



March 28, 2023

The Honorable Lily Batchelder  
Assistant Secretary for Tax Policy  
Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Mr. William Paul  
Principal Deputy Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
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Mr. Brett York  
Deputy Tax Legislative Counsel  
Department of the Treasury  
1500 Pennsylvania Ave, NW  
Washington, DC 20020

**RE: Notice 2023-2 – Initial Guidance Regarding the Application of the Excise Tax on Repurchases of Corporate Stock under Section 4501 of the Internal Revenue Code**

Dear Ms. Batchelder, Mr. Paul, 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) in providing interim guidance in [Notice 2023-2](#) (“the Notice”) addressing application of the new excise tax on repurchases of corporate stock under section<sup>1</sup> 4501, which was enacted as part of the Inflation Reduction Act of 2022.<sup>2</sup>

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”<sup>3</sup> (“the Excise Tax”). The Notice provides guidance on operating rules for the Excise Tax, including whether certain redemption transactions qualify as repurchases, rules on determining the fair market value of repurchased stock and guidelines on the computation and reporting of the Excise Tax. The interim guidance applies until the proposed regulations addressing the provisions are issued. The Excise Tax applies to certain repurchase of stock made after December 31, 2022.

The below comments and recommendations identify and provide additional information to Treasury and IRS regarding the Excise Tax guidance provided in the Notice and for rules not included in the Notice.

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<sup>1</sup> Unless otherwise indicated, all references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (IRC or the “Code”), and references to a “Treas. Reg. §” are to the Treasury regulations promulgated under the Code.

<sup>2</sup> [H.R. 5376, Public Law 117-169](#).

<sup>3</sup> Notice 2023-2, section 2.01.

Our attached comments include the following recommendations for Treasury and IRS to adopt in regulations and future guidance:

## **1. Mergers & Acquisitions**

### **Repurchases**

- Eliminate the Per Se Funding Rule.
- Eliminate the general Funding Rule, or alternatively, modify and clarify the general Funding Rule with respect to the phrases “funds by any means,” “principal purpose,” and safe harbors.

### **Repurchases of Certain Preferred Stock**

- Exclude from the definition of “stock” for purposes of section 4501 certain types of preferred stock, namely stock that is limited and preferred as to distributions and liquidation proceeds and does not participate in corporate growth to any significant extent (“nonparticipating preferred stock”).

### **Definition of Repurchase**

- Clarify how to interpret the term repurchase in section 4501(e).

### **Special Purpose Acquisition Company (SPAC) Liquidations**

- Confirm that liquidations of SPACs are covered by the provision that generally excludes liquidations from section 4501, including cases where they may technically not qualify as “complete liquidations”.

### **Taxable Acquisitions**

- Issue guidance exempting from the application of the Excise Tax payments funded by the target, directly or indirectly, in connection with a fully taxable disposition of target stock. Alternatively, Treasury could create an exemption for redemptions undertaken in connection with fully taxable stock dispositions in which target shareholders completely terminate their interest under *Zenz* and section 302(b)(3).

### **Issuances of Stock to Specified Affiliates**

- Include in the exception in section 3.08(4) of the Notice, which disregards the issuance of shares to a specified affiliate for purposes of the Netting Rule, language that would treat such shares as being issued for purposes of the Netting Rule whenever those shares are transferred to a party that is not the covered corporation or a specified affiliate.

## **2. Employee Benefits**

### **Netting Rule**

#### **Compensatory Transfers of Stock**

- Issue guidance stating that the rules of Section 3.08(3) apply to all compensatory transfers of property, without regard to the worker classification of the service provider, or whether the service provider is an individual or an unrelated entity.

#### **Withholding on Cashless Exercise**

- Issue guidance stating that the Section 3.08(3)(a) of the Notice rule disregards as an issuance any stock that remains in the hands of the corporation following the transaction. By way of example but not by way of limitation, the guidance might separately provide a non-exclusive list of typical withholdings to aid the reader.

#### **Issuances that Do Not Give Rise to U.S. Taxable Income**

- Provide guidance specifying that absence of U.S. income inclusion as a result of transfer does not affect the treatment of the transfer as an issuance.

### **Contributions of Stock to Employer Plans**

#### **Timing of Contributions**

- Confirm that the requirement that a taxpayer is not bound to deduct under section 404(a) a stock contribution to a plan in the same taxable year for which the contribution is taken into account under the section 4501(e)(2) exception.

#### **Nonqualified Trusts**

- Treat all secular employee trusts as employer-sponsored retirement plans for purposes of the section 4501(e)(2) exception.

#### **Valuation of Contributed Shares to Employer-Sponsored Retirement Plan**

- Base the value of stock for purposes of the section 4501(e)(2) exception on the greater of the value at the time of (a) repurchase or (b) contribution to employer-sponsored retirement plan.

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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 Jeff Borghino, Chair, AICPA Corporate & Shareholders TRP at (202) 521-1532 or [Jeff.Borghino@us.gt.com](mailto:Jeff.Borghino@us.gt.com); Reema Patel, Senior Manager - AICPA Tax Policy & Advocacy, at (202) 434-9217, or [Reema.Patel@aicpa-cima.com](mailto:Reema.Patel@aicpa-cima.com); or me at (601) 326-7119 or [JanLewis@HaddoxReid.com](mailto:JanLewis@HaddoxReid.com).

Sincerely,



Jan Lewis, CPA

Chair, AICPA Tax Executive Committee

cc: The Honorable Daniel I. Werfel, Commissioner, Internal Revenue Service  
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AMERICAN INSTITUTE OF CPAs

**Comments on Notice 2023-2 – Initial Guidance Regarding  
the Application of the Excise Tax on Repurchases of Corporate Stock  
under Section 4501 of the Internal Revenue Code**

**March 28, 2023**

The below comments cover the following issues:

1. Mergers & Acquisitions
2. Employee Benefits

**SPECIFIC COMMENTS**

**1. Mergers & Acquisitions**

**Repurchase**

- Overview

Section 4501(d)

In the case of an acquisition of stock of an applicable foreign 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)) from a person who is not the applicable foreign corporation or a specified affiliate of such applicable foreign corporation, for purposes of this section:

- (i) such specified affiliate shall be treated as a covered corporation with respect to such acquisition;
- (ii) such acquisition shall be treated as a repurchase of stock of a covered corporation by such covered corporation; and
- (iii) the adjustment under section 4501(c)(3) shall be determined only with respect to stock issued or provided by such specified affiliate to employees of the specified affiliate.

