating Distribution literally constitutes a Section 317(b) Redemption because Target is "acquir[ing] its stock from a shareholder in exchange for property [i.e., the Asset Reorg Consideration]." The considerations for whether the Deemed Liquidating Distribution is properly viewed as a Section 317(b) Redemption are similar to those for Section 331 Distributions (as defined below).[210] To the extent that the Asset Reorg Consideration is Qualifying Consideration, the Reorganization Exception should generally apply to avoid imposition of the Excise Tax. But for Asset Reorg Consideration that is boot, the Reorganization Exception would at least presumptively not apply under our recommended interpretation.[211]

We recommend that Treasury guidance provide that the definition of "repurchase" generally exclude the receipt of boot in the Deemed Liquidating Distribution in an Acquisitive Asset Reorganization.[212] As a general matter, the receipt of boot in an Acquisitive Asset Reorganization does not bear the hallmarks of a conventional stock repurchase. In an Acquisitive Asset Reorganization, Target shareholders are selling their Target stock to Acquiror; Acquiror is paying for that Target stock with the Asset Reorg Consideration in the same manner that Acquiror would pay for that stock with cash in a taxable purchase. As a general matter, that taxable purchase often would not implicate the Excise Tax. And the Excise Tax is only potentially relevant to Acquisitive Asset Reorganizations because of historical statutory and judicial developments in the deemed treatment of these transactions under traditional Subchapter C principles that do not appear to implicate the policy concerns that prompted Congress to enact the Excise Tax. Moreover, as described below, under traditional Subchapter C principles, the Excise Tax would *not* apply to boot received in Acquisitive Stock Reorganizations (as defined below) because Acquisitive Stock Reorganizations do not involve a deemed distribution by Target to its shareholders.[213] It is difficult to rationalize why the Excise Tax would apply to Acquisitive Asset Reorganizations but not Acquisitive Stock Reorganizations (or many taxable stock acquisitions),[214] especially when the differences between types of reorganizations are often essentially formalistic.

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[210] *See infra* Part V.F.4 and note 257.

[211] *See supra* Part V.F.1(a).

[212] Where a Target shareholder receives a mix of Qualifying Consideration and boot, the boot is taxed pursuant to section 356. Where a Target shareholder receives only boot, the boot is taxed pursuant to section 302. Although different Code provisions apply depending on the mix of consideration, this same exception to the definition of "repurchase" should apply regardless.

[213] Assuming that Acquisitive Stock Reorganizations are not generally determined to be "economically similar" to Section 317(b) Redemptions. *See* section 4501(c)(1).

[214] *Cf.* Rev. Rul. 2001-24, 2001-22 I.R.B. 1290 ("The legislative history of section 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly. *See* S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970).").

Further, an Acquisitive Asset Reorganization is not generally intended to enhance EPS or other financial metrics for the shares that remain outstanding in the manner of a conventional stock repurchase. An Acquisitive Asset Reorganization, by definition, constitutes a fundamentally transformative transaction with respect to Target's corporate structure.[215] By contrast, the types of opportunistic stock repurchases targeted by the Excise Tax generally cause no material change in the corporation's overall corporate structure or the underlying business operations.[216] Thus, to the extent that Acquisitive Asset Reorganizations can incidentally affect EPS or other financial metrics for the multiple parties to the reorganization, those effects are, as a general matter, different in kind from the effect from conventional stock repurchases.

Section 302(a)-type exchange treatment under *Clark* does have income tax advantages relative to non-redemptive distributions, but that treatment is more appropriate for an Acquisitive Asset Reorganization that is, in essence, a sale of Target to Acquiror.

Our recommended exclusion of boot in Acquisitive Asset Reorganizations is also consistent with the construct underlying the *Clark* test. Under *Clark*, the tax fiction is a deemed issuance and redemption of stock in Acquiror. As the Supreme Court stated in *Clark*, "the statute [section 356] plainly refers to one integrated transaction and . . . makes clear that we are to look to the character of the exchange as a whole and not simply its component parts."[217] Treasury guidance could also alternatively apply this issuance-and-redemption construct for purposes of the Excise Tax and thus treat the net repurchases with respect to boot in Acquisitive Asset Reorganizations as zero under the Netting Rule.

As an anti-avoidance measure, however, we recommend that Treasury guidance define "repurchase" to *include* the receipt of boot in an Acquisitive Asset Reorganization where Target controls Acquiror (or vice versa) prior to the Acquisitive Asset Reorganization, and shareholders receive boot in the Acquisitive Asset Reorganization (a "**Downstream Reorg Exception**").

We recommend the Downstream Reorg Exception because Acquisitive Asset Reorganizations can bear much greater economic similarity to conventional stock repurchases by a single corporation in cases where Target controls Acquiror.

> **Example 15**: *Downstream Acquisitive Asset Reorganization*. Target, a covered corporation, wholly owns Acquiror. In an Acquisitive Asset Reorganization, Target merges downstream into Acquiror. Some Target shareholders receive only Acquiror stock (Qualifying Consideration), while other Target shareholders receive a mix of Qualifying Consideration and boot, with the receipt of boot taxed as a section 302(a)-type exchange under section 356(a)(2) and *Clark*.

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[215] Treas. Reg. 1.368-1(b) ("The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.").

[216] *See supra* Part IV.

[217] *Commissioner v. Clark*, 489 U.S. 726, 737 (1989).

In effect, this downstream transaction has: (i) combined Acquiror and Target, and (ii) accreted the remaining Target shareholders' aggregate interests on a tax-free basis by partially squeezing out smaller Target shareholders in a section 302(a)-type exchange through the merger into Acquiror. This second result is similar to a conventional stock repurchase from the Target shareholders who received boot. Because Target controls (and indeed wholly owns) Acquiror, Target and Acquiror do not have separate shareholder bases that make an Acquisitive Asset Reorganization between unrelated corporations more analogous to a sale of Target. Instead, an Acquisitive Asset Reorganization between such related corporations is more akin to a conventional stock repurchase, much like an Equity Recapitalization with boot.[218]

For this Downstream Reorg Exception, Treasury guidance could define common control in different ways. To stay within existing Excise Tax rules, guidance could define control to exist for Target and Acquiror if Acquiror is a specified affiliate with respect to Target as a covered corporation. We do *not* recommend that Treasury guidance define control for the Downstream Reorg Exception by cross-reference to section 304(c) or any similar definition. Section 304(c)'s definition of "control" is far too broad relative to the policy concern here, which is overlapping ownership concentrated in a single corporation or closely related group of corporations that makes the Acquisitive Asset Reorganization into a transaction analogous to a single-corporation stock repurchase.[219]

In addition, Treasury could consider whether a broader anti-avoidance rule is necessary in certain circumstances where Target and Acquiror are under common control prior to the Acquisitive Asset Reorganization, and the non-controlling shareholders receive boot in the Acquisitive Asset Reorganization (an "**Acquisitive Reorg Brother-Sister Exception**"). In cases where Target and Acquiror are under common control prior to the Acquisitive Asset Reorganization, the Acquisitive Asset Reorganization can arguably bear some economic similarity to a conventional stock repurchase.

> **Example 16**: *Acquisitive Asset Reorganization with common control.* Both Target and Acquiror are covered corporations and are both 80% owned by individual Shareholder A. (Target and Acquiror are covered corporations because the remaining 20% of their stock is publicly traded.) In an Acquisitive Asset Reorganization, Acquiror acquires Target; the Asset Reorg Consideration consists of 90% Acquiror stock (Qualifying Consideration) and 10% cash boot. Shareholder A receives all Acquiror stock for its Target stock, and Target's other shareholders receive a 50/50 mix of Acquiror stock and cash for their Target stock. The receipt of cash by the other shareholders is presumably taxed as a section 302(a)-type exchange under section 356(a)(2) and *Clark*. If Acquiror and Target have the same equity value pre-transaction, then after the Acquisitive Asset Reorganization, Shareholder A will own 90% of Acquiror.

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218 *See supra* Part V.F.1(b)(i).

219 In addition, there are material existing issues in applying section 304(c) in the context of public M&A transactions. *See* NYSBA Tax Section, *Report No. 1445: Report on Section 304 in Public M&A Transactions* 10 (Nov. 19, 2020) ("[P]arties to a public M&A transaction currently face material practical difficulties as a result of the uncertain application of Section 304."), https://nysba.org/app/uploads/2021/01/Report-1445.pdf.

In effect, Shareholder A has accomplished two results in this illustrative transaction: (i) combining Acquiror and Target, and (ii) accreting its aggregate interest in Acquiror and Target—from 80% to 90% of the aggregate enterprise—on a tax-free basis by partially squeezing out smaller Target shareholders in a section 302(a)-type exchange. This second result is arguably similar to that of a conventional stock repurchase. By contrast, in an Acquisitive Asset Reorganization where Acquiror and Target are *not* commonly controlled by a single shareholder (or a closely related group of shareholders), the receipt of boot by some or all Target shareholders does not accrete proportionate equity ownership to the controlling shareholder (or group of shareholders) in the same way—i.e., in a manner that arguably implicates the policy motivations for the Excise Tax. In other words, if the shareholder base for each of Target and Acquiror is fairly atomized and unrelated, then no shareholder is, to any material degree, benefiting from the potential "left pocket/right pocket" nature of common control to achieve the result of a conventional stock repurchase in an Acquisitive Asset Reorganization across Acquiror and Target as an aggregate enterprise. Rather, Target shareholders who receive boot are only "squeezed out" in the sense of selling their interest in Target's enterprise in the manner of any taxable sale for cash to a third-party buyer.

