July 3, 2024

Ms. Aviva Aron-Dine
Acting Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Marjorie A. Rollinson
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Brett York
Deputy Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Ave, NW
Washington, DC 20020

RE: Comments on Proposed Regulations on Excise Tax on Repurchase of Corporate Stock

Dear Ms. Aron-Dine, Ms. Rollinson, Mr. Werfel, and Mr. York:

The American Institute of CPAs ("AICPA") appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS, and together with Treasury, the "Government") in providing proposed regulations on Excise Tax on Repurchase of Corporate Stock, REG-115710-22, addressing application of the new excise tax on repurchases of corporate stock under section[1] 4501, which was enacted as part of the Inflation Reduction Act of 2022.[2]

Section 4501(a) provides that a covered corporation is subject to "a tax equal to 1 percent of the fair market value of any stock of the corporation which is repurchased by such corporation during the taxable year"[3]

The attached comments and recommendations are in addition to our previous comments,[4] which are incorporated and resubmitted by reference.

Our attached comments include the following recommendations for the Government to adopt in the final regulations and other future guidance:[5]

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[1] Unless otherwise indicated, all references to a "section" are to a section of the Internal Revenue Code of 1986, as amended the "Code"), and references to a "Reg. §" or "Prop. Reg. §" are to the final or proposed, respectively, Treasury regulations promulgated under the Code.
[2] H.R. 5376, Public Law 117-169.
[3] Section 4501(a).
[4] AICPA comment letter, "AICPA Comments on Notice 2023-2 on Excise Tax on Repurchases of Corporate Stock", March 28, 2023.
[5] Capitalized terms not defined here have the meaning ascribed to them in our Comments section below.

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1. Revoke the Proposed Reg Per Se Rule and clarify and limit the application of the Proposed Reg Funding Rule solely to fundings that were made to avoid the application of section 4501(d).

2. Include an example that illustrates the application of the principal purpose test in the Proposed Reg Funding Rule in a situation where an applicable specified affiliate and an applicable foreign corporation or relevant entity have multiple arrangements between them.

3. Include a rule that treats members of a U.S. consolidated group as a single corporation for purposes of applying the section 4501(d) Netting Rule.

4. Reconsider approach to the application of section 4501 in mergers and acquisition ("M&A") transactions to ensure that application of the Excise Tax is informed by, and consistent with, the plain language and fundamental scope and spirit of the statute, which is that the Excise Tax applies to section 317(b) redemptions of covered corporation shares and *"economically similar"* transactions.

5. Clarify that the E Reorganization Exception applies to an E Reorganization Repurchase regardless of whether any shares issued in the E Reorganization are treated as a distribution to shareholders under section 305(b) and section 301 pursuant to section 305(c) and Treas. Reg. § 1.305-7(c)(1)(ii). That is, to the extent shares are repurchased in an E Reorganization in exchange for qualifying property, the fair market value of those repurchase shares should be a reduction to the Excise Tax base, regardless of whether any of the shares (*i.e.*, the qualifying property) issued are treated as distributed under section 305 and section 301.

6. Adopt a sufficient evidence requirement that does not require a certification from the shareholder in circumstances where a covered corporation has sufficient evidence on its own to conclude that a repurchase should be treated as a dividend to a shareholder for federal income tax purposes. Also adopt a sufficient evidence requirement that does not require the shareholder to treat the repurchase as a dividend on a federal income tax return.

7. Clarify that under Prop. Reg. § 58.4501-2(d)(2)(ii) a corporation is treated as a covered corporation for both issuances and repurchases made pursuant to the plan in which the corporation ceased being a covered corporation.

8. Adopt a "grandfather" rule in which certain classes of preferred stock subject to mandatory redemption and issued before August 16, 2022 (the enactment of the Inflation Reduction Act of 2022) are excepted from the definition of "stock" subject to the Excise Tax.

9. Exclude Prop. Reg. § 58.4501-4(f)(13) from the final regulations; if an anti-avoidance rule is needed, identify specific transactions that could be directly targeted.

10. Have the Netting Rule take into account all compensatory transfers by a covered corporation or a specified affiliate, without regard to the classification of the worker as an employee or non-employee service provider, or whether the stock is being transferred by the covered corporation or by a specified affiliate.

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Amy Chapman, Chair, AICPA Corporate & Shareholders TRP at (202) 533-3424 or akchapman@kpmg.com; Reema Patel, Senior Manager - AICPA Tax Policy & Advocacy, at (202) 434-9217, or Reema.Patel@aicpa-cima.com; or me at (830) 372-9692 or bvickers@alamo-group.com.

Sincerely,

Blake Vickers, CPA, CGMA
Chair, AICPA Tax Executive Committee

cc:

Ms. Helen Morrison, Benefits Tax Counsel, Office of the Benefits Tax Counsel, Department of the Treasury
Ms. Rachel Leiser Levy, Associate Chief Counsel (EEE), Internal Revenue Service
Mr. Colin Campbell, Associate Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Mr. Mark A. Schneider, Associate Chief Counsel (Corporate), Internal Revenue Service
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Mr. Daniel M. McCall, Deputy Associate Chief Counsel (International), Internal Revenue Service
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AMERICAN INSTITUTE OF CPAs

Comments on Proposed Regulations on Excise Tax on Repurchases of Corporate Stock
July 3, 2024

SPECIFIC COMMENTS

1. Funding Rule

Overview

Under section[1] 4501(d)(1), the tax imposed by section 4501 (the "Excise Tax") can apply to an acquisition of stock of an "applicable foreign corporation" (*i.e.*, a foreign publicly-traded corporation) by a specified affiliate of such corporation (other than a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner)) (an "applicable specified affiliate") from a person who is not the applicable foreign corporation or a specified affiliate of such applicable foreign corporation.[2]

In an expansion of the statute, Notice 2023-2 (the "Notice") included a "funding rule" that would subject an applicable specified affiliate to the Excise Tax to the extent it "funded" an acquisition of the stock of that foreign parent.[3] Specifically, under the Notice, an applicable specified affiliate would be treated as acquiring stock of an applicable foreign corporation:

> if the applicable specified affiliate fund[ed] by any means (including through distributions, debt, or capital contributions) the acquisition or repurchase of stock of the applicable foreign corporation by the applicable foreign corporation or a specified affiliate that is not also an applicable specified affiliate, and such funding [was] undertaken for a principal purpose of avoiding the stock repurchase excise tax (the "Notice Funding Rule").

The Notice further provided that, for the purposes of the Notice Funding Rule, a principal purpose would be deemed to exist if the applicable specified affiliate funded by any means, other than through distributions, the applicable foreign corporation or a specified affiliate that is not also an applicable specified affiliate, and such funded entity acquired or repurchased stock of the applicable foreign corporation within two years of the funding (the "Notice Per Se Rule").[4]

In our prior comment letter, which we incorporate and resubmit by reference, we (along with many other stakeholders, according to the preamble (the "Preamble")) to the proposed regulations on Excise Tax on Repurchase of Corporate Stock, REG-115710-22 (the "Proposed Regulations") recommended that the Government eliminate the Notice Per Se Rule and eliminate, or at least clarify, the Notice Funding Rule.

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[1] Unless otherwise indicated, all references to a "section" are to a section of the Internal Revenue Code of 1986, as amended the "Code"), and references to a "Reg. §" or "Prop. Reg. §" are to the final or proposed, respectively, Treasury regulations promulgated under the Code.
[2] Section 4501(d)(1).
[3] Notice § 3.05(2)(a)(ii)(A).
[4] Notice § 3.05(2)(a)(ii)(B).

The Proposed Regulations eliminate the Notice Per Se Rule; however, it is replaced with a different rule that effectively acts as a per se rule.[5] Under Prop. Reg. § 58.4501-7(e)(1), an applicable specified affiliate of an applicable foreign corporation is treated as acquiring stock of the applicable foreign corporation to the extent the applicable specified affiliate 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[6] (the "Proposed Reg. Funding Rule"). Furthermore, "[i]f a principal purpose of the covered funding[7] is to fund, directly or indirectly, a covered purchase, then there is a principal purpose of avoiding the section 4501(d) excise tax" (the "Proposed Reg. Per Se Rule").[8] The Proposed Reg. Funding Rule and the Proposed Reg. Per Se Rule are proposed to apply to fundings that occur on or after December 27, 2022, in taxable years ending after December 27, 2022.

Recommendation

We recommend that the Government revoke the Proposed Reg. Per Se Rule and clarify and limit the application of the Proposed Reg. Funding Rule solely to fundings that were made to avoid the application of section 4501(d).

Analysis

The authority granted to the Government under section 4501(f) is to prescribe regulations and other guidance as necessary, or appropriate, to carry out and prevent the avoidance of section 4501,

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[5] The Preamble indicates that, "[t]he proposed funding rule would retain the general structure of the Notice [F]unding [R]ule, but with substantial modifications that include replacing the per se rule with a rebuttable presumption that applies in limited circumstances." The rebuttable presumption referenced therein applies with respect to another rule in the Proposed Regulations, which provides that a principal purpose of avoiding the Excise Tax is presumed to exist if an 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 (a "Downstream Funding"). Proposed Reg. § 58.4501-7(e)(2). That presumption may be rebutted if facts and circumstances clearly establish that the principal purpose of a Downstream Funding was not avoiding the Excise Tax. However, in our experience, Downstream Funding is not typical; therefore, the ability to rebut a presumption in that fact pattern is not particularly impactful relative to the imposition of the Proposed Reg. Per Se Rule, which applies far more broadly, and which there does not appear to be any ability to rebut based on lack of Excise Tax avoidance purpose.