Section 4501(f) provides that the Secretary shall prescribe regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of section 4501, including regulations and other guidance:

- (i) to prevent the abuse of the exceptions provided by section 4501(e);
- (ii) to address special classes of stock and preferred stock; and
- (iii) for the application of the rules under section 4501(d).

The Notice provides a “Funding Rule” that an applicable specified affiliate is treated as acquiring stock of an applicable foreign corporation if:

- (i) the applicable specified affiliate funds 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
- (ii) such funding is undertaken for a principal purpose of avoiding the stock repurchase excise tax.<sup>1</sup>

For this purpose, the fair market value of stock treated as acquired by the applicable specified affiliate is limited to the amount funded by the applicable specified affiliate.<sup>2</sup>

A principal purpose is deemed to exist if the applicable specified affiliate “funds” by any means, other than through distributions, the applicable foreign corporation or a specified affiliate that is not also an applicable specified affiliate, and such “funded entity” acquires or repurchases stock of the applicable foreign corporation within two years of the funding (the “Per Se Funding Rule”).<sup>3</sup>

○ Recommendations

- Eliminate the Per Se Funding Rule.
- Eliminate the general Funding Rule, or alternatively, modify and clarify the general Funding Rule regarding “funds by any means,” “principal purpose,” and safe-harbors.

○ Analysis

Section 4501(d) has a description of a specific type of transactions that are subject to section 4501. The text under section 4501(d) describes an acquisition of the stock of an applicable foreign corporation by certain specified affiliates of such corporation. In contrast, the Funding Rule treats an applicable specified affiliate as acquiring the stock of an applicable foreign corporation if the applicable specified affiliate “funds by any means” an acquisition of the stock of an applicable foreign corporation if such funding is undertaken for a principal purpose of avoiding the stock repurchase excise tax. Therefore, the transactions covered by the statute (*i.e.*, a “direct acquisition” of stock of an applicable foreign corporation by a specified affiliate) are distinctly different than transactions under the Funding Rule (*i.e.*, the funding by an applicable specified affiliate of the acquisition of the stock of the applicable foreign corporation), notwithstanding whether the funding was undertaken for a principal purpose of avoiding the Excise Tax.

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<sup>1</sup> Notice 2023-2, section 3.05(2).

<sup>2</sup> Notice 2023-2, section 3.05(2).

<sup>3</sup> Notice 2023-2, section 3.05(2).

We acknowledge Treasury and IRS has authority under section 4501(f) to prescribe regulations and other guidance as necessary, or appropriate, to carry out and prevent the avoidance of section 4501 including the application of the rules under section 4501(d). If the Funding Rule was intended to carry out and prevent the avoidance of section 4501(d), we recommend that the regulations modify and clarify the Funding Rule to narrow its application to limited circumstances solely to prevent avoidance of section 4501(d).

### *Eliminate the Per Se Funding Rule*

The general Funding Rule applies only if there is “a principal purpose” of avoiding the Excise Tax. However, the Per Se Funding Rule automatically deems a principal purpose so long as the applicable specified affiliate “funds,” by any means other than through distributions, the acquisition of the applicable foreign corporation stock within two years.<sup>4</sup> This automatic aspect of the Per Se Funding Rule has the potential to impose section 4501(a) on taxpayers related to ordinary course business transactions that do not have a historical motive for tax avoidance.

For these reasons, the Per Se Funding Rule expands the scope of section 4501(d) to transactions that are dissimilar to the transactions described in the statute even if they lack a motive of excise tax avoidance. As a practical matter, this would appear to expand the application of the Excise Tax far beyond the scope of section 4501 by subjecting a significantly larger set of transactions to section 4501(d). This would increase the burden on taxpayers to comply with section 4501 because ordinary course business transactions may automatically give rise to the tax.

In our experience, transactions described in section 4501(d)(1) are not common. Specifically, it is not common for a U.S. corporation to acquire the stock of its foreign parent due to, among other things, the application of section 304(a)(2) and other adverse tax issues that arise when a subsidiary holds “hook stock.” In comparison, transactions that could be construed as a “funding” subject to the Per Se Funding Rule can be very common and conducted in the ordinary course of business as described below. It seems counterintuitive to have a broad set of transactions automatically subject to the Excise Tax in order to prevent the avoidance of a relatively narrow set of transactions that may not occur commonly in practice. Furthermore, the Per Se Funding Rule may have the effect of taxpayers reassessing and restructuring ordinary course business transactions that have no Excise Tax avoidance motive, in reaction to the Per Se Funding Rule.

Therefore, the Per Se Funding Rule should be eliminated given that it: (i) would practically expand the reach of section 4501(d) well beyond what is described in the statute; (ii) potentially creates undue burden on taxpayers in complying with section 4501; and (iii) is not necessary to carry out or prevent the avoidance of section 4501(d).

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<sup>4</sup> Notice 2023-2, section 3.05(2).

### *Funding Rule with Principal Purpose*

Similar to the Per Se Funding Rule, we have concerns that the general Funding Rule could impose tax on ordinary course business transactions and create an administrative burden on taxpayers in the government's effort to prevent the avoidance of tax related to transactions that are not common. For this reason, we recommend that the general Funding Rule not be included in the regulations.

However, notwithstanding whether transactions described in section 4501(d) commonly occur, we recognize the government's concern to prevent the avoidance of section 4501. Given the prevalence of transactions described in section 4501(d), the general Funding Rule could be clarified, to capture transactions that are structured to avoid section 4501(d) without capturing ordinary course business transactions. Specifically, the Funding Rule could be clarified so that it is more closely tailored to apply to transactions that have a clear motive of excise tax avoidance and then provide other safeguards to exclude ordinary course business transactions from being subject to the Funding Rule.