If Treasury guidance included this Acquisitive Reorg Brother-Sister Exception, that guidance could define common control in ways similar to the Downstream Reorg Exception. To stay within the Excise Tax's existing statutory concepts, guidance could define common control to exist for Target and Acquiror if Target and Acquiror either: (i) are both specified affiliates with respect to the same covered corporation, or (ii) would be specified affiliates with respect to a shareholder if that shareholder were a covered corporation. Alternatively, the Acquisitive Reorg Brother-Sister Exception could define common control to exist for Target and Acquiror if Target and Acquiror either: (i) are both members of the same "controlled group" within a modified meaning of section 1563[220] as a corporate shareholder, or (ii) are both related to the same shareholder under section 267(b)(2).[221] For the same reasons as for the Downstream Reorg Exception, we do *not* recommend that Treasury guidance define common control by cross-reference to section 304(c) or any similar definition.[222]

(3) *Tracing Approach*

Another potential approach to Acquisitive Asset Reorganizations would be to define "repurchase" to include the receipt of boot in the Deemed Liquidating Distribution in an Acquisitive Asset Reorganization to the extent that the boot is traceable to the pre-transaction assets of Target. One could argue that, to the extent that Target's assets are directly "funding" the distribution of boot, the Acquisitive Asset Reorganization is more akin to a conventional stock repurchase by Target. We have considered this approach and ultimately do not believe that it is appropriate because we do not believe that the source of the funds is the relevant policy consideration. In the context of a transformative acquisition in an Acquisitive Asset

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[220] Perhaps as modified by section 267(f) to reduce the control threshold from 80% to 50%.

[221] Note that, at least under certain definitions of "control," the Acquisitive Reorg Brother-Sister Exception would encompass the Downstream Reorg Exception.

[222] *See also supra* note 219. Treasury could also consider an exception for inversion-type "reverse acquisitions" in which Target might be viewed, in substance, as the acquiring corporation because it is significantly larger than a much smaller Acquiror. *Cf.* section 7874; Treas. Reg. 1.1502-75(d)(3).

Reorganization, we do not believe that the Excise Tax should generally apply for the reasons described above.[223] Further, tracing would seem unduly complicated, cumbersome, and formalistic given the fungible nature of cash and other assets typically distributed as boot.[224]

(iii) ***Boot in Acquisitive Stock Reorganizations***

(1) ***Basics of Acquisitive Stock Reorganizations***

In contrast to Acquisitive Asset Reorganizations, under traditional Subchapter C principles, acquisitive stock reorganizations—an A Reorganization under section 368(a)(2)(E) (a "**A/(a)(2)(E) Reorganization**")[225] and a reorganization described in section 368(a)(1)(B) (a "**B Reorganization**," and collectively with A/(a)(2)(E) Reorganizations, "**Acquisitive Stock Reorganizations**")[226]—generally do not include a Deemed Liquidating Distribution or other exchange that is arguably a Section 317(b) Redemption.[227] Thus, unless and to the extent that Treasury determines Acquisitive Stock Reorganizations to be "economically similar" to Section 317(b) Redemptions, the receipt of boot in an Acquisitive Stock Reorganization generally does not constitute a repurchase.[228] Further, while an A/(a)(2)(E) Reorganization can involve some taxable boot, a B Reorganization, by definition, generally cannot include boot.[229] Acquiror can use stock of its parent as consideration for the Target stock in a "triangular" B Reorganization, and parent stock constitutes "property" within the meaning of section 317(a) from Acquiror's perspective. But parent stock in a triangular B Reorganization is Qualifying Consideration that never results in the recognition of gain or loss to a Target shareholder, and so should always qualify for the Reorganization Exception.

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[223] Further, to the extent that Treasury guidance excludes Section 331 Distributions (as defined below) from the definition of "repurchase," Acquisitive Asset Reorganizations should generally be treated no worse. *See infra* Part V.F.4.

[224] As a simple example, Acquiror could borrow against the anticipated value of Target to fund boot, in lieu of having boot funded from Target cash. *But see* Treas. Reg. 1.279-3(b)(2) ("Obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of section 279(b)(1) where: (i) at the time of the issuance of the obligations the issuing corporation anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition, or where (ii) at the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.").

[225] A statutory merger of Acquiror into Target where the Qualifying Consideration is stock of Acquiror's parent.

[226] An acquisition by Acquiror of Target where the only consideration is voting stock of Acquiror or its parent.

[227] One exception would be an Acquisitive Stock Reorganization in which one or more Target shareholders receive cash pursuant to the exercise of dissenters' rights against Target. Such payments are generally viewed as Section 317(b) Redemptions by Target. *See, e.g.*, Rev. Rul. 68-285, 1968-1 C.B. 147. We believe that cash paid to dissenting shareholders in connection with an Acquisitive Stock Reorganization should be treated no worse or differently than boot paid by Acquiror in such a transaction.

[228] Section 4501(c)(1)(B).

[229] *See* section 368(a)(1)(B).

(2) *Recommended Approach*

We recommend that Acquisitive Stock Reorganizations generally *not* be treated as "economically similar" to Section 317(b) Redemptions because: (i) this treatment would generally be moot for B Reorganizations that would qualify in full for the Reorganization Exception; (ii) an A/(a)(2)(E) Reorganization, the other form of Acquisitive Stock Reorganization, generally does not, in form or through its treatment under the Code, include a Section 317(b) Redemption; (iii) to the extent that the receipt of boot in an A/(a)(2)(E) Reorganization is treated as capital gain rather than a dividend, that treatment is merely based on a hypothetical that analogizes to section 302 under *Commissioner v. Clark*;[230] and (iv) like Acquisitive Asset Reorganizations, Acquisitive Stock Reorganizations are transformative transactions that are not generally akin to the voluntary and opportunistic stock repurchases that should be the target of the Excise Tax from a policy perspective.[231]

We also recommend, however, that, to the extent Treasury adopts anti-avoidance rules for Acquisitive Asset Reorganizations—the Downstream Reorg Exception that we recommend, and the Acquisitive Reorg Brother-Sister Exception that could be considered—the same anti-avoidance rules should also apply to the payment of boot as in A/(a)(2)(E) Reorganizations. A/(a)(2)(E) Reorganizations that fall within these rules would implicate the policies motivating the Excise Tax to the same degree as Acquisitive Asset Reorganizations that do so.[232]

(iv) *Boot in Divisive D Reorganizations and Other Section 355 Transactions*

With respect to divisive D Reorganizations and other section 355 transactions, we recommend that Treasury guidance define "repurchase" to include boot in Split-Offs.[233] Unlike Qualifying Consideration in a Section 355 transaction (i.e., Subsidiary stock), which provides a continuing interest in Subsidiary, the receipt of boot in a Split-Off is economically similar to a conventional stock repurchase, much like boot paid in an Equity Recapitalization. As a general matter, boot in Acquisitive Asset Reorganizations and Acquisitive Stock Reorganizations is properly treated differently because those transactions involve the combination of separate corporations—i.e., the receipt of boot in those transactions is more analogous to a normal section 1001 sale than boot paid in a single-company Equity Recapitalization or a redemptive Split-Off.

By contrast, boot distributed in Spin-Offs is treated as a section 301 distribution of property (i.e., is not received in a Section 317(b) Redemption).[234] We see no policy reason why

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[230] 489 U.S. 726, 736 (1989).

[231] For similar reasons, a stock acquisition that qualifies as a wholly or partially tax-free exchange under section 351 (e.g., an acquisition effected as part of a "double dummy" combination transaction) should not be treated as economically similar to a Section 317(b) Redemption, whether or not the acquisition also qualifies as a reorganization.

[232] *See supra* Part V.F.1(b)(ii).

[233] A non-pro rata Split-Up is, as with any Split-Up, a complete liquidation of Parent. We thus recommend that boot in non-pro rata Split-Ups be treated in the same manner as we recommend for Section 331 Distributions.

[234] Section 356(b).

such boot should be subject to the Excise Tax, as with section 301 distributions generally, especially given that the Dividend Exception would apply to such boot.[235]

(v) *Straight Preferred Stock Other Than NQPS in Reorganizations*

Lastly, to the extent that Straight Preferred Stock (or other stock) is, as we recommend, not treated as a Covered Instrument, it may be necessary to promulgate a narrow anti-avoidance rule for certain Straight Preferred Stock in reorganizations. Specifically, in a reorganization, to the extent that a shareholder exchanges stock that is a Covered Instrument (e.g., common stock) for Straight Preferred Stock that is neither a Covered Instrument nor Non-Qualified Preferred Stock ("**NQPS**"), the Reorganization Exception will presumably apply to that exchange because such non-NQPS Straight Preferred Stock is "stock" for purposes of section 354. (By contrast, Straight Preferred Stock that *is* NQPS is treated as boot for reorganization purposes and so presumptively would be ineligible for the Reorganization Exception).[236]

For the scenario with non-NQPS Straight Preferred Stock, the shareholder has exchanged a Covered Instrument (common stock) for non-NQPS Straight Preferred Stock, which is *not* a Covered Instrument. And even if this exchange is defined to constitute a repurchase as described above,[237] the Reorganization Exception presumably applies to preclude Excise Tax liability on this exchange. In other words, absent an anti-avoidance rule, covered corporations could, in reorganizations, avoid the Excise Tax by exchanging non-Covered Instruments that constitute Qualifying Consideration for Covered Instruments in this manner.

