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KPMG report: Stock repurchase excise tax and funding rule considerations for inbound taxpayers

Publicly traded "inbound" taxpayers need to consider the potential application of the new stock buyback excise tax to share repurchases by a publicly traded foreign parent under the "funding rule" of Notice 2023-2 [PDF 313 KB]. As described below, there is significant uncertainty regarding how the funding rule applies and how the government may attempt to resolve this uncertainty in future guidance.

Background

Legislation in 2022 enacted a non-deductible, 1% excise tax generally applicable to net repurchases of shares by publicly traded domestic corporations on and after January 1, 2023. By statute, this 1% excise tax can also apply to a U.S. subsidiary entity of a publicly traded foreign corporation[1] when the U.S. subsidiary entity acquires the stock of its foreign parent corporation from an unrelated seller. More specifically, section 4501(d)(1) provides that the excise tax applies in the case of an acquisition of stock of an "applicable foreign corporation" (i.e., a non-U.S. publicly traded corporation) by an "applicable specified affiliate" of the foreign parent, from a person other than the foreign parent (or from another subsidiary of the foreign parent corporation).[2] An applicable specified affiliate is a "specified affiliate" other than (1) a foreign corporation or (2) a foreign partnership that does not have a domestic entity as a direct or indirect partner. A specified affiliate of an applicable foreign corporation includes (1) any corporation more than 50% owned (by vote or by value), directly or indirectly, by the applicable foreign corporation, and (2) any partnership if more than 50% of the capital or profits interests of that partnership are held, directly or indirectly, by the applicable foreign corporation.[3]

The government on December 27, 2022, released Notice 2023-2, providing taxpayers with interim guidance regarding the excise tax. The notice sets forth, in 52 pages, a detailed set of potential rules that are intended to be included in future proposed regulations. According to the notice, it is anticipated that the future regulations generally will be effective retroactively to January 1, 2023.

The guidance in the notice includes the "funding rule" described below, which would significantly expand the scope of the excise tax by treating a U.S. subsidiary of a publicly traded foreign corporation (an applicable specified affiliate) as acquiring the stock of its publicly traded foreign parent (an applicable foreign corporation) in a potentially wide-ranging set of circumstances. In particular, the notice provides that

[1] Specifically, a foreign corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1) and Treas. Reg. § 1.7704-1(b). Section 4501(d)(3)(A). Unless otherwise indicated, all references in this article to "section" are to the Internal Revenue Code of 1986, as amended.

[2] The term "applicable specified affiliate" is not found in the statute, but is introduced in Notice 2023-2. *See* Notice §3.02(4).

[3] Section 4501(c)(2)(B). A U.S. branch or a U.S. disregarded entity of a foreign corporation does not appear to be within this definition.

an applicable specified affiliate is treated as acquiring stock of an applicable foreign corporation (and, therefore potentially subject to the excise tax) if:

- 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 by a non-U.S. specified affiliate), and
- Such funding is undertaken for a principal purpose of avoiding the stock repurchase excise tax.[4]

In addition, the Notice creates a "per se funding rule," providing that the principal purpose required in the funding rule **will be deemed to exist** if:

- The applicable specified affiliate funds by any means, other than through distributions, the applicable foreign corporation (or the non-U.S. specified affiliate), and
- Such funded entity acquires or repurchases stock of the applicable foreign corporation within two years of the funding.[5]

Analysis

Thus, if an applicable specified affiliate "funds by any means," other than a distribution, a corporation that repurchases the stock of an applicable foreign corporation in the two years before or after the "funding," the per se funding rule would treat the applicable specified affiliate as acquiring such stock of the applicable foreign corporation to the extent of the funding.[6] Accordingly, under the per se funding rule, any repurchases by an applicable foreign corporation of its own stock after December 31, 2022, could potentially be treated as "funded" by an applicable specified affiliate, regardless of whether there was any intent to avoid the excise tax or even to use funds from a U.S. affiliate to fund the repurchase, and regardless of whether it can be established that the funds actually used to finance the repurchase came from other sources, such as the foreign parent's cash on hand or from distributions from other non-U.S. entities.

Further, the language "funds by any means" is naturally susceptible to a broad interpretation, and it seems intended to have a broad reach. Thus, it is plausible that "funds by any means" could include almost any intercompany payment from an applicable specified affiliate. For instance, it is unclear whether an arm's length intercompany payment for goods or services, the extension of routine intercompany credit, or the repayment of a pre-existing loan, can constitute a "funding by any means." Particularly troublesome is the potential for cash pooling arrangements, when U.S. subsidiary entities have positive gross balances, to be viewed as a loan where the cash pool header is the foreign parent (or a foreign finance company that itself finances the foreign parent's stock buybacks).

In practice, groups of affiliated entities often have myriad intercompany transactions, and the methodology of determining the amount funded by the applicable specified affiliate is unclear given that cash is fungible. On one end of the spectrum, potentially any amounts "funded" by an applicable specified affiliate could be treated as first funding any stock repurchase, maximizing the potential excise tax liability. This is reminiscent of the unfavorable stacking rules inherent in the per se funding rule of the section 385 recharacterization regulations,[7] and of the avoided cost method used in the UNICAP's interest capitalization rules.[8] Other approaches may be less draconian but would almost certainly involve significant complexity.

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[4] Notice §3.05(2)(a)(ii)(A).

[5] Notice §3.05(2)(a)(ii)(B).

[6] An applicability date in the notice limits the reach of the funding rule to funding transactions occurring after December 27, 2022 with respect to stock that is acquired or repurchased after December 31, 2022. Notice 2023-2, section 5.02.

[7] Treas. Reg. § 1.385-3(b)(3)(iii).

[8] Treas. Reg. § 1.263A-9. The avoided cost method was also used in the proposed but never finalized regulations under the now-repealed corporate equity reduction transaction (CERT) rules that limited certain NOL carrybacks.

KPMG observation

The scope of the funding rule, particularly the per se funding rule, is controversial, and Treasury has received a number of comments criticizing the proposal. If Treasury chooses to retain[9] the rule when it publishes proposed, temporary, or final regulations, it is to be hoped that such future guidance would clarify and limit the scope of the funding rule (or perhaps eliminate the two-year presumption entirely). In particular, while by no means certain, tax practitioners anticipate that Treasury would consider adding exceptions and exclusions for ordinary course transactions at arm's length pricing and for certain limited short-term funding arrangements. However, as Yogi Berra is reported to have said, "It's tough to make predictions, especially about the future." Thus, inbound taxpayers may need to consider the potential of the funding rule to result in an unwelcome additional excise tax liability.

For more information, contact a tax professional with KPMG Washington National Tax:

Maury Passman | mpassman@kpmg.com
Gary Scanlon | gscanlon@kpmg.com
Jonathan Galin | jgalin@kpmg.com
Timothy Nichols | tnichols@kpmg.com

kpmg.com/socialmedia

[9] In the context of section 385, the most recent official pronouncement on the section 385 recharacterization rule, Treasury announced that it intended to issue proposed regulations that would make the section 385 regulations "more streamlined and targeted, including by withdrawing the per se rule." T.D. 9897, 85 Fed. Reg. 28867, 28869 (May 20, 2020). This announcement is in marked contrast to the approach taken in Notice 2023-2 with respect to the excise tax.