As described above, the Funding Rule applies when a specified affiliate "funds by any means" the acquisition of stock of the applicable foreign corporation.

A clear definition of "funds by any means" is necessary to effectively and consistently apply the Funding Rule. There is no definition of "funds by any means" in the Notice except that it may include distributions, debt, or capital contributions. Absent a clear definition, such phrase could be construed to encompass a variety of transactions, and practically any transaction between an applicable specified affiliate and an applicable foreign corporation could be interpreted as a funding. For example, if an applicable specified affiliate simply repays in cash an existing debt to an applicable foreign corporation, and such applicable foreign corporation proximately repurchases stock from shareholders, such repayment could be construed by some to be a funding even if the debt existed prior to the enactment of section 4501. There are many other examples that ordinary business transactions could be interpreted to be funding "by any means" including a sale of inventory or a payment for services. One particular transaction that should not be a funding is when an applicable specified affiliate purchases stock from its foreign parent and then provides such stock to its employees similar to the deemed transaction in Example 4 of Treas. Reg. § 1.1032-3(e). In that transaction, the stock provided to the employees would qualify for the adjustment under section 4501(c), but such adjustment could be nullified if the purchase from the foreign parent was a funding.

Currently, the Funding Rule applies if a funding is undertaken for "a principal purpose" of avoiding the Excise Tax. A standard of "a principal purpose" may include a purpose of a transaction even though it is outweighed by other purposes taken together or separately.<sup>5</sup> Notwithstanding whether the definition of a "funding" remains to be broad, we recommend that the standard for the Funding Rule is "the principal purpose" so that the Funding Rule is narrowed to apply to transactions that have a primary purpose of avoidance. For other

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<sup>5</sup> *E.g.*, Treas. Reg. § 1.163(j)-1(b)(22)(iv)(C).



purposes, the standard of “the principal purpose” relies on whether the purpose of tax avoidance was more important than any other purpose.<sup>6</sup>

Whether a “principal purpose” is present for a transaction under the Funding Rule would need to be based on all facts and circumstances.<sup>7</sup> However, in other areas, the government has provided factors that are taken into account or indicate a “principal purpose.” If the general Funding Rule is retained requiring a “principal purpose,” we recommend that the government establish factors taken into account and indicate a “principal purpose.” The government has provided examples of circumstances in other areas for a similar purpose (*e.g.*, Treas. Reg. § 1.956-1(b)(4)). In addition, given that the determination of a “principal purpose” can rely on subjective factors, we recommend safe harbors for ordinary course business transactions that taxpayers can rely on for purposes of the Funding Rule. Safe harbors have been provided for in other similar contexts (*e.g.*, Treas. Reg. § 1.385-3(b)(3)(i) and Treas. Reg. § 1.385-3(c)(3) and Treas. Reg. § 1.385-3(c)(4)), though they would need to be tailored specifically in the context of section 4501 to address the concerns raised above.

Finally, if the Funding Rule is retained, additional rules are necessary to clarify how the Funding Rule applies when there is more than one applicable specified affiliate funding the same applicable funded entity. For example, a foreign parent may directly own two applicable specified affiliates, ASA 1 and ASA 2, which each fund the foreign parent \$100 during Year 1. If foreign parent subsequently repurchases \$100 of its stock during Year 1, the Funding Rule, as currently drafted, would seem to apply to both ASA 1 and ASA 2, resulting in each entity being treated as a covered corporation repurchasing \$100 of covered corporation stock. This would result in a total of \$200 of repurchases subject to the Excise Tax even though foreign parent only repurchased stock of \$100—an inappropriate multiplying effect. Therefore, we recommend that if the Funding Rule is retained, the regulations provide rules that prevent such multiplying effect. One approach would be to impose a cap on the maximum amount of the aggregate amount deemed repurchased by specified affiliates of the same applicable foreign corporation equal to the amount actually repurchased, and then allocate the amount subject to the Excise Tax between such specified affiliates. An allocation approach would limit the total amount subject to the Excise Tax to the amount actually repurchased, providing a necessary link between any funding and the repurchases. For example, applying an allocation approach in the above situation, after imposing a \$100 cap to the aggregate repurchases, each of ASA 1 and ASA 2 would be treated as repurchasing \$50 of stock.<sup>8</sup> We believe that such an allocation approach, if adopted, should also be applied to take into account funding from entities other than applicable specified affiliates, including foreign corporations and the applicable foreign corporation itself. Such a rule would acknowledge that repurchases or acquisitions of applicable foreign corporation stock may not necessarily be funded exclusively by applicable specified affiliates.

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<sup>6</sup> *E.g.*, Treas. Reg. 1.269-3(a).

<sup>7</sup> *E.g.*, Treas. Reg. § 1.163(j)-1(b)(22)(iv)(C) and Treas. Reg. § 1.385-3(b)(3)(iv).

<sup>8</sup> The formula for this calculation could be based on multiplying (i) the amount of applicable foreign corporation stock repurchased by the applicable foreign corporation (or specified affiliates of the applicable foreign corporation other than applicable specified affiliates) (*i.e.*, \$100 repurchased by the foreign parent), by (ii) the proportion of (A) the amount treated as funded by the relevant applicable specified affiliate (*i.e.*, \$50 for ASA 1), over (B) the aggregate sum of the relevant funding transactions (*i.e.*, \$100, based on \$50 by ASA 1 and \$50 by ASA 2).

### *Definition of Repurchase*

Section 4501(e) applies to stock of a corporation which is repurchased by such corporation during the taxable year. For this purpose, the term “repurchase” is defined to mean — (A) a redemption within the meaning of section 317(b) with regard to the stock of a covered corporation, and (B) any transaction determined by the Secretary to be economically similar to a transaction described in subparagraph (A).<sup>9</sup> Section 317(b) indicates: “[f]or purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.”<sup>10</sup> The “part” referenced is Subchapter C, Part I, Distributions by Corporations, which covers sections 301 through 318.