[6] The Proposed Regulations define the "section 4501(d) excise tax" as "the amount of excise tax imposed pursuant to section 4501(d) on a section 4501(d) covered corporation." Prop. Reg. § 58.4501-7(c)(1). Such a funding is defined in the Proposed Regulations as "a covered funding." Proposed Reg. § 58.4501-7(e)(1).

[7] We note that this reference is circular, as a covered funding is defined as a funding with a principal purpose of avoiding the Excise Tax. Thus, read literally, the Proposed Reg. Per Se Rule would only apply to a funding with such a purpose, such that the deeming of such a purpose would be moot. Presumably this is not what was intended.

[8] Prop. Reg. § 58.4501-7(e)(1). The Government appears to have intended the revocation of the Notice Per Se Rule to narrow the application of the Proposed Reg. Funding Rule, pursuant to the Government's stated goal of providing a "targeted anti-abuse rule ... without ordinary course intercompany funding transactions among their corporate affiliates being inadvertently captured," which we would welcome. However, because of the drafting of the Proposed Reg. Per Se Rule, in certain circumstances, taxpayers may have even more Excise Tax exposure under the Proposed Reg. Per Se Rule than they would have under the Notice Per Se Rule. In particular, distributions were explicitly excluded from the Notice Per Se Rule, whereas there is no comparable exclusion under the Proposed Reg. Per Se Rule. Additionally, the Notice Per Se Rule presumption was limited to two years; the Proposed Reg. Per Se Rule contains no temporal limit, and an example in the Proposed Regulations illustrates the application of the rule to a stock purchase that occurs more than two years after the funding. *See* Prop. Reg. § 58.4501-7(p)(3), Example 3.

including the application of the rules under section 4501(d). In our view, the Proposed Reg. Per Se Rule goes beyond what is necessary or appropriate to prevent the avoidance of section 4501.

Like the Notice Per Se Rule, the Proposed Reg. Per Se Rule can impose the Excise Tax on taxpayers related to ordinary course business transactions that do not have a motive for Excise Tax avoidance. The Proposed Reg. Per Se Rule provides that a principal purpose to fund a covered purchase equates to a principal purpose of avoiding the section 4501(d) Excise Tax. However, a purpose of funding a share repurchase is fundamentally different than a purpose of avoiding section 4501(d). To implement a repurchase of a foreign parent's shares, it is generally most practical and logical for the foreign parent, rather than an affiliate, to reacquire its own shares, regardless of the Excise Tax. Furthermore, as the Government acknowledges in the Preamble, foreign law often prohibits a subsidiary from owning stock of its parents. Thus, in our experience, the transaction described in section 4501(d), *i.e.*, an acquisition of stock of an applicable foreign corporation by a specified affiliate of such corporation from a person who is not the applicable foreign corporation or a specified affiliate of such applicable foreign corporation (a "Section 4501(d) Transaction") is not common; therefore, tax planning to avoid the application of the Excise Tax to a Section 4501(d) Transaction likewise would not be expected to be common. On the other hand, affiliates "fund[ing] by any means" a repurchase of stock of one another is common, unrelated to any tax avoidance purpose. Therefore, the Proposed Reg. Per Se Rule is greatly overinclusive if the intent is to prescribe guidance to prevent the avoidance of section 4501(d).

Further, given the fungibility of cash, the phrase "funds by any means" could be read to cover an extraordinarily broad range of situations. Many ordinary course transactions could fund a repurchase of foreign parent stock. For example, a U.S. subsidiary may transfer cash to its foreign parent as an ordinary course distribution; to pay for goods and services; as an extension of routine intercompany credit or participation in a cash pool; in repayment of a pre-existing loan; or to fund an extraordinary transaction unrelated to the Excise Tax. From a practical perspective, it is not clear how a taxpayer could establish that transfers of funds did not have a principal purpose of funding a repurchase of stock when cash is fungible and is transferred in numerous ways for numerous purposes. Typically, a foreign parent will receive funds from both U.S. and foreign entities, and commingle these funds for use for various purposes, potentially including stock repurchases. The Preamble states that the Proposed Regulations do not adopt a "tracing" approach to determine which funding sources were used for which purposes. However, it is unclear how the purpose of a particular funding should be determined in the typical context where a foreign parent receives funds from various internal and external sources to be used for various different purposes. It is likewise unclear how a taxpayer could substantiate that a funding is not for the purpose of funding a repurchase. Is a taxpayer required to keep books and records documenting the purpose of every cash transaction? The Proposed Regulations also are not clear on *whose* purpose is relevant (*e.g.*, does the applicable specified affiliate need to ascertain what the foreign parent intends to do with funds transferred?).

Under the Proposed Reg. Per Se Rule, any repurchases by an applicable foreign corporation of its own stock could potentially be treated as "funded" by an applicable specified affiliate, regardless of whether there was any intent to avoid the Excise Tax, and regardless of whether it can be established that the funds actually used to finance the repurchase came from other sources, such as the foreign parent's cash on hand or from distributions from other non-U.S. entities. We expect

the Proposed Reg. Per Se Rule (and the Proposed Reg. Funding Rule more broadly) will create a trap for the unwary and a burden to taxpayers that desire to undertake ordinary course transactions, which is disproportionate to the perceived abuse. Therefore, we recommend that the Proposed Reg. Per Se Rule (and ideally the Proposed Reg. Funding Rule generally, although we understand that the recommendation already has been rejected) be revoked, and that final regulations clarify and limit the application of the Proposed Reg. Funding Rule solely to fundings that were made to avoid the application of section 4501(d).

2. Application of the Funding Rule in the Context of Multiple Arrangements Between an Applicable Specified Affiliate and an Applicable Foreign Corporation or Relevant Entity

Overview

The Proposed Reg. Funding Rule, and in particular the Proposed Reg. Per Se Rule, could be applied to inadvertently capture a variety of transactions that do not represent an economic funding. One example involves fact patterns where an applicable specified affiliate regularly loans cash to an applicable foreign corporation, is repaid the loaned amount, and then makes another loan to the applicable foreign corporation. If the Proposed Reg. Per Se Rule is retained, the overall arrangement between the parties, including both the loans and the repayments, needs to be taken into account in determining what amount has been funded. If the overall arrangement is not taken into account, there is a risk that ordinary course business transactions could be inadvertently subject to the Funding Rule and that the amount of any covered fundings found could be inappropriately duplicated.

Recommendation

If our primary recommendations that the Proposed Reg. Per Se Rule be revoked and that final regulations clarify and limit the application of the Proposed Reg. Funding Rule solely to fundings that were made to avoid the application of section 4501(d) are not adopted,[9] we recommend that the final regulations include an example that illustrates the application of the principal purpose test in the Proposed Reg. Funding Rule where an applicable specified affiliate and an applicable foreign corporation or relevant entity have multiple arrangements between them.

Analysis

The Proposed Regulations provide that all facts and circumstances must be considered in determining whether a transaction is a covered funding within the meaning of Prop. Reg. § 58.4501-7(e)(1). Because the definition of a covered funding is broad, taxpayers need - at the very least - examples on how that determination is made. Examples are particularly needed to provide guidance on what transactions constitute a funding and in what circumstances a taxpayer has a principal purpose of funding a covered purchase or avoiding the Excise Tax.

[9] This narrowing could also be adopted if the Proposed Reg. Per Se Rule is revoked; however, we believe the adoption of such a clarification would be less pressing in that scenario because the purpose test itself would be expected to significantly limit the application of the Funding Rule even without this adjustment.

The Proposed Regulations do not contain a rule that considers only the net amount that an applicable specified affiliate funds an applicable foreign corporation, *i.e.*, the excess of the total amount funded less amounts paid by the applicable foreign corporation to the applicable specified affiliate. Such a rule would be helpful in preventing the Proposed Reg. Funding Rule, and in particular the Proposed Reg. Per Se Rule, from inadvertently capturing a variety of transactions in which there is no net transfer of value from the applicable specified affiliate to the applicable foreign parent.

However, even in the absence of such a rule, the mandate to consider "all facts and circumstances" in determining whether a transaction has a principal purpose of avoiding the Excise Tax needs to take into account other transactions between the relevant parties. For example, assume that an applicable specified affiliate loans $600x to an applicable foreign corporation, is repaid that amount, and then two more times pursuant to the same plan loans $600x to the applicable foreign corporation again and is again repaid that amount. As an initial matter, the facts and circumstances of each of the individual loans are relevant in assessing whether there is a principal purpose of avoiding section 4501(d). If none of the loans are made with such a principal purpose, then none of the loans are a covered funding.