Accordingly, while we do not think that the more debt-like nature of non-NQPS Straight Preferred Stock should override the statutory Reorganization Exception, we recommend that Treasury guidance provide an anti-avoidance rule that, to the extent that a non-Covered Instrument is exchanged for a shareholder's Covered Instrument in a reorganization—and the only reason that the Excise Tax does not apply to that exchange is because the non-Covered Instrument is non-NQPS stock for section 354 purposes (i.e., is Qualifying Consideration), and thus is eligible for the Reorganization Exception—the non-Covered Instrument is then treated as a Covered Instrument going forward.[238]

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[235] This point also applies to pro rata Split-Ups, which may technically involve an exchange for Parent stock but are, in substance, analogous to Spin-Offs for Excise Tax purposes.

[236] *See* Treas. Reg. 1.356-6(a).

[237] On defining an exchange of an outstanding Covered Instrument for Straight Preferred Stock as economically similar to a Section 317(b) Redemption if Straight Preferred Stock is not a Covered Instrument, *see supra* Part V.E.2.

[238] This "tainting" of the non-NQPS, non-Covered Instrument stock is analogous to how section 306 taints certain preferred stock.

It is possible that non-NQPS, non-Covered Instrument stock issued in a reorganization could be part of a class of stock that is already outstanding. In this scenario, Treasury guidance may need to address how to delineate between the "tainted" and non-tainted portion of that outstanding class of stock. We recommend a "FIFO"-type approach where a covered corporation must treat redeemed shares in that class as a Covered Instrument until the covered corporation has redeemed shares equal in value to the amount tainted in such a reorganization.

2. *Cash in Lieu of Fractional Shares in a Reorganization*

(a) *Basic Background*

Often in M&A transactions, and particularly in acquisitive reorganizations, the number of Acquiror shares that Target shareholders receive is "rounded up" or "rounded down" to a whole number to avoid the issuance of "fractional shares."[239] The Target shareholders then receive cash in lieu of those fractional shares. This common practice is undertaken for non-tax reasons—chiefly because corporations do not generally issue fractional shares due to the associated expense and inconvenience. Treasury guidance generally treats Acquiror's payment of cash in lieu of fractional shares to Target shareholders as a deemed redemption of those fractional shares (i.e., for tax purposes, the fractional shares are deemed issued to Target shareholders and then redeemed by Acquiror for cash).[240]

(b) *Recommended Approach*

Because Acquiror's payment of cash in lieu of fractional shares is treated as a Section 317(b) Redemption under traditional Subchapter C principles, that payment could arguably be viewed as a "repurchase" subject to the Excise Tax.[241] That would be true even if the acquisition is otherwise a tax-free reorganization that qualifies for the Reorganization Exception with respect to all non-fractional shares.

We recommend, however, that Treasury guidance define "repurchase" to exclude Acquiror's payment of cash in lieu of fractional shares where, in accordance with relevant guidance, the cash payment made by Acquiror is not separately bargained for, but is merely in lieu of fractional share interests to which the Target shareholders are entitled.[242] Such payments are unlike conventional stock repurchases; do not actually reduce the number of shares outstanding; and are only arguably treated as a Section 317(b) Redemption pursuant to a deemed transaction under traditional Subchapter C principles. This approach would acknowledge that, by applying the Netting Rule to the traditional construct for Acquiror's payment of cash in lieu of fractional shares, *no* net amount of stock is repurchased when cash is paid in lieu of fractional

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[239] *See Mills v. Commissioner*, 331 F.2d 321, 323-24 (5th Cir. 1964).

[240] Rev. Rul. 66-365, 1966-2 C.B. 116 ("In all reorganizations described in the preceding paragraphs where the cash payment made by the acquiring corporation is not bargained for, but is in lieu of fractional share interests to which the shareholders are entitled, such cash payment will be treated under section 302 of the Code as in redemption of the fractional share interests."), *amplified*, Rev. Rul. 81-81, 1981-1 C.B. 122; *see also Mills*, 331 F.2d at 323 ("The Commissioner concedes that the cash payment made to each [target shareholder in purported B reorganization] was merely for the purpose of simplifying the corporate and accounting problems which would have been caused by the actual issuance of fractional shares.").

[241] Target could avoid this deemed redemption treatment by aggregating fractional shares into a whole amount of shares issued to an agent for the Target shareholders, with the agent then selling those fractional shares into the open market for cash. That cash would then be distributed to the Target shareholders.

[242] The deemed issuance of fractional shares would also be ignored for Excise Tax purposes under this construct.

shares. As discussed above, the tax fiction is that Acquiror *issues* the fractional shares and then immediately redeems them.[243]

3. *Taxable Acquisitions*

(a) *Bootstrap Acquisitions*

Fully taxable stock acquisitions often feature elements that are treated as Section 317(b) Redemptions. For example, a portion of the sale consideration may be sourced from Target's cash on hand or from proceeds of new debt incurred by Target in order to finance the acquisition. Sometimes, the delivery of such cash to Target's shareholders is actually structured in form as a redemption of certain Target shares that precedes Acquiror's purchase of the remaining Target shares, to ensure that this part of the transaction is not treated as a pre-closing dividend. More often, the transaction takes the form of an all-cash merger, whereby Target merges with a transitory merger subsidiary owned by Acquiror and cash is delivered to Target shareholders as merger consideration in extinguishment of their stock in Target. In that case, the portion of cash consideration that is traceable to Target (or to debt proceeds borrowed by the merger subsidiary and assumed by Target in the merger) is typically treated as a section 302(b)(3) redemption, and not a section 302(d) redemption (even though all or most of Target's historic shareholders are receiving the payment pro rata), because it occurs as part of an integrated transaction involving the termination of historic shareholders' equity interests in Target.[244] The portion of the purchase price funded by Acquiror is treated as a sale or exchange governed by section 1001.[245]

Since the portion of the purchase price funded by Target (the "**Target-Funded Payment**") is treated as a Section 317(b) Redemption for federal income tax purposes, it would apparently be treated as a repurchase subject to the Excise Tax unless Treasury guidance provides otherwise. However, there are compelling arguments in favor of exempting the Target-Funded Payment in this fact pattern from the Excise Tax.

First, the transaction bears none of the hallmarks of opportunistic stock repurchases that apparently motivated Congress to enact the Excise Tax. Typically, all shareholders of Target are fully cashed out, except in some cases for a minority rollover interest in Acquiror issued to certain members of the management team in order to incentivize their retention and performance post-closing. The Target-Funded Payment does not result in manipulation of Target's EPS or otherwise impact its post-closing share price, since Target undergoes a change in ownership and ceases to be a standalone public company after the acquisition. In substance, the transaction is a sale of the entire company.

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[243] This recommendation does not apply to actual repurchases of fractional shares for property in reverse stock splits or other Stock-for-Stock Exchanges, which should be analyzed under general Excise Tax principles. *See supra* Part V.B.2.

[244] *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 78-250, 1978-1 C.B. 83; FSA 200126001 (June 29, 2001).

[245] In an acquisition treated in this manner, Target and Acquiror will be unrelated companies because, otherwise, section 304(a)(1) would apply.

Second, the treatment of the Target-Funded Payment as a Section 317(b) Redemption in this case is driven by a formalistic distinction: whether cash is sourced from the Target or Acquiror. For example, the issue can often be avoided by having Acquiror, rather than Target or a merger subsidiary that merges into Target, borrow the debt-financed portion of the purchase price. The outcome in that scenario may be less clear if—as is often the case in a private equity leveraged buyout—Acquiror is a "bidco" that has no pre-existing business of its own and is formed solely for the purpose of buying Target, if the lenders are in substance looking to Target's assets to support the debt.[246] But in any event, there is no reason from a policy perspective why the identity of the nominal borrower and the location of the debt immediately prior to the completion of the transaction should drive the applicability of the Excise Tax. Likewise, instead of using Target's cash to fund a portion of the purchase price, Acquiror could instead instruct Target to retain its cash, and use solely Acquiror's cash to pay the sellers. While this approach would seem to avoid the Excise Tax, it may produce a less efficient capital structure for Acquiror. Finally, Target could potentially escape Section 317(b) Redemption treatment by simply paying a pre-closing dividend, although that could result in the relative tax inefficiencies associated with dividends.

We recommend that Treasury issue guidance excluding Target-Funded Payments in taxable acquisitions from the Excise Tax.[247] Alternatively, Treasury guidance could apply the Pro Rata Exclusion Principle to Target-Funded Payments.

(b) *Section 304(a)(1) Transactions*

Taxable and partially taxable acquisitions often raise questions as to whether section 304(a)(1) applies to the transaction, particularly where a substantial amount of Acquiror stock is used as acquisition currency.[248] If the shareholders of the Target end up owning 50% or more of the equity of Acquiror (including any stock already owned before the transaction), section 304(a)(1) generally applies. In that case, cash and other property paid to Target shareholders is treated as "a distribution in redemption of the stock of [Acquiror]."[249] To the extent that such distribution is treated as a section 302(d) redemption, the selling shareholders are treated as contributing their Target shares to Acquiror in a section 351 transaction in exchange for Acquiror stock, which is then immediately redeemed. To the extent that such distribution is treated as a section 302(a) exchange, this deemed issuance construct does not apply.

For section 304(a)(1) transactions treated as section 302(d) redemptions, although the receipt of property is described in section 304(a)(1) as a deemed Section 317(b) Redemption of

246 *See Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972); *see also* section 382(e). Expanding the universe of Section 317(b) Redemptions to capture situations where Target is arguably the *de facto* borrower (but not the nominal borrower) would introduce even more uncertainty and complexity.

247 If Treasury guidance does not apply this recommendation, then Target-Funded Payments could be excluded to the extent that they are 100% Pro Rata Distributions.

248 Note that, unlike a section 304(a)(1) transaction, a transaction subject to section 304(a)(2) (i.e., an acquisition of a parent corporation's stock by its subsidiary) should generally already constitute a repurchase for Excise Tax purposes, as a stock acquisition by a specified affiliate. Section 4501(c)(2)(A).

