Only Buybacks in the Building

A Factor-Based Approach to the Section 4501 Excise Tax on Stock Repurchases[[1]](#footnote-1)

Marc A. Countryman

Intro Regarding Potential Guidance

As discussed above, notwithstanding the absence of any legislative history, it seems reasonably clear that section 4501 is intended to impose the excise tax on traditional stock repurchases engaged in by public companies, e.g., stock repurchased pursuant to stock repurchase programs (“**Traditional Public Company Stock Buybacks**”).[[2]](#footnote-2) Nevertheless, section 4501 was drafted with extremely broad language, so it will be necessary and appropriate for the IRS and Treasury Department to provide extensive guidance in order to establish the proper scope and application of the excise tax.

Given that Traditional Public Company Stock Buybacks are redemptions, it is no surprise that section 4501(c)(1) generally defines a repurchase for purposes of the excise tax as “a redemption within the meaning of section 317(b) with regard to the stock of a covered corporation”.[[3]](#footnote-3) Although this is a logical and appropriate starting point, “a redemption within the meaning of section 317(b)” includes numerous share exchanges that are substantially different from a Traditional Public Company Stock Buyback, potentially causing the excise tax to have a much broader application than appears to have been anticipated or intended. Further, the explicit exceptions in section 4501(e) are insufficient to preserve the likely intended scope of stock repurchases to which the excise tax would apply. In fact, some have even read the existence of certain statutory exceptions as suggesting a broader application of section 4501(a) than just Traditional Public Company Stock Buybacks.[[4]](#footnote-4) However, as drafted, section 4501 hardly provides a cohesive framework for the excise tax from which to interpret the intended scope.[[5]](#footnote-5) Rather, a much clearer picture can be drawn from commentary and discussion regarding stock buybacks and the excise tax, as well as the associated revenue estimate.[[6]](#footnote-6)

Given the statutory language and the context of the provision, it is recommended that the IRS and Treasury Department issue detailed guidance regarding the proper scope of stock acquisitions and repurchases to which the excise tax under section 4501 ought to apply. It is expected that any such guidance would generally start with the basic statutory provisions, and then provide numerous adjustments and modifications. Accordingly, the recommended guidance would provide that, generally, the excise tax only applies to share repurchases (or deemed repurchases) that constitute “a redemption within the meaning of section 317(b)”, and any other transaction that the IRS and Treasury Department has determined to be economically similar to a section 317(b) redemption and that is explicitly described in guidance issued prior to the date of the applicable transaction.[[7]](#footnote-7) Additionally, the adjustments and modifications to narrow the scope of share repurchases (or deemed repurchases) to which the excise tax might apply could then utilize one of at least two approaches: (i) a Transaction-Based Approach; or (ii) a Factor-Based Approach.[[8]](#footnote-8)

Under a Transaction-Based Approach, the IRS and Treasury Department could provide specific exceptions from the general, broad swath of share repurchases to which section 4501 might apply based on various categories of transactions. This might resemble the exceptions listed in section 4501(e), but with substantially more detail and analysis. Such an approach could likely address all or most of the significant issues but, like any specific list of exceptions, would require the drafters to identify an extensive list of transactions and would lack the flexibility to adapt to evolving transactions and fact patterns.

In contrast, a Factor-Based Approach could define the scope of share repurchases that are or are not subject to the excise tax based on various factors, rather than specifically described categories of transactions. While it is expected that either approach would potentially result in very similar outcomes, the Factor-Based Approach has the advantage that it could apply in the context of almost any type or variation of transaction, and could easily be coordinated with the special rules in section 4501(c)(2), regarding purchases by specified affiliates, and (d), regarding acquisitions of stock of certain foreign corporations.[[9]](#footnote-9)

Accordingly, it is proposed that the IRS and Treasury Department issue guidance under section 4501 that specifies that the excise tax only applies to share repurchases that constitute a redemption under section 317(b) or a “repurchase” explicitly described in guidance issued prior to the transaction, and utilizes the Factor-Based Approach, discussed below, to properly limit the scope of share acquisitions and repurchases that would otherwise be subject to the excise tax, limiting it to only those that resemble a Traditional Public Company Stock Buyback.[[10]](#footnote-10)

Overview of the Factor-Based Approach

The Factor-Based Approach would generally limit the imposition of the excise tax to a repurchase (or deemed repurchase) of shares that would otherwise be subject to section 4501 (i.e., a repurchase, or deemed repurchase, of shares of a covered corporation[[11]](#footnote-11) that constitutes a section 317(b) redemption (or an explicitly described similar transaction)) that possesses the essential attributes of a Traditional Public Company Stock Buyback. To determine this, the Factor-Based Approach would consist of an application rule, the Aggregate Repurchasing Corporation Rule, and two operative rules, the Factors Test, and the Purpose Exception.

Under the Factor-Based Approach, a repurchase (or deemed repurchase) of shares that would otherwise be subject to section 4501 would be exempt from the excise tax if it failed the Factors Test or qualified under the Purpose Exception, taking into account the Aggregate Repurchasing Corporation Rule.[[12]](#footnote-12) Although it is expected to apply in very limited situations, the Aggregate Repurchasing Corporation Rule would provide backstop protection for the Factors Test by modifying or broadening its application where necessary to prevent a repurchase (or deemed repurchase) of shares in more extreme transactions from escaping the potential application of the excise tax under a strict application of the Factors Test.