In making that determination, however, the overall arrangement, including the repayments, should also be taken into account in considering such facts and circumstances. In that regard, where an applicable specified affiliate loans $600x to, and is repaid $600x by, an applicable foreign corporation three times pursuant to an arrangement between the parties, it seems inappropriate, notwithstanding the unique facts of each loan, to treat the applicable specified affiliate as having made three separate fundings to the applicable foreign corporation for a total of $1,800x. Under these facts and circumstances, the applicable specified affiliate arguably loaned the same $600x to the applicable foreign corporation three times.

In addition, the fact that such a loan and its repayment may occur in different tax years should not prevent them from being considered together in determining whether there is a principal purpose of avoiding the Excise Tax. In Prop. Reg. § 58.4501-7(p)(3), Example 3, a distribution made on March 1, 2024, with a principal purpose of funding a covered purchase, was treated as a covered funding that was allocated to a covered purchase on May 15, 2026. This example illustrates that an overall transaction or arrangement should be taken into account, even if it crosses tax years.

We recommend that the final regulations include an example to illustrate these points.

3. Application of the Section 4501(d) Netting Rule in the Context of Indirect Funding through Applicable Specified Affiliates

Overview

The Proposed Regulations clarified that section 4501(d)(1)(C) (the "section 4501(d) Netting Rule") is applied on an entity-by-entity basis.[10] As a result, the amount of a covered funding by one applicable specified affiliate cannot be net against the amount of applicable foreign corporation stock issued or provided to an employee of another applicable specified affiliate. As

[10] Proposed Reg. § 58.4501-7(p)(2), Example 2.

discussed below, this concept presents complications when a member of a U.S. consolidated group funds an applicable foreign corporation with funds that it received from another member of the same consolidated group. Without an additional rule to address these complications, the application of the section 4501(d) Netting Rule will likely be further limited, arguably in a way that is inconsistent with the purpose of that rule.

Recommendation

The final regulations should include a rule that treats members of a U.S. consolidated group as a single corporation for purposes of applying the section 4501(d) Netting Rule.

Analysis

In Prop. Reg. § 58.4501-7(p)(2), Example 2, a publicly traded foreign corporation (FZ) directly owned all the stock of two domestic corporations (US1 and US2). US1 acquired stock of FZ in a section 4501(d)(1) repurchase, and in the same year, US2 transferred shares of FZ stock to its employee. The example concludes that US1 is a covered corporation and that its section 4501(d) Excise Tax base is increased for the repurchase but not decreased for US2 transferring FZ stock to US2 employees because US1 can only reduce its excise tax base for FZ stock issued or provided to US1 employees.

Presumably, because the consolidated return regulations do not appear to apply for purposes of the Excise Tax, the result would be the same if FZ directly owned all the stock of US1, US1 directly owned all the stock of US2, and US1 and US2 were members of a consolidated group for federal income tax purposes. Specifically, even though US1 and US2 are members of a consolidated group, they would still appear to be separate corporations for purposes of determining whether they are applicable specified affiliates, whether they have undertaken a covered funding within the meaning of Prop. Reg. § 58.4501-7(e)(1), and whether the section 4501(d) Netting Rule applies.

These types of fact patterns can present a variety of issues, particularly where amounts are transferred between members of a consolidated group before they are ultimately transferred to an applicable foreign corporation. The following example illustrates such a fact pattern involving a distribution within a consolidated group followed by a distribution to an applicable foreign corporation. Similar issues would arise in other situations, for example, where amounts are loaned between consolidated group members and then transferred to an applicable foreign corporation.

Example: Corporation FZ owns all the outstanding stock of Corporation US1, a domestic corporation, and Corporation US1 owns all the outstanding stock of Corporation US2, a domestic corporation. Corporation US1 and Corporation US2 join in the filing of a consolidated return. Employee T is an employee of Corporation US2. On February 1, 2025, Corporation US2 makes a distribution with respect to its stock of $600x to Corporation US1. On March 1, 2025, Corporation US1 makes a distribution with respect to its stock of $600x to Corporation FZ. On May 15, 2025, Corporation FZ purchases 100 shares of its stock when the fair market value of each share is $8x. Also on May 15, 2025, Corporation US2 transfers to Employee T 50 shares of stock of Corporation FZ when the fair market value of each share is $5x.

If there is a principal purpose of avoiding the Excise Tax, the question arises whether Corporation US1, Corporation US2, or both could be treated as making a covered funding of $600x to Corporation FZ. Treating both corporations as funding $600x to Corporation FZ would be inappropriate given that Corporation FZ received only $600x in total, not $1,200x. So, the question turns to whether Corporation US1 or Corporation US2 is more appropriately treated as making the covered funding.

Trying to make that determination based solely on which entity had the principal purpose of avoiding the Excise Tax may not be possible because (i) as a practical matter, it may be difficult to discern discrete purposes that members have within a consolidated group, and (ii) in any event, both members might ultimately have the same principal purpose to avoid the Excise Tax (which as noted above should not mean that they each made a covered funding of $600x). Looking to the member that initiated the flow of funds (*i.e.*, Corporation US2) is a possible approach but comes with complications and compliance burdens because in more realistic situations than the example above it may be difficult to trace back to the source of the funds. Looking instead to the member that directly transfers the amounts to the applicable foreign corporation (*i.e.*, Corporation US1) is another possibility but is rigidly focused on the last transfer from an applicable specified affiliate and may be inconsistent with the concept of indirect funding illustrated in Prop. Reg. § 58.4501-7(p)(7), Example 7. It could also permit taxpayers to choose which member is treated as making a covered funding by deciding which member directly funds the applicable foreign corporation.

The determination in these situations therefore is not straight forward and could ultimately be at least somewhat arbitrary. This is problematic because the application of the section 4501(d) Netting Rule under the Proposed Regulations depends entirely on which member makes the covered funding. If Corporation US2 is treated as making the covered funding, its section 4501(d) Excise Tax base for the 2025 taxable year would be increased by $600x for the covered funding and then reduced by $400x for the 50 shares of Corporation FZ stock treated as issued or provided to Employee T (50 shares x $8x per share = $400x). However, if Corporation US1 were instead treated as making the covered funding, its section 4501(d) Excise Tax base for the 2025 taxable year would be increased by $600x for the covered funding but not reduced for the shares issued or provided to Employee T because Employee T is not an employee of Corporation US1.

For the following reasons, we recommend that the final regulations include a rule that for purposes of the section 4501(d) Netting Rule, members of a consolidated group are treated as a single corporation. Under this rule, even if Corporation US1 were treated as having made the covered funding, its section 4501(d) Excise Tax base for its 2025 taxable year would be increased by $600x for the covered funding and reduced by $400x for the shares issued or provided to Employee T.

Including this rule would prevent the application of the section 4501(d) Netting Rule—an already limited but still helpful statutory provision in the context of applicable foreign corporations—from resting entirely on what may be an arbitrary decision of which member of a consolidated group made a covered funding. Having any additional limitations or uncertainty on the applicability of the section 4501(d) Netting Rule is even more concerning given the expansive breadth of the Proposed Reg. Funding Rule, as discussed above. This rule would also acknowledge that consolidated groups commonly decide to have employees employed by particular members of a consolidated group for a variety of reasons, including legal, business, and other non-tax reasons.

Allowing the application of the section 4501(d) Netting Rule to be dictated by those decisions is arguably not consistent with the purpose of the rule. For these reasons, we believe the recommended rule would be within the Government's broad authority to prescribe regulations appropriate to carry out the purposes of the Excise Tax.

4. Mergers & Acquisitions Transactions

Overview

Pursuant to section 4501(c)(1), a "repurchase" for Excise Tax purposes is defined to include section 317(b) redemptions and "economically similar" transactions (as determined by the U.S. Department of Treasury). Consistent with the approach taken in the Notice,[11] Proposed Regulations provide guidance with respect to the latter via an exclusive list of "economically similar" transactions,[12] subject to the caveat noted in Part XIV.F of the Preamble that additional transactions may be added to the list with retroactive application.[13]

Certain transactions that definitionally qualify as repurchases under section 4501(c) may be at least partially offset under exceptions provided by section 4501(e). One such exception relevant in the M&A context is section 4501(e)(1), which 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 shareholder under chapter 1 by reason of such reorganization" (the "Reorganization Exception").

In general, Part VII and Part VIII of the Preamble reject prior recommendations made with respect to taxable mergers and section 368 reorganizations, respectively (including recommendations included in our prior comments).

Recommendation

AICPA recommends that the Government reconsider its approach to application of section 4501 in M&A contexts to ensure that application of the Excise Tax is informed by and consistent with the plain language and fundamental scope and spirit of the statute, which is that the Excise Tax apply to section 317(b) redemptions of covered corporation shares and *"economically similar"* transactions.[14]

Specific recommendations to ensure a properly tailored application of the Excise Tax in M&A contexts include:

i. Plain language application of the reorganization exception under section 4501(e)(1) to require a three-step, conjunctive analysis as follows:

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[11] See Section 3.04(4)(a) of the Notice.

[12] See Prop. Reg. §58.4501-2(e)(4). "Economically similar" transactions under currently Proposed Regulations include: exchanges of target company stock in acquisitive reorganizations, "E" reorganizations, "F" reorganizations, split-offs, and complete liquidations to which both sections 331 and 332 apply.

[13] Note that Proposed Regulations also include a non-exclusive list of transactions that are not treated as economically similar to a section 317(b) redemption. See Prop. Reg. § 58.4501-2(e)(5).