249 Section 304(a)(1). Similar language is used in section 304(a)(2), which addresses acquisitions by subsidiaries that are less likely to occur as part of a M&A transaction.

deemed-issued Acquiror stock, any portion of the deemed redemption that is treated as a section 301(c)(1) distribution should be exempt from the Excise Tax by virtue of the Dividend Exception.[250] This leaves uncertain the treatment of the remaining portion of the deemed section 302(d) redemption that is subject to section 301(c)(2)-(3). Absent guidance, that portion may arguably be subject to the Excise Tax, although the deemed issuance of Acquiror shares in a fictional section 351 transaction presumably could potentially offset the deemed redemption of those shares under the Netting Rule.

Similar to a Target-Funded Payment in an acquisition not subject to Section 304(a)(1),[251] treating a Section 304(a)(1) transaction—whether treated as a section 302(d) or section 302(a) redemption—as a repurchase does not seem warranted as a policy matter. The actual transaction is a purchase of Target stock by Acquiror, which should not have any effect on the actual amount of shares outstanding, and the redemption is merely a tax fiction for purposes of sections 302 and 303 to prevent controlling shareholders from avoiding dividend treatment on a potential "bail-out" of E&P through the use of controlled corporations. In most cases, the policy concerns about stock price manipulation or accretion of value to non-redeemed shareholders would be absent if Target ceases to be a publicly traded corporation as a result of the transaction. Further, if the Excise Tax were to apply to section 304(a)(1) transactions, its applicability would be driven by shareholder-level facts that may be virtually impossible for the parties to determine as a practical matter. Section 304 already presents administrative challenges in M&A transactions for public corporations attempting to determine the extent of overlapping ownership between Acquiror and Target, given their likely broad and atomized shareholder bases.[252] Adding the potential applicability of the Excise Tax to the mix would only exacerbate the tax uncertainties created by section 304.

On the other hand, if a blanket exemption were given for all transactions subject to section 304(a)(1), it is possible to envision a transaction that is economically similar to a conventional stock repurchase but meets the literal requirements of section 304. Accordingly, it may be appropriate to apply the same or similar anti-avoidance rules that are applied to Acquisitive Asset Reorganizations and Acquisitive Stock Reorganizations—e.g., the Downstream Reorg Exception that we recommend, and the Acquisitive Reorg Brother-Sister Exception that could be considered—in equal measure to section 304(a)(1) transactions if section 304(a)(1) transactions are otherwise outside the scope of the Excise Tax.[253]

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[250] The one potential uncertainty in this regard is that the Dividend Exception applies to repurchases "treated as a dividend *for purposes of this title*," section 4501(e)(6) (emphasis added), whereas the deemed issuance and deemed redemption under in 304(a)(1) applies only "[f]or purposes of sections 302 and 303." However, section 304(a)(1) deemed transactions, as characterized under sections 302 and 303, have broader federal income tax implications, and so seemingly should be eligible for the Dividend Exception if otherwise applicable.

[251] *See supra* Part V.F.3(a).

[252] *See supra* note 219.

[253] We would recommend that the definition of "control" for purposes of these anti-avoidance rules be the same for section 304(a)(1) transactions as they are for Acquisitive Asset Reorganizations and Acquisitive Stock Reorganizations. *See supra* note 219.

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We recommend that Treasury provide guidance as to whether, and to what extent, the Excise Tax may apply to a deemed redemption mandated by section 304(a)(1), including, if relevant, the applicability of the Netting Rule to the corresponding deemed issuance of shares for section 304(a)(1) transactions treated as section 302(d) redemptions.

4. *Section 331 Liquidations*

The Excise Tax could also potentially be relevant to public company liquidations, which are generally taxable "complete liquidations" under section 331.

As a threshold matter, a liquidating distribution pursuant to a section 331 liquidation (a "**Section 331 Distribution**") is arguably a Section 317(b) Redemption, and so could constitute a "repurchase."[254] Under the Code, amounts received by a shareholder in a Section 331 Distribution "shall be treated as in full payment in exchange for the stock."[255] Even if Section 331 Distributions are not Section 317(b) Redemptions, the Excise Tax could still apply to such distributions if they are treated as "economically similar" to redemptions.[256]

The members of the Executive Committee of the NYSBA Tax Section expressed differences of opinion on whether a Section 331 Distribution constitutes a repurchase under the statutory definition. By its own terms, section 317(b) defines when stock is treated as redeemed "for purposes of this part," i.e., part A of Subchapter C, which encompasses sections 301 through 318. Accordingly, one could argue that section 317(b) simply does not apply to Section 331 Distributions or other transactions that have (or are deemed to have) a redemption-type element but are not governed by sections 301 through 318 (e.g., section 355 transactions or reorganizations under section 368). The IRS has disagreed with this view in the context of non-precedential guidance related to section 368,[257] and has held in published rulings, in the context of section 303, that a Section 331 Distribution is a Section 317(b) Redemption "for purposes of section 303, *even though section 317(b) does not apply to section 331*."[258] Given that these

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This parity in anti-avoidance rules would avoid disparate outcomes based on arbitrary distinctions (e.g., whether Target is "checked open" after certain acquisitions to result in a D Reorganization instead of a section 304(a)(1) transaction).

254 Section 4501(c)(1)(A).

255 Section 331(a). From a shareholder's perspective, the tax treatment of a Section 331 Distribution is generally similar to that of an actual or deemed section 301(c)(2)-(3) distribution. *See supra* Part V.D.1-2.

256 Section 4501(c)(1)(B).

257 *See, e.g.*, TAM 9627003 (Feb. 28, 1996) ("Parent argues that [section 317(b)] is limited by its terms to Part I of Subchapter C (sections 301-318) and that because the definition does not by its terms include reorganizations described in section 368, there has been no redemption for purposes of section 1.1502-13(f)(1)(vi). First, we disagree that the definition in section 317(b) has no general application. Indeed, the legislative history suggests the opposite.").

258 Rev. Rul. 79-401, 1979-2 C.B. 128 (emphasis added); *see also* Rev. Rul. 73-177, 1973-1 C.B. 168. At issue in these rulings was whether a liquidating distribution from Corp X should be included together with a subsequent redemption payment from Corp Y in determining what portion of the latter payment was eligible for favorable non-dividend exchange treatment under section 303(a). The amount eligible for section 303(a) is capped by the sum of taxes imposed because of decedent's death plus deductible funeral and administrative expenses of the estate. Redemptions from two or more corporations are aggregated and applied against the cap in the order in

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rulings involved section 303, which *is* included in part A, and focused on section 303-related policy considerations, these rulings are arguably distinguishable from the question of how to treat Section 331 Distributions under the Excise Tax.

Regardless of how this threshold interpretive question is resolved, we recommend that Treasury guidance define "repurchase" to exclude Section 331 Distributions. In general, section 331 liquidations are economically different in kind from redemptions by corporations that continue to exist. Section 331 liquidations, by definition, permanently dissolve the corporation and cease its business operations, and thus completely terminate *all* equity interests in the corporation.[259] These liquidations are not a return of capital or earnings from an ongoing business operation, which could instead be reinvested in that business by the corporation. Further, there can be no concerns about stock price manipulation and accretion to non-redeemed shareholders where the corporation ceases to exist and *all* shareholders are cashed out pro rata (i.e., the Pro Rata Exclusion Principle applies). Thus, these liquidations bear virtually no resemblance to the types of conventional stock repurchases that motivated the enactment of the Excise Tax. From a policy perspective, it would seem difficult to justify applying the Excise Tax—when nominally targeted at stock repurchases—to dissolutions.[260]

5. ***Partial Liquidations***

Under section 302(b)(4), a redemption of a non-corporate shareholder in "partial liquidation" is taxed as an exchange under section 302(a).[261] A "partial liquidation" is a distribution that: (i) "is not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level)," and (ii) "is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year."[262] A distribution satisfies the first requirement if: (i) it "is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of," a certain type of trade or business, and (ii) after the

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which the redemptions are made, with the excess amount being ineligible for section 303(a) treatment and therefore possibly taxed as a dividend. The rulings concluded that liquidating distributions from Corp X were "redemptions" and used up some of the cap, leaving an insufficient amount of cap to cover the entire amount of redemptions by Corp Y.

[259] *See, e.g.*, *Estate of Maguire v. Commissioner*, 50 T.C. 130, 142 (1968); *Mascot Stove Co. v. Commissioner*, 120 F.2d 153, 156 (6th Cir. 1941) ("[L]iquidation is the antithesis of reorganization"). This distinction between a conventional redemption and a liquidation may blur somewhat, however, in the case of a liquidation of a pure holding company.

[260] In some cases, a covered corporation may delist in connection with its liquidation and make one or more subsequent Section 331 Distributions. This raises a separate question of whether the Excise Tax can apply to a corporation that is no longer "traded on an established securities market" for purposes of section 4501(b).

[261] To the extent corporate shareholders are also being redeemed, and none of the other section 302(b) tests are met, their redemptions should be analyzed just like any other section 302(d) redemption. *See supra* Part V.D.2.

[262] Section 302(e)(1).

distribution, the distributing corporation remains "actively engaged in the conduct of" a certain type of trade or business.[263]

Crucially for the Excise Tax, a distribution made as part of a "partial liquidation" may be treated as a Section 317(b) Redemption even if it is, in form, a non-redemptive, pro rata distribution to all shareholders.[264] In other words, a pro rata distribution that would otherwise appear clearly beyond the scope of the Excise Tax can be treated as a Section 317(b) Redemption under section 302(b)(4) and section 302(e), and thereby can potentially become subject to the Excise Tax.