The Notice sets forth an exclusive list of transactions that *are* “Section 317(b) redemptions,” but *are not* repurchases, which includes: (i) the acquiring corporation’s deemed distribution in redemption of its stock in a section 304(a)(1) transaction; and (ii) payments of cash in lieu of fractional shares in section 368(a) reorganizations and section 355 distributions, provided that such payments are not separately bargained for consideration, are made solely for administrative convenience, and do not exceed the value of a single share with respect to any shareholder.<sup>11</sup>

The Notice sets forth an exclusive list of transactions that *are* economically similar transactions, which includes: (i) the exchange by target shareholders of target stock as part of an acquisitive reorganization; (ii) an exchange by recapitalizing shareholders of their recapitalizing corporation stock in a recapitalization under section 368(a)(1)(E); (iii) an exchange of transferor corporation stock as part of a reorganization under section 368(a)(1)(F); (iv) an exchange of distributing corporation stock in a distribution to which section 355 applies (a “split-off”); and (v) component distributions to which section 331 applies in the case of complete liquidations to which both section 331 and section 332 apply.<sup>12</sup>

Finally, the Notice provides a nonexclusive list of specific transactions that *are not* economically similar transactions, which includes: (i) except as provided in section 3.04(4)(a)(v) of the Notice, a distribution in complete liquidation of a covered corporation or a covered surrogate foreign corporation (as appropriate) to which section 331 or section 332(a) applies; and (ii) divisive transactions under section 355 other than split-offs.<sup>13</sup>

#### ○ Recommendation

- Clarify how to interpret the term repurchase in section 4501(e).

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<sup>9</sup> Section 4501(c)(1).

<sup>10</sup> Section 317(b).

<sup>11</sup> Notice 2023-2, section 3.04(3).

<sup>12</sup> Notice 2023-2, section 3.04(4).

<sup>13</sup> Notice 2023-2, section 3.04(4).

- Analysis

It is not clear in the Notice how Treasury and the IRS are distinguishing which items are classified as Section 317(b) redemptions versus “economically similar transactions.” For example, section 346 indicates that for the purposes of Subchapter C, “a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.”<sup>14</sup> Thus, it appears a complete liquidation generally is treated as a redemption for the purposes of Subchapter C. Yet, the Notice classifies a complete liquidation as either “economically similar” or “not economically similar,” but not as a Section 317(b) redemption. To the extent taxpayers believe a liquidation is a Section 317(b) redemption, the Notice does not effectively exclude liquidations from the Excise Tax (because they could be captured as a Section 317(b) redemption, even if not an economically similar transaction), which appears to have been the intention. It may be that Treasury and the IRS are reading the cross reference to section 317(b) in section 4501 to pull in the “for the purposes of this part” introductory language in section 317(b), such that transactions that fall outside sections 301 through section 318 are not “repurchases within the meaning of section 317(b).” If that is the case, we recommend that Treasury clarify that interpretation.

## **Repurchases of Certain Preferred Stock**

- Overview

The reference to “any stock” suggests that the Excise Tax generally applies to stock “repurchases” by publicly traded domestic corporations regardless of the class of stock and whether or not the particular stock repurchased is traded on a listed market or exchange. However, section 4501(f)(2) grants the Secretary the authority to “prescribe such regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of [section 4501], including regulations and other guidance . . . to address special classes of stock and preferred stock.”

The Notice defines stock, for purposes of section 4501, to mean “any instrument issued by a corporation that is stock or that is treated as stock for [U.S.] federal tax purposes at the time of issuance, regardless of whether the instrument is traded on an established securities market.”<sup>15</sup> Although the Notice does not include rules specifically addressing any special classes of stock or of preferred stock, Example 1 of Section 3.09 of the Notice illustrates that the repurchase of mandatorily redeemable preferred stock is a repurchase for purposes of the Excise Tax. Further, Treasury and the IRS requested comments regarding whether there are circumstances under which special rules should be provided for redeemable preferred stock or other special classes of stock or debt.

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<sup>14</sup> IRC section 346(a).

<sup>15</sup> Notice 2023-2, section 3.02.

○ Recommendation

- Exclude from the definition of “stock” for purposes of section 4501 certain types of preferred stock, namely stock that is limited and preferred as to distributions and liquidation proceeds and does not participate in corporate growth to any significant extent (“nonparticipating preferred stock”).

○ Analysis

Nonparticipating preferred stock is limited as to dividends, does not participate in corporate growth to any significant extent, and has redemption and liquidation rights that generally do not exceed the issue price of such stock. As a result, issuances and repurchases of nonparticipating preferred stock are analogous to the issuance and repayment of debt and are often seen as a close alternative to mezzanine financing, which is also subordinate to senior creditors but senior to common equity.

There are differences, however, between mezzanine financing and an investment in nonparticipating preferred stock that can yield a variety of commercial benefits. For example, the issuance of nonparticipating preferred stock may permit the parties to tailor the terms of the investment more closely to align with their particular circumstances than they might be able to with a loan. In addition, the corporation may be able to attract investment from a wider pool of potential investors using nonparticipating preferred stock, particularly where a lending transaction may not be available.

If the repurchase of nonparticipating preferred stock is subject to the Excise Tax, this would represent another decision point for corporations as they try to obtain financing. This has the potential to cause a shift in commercial financing markets toward lending transactions, which could have a variety of nontax implications, such as increased leverage and insolvency risk, and some tax implications as well, including additional tax-deductible interest expense for corporations. Notably, given the scope of the Excise Tax, these considerations and potential implications may be relevant only for publicly traded corporations, not privately held corporations. As a result, not creating an exception for nonparticipating preferred stock would seem to create an inconsistency in the treatment of publicly traded and privately held corporations.

Alternatively, the Excise Tax may also impact the financing market for privately held corporations as well because, where such corporations undergo an initial public offering (“IPO”), a portion of the proceeds are typically used to repurchase any outstanding nonparticipating preferred stock. Given that such a corporation would appear to have become a covered corporation as a result of the IPO, those repurchases would appear to be subject to the Excise Tax. Therefore, privately held corporations anticipating an IPO may preemptively eschew the issuance of nonparticipating preferred in lieu of debt financing.