[14] Emphasis added.

a. Step 1: Threshold determination that a "repurchase" has occurred (as defined by Section 4501(c)(1)).
b. Step 2: Determination that the "repurchase" is part of a section 368(a) reorganization transaction.
c. Step 3: Receipt of qualifying, non-recognition property by shareholders as consideration for the "repurchase."[15]

ii. Extension of the sourcing approach applicable to taxable M&A transactions to acquisitive reorganizations.[16]

iii. Prospective application of section 4501 to any M&A transactions added to the list of "economically similar" transactions[17] after enactment of the final regulations. In the event that this recommendation is not adopted, the final regulations or other guidance should provide an objective framework for taxpayers to utilize in evaluating economic similarity based on facts and circumstances.

Analysis

1. Plain language application of the reorganization exception under section 4501(e)(1) to require a three-step, conjunctive analysis.

Part VIII.A.2.d of the Preamble indicates that the Government is of the view that the presence of the Reorganization Exception in section 4501(e)(1) of the statute requires that all exchanges of target corporation stock occurring as part of an acquisitive reorganization be treated as subject to the Excise Tax as a threshold matter in order to give effect to the statutory language and relevance to the Reorganization Exception. We respectfully disagree with this conclusion and do not believe that the mere presence of the Reorganization Exception within the statutory framework broadly implies that all acquisitive reorganizations are subject to the Excise Tax except to the extent excluded under section 4501(e)(1). Instead, we believe that the statutory language requires a three-step analysis as follows:

- Step 1: Determination that a "repurchase" has occurred under section 4501(c)(1).
- Step 2: Determination that the "repurchase" occurred as "part of a reorganization."
- Step 3: Receipt of qualifying property by shareholders in connection with the reorganization.[18]

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[15] As described in Part X.A.1 of the Preamble, qualifying non-recognition property is property permitted to be received by shareholders without the recognition of gain or loss under section 354 or section 355.
[16] For clarity, sourcing in section 368(a) reorganization contexts is relevant only to the extent that a "repurchase" has occurred within the meaning of section 4501(c)(1) as a threshold matter. Accordingly, this recommendation is intended to apply to the extent that this threshold determination has been made.
[17] See Prop. Reg. § 58.4501-2(e)(4) for list of "economically similar" transactions under regulations as currently proposed.
[18] As described in Part X.A.1 of the Preamble to the Proposed Regulations, qualifying non-recognition property is property permitted to be received by shareholders without the recognition of gain or loss under section 354 or section 355.

Step 1: Threshold determination that a "repurchase" has occurred (as defined by section 4501(c)(1)).

Based on the plain language of section 4501(e)(1), a step one analysis is required to determine whether a "repurchase" has occurred under section 4501(c) due to the occurrence of a section 317(b) redemption or "economically similar" transaction. While we understand the scope of the Excise Tax in concept, the list of "economically similar" transactions contained in Prop. Reg. § 58.4501-2(e)(4) as currently proposed is overbroad, resulting in transactions that are economically distinguishable from a section 317(b) redemption being subject to potential Excise Tax liability.[19]

While the Preamble claims to rely on the plain language of the statute and established federal income tax concepts as informing the determination as to what constitutes a section 317(b) redemption or an "economically similar" transaction, these concepts do not appear to be consistently applied in M&A contexts, and particularly in reorganization contexts. For example, an "acquisitive reorganization" (as defined by Prop. Reg. § 58.4501-1(b)(1))[20] would be treated as an "economically similar" transaction subject to Excise Tax liability to the extent of any non-qualifying property received by shareholders (i.e., "boot"), notwithstanding whether the non-qualifying payment is sourced from the target or acquiring company. This is in contrast to the treatment of an economically similar taxable transaction, which would only be subject to application of the Excise Tax to the extent of target-funded payments. In this specific example, the practical result is to treat taxable transactions more favorably than economically similar reorganization transactions for Excise Tax purposes in certain cases. Another example of more favorable treatment of taxable M&A transactions for Excise Tax purposes is in Part VIII of the Preamble, which distinguishes taxable forward mergers (which are not subject to the Excise Tax to the extent that consideration is sourced from the acquiring corporation) from forward mergers structured as reorganizations (which are subject to the Excise Tax to the extent of any non-qualifying consideration without regard to the source of the non-qualifying consideration).[21]

We believe that these results are contrary to the plain language of section 4501(c)(1), which defines "repurchase" to include section 317(b) redemptions and "economically similar" transactions. While the Preamble cites a need to give "full effect" to the statutory language as support for the current interpretation, the currently proposed applications in reorganization contexts result in internal inconsistency within the statute that effectively renders the text and spirit of section 4501(c)(1)(B) inoperative by allowing the Excise Tax to apply to economically distinguishable

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[19] The extent of the overbreadth and lack of clarity is demonstrated by the divergent perspectives and stakeholder debate summarized in the Preamble regarding: (i) what does (and does not) constitute a section 317(b) redemption, and (ii) what it means to be "economically similar" to a section 317(b) redemption.

[20] As defined by Prop. Reg. § 58.4501-1(b)(1), "acquisitive reorganizations" include transactions qualifying as reorganizations under section 368(a)(1)(A) (including via sections 368(a)(2)(D) or 368(a)(2)(E)), 368(a)(1)(C), 368(a)(1)(D) (if the D reorganization satisfies the requirements of section 354(b)(1)), and 368(a)(1)(G) (if the reorganization satisfies the requirements of section 354(b)(1)).

[21] The apparent basis for the distinction is that a successor to the target corporation exists in a reorganization context via section 381(a); whereas the target corporation in a section 331 liquidation ceases to exist for federal income tax purposes. Notwithstanding this section 381 successor theory, a section 332 liquidation, which also involves section 381 successor concepts, is apparently not subject to the Excise Tax. See Prop. Reg. §58.4501–2(e)(5)(i). While we do not necessarily disagree with this result in a section 332 liquidation context based on the substance of that transaction, this is another example of the type of intellectual inconsistency that applies in M&A contexts throughout the Preamble and currently proposed regulations.

transactions. The linguistic tension and intellectual inconsistency underlying the proposed application of section 4501 in reorganization contexts make it unclear what federal income tax concepts and/or specific tax policy apply to determine what constitutes a section 317(b) redemption and what it means to be "economically similar" to a section 317(b) for Excise Tax purposes. The Government appears to reject well-established federal corporate income tax principles in reorganization contexts. Additionally, while there are no congressional reports addressing section 4501 from which we can draw specific legislative intent, we do not believe that reorganizations where the target corporation's shareholders receive no consideration funded by the target corporation implicate known policy concerns associated with traditional stock repurchase transactions.

In light of the foregoing, we recommend extension of the sourcing approach applicable to taxable M&A transactions to stock-equivalent section 368(a) reorganizations that include a "repurchase" component to limit application of the Excise Tax to non-qualifying property sourced from the target corporation in reorganization contexts. Contrary to the assertion in Part VIII.A.2.d of the Preamble, we do not believe that this reading "reduce[s] the statutorily mandated scope of the reorganization exception." To the contrary, this approach eliminates inconsistent treatment of economically similar transaction structures for Excise Tax purposes (e.g., triangular mergers) and furthers stated goals of certainty and administrability.[22] We believe that our recommended approach gives full operative effect to the statutory language of section 4501(c)(1) and section 4501(e)(1) both independently and on a holistic basis, consistent with well-established canons of statutory construction.

Step 2: Determination that the "repurchase" is part of a section 368(a) reorganization transaction.

If it is determined that a repurchase has occurred, step two is to determine whether the repurchase was completed as part of a section 368 reorganization transaction.

Step 3: Receipt of qualifying, non-recognition property by shareholders as consideration for the "repurchase."[23]

Based on the statutory language of section 4501(e)(1), if a "repurchase" has occurred that is also "part of a reorganization" based on steps one and two, potential Excise Tax liability could be triggered under section 4501(a) to the extent that gain or loss is recognized by shareholders.

While the statute incorporates a gain or loss standard for determining Excise Tax liability in reorganization contexts, the Proposed Regulations adopt a consideration-based approach that focuses on whether shareholders receive property permitted to be received without the recognition of gain or loss under section 354 or section 355 (i.e., qualifying non-recognition property).[24] In

[22] For clarity, sourcing in section 368(a) reorganization contexts is relevant only to the extent that a "repurchase" has occurred within the meaning of section 4501(c)(1) as a threshold matter. Accordingly, this recommendation is intended to apply to the extent that this threshold determination has been made.

[23] As described in Part X.A.1 of the Preamble to the Proposed Regulations, qualifying non-recognition property is property permitted to be received by shareholders without the recognition of gain or loss under section 354 or section 355.

[24] See Part X.A.1 of the Preamble to the Proposed Regulations.

summary, the Reorganization Exception applies to avoid Excise Tax liability to the extent shareholders receive qualifying non-recognition property in a reorganization; however, the Excise Tax applies to the extent of any non-qualifying "boot" received.