The proposed Factor-Based Approach is organized in this manner to allow the Factors Test to provide a relatively simple and objective means of assessing whether a share repurchase (or deemed repurchase) that would generally be subject to the excise tax appears to be the type to which the excise tax ought to apply. The Aggregate Repurchasing Corporation Rule facilitates this by separately addressing more extreme situations (i.e., it avoids the need to articulate the factors in the Factors Test in an overly complex way). The Purpose Exception would complement the Factors Test by ensuring that section 4501 is not applied solely based on wooden, mechanical rules.[[13]](#footnote-13)

Although the Factors Test is the primary rule in the Factor-Based Approach, logically, the Aggregate Repurchasing Corporation Rule would be considered first to determine the proper evaluation of the transaction (although it would rarely apply). If, taking the Aggregate Repurchasing Corporation Rule into account, the transaction results in a repurchase (or deemed repurchase) of shares, then the Factors Test would be applied to determine whether the repurchase (or deemed repurchase) of shares appears to be the type to which the excise tax should apply. If so, the repurchase (or deemed repurchase) of shares can be further evaluated under the Purpose Exception to determine if it really ought to be subject to the excise tax. If the repurchase (or deemed repurchase) of shares lacks one or more of the factors in the Factors Test, or possesses all five factors, but qualifies under the Purpose Exception, then the repurchase (or deemed repurchase) of shares does not resemble a Traditional Public Company Stock Buyback and it is appropriately treated as not a repurchase for purposes of the excise tax.

It is worth noting that this Factor-Based Approach is presented as applying with respect to a repurchase of shares, which would include a repurchase of any financial instrument that is properly treated a stock for US federal income tax purposes. An analysis of a repurchase of other financial instruments is beyond the scope of this proposal. However, it is expected that the IRS and Treasury Department could use the authority granted in section 4501(c)(1)(B)[[14]](#footnote-14) to specify whether or the extent to which the repurchase of certain financial instruments that are not treated as stock for US federal income tax purposes is treated as a repurchase of shares to which section 4501 might apply. Based on such guidance, a repurchase of such other financial instruments could then be analyzed under the Factor-Based Approach like a repurchase of shares, as specified in any other guidance.[[15]](#footnote-15)

Additionally, this proposal does not offer an interpretation of the treatment of a purchase by a specified affiliate, or the acquisition of stock of a foreign corporation. Those types of transactions are governed by section 4501(c)(2) and (d), respectively, and any associated guidance the IRS and Treasury Department might provide. To the extent those provisions cause a transaction to be treated as a repurchase of shares to which section 4501 might apply, such a repurchase of shares could potentially be analyzed under the Factor-Based Approach.[[16]](#footnote-16)

The Aggregate Repurchasing Corporation Rule

Although it is expected that the Aggregate Repurchasing Corporation Rule would apply in rare circumstances, there could be extreme situations or transactions in which a share acquisition or repurchase might inappropriately avoid the excise tax under a strict application of the Factors Test, discussed below. This is not to suggest that all share acquisitions or repurchases in such a situation ought to be subject to the excise tax. Rather, in those cases, an evaluation of the share acquisition or repurchase under a strict application of the Factors Test might not result in the most accurate determination of whether the share acquisition or repurchase appears to be the type to which the excise tax might apply. This could arise whether or not the transaction was affirmatively structured to avoid the excise tax. Accordingly, the Aggregate Repurchasing Corporation Rule could apply to modify or broaden the application of the Factors Test where necessary to allow it to properly evaluate whether an acquisition or repurchase of shares sufficiently resembles a Traditional Public Company Stock Buyback to be potentially subject to the excise tax.

This Aggregate Repurchasing Corporation Rule would address transactions involving an acquiring corporation that is essentially a continuation or extension of the corporation whose shares are being acquired or redeemed and, if applicable, the Factors Test and the Purpose Exception would be applied to the relevant corporations on a single-entity basis.

The Aggregate Repurchasing Corporation Rule applies if:

1. The acquiring corporation (“**Acquiring Corporation**”) (or a subsidiary of the Acquiring Corporation, an “**Acquiring Subsidiary**”) acquires:
   1. assets of a publicly traded corporation (the “**Public Target Corporation**”) in a transaction in which the Acquiring Corporation or the Acquiring Subsidiary succeeds to attributes of the Public Target Corporation under section 381(a), or
   2. stock of the Public Target Corporation in an exchange to which any of sections 351, 354, or 356 apply, and the Acquiring Corporation (or Acquiring Subsidiary) is not a specified affiliate of the Public Target Corporation immediately before such stock acquisition;[[17]](#footnote-17)
2. The Acquiring Corporation is publicly traded or becomes publicly traded in connection with the acquisition;[[18]](#footnote-18) and
3. At least 80% of the value of the stock of the Acquiring Corporation is received by the former shareholders of the Public Target Corporation in exchange for stock of the Public Target Corporation.

The Aggregate Repurchasing Corporation Rule is expected to have fairly limited application, and only apply where the Public Target Corporation is acquired in an asset reorganization (including a triangular), a stock reorganization (including a triangular), or a section 351 exchange, in which the issuing corporation is or becomes publicly traded, and the Public Target Shareholders own at least 80% of the stock of the issuing corporation by reason of owning stock of the Public Target Corporation. It seems appropriate to limit the Aggregate Repurchasing Corporation Rule to these types of transactions where at least a portion of the shares of the Public Target Corporation is surrendered in an exchange to which nonrecognition is applicable. If the Public Target Corporation’s shares were surrendered in a fully taxable exchange, that is inherently different from a Traditional Public Company Stock Buyback, and it should be sufficient to evaluate it under the Factors Test without modification.

The Aggregate Repurchasing Corporation Rule would capture holdco formations, potentially “flip” transactions (i.e., where a subsidiary corporation acquires the stock of its parent corporation, and becomes the new parent corporation)[[19]](#footnote-19), downstream reorganizations, and “reverse acquisitions” where SmallCo acquires BigCo.