Adopting this recommendation is consistent with the treatment of nonparticipating preferred stock in the commercial market as a debt-like instrument, like mezzanine financing. Repayments of debt are not treated as repurchases of stock under the Excise

Tax. It is also consistent with how such nonparticipating preferred stock is treated as a debt-like instrument for other purposes of the Code. For example, stock that has characteristics of nonparticipating preferred stock is (i) treated as boot when issued in the context of a potential section 351 exchange,<sup>16</sup> and (ii) disregarded entirely when determining whether a corporation is a member of an affiliated group under section 1504.<sup>17</sup> This recommendation is also within Congress's express mandate in section 4501(f)(2) for Treasury and the IRS to issue regulations with respect to special classes of stock and preferred stock.

To implement this recommendation, regulations could adopt a rule that excludes nonparticipating preferred stock from the definition of "stock" for purposes of the Excise Tax. Language similar to that in section 351(g)(2) or section 1504(a)(4) could be used. Alternatively, regulations could adopt a rule that excludes repurchases of nonparticipating preferred stock from the calculation of the Excise Tax base.

### **Special Purpose Acquisition Company (SPAC) Liquidations**

- Overview

As a general rule, when a corporation makes a distribution or deemed distribution to its shareholder(s) in "complete liquidation" of the corporation, the shareholder recognizes gain or loss on the amount received in full payment in exchange for its stock in the liquidating corporation.<sup>18</sup> Alternatively, if certain requirements are satisfied, a "complete liquidation" of a corporate subsidiary may qualify for tax-free treatment.<sup>19</sup> In either case, generally, in order for a liquidation to constitute a "complete liquidation," the shareholders of the liquidating corporation must receive or be deemed to receive at least partial payment for stock owned in the liquidating corporation.<sup>20</sup> Courts have interpreted this requirement to mean that the distributing corporation must distribute assets with a fair market value in excess of liabilities assumed or distributed with respect to every class of outstanding stock.<sup>21</sup> Thus, if no payment of value will be received on a class of stock, arguably neither section 332 nor section 331 will apply to the distribution.

Often in SPAC transactions, founding members do not receive any consideration for their founder stock upon liquidation of the SPAC.

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<sup>16</sup> See section 351(b) and (g).

<sup>17</sup> See section 1504(a)(4).

<sup>18</sup> Section 331.

<sup>19</sup> Section 332.

<sup>20</sup> Treas. Reg. § 1.332-2(b).

<sup>21</sup> See e.g., *Spaulding Bakeries, Inc. v. Comm'r*, 27 T.C. 684, 688 (1957), *aff'd*, 252 F.2d 693 (2d Cir. 1958); *H.K. Porter Co. v. Comm'r*, 87 T.C. 689 (1986).

- Recommendation

- Confirm that liquidations of SPACs are covered by the provision that generally excludes liquidations from section 4501, including cases where they may technically not qualify as “complete liquidations.”

- Analysis

Although cases where founders do not receive property in exchange for their founders’ stock may technically not qualify as “complete liquidations,” we can think of no policy reason to treat such liquidations differently than a “complete liquidation” for the purposes of section 4501.

## **Taxable Acquisitions**

- Overview

### *Zenz and Complete Termination of Shareholder Interest*

Fully taxable stock acquisitions, when coupled with certain redemptive transactions, can be treated as Section 317(b) redemptions. For example, assume that in connection with a taxable sale of the target stock, the target uses cash as part of the overall deal consideration, potentially as a redemption pre-acquisition, but as part of the same plan of acquisition. Cash may also come in the form of new debt at the target, coupled with the same pre-acquisition redemption transaction. These redemptive transactions are often structured as part of the overall plan to ensure that the shareholders receive capital gain treatment on the proceeds, rather than dividend treatment should the redemption be covered under section 302(d). These acquisition transactions, in form, can either be fully taxable stock purchases or all cash mergers to which the section 368 reorganization provisions do not apply. In these transactions, the target typically merges with a transitory merger sub of the acquiring company, with the target shareholders receiving the transaction consideration in exchange for their stock of the target corporation. To the extent the selling shareholders can trace some of the cash consideration to the target, either as cash on hand or a new injection of leverage (as described above), the proceeds will typically be treated as a complete termination of the shareholders interest under section 302(b)(3), and not a dividend equivalent redemption under section 302(d).<sup>22</sup> Thus, even though the target shareholders generally receive cash pro-rata in the exchange, they are permitted to treat the proceeds deemed transferred from target as additional capital gains proceeds.

While normally a taxpayer friendly rule, these redemption proceeds are treated as redemption payments under section 317(b), and based on the language of the Notice, the exchanges are treated as repurchases subject to the Excise Tax. However, this is a transaction for which an exemption from the Excise Tax should exist.

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<sup>22</sup> See *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 78-250, 1978-1 C.B. 83.

○ Recommendation

- Issue guidance exempting from the application of the Excise Tax payments funded by the target, directly or indirectly, in connection with a fully taxable disposition of target stock. Alternatively, Treasury could create an exemption for redemptions undertaken in connection with fully taxable stock dispositions in which target shareholders completely terminate their interest under *Zenz* and section 302(b)(3).

○ Analysis

The application of the Excise Tax in this fact pattern seems to create an arbitrary distinction between cash funded by the target, and cash funded by the acquiring company. As described above, the reason why the target shareholders are allowed sale or exchange treatment, *i.e.*, redemption treatment, is because the cash is generally sourced from the target, either as part of the integrated transaction (*i.e.*, a merger) or a pre-transaction redemption which is part of a plan by the target shareholders to completely terminate their interest. If the cash were instead sourced from the acquiring company, it would be considered additional taxable proceeds for the target stock. In either case, the shareholder may be treated as recognizing gain on the sale or exchange of stock. However, the former is clearly within the rules for redemptions under the Excise Tax, and the latter is not. In a fully taxable stock acquisition this distinction seems arbitrary.