Despite the apparent priority to be faithful to the text of the statute in determining whether a "repurchase" has occurred that is "part of a reorganization" in steps one and two to the Government adopts a consideration-based approach to step three of the Reorganization Exception, which focuses on the use of qualifying non-recognition property rather than on actual gain or loss recognition. We acknowledge the potential challenges that could be associated with an approach focused on actual gain/loss and the benefits to administration and enforcement facilitated by the consideration-based approach, and we do not necessarily disagree with the approach. Our purpose in pointing this out is simply to reiterate the inconsistency in overall statutory construction and methodology.

2. Prospective application of section 4501 to M&A transactions added to the list of "economically similar" transactions[25] after enactment of final regulations.

Prop. Reg. § 58.4501-2(e)(4) provides an exclusive list of "economically similar" M&A transactions for purposes of determining applicability of section 4501, subject to the significant caveat that additional transactions may be subsequently added to the list with retroactive application.[26] Specifically, Part XIV.F of the Preamble states: "[a]lthough the Treasury Department and the IRS anticipate that most transactions treated as economically similar transactions would be treated as such only on a prospective basis, there may be transactions that warrant retroactive application."

Conceptually, the use of an exclusive list to define "economically similar" transactions provides benefits of clarity and certainty, which facilitates efficient application, administration, and enforcement of the Excise Tax. Accordingly, we agree with the current approach of Prop. Reg. § 58.4501-2(e)(4) in concept. However, we believe that the potential for transactions not currently included on the list to become retroactively subject to section 4501 is inconsistent with the concept of an exclusive list insofar that it introduces uncertainty, adds administrative recordkeeping complexity, and erodes the purported benefits of an exclusive list. This uncertainty is compounded by inconsistent treatment of transactions with similar economic outcomes under Proposed Regulations as currently drafted (e.g., triangular mergers, liquidations, two-party acquisitive reorganizations) and a resulting inability to extract objective criteria for determining whether a transaction is economically similar to a section 317(b) redemption.

Based on the foregoing, we recommend that any additional M&A transactions subsequently added to the list become subject to section 4501 on a prospective basis following issuance of proper notice and guidance to taxpayers and a statement to such effect be included when the Proposed Regulations are finalized. In the event that this recommendation is not adopted, final regulations or other guidance should provide an objective framework for taxpayers to utilize in evaluating economic similarity based on facts and circumstances.

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[25] See Prop. Reg. § 58.4501-2(e)(4) for list of "economically similar" transactions under regulations as currently proposed.

[26] See Part XIV.F of the Preamble (transactions deemed to be abusive may warrant retroactive application).

5. Recapitalization

<u>Overview</u>

The exclusive list of economically similar transactions under Prop. Reg. § 58.4501-2(e)(4) includes an exchange by the recapitalizing corporation shareholders of their recapitalizing corporation stock as part of an E reorganization (as defined in Prop. Reg. § 58.4501-1(b)(12)) when the recapitalizing corporation is a covered corporation (an "E Reorganization Repurchase").

The exceptions under section 4501(e) and Prop. Reg. § 58.4501-3(c) include the fair market value of stock repurchased by a recapitalizing corporation in an E reorganization, pursuant to the plan, to the extent that the repurchase is for "qualifying property" permitted to be received by section 354 without recognition of gain or loss (the "E Reorganization Exception" under Prop. Reg. § 58.4501-3(c)(2)).

The regulations under section 305 in Treas. Reg. § 1.305-7 provide that a recapitalization may be treated as a distribution under certain circumstances described in section 305(c). Specifically, under Treas. Reg. § 1.305-7(c)(1)(ii), a recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which section 305(c) applies if, a shareholder owning preferred stock with dividends in arrears exchanges his stock for other stock and, as a result, increases his proportionate interest in the assets or earnings and profits of the corporation. The amount of such distribution is the lesser of: (i) the amount by which the fair market value or the liquidation preference exceeds the issue price; or (ii) the amount of the dividends in arrears. Pursuant to Treas. Reg. § 1.305-7(a), sections 305(b) and 301 apply to such a distribution if it has a result described in sections 305(b)(2), (3), (4) or (5).

Furthermore, Treas. Reg. § 1.301-1(j) provides that a distribution to shareholders with respect to their stock is within the terms of section 301 if the distribution is in substance a separate transaction (whether or not connected in a formal sense) although it takes place at the same time as another transaction. An illustrative example in Treas. Reg. § 1.301-1(j) provides for a corporation having only common stock outstanding and exchanging one share of newly issued common stock and a bond for each share of outstanding common stock. The example treats the distribution of the bond as a distribution even though the exchange of common stock for common stock was an E reorganization.

Prop. Reg. § 58.4501-4, which provides rules regarding to the application the netting rule of section 4501(c)(3) (the "Netting Rule"), provides that the Excise Tax base for a taxable year of a covered corporation is generally reduced by the aggregate fair market value of stock that is issued by the covered corporation. However, Prop. Reg. § 58.4501-4(f) provides that certain issuances are disregarded for purposes of the Netting Rule including stock of a covered corporation distributed by the covered corporation to its shareholders with respect to the covered corporation's stock under Prop. Reg. § 58.4501-4(f)(1). The Preamble specifies that the disregarded stock under Prop. Reg. § 58.4501-4(f)(1) includes stock distributed under section 305(b).

Recommendation

We recommend that the final regulations clarify that the E Reorganization Exception applies to an E Reorganization Repurchase regardless of whether any shares issued in the E Reorganization are treated as a distribution to shareholders under section 305(b) and section 301 pursuant to section 305(c) and Treas. Reg. § 1.305-7(c)(1)(ii). That is, to the extent shares are repurchased in an E Reorganization in exchange for qualifying property, the fair market value of those repurchase shares should be a reduction to the Excise Tax base, regardless of whether any of the shares (*i.e.*, the qualifying property) issued are treated as distributed under section 305 and section 301.

Analysis

The E Reorganization Exception in the Proposed Regulations seems to be intended to exclude stock repurchases to the extent that section 354 would apply, and no gain or loss is recognized to a shareholder, in an E reorganization. This interpretation of the E Reorganization Exception is consistent with the statute under section 4501(e)(1).[27]

However, in the case of a recapitalization that results in a distribution to which sections 305(b) and 301 apply as described in Treas. Reg. § 1.305-7(c)(1)(ii), it is not clear whether the E Reorganization Exception would apply to the entire E Reorganization Repurchase or if the E Reorganization Exception would only apply to the portion of the E Reorganization Repurchase that is not treated as a distribution under sections 305(b) and 301. On first impression, the E Reorganization Exception would apply to the extent qualifying property under section 354 was received in exchange for the repurchased shares. However, if qualifying property is a deemed distribution under section 305(c), which sections 305(b) and 301 apply, it is unclear whether that would affect the extent that the E Reorganization Exception applies. If the E Reorganization Exception does not apply to the E Reorganization Repurchase, there could be circumstances in which the Excise Tax base includes the amount attributed to the distribution portion. For example, the exception for dividends in Prop. Reg. § 58.4501-3(g) (the "Dividend Exception"), if otherwise applicable, would potentially not apply if the covered corporation did not have sufficient earnings and profits. Furthermore, the issuance of covered corporation stock would be disregarded for purposes of the Netting Rule under Prop. Reg. § 58.4501-4(f)(1) because such stock was distributed under section 305(b).

This is illustrated in the following example:

Example: A shareholder owns preferred stock in a covered corporation with a fair market value of $120, which has an issue price of $100 and dividends in arrears of $20. Pursuant to a recapitalization under section 368(a)(1)(E), the shareholder exchanges the preferred stock for common stock of the covered corporation with a fair market value of $120. Under Treas. Reg. § 1.305-7(c)(1)(ii) and (2), the shareholder is deemed under section 305(c) to receive a distribution in the amount of $20 and the distribution is one to which section 305(b)(4) and section 301 applies. The covered corporation has no current and accumulated earnings and profits.

[27] This section of the comment letter assumes that the Government will not consider or rejects our recommendation outlined in the above Mergers and Acquisition Transactions section, Step 1, and that a section 368(a)(1)(E) transaction is treated as a repurchase.

We recommend that the final regulations clarify that the E Reorganization Exception includes the fair market value of the entire E Reorganization Repurchase of $120, and not solely the fair market value of the portion of the E Reorganization Repurchase that is not treated as a distribution under sections 305(b) and 301. Our view is that the application of section 305(b) in the above example should not impact the characterization of the transaction as an E reorganization and, therefore, should not impact the extent that the E Reorganization Exception applies to it. Thus, applying the E Reorganization Exception in the example above, the entire fair market value of the E Reorganization Repurchase of $120 should be a reduction to the Excise Tax base because the entire E Reorganization Repurchase is for qualifying property.

In the example above, stock of the covered corporation with the same fair market value is outstanding, and held by the same shareholder, both before and after the recapitalization regardless whether section 305(b) applies. Therefore, it is appropriate that the E Reorganization Exception applies for purposes of section 4501(a) because there is no reduction of the fair market value in the stock of the covered corporation held by the same shareholder when comparing before and after the recapitalization. The above example is different than the example in Treas. Reg. § 1.301-1(j) because the entire E Reorganization Repurchase is attributed to property permitted to be received by section 354 without recognition of gain or loss to the shareholder, which is consistent with the statutory language in section 4501(e)(1).