As noted above, in a case to which the Aggregate Repurchasing Corporation Rule applies, the Factors Test and the Purpose Exception would be applied by treating the Public Target Corporation and the Acquiring Corporation (and Acquiring Subsidiary, if applicable) as if they were a single corporation. Thus, any acquisition of Public Target Corporation shares by the Acquiring Corporation (or Acquiring Subsidiary, if applicable) would be treated as a repurchase of shares to be analyzed under the Factors Test and Purpose Exception.

Although a transaction to which the Aggregate Repurchasing Corporation Rule applies is acquisitive in form, and might involve the Public Target Corporation ceasing to exist or ceasing to be publicly traded, for purposes of applying the Factors Test and Purpose Exception, it is more appropriately analyzed as a single-corporation transaction for this purpose. Accordingly, any acquisition or actual repurchase of the Public Target Corporation stock in a transaction to which the Aggregate Repurchasing Corporation Rule applies ought to be analyzed under the Factors Test without regard to the fact that it is in form acquisitive, or results in the Public Target Corporation ceasing to exist or ceasing to be publicly traded. Nevertheless, an acquisition or actual repurchase of the Public Target Corporation stock in a transaction to which the Aggregate Repurchasing Corporation Rule applies might still be exempted under the Factors Test or qualify under the Purpose Exception.[[20]](#footnote-20)

The Factors Test

The Factors Test would provide that a repurchase, or deemed repurchase, of shares could only be the type of repurchase to which the excise tax might apply if the repurchase, or deemed repurchase, possessed all five of the specified factors. These factors would be based on the following key attributes of a Traditional Public Company Stock Buyback. That is, the repurchase:

1. Is made by a corporation that is publicly traded before and after the repurchase;
2. Is in the context of a single-corporation transaction (i.e., not in an acquisitive or divisive transaction);
3. Consists of shares other than regular preferred stock;[[21]](#footnote-21)
4. Is not pro rata; and
5. Is made by a corporation that conducts, directly or indirectly, operations that generate material revenues and expenses at the time of the share repurchase.

For purposes of this discussion, the “**Repurchasing Corporation**” is the corporation engaging in the share repurchase. Additionally, for purposes of applying the Factors Test (and the Purpose Exception) an exchange of shares of a Repurchasing Corporation for newly issued Regular Preferred Shares of the Repurchasing Corporation would be treated as an exchange of shares for property.[[22]](#footnote-22) An exchange of shares of the Repurchasing Corporation for Regular Preferred Shares of the Repurchasing Corporation could produce a result that is similar to a Traditional Public Company Stock Buyback in that it is similar to a repurchase of shares in exchange for a debt instrument (i.e., it limits the exchanging shareholders’ economic interest in the Repurchasing Corporation and prioritizes such interests relative to the other shares of the Repurchasing Corporation). Additionally, even if one did not believe that this type of share-for-share exchange would produce such a result, it could potentially set up the Repurchasing Corporation to engage in a two-step repurchase that is similar to a Traditional Public Company Stock Buyback that could otherwise escape the excise tax.[[23]](#footnote-23) For all these reasons, it would be appropriate to treat an exchange of shares of the Repurchasing Corporation for Regular Preferred Shares of the Repurchasing Corporation in the same manner as a repurchase for property.[[24]](#footnote-24)

*Factor 1: The Repurchasing Corporation is an issuer of stock that is traded on an established securities market (i.e., publicly traded) immediately before the share repurchase, and continues to be publicly traded after the share repurchase.*

Applying this factor, any repurchase of shares by a corporation that is not publicly traded at the time of the share repurchase, or that ceases to be publicly traded in connection with the share repurchase would not be a repurchase to which section 4501 would apply. This closely aligns with the definition of “covered corporation” in section 4501(b), but provides more specificity regarding the significance of the corporation’s status as a publicly traded corporation relative to the share repurchase.

Share repurchases that occur before a corporation is publicly traded would appropriately be ignored. If the corporation wasn’t already publicly traded, the repurchase can’t have the effect of a Traditional Public Company Stock Buyback and ought not be subject to the excise tax. This would apply even if the corporation subsequently issues stock to the public as part of the same plan or arrangement. Further, because this factor would apply to exempt share repurchases if the issuing corporation ceases to be publicly traded in connection with the share repurchase, it would exempt “take-private” transactions, and other truly acquisitive transactions, as well as corporation liquidations. In the case of “take-private” and other acquisitive transactions, the business objectives of the acquisition or business combination are substantially different from those of a Traditional Public Company Stock Buyback, and are a significant distinguishing feature. One might argue that a share repurchase by a public target corporation that occurs as part of an acquisition of such corporation by another publicly traded corporation could have the appearance of a Traditional Public Company Stock Buyback if the two corporations were viewed collectively. However, an acquisitive transaction involving two publicly traded corporations is motivated by substantial business objectives that are materially different from a Traditional Public Company Stock Buyback, and such transactions are subject to numerous constraints and requirements that are generally not applicable to a Traditional Public Company Stock Buyback. Accordingly, regardless of whether the transaction is structured as a stock or asset acquisition, or involves the use of borrowed funds or excess cash of the target corporation, share repurchases in connection with a transaction in which the Repurchasing Corporation ceases to be publicly traded is not similar to the Traditional Public Company Stock Buyback and should not be a repurchase to which section 4501 applies. Such an exemption avoids potential inconsistencies between various acquisitive transactions, and prevents the excise tax from operating as a partial tax on transactions more broadly. The Aggregate Repurchasing Corporation Rule, discussed above, provides protections that ought to be sufficient to police more extreme cases.