However, these types of partial liquidations do not seem to implicate the policies behind the Excise Tax because: (i) the shareholder-level sale or exchange treatment is driven by corporate-level characteristics, and (ii) a pro rata distribution, by definition, does not shift the shareholders' proportionate interests. We believe that, if a pro rata distribution is only treated as a section 302(a) sale or exchange because it is a partial liquidation, Treasury guidance should exclude that pro rata distribution from the definition of "repurchase."[265] The Pro Rata Exclusion Principle would also achieve this result. To the extent a distribution is not entirely pro rata, the analysis should be the same as the approach outlined for section 302(d) redemptions above.[266]

6. *Considerations for SPACs*

The Excise Tax raises particular considerations for SPACs. A SPAC issues shares and warrants to the public for cash in an initial public offering. That cash is held in trust while the SPAC searches for an operating business to acquire. If the SPAC does not acquire or combine with an operating business within a specified timeframe (and does not obtain shareholder approval to extend the deadline), then the SPAC is required to liquidate in a section 331 liquidation (a "**SPAC Liquidation**"), with the public shareholders surrendering their shares in exchange for the SPAC's cash held in trust. A SPAC Liquidation avoids a situation where investor cash remains indefinitely in a SPAC vehicle that has been unable to find a suitable acquisition target.

Because numerous SPACs were formed prior to August 16th, 2022, the date of enactment for the Excise Tax, the terms of the SPAC's trust account that holds the cash raised from the public would generally prohibit the SPAC from using the principal balance of the trust to pay *any* expense (including the Excise Tax) in order to ensure that SPAC investors can recover their entire invested capital in a liquidation scenario. Thus, if the Excise Tax were applied to SPAC Liquidations, the SPAC may not have funds that it could legally use to pay the Excise Tax because the trustee may refuse to release cash from the trust account for that purpose. Instead,

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[263] Section 302(e)(2). By its terms, section 302(e)(2) provides sufficient but not necessary conditions to satisfy section 302(e)(1)(A), so other types of distributions can theoretically satisfy the first requirement of section 302(e)(1). Bittker & Eustice, *supra* note 99, ¶ 9.07[2] (discussing the corporate contraction doctrine in the context of section 302(e)(1)).

[264] *E.g.*, Rev. Rul. 90-13, 1990-1 C.B. 65.

[265] Otherwise, the IRS may have an incentive to "hunt" for distributions that could be characterized as partial liquidations in order to apply the Excise Tax.

[266] *See supra* Part V.D.2.

the trustee may distribute all cash in the trust account to the SPAC's shareholders in the section 331 liquidation. That could mean that the IRS, in order to receive payment of the Excise Tax, would have to attempt to pursue collection from individual SPAC shareholders or possibly SPAC directors. Alternatively, the SPAC may initiate a bankruptcy proceeding that imposes a burden on public legal resources.

Even in the case of SPACs that could legally pay Excise Tax imposed in connection with a SPAC Liquidation, SPAC investors would lose 1% of their cash to the Excise Tax when that cash was never actually invested in an operating business.

In addition to SPAC Liquidations, SPACs often redeem some (but not all) shareholders in cases where the SPAC finds an acquisition target and completes an acquisition or otherwise combines with the target (commonly referred to as a "**de-SPAC**" transaction). In that case, the SPAC shareholders who do not approve the transaction have a right to redeem their shares for the amount originally paid for SPAC shares and warrants in the initial public offering. These redemption rights are an inherent feature of the SPAC shares; the SPAC has no optionality in this regard.

In other cases, SPACs may be required to offer similar redemption rights to shareholders when they solicit shareholder approval to extend the term of the SPAC's existence before a SPAC Liquidation would be required. As with a de-SPAC transaction, the SPAC does not have the option not to provide these redemption rights in such a scenario.

Many of the above redemptions fit squarely within the definition of a Section 317(b) Redemption.[267]

Redemptions in connection with a de-SPAC transaction often may not result in an Excise Tax liability due to the Netting Rule, if there are sufficient contemporaneous issuances of new SPAC shares to the shareholders of target that is acquired in the transaction, or to new private investors in equity securities (commonly referred to as the "PIPE") whose funds are replacing the cash withdrawn by redeeming shareholders. However, in certain cases, the form of the de-SPAC transaction may be structured as an acquisition of the SPAC by another corporation—e.g., by the nominal "target" or by a new holding company formed to acquire both the SPAC and the target in a "double dummy" section 351 transaction. In that case, for purposes of the Netting Rule, it could be considered whether to allow netting of redemptions by the SPAC with the new issuances by the other corporation, which could be viewed as a successor to the SPAC to the extent the redemptions and offsetting issuances are occurring as part of the same overall de-SPAC transaction. The statutory Netting Rule does not, however, include a concept of netting issuances by a successor against repurchases by a predecessor, or vice versa. We recommend that Treasury issue guidance on the application of the Netting Rule in such cases, whether involving

[267] It is unclear whether at least certain members of Congress anticipated that the Excise Tax would apply to SPAC redemptions. *See* Chandra Wallace, *New Trouble Ahead for SPACs: The Stock Buyback Tax*, 176 Tax Notes Fed. (TA) 1897, 1897 (Sept. 19, 2022) ("For their part, Senate Finance Committee members Sherrod Brown, D-Ohio, and Patrick J. Toomey, R-Pa., were both unaware that the new tax would apply to SPAC redemptions.").

SPACs or other corporations.[268] The Netting Rule may also not be available in cases where a redemption occurs (e.g., in connection with a vote to extend the SPAC's term) in a taxable year that precedes the de-SPAC transaction and in which no new stock issuances occur.

Further, as discussed above in connection with SPAC Liquidations, applying the Excise Tax to a redemption that amounts to a return of a shareholder's capital and does not result in either stock price manipulation or accretion to other shareholders is questionable from a policy perspective. It may also produce a liability that the SPAC is not legally able to pay. Finally, in the current SPAC market, there can be very high redemption rates in de-SPAC transactions and in connection with extension requests.[269] Those high redemption rates result in much less of an economic distinction between Section 331 Distributions by SPACs and redemptions in connection with de-SPAC transactions or extension requests.

Treasury guidance could exempt all or certain SPAC redemptions from the Excise Tax; we do not make a recommendation in this regard. Absent such an exemption, however, we recommend that Treasury guidance consider whether certain cases may warrant transition relief, as discussed below.

G. *Other Issues*

1. *Effective Date and Transition Relief*

(a) *Accelerated Share Repurchases*

The effective date for the Excise Tax states that the tax applies to "repurchases . . . of stock after December 31, 2022."[270] This raises the question of when a repurchase is treated as completed for tax purposes relative to that effective date. In particular, public companies often engage in accelerated share repurchases ("**ASRs**"), which involve the use of an intermediary investment bank to complete the stock repurchase. ASRs allow companies to quickly purchase large blocks of their own shares without engaging in direct transactions on the market or having to launch a tender offer. We understand that public companies have engaged in a significant volume of ASRs during 2022.[271]

In a typical ASR transaction, the covered corporation enters into a forward contract with the investment bank to purchase a certain amount of the covered corporation's shares. The

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[268] A similar issue arises in an Acquisitive Asset Reorganization—if our recommendations with respect to how the Excise Tax applies to Acquisitive Asset Reorganizations are not adopted—when Target distributes newly issued Acquiror stock as part of the Asset Reorg Consideration. If the distribution of boot in this case is treated as a repurchase by Target giving rise to the Excise Tax, Treasury could consider whether the issuance of Acquiror stock (although it is not the same corporation as the Target) should be treated as an issuance by Target for purposes of applying the Netting Rule to Target.

[269] *See, e.g.*, Christopher M. Barlow et al., *Despite Slowdown in SPAC Activity, Opportunities Remain*, Skadden Insights (Sept. 21, 2022), https://www.skadden.com/insights/publications/2022/09/quarterly-insights/despite-slowdown-in-spac-activity-opportunities-remain.

[270] Inflation Reduction Act of 2022, section 10201(d).

[271] *E.g.*, Nicholas Megaw, *US Companies Buy Back Shares in Record Volumes*, Financial Times (Mar. 27, 2022), https://www.ft.com/content/e27975fc-a4f6-4e71-9ac8-af8a2418caca.

investment bank borrows those shares from other financial institutions and delivers them to the covered corporation in exchange for an upfront payment, which may often exceed the current trading price of the shares to be purchased in order to provide downside protection to the investment bank.[272] The investment bank then gradually buys shares on the market in order to close out its loan position. It may take a long time to complete the latter step, given that purchasing a large block of shares on the market in a single day is usually not feasible and, even if it were, the pricing may be disadvantageous.

To mitigate the investment bank's exposure to the market, the price that the covered corporation must pay to the investment bank is determined by the average market price over a period of time. (Importantly, that price does not have to match the price actually paid by the investment bank in effecting its purchases on the market, so the investment bank bears some risk of loss and opportunity for gain on the overall transaction.) Accordingly, in addition to the initial upfront payment, a subsequent purchase price adjustment may be payable at final settlement. Notably, the covered corporation may have the option of delivering its shares, rather than cash, to meet its obligation to pay the investment bank.[273] If the investment bank is the party owing a true-up payment, it would typically be required to settle its obligation in shares of the covered corporation.[274]

For federal income tax purposes, the ASR is typically treated as a purchase of the shares by the covered corporation upon their delivery by the investment bank to the covered corporation (i.e., tax ownership is viewed as transferring in the delivered shares upon their delivery). At that point, the covered corporation has obtained the benefits and burdens of ownership of such shares, notwithstanding the possibility of additional payments in the future. The purchased shares become treasury stock, reducing the overall pool of outstanding shares in the market at that time. This characterization hinges in part on the investment bank being treated as trading in the shares for its own account as a principal, rather than being treated as an agent for the covered corporation. As noted above, this is normally the case where the investment bank does not "pass through" to the corporation the price that the investment bank paid on the market.