Further, although Prop. Reg. § 58.4501-4(f)(1) provides that stock issued in a section 305 distribution is disregarded for purposes of the Netting Rule, that rule is irrelevant in the example above because the E Reorganization Exception applies before the Netting Rule and, as a result, all the stock issued in the E Reorganization is presumably already disregarded for purposes of the Netting Rule under the no double benefit rule under Prop. Reg. § 58.4501-4(f)(3) (the "No Double Benefit Rule") (see comments below regarding the application of the No Double Benefit Rule in the context of an E reorganization).

6. Dividend Exception

Overview

The statutory exception under Prop. Reg. § 58.4501-3(g) provides that the fair market value of stock repurchased by a covered corporation is a reduction for purposes of computing the covered corporation's stock repurchase tax base to the extent the repurchase is treated as a distribution of a dividend under section 301(c)(1) or section 356(a)(2) (the "Dividend Exception").

The Dividend Exception has a rebuttable presumption that a repurchase to which section 302 or section 356(a) applies is presumed to be subject to section 302(a) or section 356(a)(1), respectively, and therefore, such repurchase is presumed to be ineligible for the Dividend Exception. A covered corporation may rebut the presumption with regard to a specific shareholder solely by establishing with sufficient evidence that the shareholder treats the repurchase as a dividend on the shareholder's federal income tax return (the "sufficient evidence requirement").

The Proposed Regulations under Prop. Reg. § 58.4501-3(g)(2)(iii) require that a covered corporation must do all of the following to meet the sufficient evidence requirement: (i) obtain

certification from the shareholder in accordance with Prop. Reg. § 58.4501-3(g)(3); (ii) treat the repurchase consistent with the shareholder certification; (iii) have no knowledge of facts that would indicate that the shareholder certification is incorrect, and (iv) demonstrate sufficient earnings and profits to treat as a dividend either the redemption under section 302 or the receipt of money or other property under section 356.

Recommendation

We recommend that the final regulations adopt a sufficient evidence requirement that does not require a certification from the shareholder in circumstances where a covered corporation has sufficient evidence on its own to conclude that a repurchase should be treated as a dividend to a shareholder for federal income tax purposes.

We also recommend that the final regulations adopt a sufficient evidence requirement that does not require the shareholder to treat the repurchase as a dividend on a federal income tax return.

Analysis

Currently, under Prop. Reg. § 58.4501-3(g)(2)(iii), the sufficient evidence requirement would not be satisfied unless a covered corporation obtains certification from each shareholder in accordance with Prop. Reg. § 58.4501-3(g)(3). Under Prop. Reg. § 58.4501-3(g)(3), the shareholder must certify that either: (i) the repurchase is a payment in exchange for stock because the shareholder's proportionate interest in the corporation has been reduced but not completely terminated; (ii) the repurchase is a payment in exchange for stock because the shareholder's interest in the corporation is completely terminated; or (iii) the repurchase is a dividend. If the shareholder is not a United States person (within the meaning of section 7701(a)(30)) and the shares are held through a broker, the certification must include a statement that a copy of the certification has been provided to the shareholder's broker.

The mandate in the Proposed Regulations that a covered corporation obtain certification from each shareholder creates a burdensome requirement for a covered corporation to qualify for the Dividend Exception. Each covered corporation subject to section 4501 may have no control whether a shareholder would provide a shareholder certification in a manner to satisfy the sufficient evidence requirement in the Proposed Regulations. Our view is that the shareholder certification should only be required to confirm whether a repurchase is treated as a dividend in circumstances where a covered corporation does not have sufficient evidence to conclude such repurchase should be treated as a dividend on its own. For example, a covered corporation may not have direct knowledge of a shareholder's constructive ownership of its stock under section 318 for purposes of section 302(c). Covered corporations already face these issues, without a required shareholder certification, for purposes of reporting dividends on Form 1099-DIV, *Dividends and Distributions*, non-dividend distributions on Form 8937, *Report of Organization Actions Affecting Basis of Securities*, and earnings and profits on Form 5452, *Corporate Report of Nondividend Distributions*.

While the Notice had a sufficient evidence requirement similar to the Proposed Regulations, the Notice included that the covered corporation provided information reporting, if applicable, to the

redeemed shareholder that the repurchase constitutes a dividend. We understand from the Preamble that the information reporting requirement in the Notice was not included in the Proposed Regulations because publicly traded stock is typically held by shareholders through a broker, the brokers provide information reporting to the shareholders, and the brokers do not provide such information to the issuers.

While publicly traded stock may be typically held by shareholders through a broker, in our experience, some covered corporations may have sufficient evidence to conclude that repurchases, including repurchases of its non-publicly traded stock, should be treated as a dividend without a shareholder certification. For example, a covered corporation that has issued and outstanding preferred stock will usually know the identity of the shareholders holding such preferred stock and sometimes whether and the extent that such shareholders own other stock of the corporation. Under such circumstances, a covered corporation may be able to conclude that a repurchase is treated as a dividend without confirmation from the shareholder. According to the IRS, a repurchase of preferred stock may be treated as a dividend when a shareholder retains other stock under certain circumstances (*e.g.*, Rev. Rul. 85-106 (1985- C.B. 116)).

Therefore, our view is that a shareholder certification should not always be required if a covered corporation has sufficient evidence or documentation to conclude that a repurchase should be treated as a dividend and the other requirements are met including that the covered corporation's tax returns and information reporting provide for consistent treatment of the repurchase as a dividend. A shareholder certification is only needed when a covered corporation needs evidence from the shareholder to conclude whether a repurchase of covered corporation stock may be treated as a dividend for purposes of the Dividend Exception. However, given that shareholders may not respond, we recommend that a shareholder certification not be required and that a covered corporation may meet the sufficient evidence requirement without a shareholder certification.

Furthermore, the Proposed Regulations provide that the sufficient evidence requirement is met by a covered corporation with regard to a specific shareholder solely by establishing with sufficient evidence that the shareholder treats the repurchase as a dividend on the shareholder's federal income tax return. Some shareholders may not be required to file a federal income tax return. Therefore, we recommend that the sufficient evidence requirement does not require a shareholder to treat the repurchase as a dividend on a federal income tax return.

7. Repurchases Pursuant to a Plan After Cessation Date

<u>Overview</u>

Generally, the Excise Tax only applies to repurchases and issuances that occur while a corporation is a covered corporation. Proposed Reg. § 58.4501-4(b)(2) provides that "Any stock of a covered corporation issued by the covered corporation or provided by a specified affiliate of the covered corporation before the initiation date or after the cessation date is not taken into account under paragraph (b)(1) of this section."
The Proposed Regulations then provide an exception to this rule for corporations that cease to be a covered corporation pursuant to a plan that includes a repurchase and the corporation's cessation date precedes the date on which any repurchase undertaken pursuant to the plan occurs. In

discussing this exception, the Preamble states: "Under the proposed regulations, 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, then the corporation would continue to be a covered corporation until the end of the date on which the repurchase occurs." However, Prop. Reg. § 58.4501-2(d)(2)(ii) provides, "If a corporation ceases to be a covered corporation pursuant to a plan that includes a repurchase, and if the cessation date precedes the date on which any repurchase undertaken pursuant to the plan occurs (for example, if stock of a covered corporation ceases trading prior to completion of an acquisitive reorganization), then the corporation will continue to be a covered corporation *with regard to each repurchase* [emphasis added] pursuant to the plan until the end of the date on which the last repurchase pursuant to the plan occurs."

Recommendation

We recommend that the final regulations clarify that under Prop. Reg. § 58.4501-2(d)(2)(ii) a corporation is treated as a covered corporation for both issuances and repurchases made pursuant to the plan in which the corporation ceased being a covered corporation.

Specifically, we recommend:

(i) "repurchase pursuant to the plan until the end of the date on which the last repurchase pursuant to the plan occurs." is stricken from Prop. Reg. § 58.4501-2(d)(2)(ii) and replaced with "issuances and repurchases made pursuant to the plan in which the corporation ceased being a covered corporation."; and

(ii) a parenthetical is added to Prop. Reg. § 58.4501-4(b)(2) stating "(except pursuant to regulation § 58.4501-2(d)(2) to the extent such corporation is treated as a covered corporation until the end of a plan that includes a repurchase)."

Analysis

Based on the Proposed Regulations, a corporation that ceases to be a covered corporation pursuant to a plan that includes a repurchase after its cessation date seems to be treated as a covered corporation only for purposes of repurchases made pursuant to the plan. This contrasts the description in the Preamble that indicates that a corporation is treated as a covered corporation for all purposes up until the date of the final repurchase that is part of the plan in which the corporation ceases to be a covered corporation.

Notably the Preamble and Prop. Reg. § 58.4501-2(d)(2)(ii) differ slightly in language. Proposed Reg. § 58.4501-2(d)(2)(ii) provides that if a corporation ceases to be a covered corporation pursuant to a plan that includes a repurchase, "then the corporation will continue to be a covered corporation *with regard to each repurchase* pursuant to the plan until the end of the date on which the last repurchase pursuant to the plan occurs" (emphasis added). On the other hand, the Preamble does not include the phrase "with regard to each repurchase" stating instead that "the corporation would continue to be a covered corporation until the end of the date on which the repurchase occurs." The language in the Preamble indicates an intention to treat a corporation as a covered

corporation for all purposes up until the date of the final repurchase that is part of the plan, without limiting the treatment as a covered corporation to only the repurchases made pursuant to the plan, and we recommend the language of the regulations are altered to clarify this is the intended interpretation of the rule.