In the case of a liquidation of a publicly traded corporation, it seems very clear that it is well outside the intended scope of the excise tax. A liquidation results in a termination of all of the corporation’s activities and an elimination of the entity, and bears no resemblance to a Traditional Public Company Stock Buyback. Accordingly, this factor properly exempts a share repurchase that is part of a corporate liquidation.

*Factor 2: The share repurchase is a single-corporation transaction; that is, not a step in the acquisition of the Repurchasing Corporation, or a divisive distribution by the Repurchasing Corporation.*

This factor would generally exempt share repurchases by the acquired corporation in an acquisitive transaction, and by the distributing corporation in a divisive distribution. In many cases, the application of this factor would overlap with Factor 1. However, this factor is not completely coextensive with Factor 1, and is properly included as a distinct element in the analysis to test the nature of the transaction in which a share repurchase occurs.

For purposes of this factor, a transaction would generally be considered to be acquisitive if either: (i) a person acquires all or part of the assets of the Repurchasing Corporation and the Repurchasing Corporation ceases to exist in connection with the asset acquisition; or (ii) the Repurchasing Corporation remains in existence and at least 50% of the total value of the stock of the Repurchasing Corporation is acquired in a transaction that is not subject to section 4501(c)(2) or (d).[[25]](#footnote-25)

Section 318 attribution would apply for purposes of determining the extent to which an acquiror directly or indirectly acquired stock of the Repurchasing Corporation, and any share repurchases by the Repurchasing Corporation that occur in connection with the stock acquisition would be taken into account for purposes of measuring the percentage of the total value of the stock of the Repurchasing Corporation that was acquired by the acquiror. Accordingly, if two or more persons acquired stock of the Repurchasing Corporation, and such persons were sufficiently related for section 318 to attribute the ownership of stock between them, such acquisitions would essentially be wholly or partially aggregated for purposes of applying this factor.[[26]](#footnote-26) Further, because any share repurchases by the Repurchasing Corporation that occur in connection with the stock acquisition would be taken into account for purposes of measuring the percentage of the total value of the stock acquired by the shareholder, a purchase of less than 50% of the total value of the stock of the Repurchasing Corporation could result in an acquisition of at least 50% once the repurchases are taken into account.

For purposes of this factor, a transaction is divisive to the extent the repurchase occurs in a distribution by the Repurchasing Corporation to which section 355 applies (regardless of whether it is in connection with a reorganization under section 368(a)(1)(D)), or that constitutes a partial liquidation as defined in section 302(e) and without regard to whether section 302(b)(4) applied to any distributee.

As noted above, an acquisitive transaction is fundamentally different from a Traditional Public Company Stock Buyback based on the substance of the transaction, the motivations for the transaction, and the other relevant considerations associated with the transaction. Accordingly, this factor would exempt share repurchases by the acquired corporation in connection with the acquisition of the corporation. However, it would not apply to share repurchases by the acquiring corporation, whether or not such repurchase is in connection with the acquisition.[[27]](#footnote-27)

In the case of divisive distributions, the statutory and regulatory requirements for a distribution to qualify under section 355 or satisfy the definition of a partial liquidation in section 302(e) similarly establish that such a distribution is fundamentally different from a Traditional Public Company Stock Buyback. Accordingly, repurchases in such divisive distributions ought to be exempted from the excise tax under this factor. However, this factor would only cover the actual divisive distribution, and a repurchase of shares by the distributing corporation in connection with such a transaction (e.g., a boot distribution redemption in a section 355 transaction) would not be exempted under this factor.[[28]](#footnote-28)

*Factor 3: The Repurchasing Corporation is repurchasing shares other than Regular Preferred Shares.*

Given their limited yield and preferred status relative to other classes of shares, Regular Preferred Shares are essentially debt-like with respect to the other classes of shares for purposes of evaluating whether a repurchase of Regular Preferred Shares (whether pursuant to the terms of the stock or otherwise) resembles a Traditional Public Company Stock Buyback.[[29]](#footnote-29) Whether the Regular Preferred Shares have a set redemption date or are perpetual likely should not matter. If the Regular Preferred Shares are perpetual, the expectation is that they would have to be redeemed for their fair market value, which would approximate the present value of expected cash flows the Regular Preferred Shares would provide to the holders. So, the remaining value and cash flow left for the nonredeemed shares ought to generally be similar whether the Regular Preferred Shares remain outstanding or not. At a minimum, even a redemption of perpetual Regular Preferred Shares ought to be substantially different from a Traditional Public Company Stock Buyback. Accordingly, under this factor, a repurchase of Regular Preferred Shares would be exempted from the excise tax.

*Factor 4: The Repurchase is not pro rata.*

This factor would apply to limit the potential application of the excise tax to a repurchase to the extent it is not pro rata. To the extent a repurchase is pro rata, it is materially different from a Traditional Public Company Stock Buyback because each shareholder is experiencing a proportionate tax event, and the number of outstanding shares owned by the shareholder is being reduced proportionately. Accordingly, to the extent a repurchase is pro rata, it does not advantage or disadvantage the shareholders based on their participation. In other words, to that extent it is similar to a pure section 301 distribution.[[30]](#footnote-30)

The extent to which the redemption is not pro rata would be measured based on the shareholders’ proportionate ownership in the Repurchasing Corporation by value, and their participation in the share repurchase. Additionally, for this purpose, small public shareholders (i.e., shareholders other than insiders and those that report share ownership publicly or to the Repurchasing Corporation) would be aggregated and treated as a single shareholder. If there are multiple classes of equity outstanding, except for Regular Preferred Shares, the value of those shares would be taken into account in comparing the shareholders’ proportionate ownership, and their participation in the share repurchase to determine the extent to which the redemption is not pro rata. If the Repurchasing Corporation has one or more classes of Regular Preferred Shares outstanding, such shares would be ignored in assessing the extent to which the repurchase is not pro rata.[[31]](#footnote-31)