A similar concern is raised when an acquisition is financed through debt, as is very common. Take for example a transitory merger subsidiary that borrows in order to acquire a publicly traded target. To the extent cash is then used to fund the redemption of target shareholders, the transaction appears to result in a redemption by the target corporation subject to the Excise Tax. However, if the acquisition proceeds were borrowed instead by a corporation that subsequently contributed the proceeds to the merger subsidiary, the exchange between the target corporation and its shareholders would not be subject to the Excise Tax. Thus, in economically similar transactions, the location of the borrowing used to finance the acquisition likely determines whether the Excise Tax applies. This distinction seems to be driven by factors that in many cases may be commercially focused, such as the ability to obtain third-party financing and the company's desired capital structure, and that do not appear to warrant a different result under the Excise Tax.

Should taxpayers want to mitigate the application of the rule in these sorts of fully taxable acquisitions, the acquiring company may be forced to pay extra consideration for the target stock, in effect buying the excess cash on the target balance sheet. This may lead to increased acquiror expense due to increased leverage in transactions, and an overall increase in acquiror cash needed to fund acquisitions, without a meaningful distinction in the net cash to shareholders.

## Issuances of stock to specified affiliates

### ○ Overview

Under section 4501(c)(3), the amount of stock repurchased by a covered corporation during the taxable year is “reduced by the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation during the taxable year, whether or not such stock is issued or provided in response to the exercise of an option to purchase such stock.”

Likewise, under section 3.08(1) of the Notice, a covered corporation’s Excise Tax Base is reduced by the aggregate fair market value of stock of the covered corporation (i) issued or provided to employees of the covered corporation or employees of a specified affiliate during the covered corporation’s taxable year, and (ii) issued by the covered corporation to persons other than such employees during the covered corporation’s taxable year (the “Netting Rule”). An exception in the Notice, however, provides that “[s]tock issued by a covered corporation to a specified affiliate of the covered corporation is not treated as issued.”<sup>23</sup>

Generally, the Netting Rule reduces a covered corporation’s Excise Tax base for a taxable year to the extent repurchased shares are replaced by other shares issued by the covered corporation. The exception for shares issued to a specified affiliate seems to be based on the idea that shares issued by a covered corporation to a specified affiliate are not actually replacing any repurchased shares. But the exception in its current form would appear to prevent those shares issued to a specified affiliate from ever being treated as issued, for example even when the specified affiliate transfers the shares to a party that is not the covered corporation or another specified affiliate.

### ○ Recommendation

- Include in the exception in section 3.08(4) of the Notice that disregards the issuance of shares to a specified affiliate for purposes of the Netting Rule language that would treat such shares as being issued for purposes of the Netting Rule whenever those shares are transferred to a party that is not the covered corporation or a specified affiliate.

### ○ Analysis

The exception for stock issuances to specified affiliates is currently too broad because under a strict reading it would permanently prevent that stock from being taken into account under the Netting Rule given that any subsequent transfer would not technically constitute an issuance. This result is not consistent with the general premise underlying the Netting Rule that the Excise Tax base should generally be reduced where repurchased shares are replaced with other shares. An issuance of shares by the covered corporation to a specified affiliate and then a subsequent transfer of the shares to a party other than the

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<sup>23</sup> Notice 2023-2, section 3.08(4)(c).



covered corporation or another specified affiliate has the same effect as the covered corporation issuing shares.

Section 4501 and the Notice permit covered corporations to take into account for purposes of the Netting Rule shares “provided to . . . employees of a specified affiliate.” The use of the word “provided” could be interpreted to address this issue because it would seem to include under the Netting Rule shares issued by the covered corporation to the specified affiliate and then transferred (though not technically “issued”) by the specified affiliate to its employees. However, the scope of this language is not broad enough because the Notice defines “employee” narrowly to mean “an employee as defined in section 3401(c) and Treas. Reg. § 31.3401(c)-1 of the Collection of Income Tax at Source Regulations (26 CFR part 31), or a former employee, of the covered corporation or specified affiliate, as applicable.”<sup>24</sup> Therefore, although subsequent transfers to “employees” may be taken into account, other common transactions are not taken into account, including the specified affiliate compensating independent contractors, board members, or other services providers or using the shares for any other purposes.

## 2. Employee Benefits

### Netting Rule

#### ○ Overview

The “Netting Rule” under section 4501(c)(3) provides that the amount treated as repurchased for purposes of the Excise Tax is first reduced by “the fair market value of any stock issued by the covered corporation during the tax year.” That is, the repurchased stock is net of stock issued during the same year. The statute expressly includes stock transfers to employees, even when the stock is received as the result of an exercise of an option. Section 3.08 of the Notice provides initial guidance on the operation of the Netting Rule, addressing general rules (3.08(1)), timing of issuance (3.08(2)), stock issued to employees (3.08(3)), disregarded issuances (3.08(4)), and valuation of stock issued to non-employees (3.08(5)).

#### *Compensatory transfers of stock*

Section 3.08(3) of the Notice addresses the treatment of issuances of stock to employees, specifying rules for treatment of cashless exercises, and generally providing that the timing of when stock is treated as issued and the value at issuance will follow section 83 principles for compensatory transfers of property. For issuances to persons other than employees, the Notice provides that the valuation of the stock will instead be governed by Section 3.08(5), which is more prescriptive, allowing four acceptable methods for valuation of stock traded on an established securities market, and requiring stock not so traded to be valued only under the principles of Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1). Importantly, the Notice defines an employee by reference to section 3401(c), and Treas. Reg. § 31.3401(c)-1,

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<sup>24</sup> Notice 2023-2, section 3.02(11).

which will generally include only common-law employees, and would not include other service providers, such as directors or independent contractors (including service providers that are unrelated entities).

○ Recommendation

- Issue guidance stating that the rules of Section 3.08(3) of the Notice apply to all compensatory transfers of property, without regard to the worker classification of the service provider, or whether the service provider is an individual or an unrelated entity.