In addition to the intention indicated in the Preamble, a rule that treats a corporation as a covered corporation only for purposes of repurchases would potentially create distortions for transactions pursuant to a plan that includes both repurchases and issuances. Certain going private transactions are structured to include significant issuances to new parties coupled with significant repurchases from others. The timing of the issuances may not always precede the date that a corporation ceases to have stock that is traded on an established securities market. Therefore, a rule that only treats a corporation as a covered corporation with regard to repurchases could result in a higher Excise Tax base even if there were issuances made by the corporation pursuant to the same plan. Our view is that both repurchases and issuances pursuant to a plan should be considered for purposes of the Excise Tax base.

If the Government is concerned about the potential for abuse during this period (i.e., a corporation intentionally includes a relatively small repurchase as part of the plan so that issuances after delisting can still be counted for purpose of the Netting Rule), an anti-abuse rule could cover abusive concerns without ignoring all issuances, such as a rule that provides a clear definition of a plan for purposes of Prop. Reg. § 58.4501-2(d)(2)(ii) that excludes repurchases and issuances not necessary to achieve the main purposes of the overall transaction.

Due to the contrasting language in the Preamble and the regulation, and the potential for distortive results in the Excise Tax base, we recommend that the Government clarify the proposed regulations to provide that, if a corporation ceases to be a covered corporation pursuant to a plan that includes a repurchase, then the corporation will continue to be a covered corporation for both issuances and repurchases made pursuant to the plan in which the corporation ceased being a covered corporation.

8. Grandfathered Mandatorily Redeemable Preferred Stock

Overview

Pursuant to section 4501(f), the Secretary is directed to prescribe regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the Excise Tax. Specifically, section 4501(f)(2) directs this additional guidance to address special classes of stock and preferred stock.

Regarding such classes, Prop. Reg. § 58.4501-1(b)(29) defines "stock" as any instrument issued by a corporation that is either stock, or treated as stock, for federal tax purposes at the time of issuance. The single exception under the Proposed Regulations is for "additional tier 1 capital" stock pursuant to 12 C.F.R. §§ 3.20(c), 217.20(c), or 324.20(c), that does not qualify as "common equity tier 1 capital" within the meaning of 12 C.F.R. §§ 3.20(b), 217.20(b), or 324.20(b). As noted in the Preamble, absent this narrow exception applying, the Excise Tax would apply to repurchases

of both common and preferred stock, as well as to any instruments that are not in the form of stock but are nonetheless treated as such for federal tax purposes.

Recommendation

We recommend that the final regulations adopt a "grandfather" rule in which certain classes of preferred stock subject to mandatory redemption and issued before August 16, 2022 (the enactment of the Inflation Reduction Act of 2022, Pub L. No. 117-169) are excepted from the definition of "stock" subject to the Excise Tax.

Analysis

The statutory language of section 4501(f) calls on the Secretary to address special classes of stock *and* preferred stock as is necessary or appropriate to carry out, and to prevent the avoidance of, the Excise Tax. The Preamble notes that the plain language of section 4501 consistently refers to stock but does not make any exceptions for particular types. This seems at odds with the specific language in the statute permitting the Government to provide guidance with respect to particular types of stock.

It further notes that the view of the Government is that Treasury regulations that utilize the broadly applicable term "stock" would facilitate the IRS's ability to administer and enforce the Excise Tax. From the Preamble, it appears exceptions suggested in comments to Notice 2023-2 would hamper the administrative efficiency of such a broad approach. However, it is our view that a grandfather rule in which certain mandatory redeemable instruments issued prior to the Inflation Reduction Act would be a sensible exception.

Preferred stock subject to mandatory redemption can resemble other instruments treated as debt for tax purposes. A mandatory redemption date, analogous to a maturity date, is a significant factor in concluding an instrument is treated as debt for federal tax purposes.[28] Nonetheless, mandatory redemption is not conclusive of debt treatment, and certain courts and the IRS have found that preferred stock with a mandatory redemption feature could be treated as equity for federal income tax purposes.[29] That is to say the line between debt and equity treatment on such instruments is often ambiguous, with such determination making the difference between whether or not the Excise Tax applies. Without an exception, the Proposed Regulations could result in disparate tax treatment between two instruments, one respected as debt, the other as equity, despite being economically equivalent.

Further, like a traditional debt instrument, payment (redemption) at maturity on mandatory redeemable preferred stock must occur barring some sort of subsequent exchange. By imposing the Excise Tax on instruments that require redemption that were issued prior to the enactment of the Inflation Reduction Act of 2022, the Proposed Regulations would tax issuers that (i) could not have had an intent to avoid a tax that had not been enacted, and (ii) would subsequently have no discretion over the timing of such redemption other than through a secondary transaction. This

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[28] See United States v. South Georgia Ry. Co., 107 F.2d 3, 5 (5th Cir. 1939).
[29] See Comm'r v. Meridian & Thirteenth Realty Co., 132 F2d 182, 187 (7th Cir. 1942); Rev. Rul. 78-142, 1978-1 C.B. 111.

assumes of course that such stock could not be reorganized or recapitalized in a transaction that otherwise excepts its exchange from the Excise Tax base.

Appreciating the need for administrative simplicity, in our view such stock should not be subject to the Excise Tax. An exception for grandfathered mandatorily redeemable preferred stock would neither encourage the avoidance of the Excise Tax, nor appear to create an administrative burden on its enforcement. Such an exception might incorporate taxpayer documentation requirements to further alleviate administrative concerns regarding its application, with the general rule of including all "stock" acting as the default treatment in the case where such requirements are not met.

9. Instruments Not in the Legal Form of Stock, Prop. Reg. § 58.4501-4(f)(13)

Overview

Proposed Reg. § 58.4501-4 provides that the Excise Tax base for a taxable year of a covered corporation is generally reduced by the aggregate fair market value of stock that is issued by the covered corporation. However, Prop. Reg. § 58.4501-4(f) provides that certain issuances are disregarded for purposes of the Netting Rule, including certain issuances of instruments that are not in the legal form of stock but are still treated as stock for purposes of federal income tax (a "non-stock instrument") under Prop. Reg. § 58.4501-4(f)(13).

Proposed Reg. § 58.4501-4(f)(13)(ii)(A) provides that the issuance of a non-stock instrument is then regarded at the time that the non-stock instrument is repurchased by the covered corporation, or at the time it is acquired by a specified affiliate of the corporation. For this purpose, the delivery of stock pursuant to the terms of the non-stock instrument is treated as a repurchase of the non-stock instrument in exchange for an issuance or provision of the stock delivered.

Pursuant to Prop. Reg. § 58.4501-4(f)(13)(ii)(E) the amount of the reduction for the issuance for purposes of the Netting Rule is equal to the lesser of: (i) the fair market value of the non-stock instrument at the time it was issued; or (ii) the fair market value of the non-stock instrument at the time of the repurchase by the covered corporation or at the time of the acquisition by the specified affiliate.

Recommendation

We recommend that the final regulations exclude Prop. Reg. § 58.4501-4(f)(13) and if an anti-avoidance rule is needed, that the Government identify specific transactions that could be directly targeted.

Analysis

The rule under Prop. Reg. § 58.4501-4(f)(13) appears to be an anti-avoidance measure based on a concern that non-stock instruments could be issued to get an artificial reduction of the Excise Tax base under the Netting Rule for purposes of section 4501.

When analyzing whether non-stock instruments are treated as stock, taxpayers and tax practitioners generally rely on well-established authorities and principles based on substance over form that treat such instruments as stock for all purposes under the federal income tax law. For example, Rev. Rul. 82-150 is a widely accepted authority, in which the IRS ruled a taxpayer purchasing a deep-in-the-money option constituted a purchase of stock, thus, the option holder was the owner of the stock in the facts of the ruling. In practice, the principle in Rev. Rul. 82-150 is most commonly applied to options to purchase stock for a nominal exercise price (*e.g.*, an option to purchase stock for $0.01 per share) when the stock had more value than the exercise price at the time of issuance.

One concern that may have led to the inclusion of Prop. Reg. § 58.4501-4(f)(13) would be if a covered corporation could issue a non-stock instrument (*e.g.*, a deep-in-the-money stock option) to a friendly party that willingly foregoes its conversion to actual stock in order to inflate issuances to reduce the Excise Tax base under section 4501. Thus, absent an anti-avoidance rule, the non-stock instrument would be treated as an issuance of stock for purposes of section 4501 but never come into fruition as actual stock issued by the covered corporation. However, our view is that covered corporations are unlikely to engage in these types of friendly party transactions as they are generally subject to reporting obligations, and treating the non-stock instrument as stock for federal income tax purposes requires the substance of the instrument to be stock, which can be challenged by the IRS on substance without the need for a specific rule in the Proposed Regulations. Thus, we think potential avoidance of the Excise Tax by using non-stock instruments is tempered by the transparency covered corporations are generally subject to and the complexity in applying the rule in Prop. Reg. § 58.4501-4(f)(13) far outweighs the concern for avoidance.