Accordingly, the extent to which the repurchase is not pro rata would generally be based on the extent to which the insiders and reporting shareholders participate in the share repurchase, and the Repurchasing Corporation would be required to collect participation information from such reporting shareholders to establish this. For example, if the corporation was owned 10% by reporting shareholders, and it repurchased $300M of shares, of which $3M was repurchased proportionately from the reporting shareholders,[[32]](#footnote-32) the repurchase would only be pro rata to the extent of 10% of the repurchase (i.e., the insiders would have surrendered $30M of stock if it had been fully pro rata, but only surrendered $3M, or 10% of $30M). Accordingly, only 10% of the $300M repurchase would be exempt under this factor as pro rata.[[33]](#footnote-33) With respect to the non pro rata portion of such repurchase, it is still possible that one or more of the other factors in the Factors Test, or the Purpose Exception, might exempt it.

*Factor 5: The Repurchasing Corporation must conduct, directly or indirectly, operations that generate material revenues and expenses at the time of the repurchase.*

If the Repurchasing Corporation doesn’t conduct operations with material revenues and expenses (either because it has never conducted such operations, or has previously terminated all material operations), the repurchase can’t have the effect of boosting stock values or improving capital markets metrics to an extent that causes it to resemble a Traditional Public Company Stock Buyback. As such, a share repurchase by a corporation that does not have operations that generate material revenues and expenses at the time of the repurchase should not be treated as a repurchase to which the excise tax might apply. This factor would likely be narrow in application, but it is still a relevant element in the analysis because it helps to evaluate the nature of the repurchase. It would potentially exempt SPAC redemptions prior to or in connection with a de-SPAC transaction.[[34]](#footnote-34) It would also likely apply to a share repurchase by a corporation that is in winddown mode, but has not quite reached the point of completely liquidating.

For purposes of assessing whether the Repurchasing Corporation conducts operations with material revenues and expenses, all members of the Repurchasing Corporation’s separate affiliated group (within the meaning of section 355(b)(3)) would be treated as a single corporation. Further, whether such separate affiliated group directly or indirectly conducts operations that generate material revenues and expenses at the time of the share repurchase would be determined be based on section 355(b) active trade or business principles, without regard to whether it has been conducted by the members of the separate affiliated group for 5-years.

The Purpose Exception

A repurchase of shares of the Repurchasing Corporation stock would not be treated as a repurchase to which the excise tax might apply even if it possessed all of the factors under the Factors Test (taking into account the Aggregate Repurchasing Corporation Rule) if it can be established that the repurchase of shares otherwise does not resemble a Traditional Public Company Stock Buyback and, therefore, the purpose of the excise tax is not served by subjecting the repurchase to it. This exception would apply based on either the nature of the transaction, or the facts and circumstances, that show the share repurchase is not similar to a Traditional Public Company Stock Buyback. For this purpose, the relevant facts and circumstances would include both the principal purpose for the share repurchase and the reasonably anticipated results of the share repurchase.

Under this Purpose Exception, a repurchase of shares of the Repurchasing Corporation stock would be exempted from the excise tax:

* To the extent the repurchase is a payment of property in lieu of the issuance of fractional shares, provided such payment does not exceed [X%][[35]](#footnote-35) of the total value of the shares being exchanged in the transaction.[[36]](#footnote-36)
* To the extent the acquisition of the shares is not subject to section 4501(c)(2) or (d) and, taking into account the Aggregate Repurchasing Corporation Rule, it results in a deemed redemption (within the meaning of section 317(b)) solely due to the application of section 304(a)(1).[[37]](#footnote-37)
* To the extent the share repurchase constitutes an intercompany transaction to which Reg. §1.1502-13 applies.[[38]](#footnote-38)
* If it can be shown that the principal purpose for the share repurchase is to facilitate another transaction.
* If the repurchased shares are of a class that is not publicly traded, and not convertible into shares that are publicly traded.[[39]](#footnote-39)

Other Coordinating Provisions

1. *Section 4501(e)(1) exception*

If the Factor-Based Approach were adopted, in order to allow the treatment of an exchange of shares of a Repurchasing Corporation for newly issued Regular Preferred Shares of the Repurchasing Corporation to function as described above, the exception in section 4501(e)(1) would need to be limited such that it would not provide an exception for a repurchase of shares of a Repurchasing Corporation in exchange for newly issued Regular Preferred Shares of the Repurchasing Corporation.

1. *The Section 4501(c)(3) Adjustment*

To create symmetry with respect to the factors set forth above, there ought to be a provision that indicates that stock issuances are not taken into account in the adjustment under section 4501(c)(3) to the extent the issuance does not actually have the effect of netting against the buyback. These include an issuance of:

* shares prior to the issuing corporation becoming publicly traded;
* Regular Preferred Shares, whether or not publicly traded;[[40]](#footnote-40)
* shares of a class that is not publicly traded (unless it can be shown that the issuance is expected to have a dilutive impact on public trading price/EPS calculations/other capital markets metrics/etc); and
* shares in exchange for shares of the issuing corporation other than Regular Preferred Shares, or an issuance of shares of the Acquiring Corporation with respect to shares of a Public Target Corporation in a transaction to which the Aggregate Repurchasing Corporation Rule applies.[[41]](#footnote-41)