○ Analysis

Providing guidance stating that the rules of Section 3.08(3) of the Notice apply to all compensatory transfers would allow transfers to all service providers to be governed by the same rules for the timing and valuation of the stock being transferred, avoiding both the burden and confusion of applying disparate standards to compensatory transfers, depending on the classification of the worker. If the rules of Section 3.08(3) of the Notice are limited to common-law employees, this will mean, for example, that restricted stock issued to a director who makes a section 83(b) election would be recognized under the Netting Rule at vesting rather than grant, but an employee's section 83(b) election would be recognized at grant. Another difference is that compensatory transfers to a non-employee would be confined to the prescribed valuation methods of Section 3.08(5) of the Notice, which exclude methods commonly used for compensatory transfers, such as the closing price on the prior trading date. It is unclear what the policy rationale would be for these differences.

In considering the statutory basis for aligning all compensatory transfers, we are cognizant that the statutory Netting Rule does note that the adjustment 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” (emphasis added). Importantly, however, this statutory language is clearly by way of example and does not limit the Netting Rule to issuances to employees but rather applies to “any stock issued by the covered corporation during the taxable year.” The comprehensive nature of the Netting Rule is apparent in the Notice, which does apply the rule to all issuances. Our recommendation would apply the timing and valuation rules of section 3.08(3) of the Notice (rather than the rules of section 3.08(5) of the Notice) to all compensatory transfers without regard to the service provider's classification or whether section 83 would govern the taxation of the transfer. This would, for example, include compensatory stock options, section 423 employee stock purchase plans, stock-settled stock appreciation rights, compensatory restricted stock, and stock-settled restricted stock units provided to employees or other service providers.

### *Withholding on cashless exercise*

Section 3.08(3)(a) of the Notice provides a rule for cashless exercise. The rule would not treat stock as “issued” for purposes of the Netting Rule if the stock is withheld to satisfy federal income tax withholding (FITW) under section 3402 or Federal Insurance Contributions Act (FICA) withholding under section 3102 on wages, or the exercise price. In contrast, if a third party advances amounts to an employee to satisfy these obligations, stock transferred to the third party, or the employee is treated as “issued.”

#### ○ Recommendation

- Issue guidance stating that the Section 3.08(3)(a) rule disregards as an issuance any stock that remains in the hands of the corporation following the transaction. By way of example but not by way of limitation, the guidance might separately provide a non-exclusive list of typical withholdings to aid the reader.

#### ○ Analysis

The Notice’s interpretation of the treatment of cashless exercise is appropriate and consistent with the statute. However, there is one clarification that would be helpful. Section 3.08(3)(a)(ii) of the Notice notes FITW and FICA, and Section 3.08(3)(a)(iii) of the Notice notes the exercise price, but no other less typical obligations are addressed, such as state and local tax withholding. As we understand it, the rule means to establish the principle that any stock that remains in the hands of the covered corporation following the transaction is not “issued,” hence the different treatment of sell-to-cover transactions. Itemizing specific withholdings leaves room for confusion on how to treat a particular withholding that is not itemized.

Accordingly, we recommend that the rule simply disregard as an issuance any stock that remains in the hands of the corporation following the transaction, but separately provide a non-exclusive list of typical withholdings to aid the reader.

This list might, as an example, include withholdings for pre-tax amounts elected by employees for contributions from compensation, such as contributions to a section 401(k) plan. Some section 401(k) plans use a definition of compensation based on Form W-2 compensation or section 3401(a) remuneration (federal income tax withholding) and thus require withholding for contributions to these plans from stock options, restricted shares and nonqualified deferred compensation plans that are distributed in stock.

### *Issuances that do not give rise to U.S. taxable income*

As we understand the Netting Rule – both in the Notice and in the statute – the existence and value of an issuance is determined without regard to United States (“U.S.”) income inclusion. That is, for example, if stock is issued to a nonresident alien who is not taxed in the U.S. on the value of the stock, the fair market value of the stock is nevertheless treated as issued for purposes of section 4501(c)(3) of the Notice when ownership of the stock transfers from the covered corporation to the nonresident alien.

- Recommendation

- Provide guidance specifying that absence of U.S. income inclusion as a result of transfer does not affect the treatment of the transfer as an issuance.

- Analysis

Section 4501(c)(3) reduces the excise tax by “the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any stock issued or provided to employees of such covered corporation . . . .” Although the issuance would ordinarily result in U.S. income inclusion by the recipient, this would not be the case, for example, if the recipient is an employee who is a nonresident alien not performing services in the U.S. The statute, however, does not premise the Netting Rule on taxation of the issuance. Rather, an issuance is taken into account without regard to the recipient’s taxation. Furthermore, imposing such a requirement would create an administrative headache. Accordingly, we recommend that guidance make clear that an issuance is taken into account for purposes of the Netting Rule without regard to whether or to what extent the issuance is taxed.

## **Contributions of Stock to Employer Plans**

- Overview

Section 4501(e) provides that “[s]ubsection (a) [imposing the 1% excise tax] shall not apply in any case in which the stock repurchased is, or an amount of stock equal to the value of the stock repurchased is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan.”

### *Timing of contributions*

- Overview

Section 3.07(3) of the Notice provides that the plan contribution exception may be applied such that stock contributed after the close of a taxable year but prior to the filing deadline for the Form 720 for that taxable year may be treated as having been contributed in the prior taxable year, provided that the contribution could be treated as made on account of the prior year within the meaning of section 404(a)(6). Under section 404(a)(6), for purposes of deducting contributions to qualified retirement plans, a contribution may be treated as made in the preceding year if deposited to the plan’s trust before the due date of the plan sponsor’s return for that year and treated by the plan in the same manner as the plan would treat a contribution actually received on the last day of the preceding tax year. The Notice would, thus, allow a similar grace period for purposes of the section 4501(e)(2) exception, but clarifies, “However, stock contributions that are treated as having been contributed in the taxable year to which the Form 720 applies cannot be treated as having been contributed for any other taxable year.”

○ Recommendation

- Confirm that a taxpayer is not bound to deduct under section 404(a) a stock contribution to a plan in the same taxable year for which the contribution is taken into account under the section 4501(e)(2) exception.