We recommend that Treasury issue guidance confirming that, for purposes of the effective date of the Excise Tax, the "repurchase" shall be deemed completed upon the delivery of the shares to the covered corporation in a typical ASR transaction.[275]

(b) *Transitional Guidance*

There will presumably be a transition period between the effective date for the Excise Tax and when Treasury guidance addresses at least some of the issues described in this Report.

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[272] The portion of the payment that exceeds the current fair market value of the shares raises a question as to the proper value that should be subject to the Excise Tax. *See supra* Part V.E.1 (discussing similar issues for Option Contracts); *see infra* note 284.

[273] This payment in shares would presumably constitute an issuance for purposes of the Netting Rule.

[274] This payment in shares would presumably constitute a repurchase for purposes of the Excise Tax.

[275] Subject to potential transitional guidance described *infra* Part V.G.1(b), to the extent repurchased shares are delivered to the covered corporation after 2022 in a typical ASR, that transaction should be subject to the Excise Tax upon that delivery under this approach.

Where Treasury guidance classifies a given instrument or transaction as "economically similar" to a Section 317(b) Redemption (and therefore subject to the Excise Tax), we recommend that such guidance apply prospectively, except for any transactions deemed abusive that may warrant retroactive application.

Similarly, for extraordinary transactions that may at least arguably meet the literal definition of a Section 317(b) Redemption but do not constitute conventional stock repurchases, Treasury could consider applying the Excise Tax (if at all) solely on a prospective basis from the date that relevant guidance is issued. These transactions would include: (i) Section 331 Distributions, including pursuant to SPAC Liquidations, and (ii) M&A transactions that arguably feature a Section 317(b) Redemption component as a technical matter.

Finally, even in cases where it is clear that the Excise Tax applies (or if Treasury guidance does not apply our immediately preceding recommendation), we recommend that Treasury also consider exempting certain transactions that occur after 2022 but that were subject to a binding commitment that existed prior to the enactment of the Excise Tax. Candidates that could be considered for this potential relief—to the extent otherwise treated as subject to the Excise Tax under applicable guidance (or not explicitly exempted under such guidance)—include:

- SPAC Liquidations and redemptions by SPACs formed prior to the enactment date to the extent: (i) otherwise subject to the Excise Tax, and (ii) that a SPAC is contractually obligated to offer redemption rights to its shareholders, as agreed prior to the enactment date;

- Payments in connection with M&A transactions that are completed pursuant to a binding commitment entered into prior to the enactment date, to the extent such payments are otherwise subject to the Excise Tax;

- Repurchases pursuant to ASR transactions that are completed pursuant to a binding commitment entered into prior to the enactment date;

- Section 331 Distributions pursuant to a plan of liquidation adopted prior to the enactment date; and

- Redemptions of Straight Preferred Stock and complete redemptions of tracking stock issued prior to the enactment date, to the extent such redemptions are otherwise subject to the Excise Tax.

2. *"Stock of Which Is Traded on an Established Securities Market" for Section 4501(b)*

To qualify as a covered corporation, a corporation must have "stock" that "is traded on an established securities market (within the meaning of section 7704(b)(1))."[276] The publicly traded

[276] Section 4501(b).

partnership ("**PTP**") rules in section 7704(b)(1) thus define when stock is publicly traded for Excise Tax purposes. Specifically, the Treasury Regulations under section 7704(b)(1) define "established securities market" to include various securities exchanges and also "[a]n interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise" (an "**Interdealer System**").[277] The PTP rules include an "[i]nvolvement of the partnership" safe harbor against PTP status when the partnership would otherwise qualify as a PTP due to an Interdealer System (the "**Involvement Safe Harbor**").[278] Under the Involvement Safe Harbor, a partnership will not be a PTP due solely to an Interdealer System unless the partnership either: (i) "participates in the establishment of the market or the inclusion of its interests thereon," or (ii) "recognizes any transfers made on the market by" either redeeming the transferor or admitting the transferee as a partner or otherwise recognizing any rights of the transferee.[279]

We understand that, in some cases, shares of private corporations may trade on OTC or similar markets, even without the corporation's involvement. Depending on the facts and circumstances, certain of such OTC or similar markets could conceivably qualify as Interdealer Systems.[280] In other words, a corporation could potentially become a covered corporation without engaging in an affirmative listing on an exchange, by virtue of independent shareholder actions. And to the extent that a corporation treats *any* transferees from trades on such markets as shareholders, the Involvement Safe Harbor would apparently be unavailable.

We recommend that "stock" for purposes of the "covered corporation" definition in section 4501(b) *not* include any non-stock instruments that are treated as Covered Instruments for purposes of the definition of "repurchase" in section 4501(c)(1). We also recommend that Treasury affirm that the Involvement Safe Harbor applies for status as a covered corporation due to an Interdealer System, with any necessary adjustments for application to corporations as opposed to partnerships.

3. *Valuation for Purposes of Section 4501(a) and the Netting Rule*

(a) *In General*

We recommend that Treasury provide guidance on acceptable valuation methods for determining both: (i) "the fair market value of any stock of the corporation which is repurchased"[281]—i.e., the base for the Excise Tax, and (ii) "the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any

[277] Treas. Reg. 1.7704-1(b).

[278] Treas. Reg. 1.7704-1(d).

[279] Treas. Reg. 1.7704-1(d).

[280] Treas. Reg. 1.7704-1(b)(5).

[281] Section 4501(a).

stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation," for purposes of the Netting Rule.[282]

We recommend that Treasury guidance mandate that the "fair market value" with respect to each repurchase and issuance is: (i) the actual price that the Applicable Entity paid or received for the Covered Instrument in the repurchase or issuance if the repurchase or issuance was from or to an unrelated party for cash or cash-equivalents, and the price was negotiated at arm's length and *not* pursuant to a preexisting Option Contract[283] or other arrangement that involved the delivery of stock at a price other than the stock's fair market value at delivery,[284] and (ii) in all other cases, the market price of the stock on the day of the repurchase or issuance.

(b) *Publicly Traded Stock*

For this purpose, for publicly traded stock, taxpayers should be permitted (but not required) to determine market price based on one or more "safe harbor" commonly accepted valuation methods for publicly traded securities, consistently applied to all repurchases and issuances throughout the taxable year. These commonly accepted valuation methods could include daily volume-weighted average trading ("**VWAP**"), daily average high-low price,[285] and daily closing price (i.e., "market on close").[286] This type of approach to measuring fair market value is a natural interpretation of the statute because it accords with established federal tax valuation standards for the fair market value of publicly traded securities.

(c) *Privately Owned Stock*

By its terms, the Excise Tax apparently applies to stock of a covered corporation that is not traded on an established securities market. A covered corporation must have stock traded on an established securities market to qualify as a covered corporation,[287] but that does not necessarily mean that *all* stock of the covered corporation is traded on an established securities

[282] Section 4501(c)(3).

[283] *See supra* Part V.E.1 (discussing valuation with respect to strike prices under Option Contracts).

[284] For example, in ASRs, the covered corporation's upfront payment often exceeds the current trading price of the shares to be purchased in order to provide downside protection to the investment bank. *See supra* Part V.G.1(a). Accordingly, this upfront payment would constitute an arrangement that involved negotiation of a price at other than fair market value, such that shares delivered in an ASR pursuant to that upfront payment would be valued for Excise Tax purposes based on their fair market value.

[285] *Cf.* Treas. Reg. 20.2031-2(b) ("In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond."); Treas. Reg. 25.2512-2(b) ("In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond.").

[286] *Cf.* Rev. Proc. 2018-12, 2018-16 I.R.B. 349, section 4.01 (providing all three of these valuation methods as "Safe Harbor Valuation Methods" accepted for purposes of determining whether the continuity of interest requirement under Treas. Reg. 1.368-1(e) is satisfied).

[287] Section 4501(b).

market. And section 4501(a), in applying the Excise Tax, does *not* limit the tax base to repurchases of stock traded on an established securities market.

We recommend that Treasury clarify whether the Excise Tax applies to stock of a covered corporation that is not traded on an established securities market. Assuming that it does, general valuation principles for valuing privately owned securities should apply for Excise Tax purposes.[288]

(d) *Alternative Annual Valuation Convention*

One alternative valuation approach would be to allow covered corporations to use an *annual* valuation convention—e.g., VWAP or average high-low price for the entire taxable year—to determine a single, uniform "fair market value" for all relevant repurchases and issuances made during the taxable year. An annual convention, which values all Covered Instruments of the same type repurchased and issued during the taxable year at the same price, would smooth-out the effect of share volatility during the taxable year.[289] It would also simplify the Netting Rule because this uniform annual price for all repurchases and issuances in the taxable year would effectively allow for netting to be calculated purely based on share count for each type of Covered Instrument of a covered corporation: the number of shares repurchased minus the number of shares redeemed. However, an annual convention that converts the Netting Rule into more of a share-count rule is in tension with the statutory requirement to value stock based on "fair market value."[290] Typically, valuation standards for other Code provisions do not permit fair market value to be averaged over such a long time horizon for publicly traded securities.[291] Further, an annual convention could cause a covered corporation's Excise Tax liability to rise or fall dramatically after issuances or repurchases earlier in the taxable year, based on later-year volatility. Thus, we do not make a recommendation with respect to whether Treasury should allow for an annual valuation convention.