1. The following is an excerpt from the draft paper provided in advance of the conference to supplement the slide deck. [↑](#footnote-ref-1)
2. All of the discussion and commentary regarding section 4501, the revenue estimate, and the general context support this view [discussion not included in this excerpt]. [↑](#footnote-ref-2)
3. Section 317(b) provides: “For purposes of [sections 301-318], stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.” Additionally, section 317(a) provides: “For purposes of [sections 301-318], the term “property” means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).” [↑](#footnote-ref-3)
4. For example, one might argue that the exception in section 4501(e)(1) for certain share exchanges in a section 368(a) reorganization suggests that Congress was aware that the excise tax could have very broad application given that “repurchase” was defined by reference to a redemption within the meaning of section 317(b). However, the exact scope of section 4501(e)(1) is not clear, and it appears more likely that it was merely attempting to provide extra clarity that a share-for-share exchange in a section 368(a) reorganization is not intended to be subject to the excise tax. [↑](#footnote-ref-4)
5. The limited and ambiguous scope of the exception in section 4501(e)(1) itself suggests that it cannot be informative of the intended application of section 4501. For example, it seems unlikely that Congress intended that an exchange of target corporation shares for cash and acquiring corporation shares in a section 368 reorganization to be wholly exempt from the excise tax merely because the shareholder’s basis in each of the target corporation shares surrendered exceeds the value of each such share, and the shareholder would not recognize any loss under section 356(c). As suggested herein, boot in most asset reorganizations really shouldn’t be subject to the excise tax, but that is better supported by the fact that most asset reorganizations are substantially distinguishable from Traditional Public Company Stock Buybacks than based on a literal application of sections 4501(e)(1) and 356(c). [↑](#footnote-ref-5)
6. The discussion in the earlier portion of the paper will address this. [↑](#footnote-ref-6)
7. Given that section 4501 defaults to an incredibly broad scope, i.e., potentially any redemption within the meaning of section 317(b), retroactively expanding upon that seems excessive. Further, compliance with section 4501 would be even more burdensome if taxpayers were required to imagine anything that the IRS and Treasury Department might subsequently deem to be “economically similar” to a section 317(b) redemption, and then potentially be required to apply section 4501 on such basis. Without clear, prospective guidance, compliance and administration of the statute is likely to be inconsistent, and that is not appropriate for taxpayers or the government. [↑](#footnote-ref-7)
8. Section 4501(f) provides: “The Secretary shall prescribe such regulations and other guidance as are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section ….” Thus, the IRS and Treasury Department have ample authority, as well as a directive, to articulate the proper scope and application of the excise tax that both carries out the purposes of the section and prevents avoidance of the tax. It should also be noted that any such guidance, following either a Transaction-Based Approach or a Factor-Based Approach, can properly limit the application of section 4501 to only share repurchases that resemble Traditional Public Company Stock Buybacks, and not be expected to adversely impact the associated revenue relative to the estimates. [↑](#footnote-ref-8)
9. With respect to an acquisition of stock to which section 4501(c)(2) applies, the Factor-Based Approach could simply be applied based on the treatment of the stock acquisition under section 4501(c)(2)(A) as a “repurchase of the stock of the covered corporation by such covered corporation”. In the case of a repurchase or acquisition of stock to which section 4501(d) applies, the Factor-Based Approach could also be applied, but would likely need to be expanded a bit to apply in a manner that takes the relevant foreign corporation into account. [↑](#footnote-ref-9)
10. It is worth acknowledging that a hybrid approach is also possible in which the guidance provides an exception for share repurchases based on list of a specifically described categories of transactions as well as a general exception based on a series of factors. For example, see Reg. §1.367(a)-8(k) regarding triggering event exceptions for gain recognition agreements under Reg. §1.367(a)-3. However, if the general exception is drafted with sufficient accuracy, the exceptions for specific categories of transactions are likely redundant. [↑](#footnote-ref-10)
11. Section 4501(b) provides that a “covered corporation” is “any domestic corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)).” However, see section 4501(d) for certain other entities that are treated as a covered corporation for purposes of section 4501. [↑](#footnote-ref-11)
12. If a share repurchase that would generally be subject to section 4501 is exempted under the Factor-Based Approach, it would be ignored for purposes of applying section 4501. If it is determined that section 4501 applies to a share repurchase after applying the Factor-Based Approach, it would be subject to all of the provisions of section 4501, including the adjustment under section 4501(c)(3). [↑](#footnote-ref-12)
13. This structure is generally similar to the approach taken in Reg. §1.355-6 issued under section 355(d) that contain a number of mechanical rules, but also provides a more general exception for section 355 distributions that do not violate the purposes of section 355(d), as set forth in the regulations. [↑](#footnote-ref-13)
14. Section 4501(c)(1)(B) provides that, in addition to a redemption within the meaning of section 317(b), for purposes of section 4501, a repurchase includes “any transaction determined by the Secretary to be economically similar to a” redemption within the meaning of section 317(b). [↑](#footnote-ref-14)
15. The Factor-Based Approach is intended to provide the general framework for the determination of the type of repurchase (or deemed repurchase) to which the excise tax might apply, and the determination of the treatment of non-stock financial instruments is a distinct issue. [↑](#footnote-ref-15)
16. As noted above, the Factor-Based Approach could be applied based on the treatment of a stock acquisition under section 4501(c)(2). However, in the case of a repurchase or acquisition of stock to which section 4501(d) applies, the Factor-Based Approach would likely need to be expanded to apply in a manner that takes the relevant foreign corporation into account. [↑](#footnote-ref-16)