○ Analysis

We fully support the introduction of a grace period concept into the section 4501(e)(2) exception, and thank Treasury and the IRS for offering this flexibility to taxpayers. As we understand the Notice’s limitation in prohibiting the grace period contribution from being treated as contributed in another year, it is meant to prohibit double counting for purposes of section 4501, and not to broadly bind a taxpayer to deduct the contribution in the same year as taken into account under section 4501(e)(2).

For example, a plan sponsor maintaining a calendar year plan and operating on a calendar year fiscal year makes a \$1M contribution in employer stock into its defined benefit plan on March 1, 2024, prior to the due date for its Form 720. For purposes of section 4501, the plan sponsor treats the contribution as having been in 2023. However, under section 404, the plan sponsor deducts the contribution in 2024, the year of the deposit into the trust (even though the contribution could meet the conditions to be deducted in the prior year under section 404(a)(6)). We suggest that Treasury and the IRS confirm that the deduction of the contribution in 2024 does not violate the 4501(e)(2) grace period rule by treating the stock as “having been contributed for another taxable year.” Similarly, in the example above, if the contribution meets the conditions for deductibility in the prior year under section 404(a)(6), and the plan sponsor does in fact deduct the contributions in the prior year, the plan sponsor could still claim the section 4501(e)(2) exception in the year of the contribution, subject to the condition that it did not claim the exception in the prior year.

*Nonqualified trusts*

The section 4501(e)(2) exception applies to contributions to an “employer sponsored retirement plan.” The statute does not define this term. Section 3.02(12) of the Notice limits the exception to U.S.-qualified plans: “The term *employer-sponsored retirement plan* means a retirement plan maintained by a covered corporation that is qualified under section 401(a), including an employee stock ownership plan described in section 4975(e)(7).”

○ Recommendation

- Treat all secular employee trusts as employer-sponsored retirement plans for purposes of the section 4501(e)(2) exception.

- Analysis

Section 4501(e)(2) does not limit an employer-sponsored retirement plan to only those plans qualified under section 401(a), a particularly strict definition that will naturally exclude any foreign-based plan because such a plan will not have a U.S.-sited trust. If such a narrow reading had been intended, it could have easily been accomplished by statute, and Congress has made this choice in numerous other places in the Code but did not do so here. As a result, this interpretation is not consistent with the statute.

The statute does limit the exception to amounts “contributed” into the plan, which suggests that the intent was for amounts eligible for the exception to no longer be among the employer’s assets. Thus, for example, excluding a rabbi trust – which remains subject to the claims of the employer’s creditors – from the exception would appear to be reasonably contemplated by the statute. In contrast, excluding a secular trust – which is not subject to the claims of creditors – does not seem to be a reasonable interpretation of the statute.

Many foreign-based plans that are the functional equivalent of U.S.-qualified plans are funded via a secular trust but will not be qualified under section 401(a). Inclusion of these trusts is consistent with the statutory text and supported by the same policy rationale that appears to support the section 4501(e)(2) exception. Accordingly, we urge Treasury and the IRS to include employee plans funded by secular trusts in the term “employer-sponsored retirement plan” for purposes of section 4501(e)(2).

*Valuation of contributed shares to employer-sponsored retirement plan*

- Overview

Section 3.07(3)(c)(i) of the Notice provides: “If a covered corporation repurchases stock and contributes to an employer-sponsored retirement plan stock of the same class, then the amount of the reduction under section 3.07(3)(a) of this notice is equal to the aggregate fair market value of the stock repurchased during the taxable year (as determined under section 3.06(2) of this notice) divided by the number of shares repurchased multiplied by the number of shares contributed, but not in excess of the aggregate fair market value of the stock of the same class that was repurchased during the taxable year.” Section 3.06(2) provides various rules for determining the value of repurchased stock, generally determining the value of stock repurchased during the year using the value on the dates of actual repurchase. This takes into account that repurchases will happen at varying points during the year. Under the first part of the formula in section 3.07(3)(c)(i) of the Notice, the taxpayer would first determine what is an average per share value of all stock repurchased during the year. That average value is then multiplied by the number of shares contributed to the plan. The resulting value is the section 4501(e)(2) exception amount. The net effect of this calculation is that the same value -- the weighted average value over the year -- that is used to calculate the gross amount of repurchase is also used to calculate the amount of the section 4501(e)(2) exception.

○ Recommendation

- Base the value of stock for purposes of the section 4501(e)(2) exception on the greater of the value at the time of (a) repurchase or (b) contribution to employer-sponsored retirement plan.

○ Analysis

Section 4501(e)(2) provides that subsection (a) (imposing the excise tax) shall not apply “in any case in which the stock repurchased [“Clause 1”] is, or an amount of stock equal to the value of the stock repurchased [Clause 2”] is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan.” The “or” connotes that the statute allows for two alternative section 4501(e)(2) amounts. First, under Clause 1, the exception applies to the shares of repurchased stock subsequently contributed to the qualified plan. This alternative looks simply to the number of shares (from the repurchase) that were contributed to the qualified plan. Of course, since the exception has to be tied to a value (so that the overall tax can be calculated), this number of shares would then have to be valued. The second alternative, Clause 2, applies to “an amount equal to the value of the shares repurchased.” Because the statute makes both options available, we understand the statute to give the taxpayer a choice between the two alternatives in a given year.

*Example 1*

During a taxable year, a covered corporation repurchases 1M shares valued at \$10 per share. The resulting tax under section 4501 would be \$100,000 (1M shares x \$10 (\$10,000,000) x 1%). The covered corporation then contributes 500,000 shares into its employer-sponsored retirement plan. At the time of contribution, the shares are valued at \$12 per share. In this case, Clause 1 permits the covered corporation a reduction based on the number of repurchased shares, valued at the time of contribution. Thus, the section 4501(e)(2) exception amount is \$6M (500,000 shares x \$12).

*Example 2*

Same facts as in Example 1 except that the 500,000 in stock is valued at \$8 per share at the time of contribution to the plan. Under these facts, Clause 2 allows “an amount equal to the value of the stock repurchased” to be taken into account. Thus, the section 4501(e)(2) exception amount is \$5M (500,000 shares x \$10).