4. *Certain Issues Under Section 4501(d)*

We recommend that Treasury issue guidance for certain interpretive issues related to the "special rules" in section 4501(d).

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288 *Cf*. John A. Bogdanski, *Federal Tax Valuation*, ¶ 2.01 (1996 & Supp. 2022-1).

289 Absent an annual convention, an Applicable Entity could have net positive stock repurchases even if the number of shares issued is greater than or equal to the number of shares repurchased in the taxable year.

290 Section 4501(a); Section 4501(c)(3).

291 *E.g.*, *United States v. Cartwright*, 411 U.S. 546, 551 (1973) ("Under [the willing-buyer, willing-seller] this test, it is clear that if the decedent had owned ordinary corporate stock listed on an exchange, its 'value' for estate tax purposes would be the price the estate could have obtained if it had sold the stock on the valuation date, that price being, under Treas. Reg. 20.2031-2(b), the mean between the highest and lowest quoted selling prices on that day."); Treas. Reg. 20.2031-2(a) ("The value of stocks and bonds is the fair market value per share or bond *on the applicable valuation date*." (emphasis added)); Treas. Reg. 25.2512-2(a) ("The value of stocks and bonds is the fair market value per share or bond *on the date of the gift*." (emphasis added)).

(a) ***Domestic Partners of Foreign Partnerships that Are Specified Affiliates***

The Excise Tax does not apply if the specified affiliate acquiring an applicable foreign corporation's Covered Instrument is "a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner)."[292]

We recommend that Treasury guidance address two aspects of the domestic partner exception in the quoted parenthetical. First, we recommend that Treasury guidance clarify that, if a foreign corporation is a direct or indirect partner in a foreign partnership, domestic ownership of that foreign corporation-partner (i.e., domestic ownership *above* the foreign corporation-partner) is *not* considered. Foreign corporations are otherwise treated as *per se* foreign for purposes of section 4501(d)(1), and we believe that treatment should be consistent for the domestic partnership exception notwithstanding the use of the term "indirect partner."[293] This clarification is also necessary because a partnership that is an applicable foreign corporation's specified affiliate is, by definition, majority-owned by the applicable foreign corporation.[294] And because the stock of applicable foreign corporations is "traded on an established securities market,"[295] most applicable foreign corporations will have domestic shareholders (e.g., small U.S. owners of stock in publicly traded foreign corporations). In other words, absent this requested clarification for foreign corporation-partners, almost no partnership would qualify as foreign.

Second, we recommend that Treasury guidance define "a domestic entity" that is "a direct or indirect partner" to require a minimum direct and indirect ownership threshold. We believe that de minimis ownership by a "domestic entity" should not cause a foreign partnership to be treated as domestic. This minimum ownership threshold could be set in the range of de minimis thresholds found elsewhere in the Code.[296]

(b) ***Treatment of Surrogate Foreign Corporations that Are Domestic Under Section 7874(b)***

It is arguably ambiguous whether a surrogate foreign corporation that is treated as domestic under section 7874(b) as the result of a transaction that was completed after September 20, 2021 (a "**Section 7874(b) Corporation**") is treated for Excise Tax purposes: (i) as a covered surrogate foreign corporation subject to section 4501(d)(2) because the definition of "covered surrogate foreign corporation" literally includes Section 7874(b) Corporations,[297] or instead (ii)

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[292] Section 4501(d)(1).

[293] Section 4501(d)(1).

[294] Section 4501(c)(2)(B).

[295] Section 4501(d)(3)(A).

[296] *E.g.*, Treas. Reg. 1.351-1(c)(7), Ex. 1 (treating sub-1% as de minimis for purposes of section 351(e)); Treas. Reg. 1.1202-2(a)(2) (applying a 2% de minimis threshold for purposes of section 1202).

[297] A "covered surrogate foreign corporation" is defined in section 4501(d)(3)(B) as a "surrogate foreign corporation" within the meaning of section 7874(a)(2)(B) that meets certain additional requirements. A Section 7874(b) Corporation is literally a "surrogate foreign corporation" under section 7874(b)(2)(B), and so arguably

(cont'd)

as a domestic corporation subject to section 4501(a) because section 7874(b) provides that a Section 7874(b) Corporation "shall be treated for purposes of this title [which includes the Excise Tax] as a domestic corporation."

We recommend that Treasury guidance provide that a Section 7874(b) Corporation is subject to section 4501(a), and not section 4501(d)(2). That approach would best implement section 7874(b)'s directive to treat 7874(b) Corporations as domestic corporations under the Code.

(c) ***Modified Netting Rule for Applicable Foreign Corporations***

For applicable foreign corporations, section 4501(d)(1)(C) provides that the Netting Rule "shall be determined only with respect to stock issued or provided by such specified affiliate [acquiring the applicable foreign corporation's stock] to employees of the specified affiliate."

We recommend that Treasury guidance clarify the application of section 4501(d)(1)(C)'s modified Netting Rule, although we do not recommend a particular approach. Guidance could provide that this netting rule is applied separately to each domestic specified affiliate: netting the value of all Covered Instruments of the applicable foreign corporation issued or provided by each domestic specified affiliate against the value of all Covered Instruments of the applicable foreign corporation repurchased *only* by that *one* domestic specified affiliate.[298] This approach is arguably most consonant with the statutory language, which provides that this modified Netting Rule shall "be determined only with respect to stock issued or provided by *such* specified affiliate."[299]

Alternatively, guidance could provide that this modified Netting Rule is applied on an aggregate basis to *all* domestic specified affiliates: netting the value of all Covered Instruments of the applicable foreign corporation issued or provided by *all* domestic specified affiliates against the value of all Covered Instruments of the applicable foreign corporation repurchased by *all* domestic specified affiliates. This aggregate approach would better achieve the anti-dilutive policy focus of the Netting Rule and would simplify compliance.

(d) ***Modified Netting Rule for Covered Surrogate Foreign Corporations***

For covered surrogate foreign corporations, section 4501(d)(2)(C) provides that the Netting Rule "shall be determined only with respect to stock issued or provided by such expatriated entity to employees of the expatriated entity."

The expatriated entity may cease to exist after the completion of the Section 7874(a)(2)(B) Transaction. But section 4501(d)(2)(B) otherwise treats repurchases or acquisitions of the covered surrogate foreign corporation's stock by the covered surrogate

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could be a "covered surrogate foreign corporation" under section 4501(d)(3)(B) if the Section 7874(b) Corporation meets section 4501(d)(3)(B)'s additional requirements.

[298] For this purpose, Treasury could consider whether or not a U.S. consolidated group is treated as a single entity.

[299] Section 4501(d)(1)(C) (emphasis added).

foreign corporation or its specified affiliates as repurchases by the expatriated entity. We recommend that Treasury guidance to clarify that this deemed treatment extends to the modified Netting Rule for covered surrogate foreign corporations. In other words, where a *repurchase* would be treated as made by the expatriated entity under section 4501(d)(2)(B), an *issuance* by the same entity or entities is presumably likewise treated as made by the expatriated entity under section 4501(d)(2)(C).

We also recommend that Treasury guidance clarify whether section 4501(d)(2)(C)'s modified Netting Rule is applied on a separate entity or aggregate basis. Although we do not recommend a particular approach, we believe that whichever conceptual approach Treasury guidance chooses—separate entity or aggregate—should be the same for applicable foreign corporations under section 4501(d)(1)(C) and for covered surrogate foreign corporations under section 4501(d)(2)(C). A consistent approach is warranted because: (i) the statutory language in these two modified Netting Rule provisions corresponds, and (ii) a consistent approach avoids the unnecessary complexity of different approaches.

(e) *SFC Related-Party Acquisitions*

One relevant difference between section 4501(d)(1) and section 4501(d)(2) is that the statutory language in section 4501(d)(2) does not appear to exclude stock acquisitions from the covered surrogate foreign corporation or another specified affiliate ("**SFC Related-Party Acquisitions**"), while section 4501(d)(1) does.[300]

> **Example 17**: *SFC Related-Party Acquisitions*. Corp Y, a covered surrogate foreign corporation, wholly owns a domestic corporate subsidiary ("**USS1**"). USS1 in turn wholly owns another domestic corporate subsidiary ("**USS2**"). An employee of USS2 is compensated for services to USS2 with unrestricted Corp Y stock.

USS1 is deemed to have acquired Corp Y stock; USS1 then is deemed to transfer the Corp Y stock to USS2 in another SFC Related-Party Acquisition; and USS2 is deemed to issue the Corp Y stock to the employee.[301] If SFC Related-Party Acquisitions constitute repurchases and section 4501(d)(2)(C)'s modified Netting Rule is applied on a separate-entity basis, then the issuance of stock to the employee nets against the SFC Related-Party Acquisition by USS2, and not the SFC Related-Party Acquisition by USS1 from Corp Y.

Treasury guidance could clarify whether SFC Related-Party Acquisitions constitute repurchases for Excise Tax purposes, and how the approach to SFC Related-Party Acquisitions interacts with section 4501(d)(2)(C)'s modified Netting Rule.

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[300] Section 4501(d)(1) provides: "In the case of an acquisition . . . from a person *who is not the applicable foreign corporation or a specified affiliate of such applicable foreign corporation* . . . ." (emphasis added). Section 4501(d)(2) does not include similar language.

[301] Treas. Reg. 1.83-6(d); Treas. Reg. 1.1032-3.