17. If the Acquiring Corporation (or the Acquiring Subsidiary) is properly treated as a specified affiliate of the Public Target Corporation immediately before the stock acquisition, the acquisition of shares of the Public Target Corporation ought to be subject to section 4501(c)(2)(A), and not this Aggregate Repurchasing Corporation Rule. [↑](#footnote-ref-17)
18. If the Acquiring Corporation is not publicly traded and does not become publicly traded in connection with the acquisition, then the transaction is a “take-private” transaction and not generally a continuation of the status quo, and any share repurchase would be properly analyzed under the Factors Test solely by reference to the Public Target Corporation. [↑](#footnote-ref-18)
19. In the case of a “flip” transaction where the Acquiring Corporation is formed as a wholly owned subsidiary of the target corporation prior to the “flip”, it is not entirely clear whether the acquiring corporation would be a specified affiliate of the Public Target Corporation given the fact that its status as a wholly owned subsidiary of the Public Target Corporation is typically transitory. If the Acquiring Corporation in a “flip” transaction did constitute a specified affiliate of the target corporation, its acquisition of the Public Target Corporation stock would seem to be subject to section 4501(c)(2)(A), and ought to be addressed under separate guidance. Having noted that, if the Acquiring Corporation’s status as a specified affiliate is transitory (or otherwise fails to be subject to section 4501(c)(2)), it would be appropriate to analyze it under the Aggregate Repurchasing Corporation Rule. [↑](#footnote-ref-19)
20. For example, a Public Target Corporation might merge into an Acquiring Corporation in a transaction to which the Aggregate Repurchasing Corporation Rule applies and in which the Public Target Corporation shareholders receive (i) Acquiring Corporation common stock in exchange for the Public Target Corporation common stock, and (ii) cash in exchange for Public Target Corporation Regular Preferred Shares. See e.g., Rev. Rul. 74-515, 1974-2 C.B. 118 (respecting the exchange of *X* common stock for *Y* common stock, and *X* preferred stock for cash, regardless of whether a shareholder held both *X* common stock and *X* preferred stock). In such a case, under the Aggregate Repurchasing Corporation Rule, the Factors Test would be applied by treating the Public Target Corporation and the Acquiring Corporation as a single corporation. Accordingly, the exchange of Public Target Corporation common stock for Acquiring Corporation common stock would not be a redemption within the meaning of section 317(b) (i.e., it would be treated as a share-for-share exchange of the single corporation), and the exchange of Public Target Corporation Regular Preferred Shares for cash would be exempt under Factor 3 because it is a repurchase of Regular Preferred Shares. See the discussion of the Factors Test, below. [↑](#footnote-ref-20)
21. For this purpose, regular preferred stock is stock that, taking into account any conversion features or other rights, possesses a priority as to dividends and on liquidation relative to all classes of common stock, is limited as to dividends, and does not participate in corporate growth to any significant extent (“**Regular Preferred Shares**”). [↑](#footnote-ref-21)
22. As articulated, this treatment would apply to an exchange of Regular Preferred Shares of the Repurchasing Corporation for newly issued Regular Preferred Shares of the Repurchasing Corporation (i.e., the exchange would be treated in the same manner as a repurchase of the Regular Preferred Shares for property). However, such an exchange would be exempt under Factor 3, discussed below. As an alternative, an exchange of Regular Preferred Shares of the Repurchasing Corporation for newly issued Regular Preferred Shares of the Repurchasing Corporation could be exempted from this operating rule, generally similar to the treatment of exchanges of nonqualified preferred stock under section 354(a)(2)(C) (i.e., “bad” stock exchanged for “bad” stock is “good”). [↑](#footnote-ref-22)
23. For example, absent this limitation (and assuming that step transaction principles would not apply to disregard the issuance of the Regular Preferred Shares), a corporation might be able to repurchase common shares in exchange for Regular Preferred Shares in a share repurchase that would be exempt from the excise tax under this factor because the common shares were repurchased for newly issued shares of the Repurchasing Corporation and, subsequently, redeem those Regular Preferred Shares in a share repurchase that would be exempt from the excise tax under Factor 3 because the repurchased shares are Regular Preferred Shares. [↑](#footnote-ref-23)
24. To be clear, this could actually treat a share exchange as a repurchase to which the excise tax might apply even though it might qualify as a recapitalization under section 368(a)(1)(E) and section 354 provided for nonrecognition with respect to the exchange. [↑](#footnote-ref-24)
25. For example, an acquisition of stock of a corporation by a specified affiliate is properly addressed under section 4501(c)(2)(A), and the resulting repurchase of shares can be evaluated under the Factor-Based Approach, without treating the acquisition by the specified affiliate as acquisitive. However, it is possible that an acquisition of shares of a corporation by a specified affiliate might occur in the context of a broader transaction that is acquisitive, as determined under this factor. In such a case, the acquisition of shares by the specified affiliate could be treated as a repurchase of shares under section 4501(c)(2)(A), and such deemed share repurchase might be exempt from the excise tax because it occurs in the context of the broader acquisitive transaction. [↑](#footnote-ref-25)
26. For example, if two partnerships with significantly overlapping partners each acquired shares of a target corporation, the stock acquired by each partnership could be attributed under section 318(a)(2)(A) and (3)(A) to the other partnership, and either partnership (or both) might be treated as having acquired at least 50% of the total value of the stock of the target corporation. [↑](#footnote-ref-26)
27. The transaction is not acquisitive with respect to the acquiring corporation. Accordingly, this factor would not provide a potential exemption for a repurchase by the acquiring corporation. Nevertheless, a repurchase of shares by the acquiring corporation might still be exempted under one or more of the other factors in the Factors Test, subject to the Aggregate Repurchasing Corporation Rule, or might be exempted under the Purpose Exception.