Given that the treatment of non-stock instruments for federal income tax purposes is driven by the substance, we think there is not potential for abuse in a magnitude that warrants the rule under Prop. Reg. § 58.4501-4(f)(13). If a non-stock instrument is issued, the instrument will be treated as stock for federal income tax purposes and will carry economic and federal income tax consequences to the holder and the covered corporation, and thus is unlikely to be used for avoidance of the Excise Tax. Similar to many other areas of the Excise Tax where the Excise Tax relies on federal income tax characterizations, it seems appropriate to treat a non-stock instrument consistently for both federal income tax purposes and section 4501. By having Prop. Reg. § 58.4501-4(f)(13), the regulations under section 4501 would permit the form of the non-stock instruments to control the treatment over the substance of the instrument that is issued.

It is our view that Prop. Reg. § 58.4501-4(f)(13)(ii)(A) could actually permit more flexibility to taxpayers for purposes of the Netting Rule, which could be an additional tool for avoidance of the Excise Tax. In the absence of the rule under Prop. Reg. § 58.4501-4(f)(13)(i), the Netting Rule would recognize the issuance of a non-stock instrument in the taxable year of issuance which would seem appropriate given a non-stock instrument would be substantively the issuance of stock. On the other hand, if Prop. Reg. § 58.4501-4(f)(13)(i) and Prop. Reg. § 58.4501-4(f)(13)(ii)(A) apply, the issuance of a non-stock instrument could allow a covered corporation flexibility on the timing of the issuance for purposes of the Netting Rule because the non-stock instrument is not regarded until the repurchase of such non-stock instrument. For example, if a covered corporation plans to issue stock in a given taxable year, but it does not need issuances for purposes of the Excise Tax base, then the covered corporation could issue a non-stock instrument that is treated as

stock for tax purposes that effectively defers the issuance to a subsequent tax year (essentially circumventing rules that apply the Netting Rule only on an annual basis with no carryforward of excess issuances). This consideration could actually incentivize more non-stock instruments to be issued by covered corporations than what we see today in our experience.

If the recommendation to exclude Prop. Reg. § 58.4501-4(f)(13) is not adopted, there would be significant complexity in the application of Prop. Reg. § 58.4501-4(f)(13)(ii) to specific transactions, one of which is illustrated below.

> *Example:* In year 1, a covered corporation issues options to purchase 1,000,000 shares of common stock that may be exercised in year 2 for an exercise price of $0.01 when a share of the common stock has a fair market value of $10 per share. The options are issued significantly in-the-money and treated as stock for federal income tax purposes under the principles in Rev. Rul. 82-150. For illustrative purposes, we have assumed that the fair market value of the options at the time of issuance is equal to the net settlement value of $9,990,000, which is $10,000,000 (the product of 1,000,000 shares and $10 of fair market value per share) less $10,000 (the product of 1,000,000 shares and $0.01 of exercise price per share).
>
> In year 2, at a time when a common share has a fair market value of $15 per share, the covered corporation issues solely new common shares with a fair market value of $14,990,000 in exchange for the options in a transaction that qualifies as a recapitalization under section 368(a)(1)(E) and qualifies for the exception under Prop. Reg. § 58.4501-3(c)(2).

Based on our interpretation, the above transaction should result in $0 change to the Excise Tax base in year 1 and a net reduction in Excise Tax base (*i.e.* net issuance of stock) of $9,990,000 in year 2, as detailed below.

In year 1, under Prop. Reg. § 58.4501-4(f)(13)(i), the issuance of the non-stock instruments are disregarded for purposes of section 4501(c) resulting in no change to the Excise Tax base in year 1. In year 2, upon the recapitalization, there are three events taken into account. First, the recapitalization is considered a repurchase of the non-stock instruments and the issuance of the options can be taken into account under Prop. Reg. § 58.4501-4(f)(13)(ii) in year 2 for the amount of the lesser of the fair market value at the time of issuance ($9,990,000) and the fair market value at time of the repurchase ($14,990,000). Second, since that non-stock instrument is treated as stock for purpose of the repurchase, there is a $14,990,000 repurchase of stock that qualifies for the exception under Prop. Reg. § 58.4501-3(c)(2) generating a $14,990,000 repurchase with an offsetting $14,990,000 reduction. Finally, the actual issuance of new common shares with a fair market value of $14,990,000 would appropriately be disregarded for purposes of the Netting Rule under the No Double Benefit Rule. Therefore, the transaction in the example above would appear to result in a net decrease to the Excise Tax base of $9,990,000.

One further question on the above example is whether the No Double Benefit Rule would even apply to an E Reorganization. The current language in Prop. Reg. § 58.4501-4(f)(3)(ii) specifies that the No Double Benefit Rule applies to disregard the issuance of stock by a covered corporation if the stock is issued as part of a reorganization, the stock constitutes permitted property under section 354 or 355 and "the stock is used by another covered corporation to repurchase stock of

the second covered corporation," where that repurchase is not included in that second corporation's Excise Tax base due to being a qualifying property repurchase. In the above transaction, there is no second corporation because a typical E Reorganization is a reorganization involving one corporation; however, the Preamble indicates the intention for the No Double Benefit Rule to also apply to E Reorganizations.

There are likely many more complex transactions, and variations of those transactions, involving non-stock instruments that could provide similar complexity in computing the Excise Tax base compared to the relatively simple transaction illustrated above.

Therefore, our recommendation is to exclude the current rule under Prop. Reg. § 58.4501-4(f)(13) entirely from the final regulations.

10. The Netting Rule and Stock Issued to Non-Employee Service Providers of Specified Affiliates

Overview

The Netting Rule under section 4501(c)(3) provides that the amount treated as repurchased for purposes of the Excise Tax is reduced by "the fair market value of any stock issued by the covered corporation during the tax year." That is, the amount of repurchased stock is netted against stock issued during the same tax year. In applying this Netting Rule, section 4501(c)(3) expressly includes stock transfers to employees, even when the stock is received as the result of an exercise of an option.

Under the Notice, compensatory transfers were taken into account, but the applicable valuation rule was contingent on whether the transfer was to an employee or to a non-employee, the former following section 83 rules, and the latter following bespoke valuation rules set forth in the Notice. AICPA recommended that all compensatory transfers be valued under section 83 rules, as those rules would otherwise govern their tax treatment.

In the Preamble to the Proposed Regulations, the Government carved out transfers by a specified affiliate to non-employees, excluding them entirely from the Netting Rule. As a result, under the proposed rule, stock transferred to a non-employee service provider of a specified affiliate would not reduce the repurchased amount.

Recommendation

The Netting Rule should take into account all compensatory transfers by a covered corporation or a specified affiliate, without regard to the classification of the worker as an employee or non-employee service provider, or whether the stock is being transferred by the covered corporation or by a specified affiliate.

Analysis

The Netting Rule broadly provides that the amount taken into account for purposes of the Excise Tax is "reduced by the fair market value of any stock issued by the covered corporation during the taxable year ...." The text is followed by a clause containing examples that appear intended to make clear that compensatory transfers are in the scope of the Netting Rule: "including the fair market value of any stock issued or provided to employees 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." In response to a commenter's suggestion, the Preamble explains that "issued" and "provided" are distinct terms with different and mutually exclusive meanings: "issued" indicates stock coming directly from the covered corporation, and "provided" indicates stock coming from a specified affiliate. Furthermore, stock coming directly from a covered corporation is treated as coming from the specified affiliate if the recipient is a service provider to the specified affiliate. On this basis, the Government has proposed a rule that would exclude stock transferred to non-employee service providers of a specified affiliate from the Netting Rule.

The Preamble does not specify a policy justification for this distinction. Why stock transferred to a non-employee service provider of a specified affiliate should be treated differently than stock transferred to an employee service provider of the same entity is unclear. While the statute does not specifically reference a non-employee service provider of a specified affiliate, the example language in section 4501(c)(3) does not appear to have been intended to be exhaustive.

It seems clear that the Netting Rule is composed of a controlling rule clause, followed by an illustrative clause. The illustrative clause cannot be the rule because it would limit the Netting Rule to compensatory transfers, which would be inconsistent with Government's general reading of the statute. Yet, only the term "issued" and not the term "provided" is used in the controlling clause, whereas both are used in the illustrative clause. This means that the statutory drafters understood "provided" to be a subset of "issued" rather than a mutually exclusive term, as Treasury and the IRS have interpreted it. Further, the usage of "provided" in the illustrative clause seems inconsistent with the proffered interpretation as espoused in the Preamble. The illustrative clause states that Netting Rule stock includes "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." Without a "respectively" following this clause, the natural reading is that stock may be either issued or provided to employees of either a covered corporation or its specified affiliate. The regulatory drafters' reasoning then appears to this logic a step further by excluding nonemployee service providers of specified affiliates entirely from the Netting Rule, presumably because they are not expressly noted in the illustrative clause (which in fact does not mention nonemployee service providers at all). It is unclear how the carveout of non-employee service providers of specified affiliated is supported by the statutory language and or some broader tax policy. We see little risk for abuse should the Netting Rule also apply to non-employee service providers of specified affiliates.