5. *The Employee Plan Exception*

Unlike section 4501(a) and the Netting Rule—which refer specifically to "fair market value" of the stock repurchased and issued—the Employee Plan Exception also refers to the Excise Tax not applying to "the stock repurchased" if it is "contributed" to an Employee Plan.[302] This difference in language appears to indicates that the Employee Plan Exception should exclude repurchased Covered Instruments from the Excise Tax if those Covered Instruments are contributed to an Employee Plan, regardless of the relative value of the Covered Instruments at the time of repurchase and the time of contribution to the Employee Plan. The Employee Plan Exception's measurement language is also disjunctive, providing that the Excise Tax does not apply "in any case in which the stock repurchased is, *or* an amount of stock equal to the value of the stock repurchased is, contributed to" an Employee Plan.[303]

We recommend that Treasury Guidance clarify this language in the Employee Plan Exception. Guidance could apply the same "fair market value" standard used in section 4501(a) and the Netting Rule on the grounds that there is no compelling policy reason for a different standard to apply for the Employee Plan Exception. Alternatively, if that approach is seen as undesirable, guidance could instead focus on giving effect to the plain language of the Employee Plan Exception, which indicates that a different two-prong framework applies.

For the second approach, to give effect to the first prong of the Employee Plan Exception's measurement language,[304] Treasury guidance could provide a tracing rule, to match the number of shares repurchased with the number of shares contributed to any Employee Plan (the "**Section 4501(e)(2) Tracing Rule**"). The Section 4501(e)(2) Tracing Rule would allow taxpayers to treat any shares contributed to an Employee Plan as the shares of the same class of stock repurchased at any point in the same taxable year prior to that contribution. This approach would provide taxpayers with reasonable flexibility in applying the plain language of the Employee Plan Exception without requiring that specific shares with specific CUSIP numbers be traced from repurchase to contribution. Once shares were traced to a given repurchase under the Section 4501(e)(2) Tracing Rule, the fair market value of that particular repurchase would be eliminated from the base of the Excise Tax under section 4501(a).

> **Example 18**: *Application of the Section 4501(e)(2) Tracing Rule*. Corp X has 100 shares of common stock outstanding and no other outstanding equity. In Year 1, Corp X repurchases five shares for $10 each on January 14th; repurchases seven shares for $11 each on March 9th; and repurchases twelve shares for $14 each on October 31st. Also in Year 1, Corp X contributes four shares to an Employee Plan within the meaning of the Employee Plan Exception on September 1st when the price per share is $4.

Under the Section 4501(e)(2) Tracing Rule, Corp X could treat the four shares contributed to the Employee Plan as four of the shares repurchased on January 14th or March 9th

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[302] Section 4501(e)(2).

[303] Section 4501(e)(2) (emphasis added).

[304] Section 4501(e)(2) ("in any case in which the stock repurchased is . . .").

(i.e., the repurchases that occurred prior to the contribution to the Employee Plan). Under this rule, Corp X would have the ability to trace the four contributed shares to the March 9th repurchase in order to offset the pre-contribution shares repurchased at the highest price ($11 on March 9th as opposed to $10 on January 14th). If it did so, four of the seven shares repurchased on March 9th would be eliminated from the base of the Excise Tax.

In addition, to give effect to the second prong of the Employee Plan Exception's measurement language under this plain-language approach,[305] taxpayers could be able to elect, in lieu of the Section 4501(e)(2) Tracing Rule, to determine the fair market value of the stock contributed to an Employee Plan as of the date of the contribution using the same general valuation standards provided for valuing stock repurchased and issued.[306] The fair market value of the contributed stock can then offset the value of repurchased stock in the same manner as under the Netting Rule.

6. *Overall Ordering Rule for the Netting Rule and Section 4501(e) Exceptions*

We recommend that Treasury guidance clarify the order in which taxpayers are to apply regulatory exclusions from the definition of "repurchase," the Netting Rule, and the Section 4501(e) Exceptions when calculating their Excise Tax liability.

First, exclusions from the threshold definition of "stock" or "repurchase"—e.g., for Straight Preferred Stock and Section 331 Distributions, if those recommendations are adopted—should apply *before* the Section 4501(e) Exceptions and the Netting Rule. Both of those sets of rules only apply to transactions that are repurchases in the first instance. Second, the statutory language indicates that the Section 4501(e) Exceptions should apply *before* the Netting Rule. Section 4501(e), by its terms, provides circumstances in which transactions that are otherwise repurchases are excluded entirely from the gross Excise Tax base.[307] The Netting Rule, by contrast, is described as an "adjustment" to the gross Excise Tax base under section 4501(a),[308] which indicates that the Netting Rule should apply after the gross Excise Tax base is determined as a threshold matter (i.e., after application of the Section 4501(e) Exceptions).[309] This ordering is also sensible because the Section 4501(e)(2) Tracing Rule, if adopted, would be most easily applied, as a mathematical matter, before any repurchases are netted-out under the Netting Rule.[310]

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[305] Section 4501(e)(2) ("or an amount of stock equal to the *value* of the stock repurchased . . . " (emphasis added)).

[306] *See supra* Part V.G.3.

[307] Section 4501(e) ("Subsection (a) shall not apply . . .").

[308] The title for section 4501(c)(3) is "Adjustment," and section 4501(c)(3) adjusts "[t]he amount taken into account under subsection (a)."

[309] In other words, the Section 4501(e) Exceptions exclude amounts from the section 4501(a) gross amount in the first instance, and the Netting Rule then adjusts the gross section 4501(a) amount once that gross amount is established.

[310] *See supra* Part V.G.5.

Within the Section 4501(e) Exceptions, the plain language of the De Minimis Exception indicates that it applies before the other Section 4501(e) Exceptions (and the Netting Rule). The De Minimis Exception applies to "the *total* value of the stock repurchased," which is read most naturally to refer to the gross repurchase amount, rather than the net repurchase amount after application of the other Section 4501(e) Exceptions and the Netting Rule.[311]

Accordingly, our recommended approach to ordering would be:

- Step 1: The taxpayer calculates its gross repurchases for the taxable year, taking into account any exclusions from the definitions of "stock" and "repurchase."

- Step 2(a): The taxpayer tests whether the De Minimis Exception applies to the amount calculated in Step 1. If the De Minimis Exception applies, there is no Excise Tax liability for the taxable year, and no further calculations are necessary.

- Step 2(b): The taxpayer applies the other Section 4501(e) Exceptions to reduce the amount calculated in Step 1.

- Step 3: The taxpayer applies the Netting Rule to the amount calculated in step 2(b), resulting in the net repurchase amount subject to the Excise Tax.

7. *Procedural Issues*

We recommend that Treasury guidance provide that a corporation's Excise Tax return is required to be filed at the same time as the corporation's Form 1120, and that the Excise Tax return cover the same annual period as the Form 1120.[312] We recommend that an automatic six-month extension of time to file be provided for Excise Tax returns, matching the extension available for the Form 1120.[313] We also recommend that payment of the Excise Tax be due at the filing deadline for the Excise Tax return (without regard to extensions), and that no estimated payments or withholding be required with respect to the Excise Tax prior to that payment deadline.

Because section 4501 cross-references to concepts and principles from Subchapter C of the Code, it is sensible, both practically and as a policy matter, for tax reporting of the Excise Tax to occur at the same time as for the corporate income tax.[314] With respect to payment, we believe that annual payment upon return filing is appropriate primarily given the Netting Rule, whereby stock repurchases early in the year would be netted against stock issuances later in the year. In other words, net stock issuances and repurchases would appear likely to be uneven

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[311] Section 4501(e)(3) (emphasis added). Further, repurchases subject to other Section 4501(e) Exceptions, although excluded from the Excise Tax base, are still repurchases within the meaning of the statute (and so presumably within the meaning of the De Minimis Exception).

[312] Section 6072(a); Treas. Reg. 1.6012-2(a).

[313] Treas. Reg. 1.6081-3(a).

[314] For instance, the calculation of the Excise Tax may depend on a corporation's E&P, which is computed as of the close of the taxable year. *See* Section 316(a)(2).

during the taxable year in the typical case, so annual payment at the time that the tax return is filed appears appropriate.[315] If estimated payments are required, then we recommend that they be no more frequent than quarterly, as is the case for the corporate income tax.[316]

We further recommend that Treasury consider waiving certain applicable penalties with respect to the Excise Tax in a manner consistent with the temporary penalty relief afforded for other recently enacted or renewed federal excise taxes.[317] Treasury has recognized that targeted penalty relief may be appropriate where there are "difficulties of computing the correct amount" of a newly imposed excise tax.[318]

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[315] A counter-argument would be that a corporation's income can also vary dramatically throughout the year, yet estimated payments are required for the corporate income tax during the taxable year. *See* Bloomberg, *Estimated Tax*, 581-3rd Tax Management Portfolio (BNA), at IV(A)(4). Our view is that net stock issuances and repurchases for or by Applicable Entities are less likely to be correlated month-to-month, or quarter-to-quarter, than corporate net income.

In addition, other more annualized calculations could be required for E&P for the Dividend Exception; the De Minimis Exception; and the Section 4501(e)(2) Tracing Rule.

[316] *Cf.* section 6655(c).

[317] *See, e.g.*, Notice 2018-10, 2018-8 I.R.B. 359 (temporary relief from penalty for failure to make deposits of section 4191 medical device tax); Notice 2022-15, 2022-18 I.R.B. 1043 (temporary relief from penalty for failure to make deposits of section 4661 and section 4671 Superfund chemical taxes). As noted above, our recommendation is that the Excise Tax not be required to be deposited more frequently than annually. If, contrary to this recommendation, more frequent deposits of the Excise Tax are required, we recommend that temporary relief from the section 6656 failure to deposit penalty be granted until comprehensive guidance or regulations on the Excise Tax are issued.

[318] Notice 2022-15, section 2(c).