    Clearly, directionality would matter in applying this factor. A mechanical, direction-neutral rule that essentially operates like the reverse acquisition rule in Reg. §1.1502-75(d)(3) (e.g., the larger corporation is always treated as the acquiring corporation for this purpose) could be drafted, but might be challenging to implement and difficult to coordinate with the other factors. Accordingly, it seems more practical to apply the factors based on the actual form of the transaction that involves the stock repurchase, and leave any repurchases by the acquiring corporation to be addressed by the other factors in the Factors Test and the Purpose Exception. Additionally, the Aggregate Repurchasing Corporation Rule provides protections to police extreme cases where the direction of the transaction is reversed (e.g., SmallCo acquires BigCo). [↑](#footnote-ref-27)
28. Similar to share repurchases by the acquiring corporation, a share repurchase by the distributing corporation that is executed in connection with a divisive transaction, but is not itself a divisive distribution, would not be exempted under this factor. Nevertheless, a repurchase of shares by the distributing corporation in connection with a divisive transaction might still be exempted under one or more of the other factors in the Factors Test, subject to the Aggregate Repurchasing Corporation Rule, or might be exempted under the Purpose Exception. [↑](#footnote-ref-28)
29. For example, in the case of a corporation that has both common and Regular Preferred Shares outstanding, the Regular Preferred Shares will provide the holders with a limited and preferred yield, and a preference with respect to any liquidation proceeds equal to the face amount of the Regular Preferred Shares, plus any accrued and unpaid dividends. Accordingly, the holders of the common shares will generally enjoy all of the benefits and burdens of the residual economics of the corporation above what the Regular Preferred Shares are entitled to. As a result, a repurchase of all or part of the Regular Preferred Shares would have far less impact on the holders of the common shares than a repurchase of a portion of the common shares. This is not to suggest that the holders of the common shares would always be entirely indifferent to whether the Regular Preferred Shares are outstanding or not. Rather, the point is that a partial or complete repurchase of the Regular Preferred Shares is meaningfully distinguishable from a Traditional Public Company Stock Buyback. [↑](#footnote-ref-29)
30. This might be the idea that the exception in section 4501(c)(6) (“to the extent that the repurchase is treated as a dividend for purposes of this title”) was based on. However, the extent to which the share repurchase is pro rata seems far more relevant than the degree to which the distribution is out of earnings and profits of the corporation. [↑](#footnote-ref-30)
31. It might make sense to also ignore for this purpose shares of a class that is not publicly traded, and to which the Purpose Exception could apply if such shares were repurchased. [↑](#footnote-ref-31)
32. Obviously, if any reporting shareholder failed to participate proportionately in the repurchase, it would significantly impact the extent to which repurchase is pro rata. However, such a limitation on the “not pro rata” factor seems appropriate for purposes of applying section 4501 given the concerns regarding Traditional Public Company Stock Buybacks. [↑](#footnote-ref-32)
33. Practically speaking, this “not pro rata” factor might not exempt much from what is a repurchase for purposes of section 4501. However, it is still a valid element in the Factor-Based Approach for determining the proper application of the excise tax. [↑](#footnote-ref-33)
34. Obviously, following the completion of a de-SPAC transaction, this factor would not apply to exempt a share repurchase by the corporation from the excise tax. [↑](#footnote-ref-34)
35. There is nothing significant about the proposed [X%] threshold. The key would be that the property in lieu of fractional shares not constitute a meaningful amount in the context of the overall share exchange. [↑](#footnote-ref-35)
36. It makes sense to exempt cash in lieu of fractional shares without any set dollar limit because it is merely a rounding off of shares for administrative convenience, and not separately bargained for consideration. However, it is probably necessary to put a cap on it to prevent people from playing games with this (e.g., engaging in an extreme verse-stock-split recap where a large amount could be paid out in lieu of fractional shares. [↑](#footnote-ref-36)
37. If the shares are acquired from the target corporation shareholders in an actual stock acquisition that would only result in a deemed redemption due to the application of section 304(a)(1), taking into account the Aggregate Repurchasing Corporation Rule, the stock acquisition ought to be respected as such for purposes of applying section 4501 and not result in any share repurchase for purposes of the excise tax. See e.g., 1995 FSA LEXIS 470 (October 25, 1995) (IRS concludes that the deemed redemption pursuant to section 304 is not a redemption for purposes of section 162(k), in part based on the fact that the courts in *Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977) and *Webb v. Commissioner*, 67 T.C. 293, 307 (1976) note that the section 304 mechanics don’t change the fact that stock is not actually redeemed). [↑](#footnote-ref-37)
38. Thus, if the Repurchasing Corporation were a member of a consolidated group, any repurchase of shares by the Repurchasing Corporation from another member of the consolidated group would not be treated as a repurchase for purposes of the excise tax. This may be a rare situation, but it is appropriate and consistent with the single-entity principles of Reg. §1.1502-13. [↑](#footnote-ref-38)
39. Clearly, this would only be relevant for shares that are not Regular Preferred Shares. It might make sense to provide that, for this purpose, the determination of whether the repurchased shares are of a class that is not publicly traded would be based on the economic terms of the stock (i.e., not solely based on voting rights). [↑](#footnote-ref-39)
40. If repurchases of Regular Preferred Shares are exempted from the excise tax, and not factored into the assessment of the extent to which a repurchase of other shares is not pro rata, the issuance of Regular Preferred Shares should not be taken into account in applying the adjustment in section 4501(c)(3). [↑](#footnote-ref-40)
41. A share issuance that is essentially just a change to the capital structure of the corporation should not count towards the adjustment under section 4501(c)(3). [↑](#footnote-ref-41)