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More Fun with Extraterritorial Taxes: Application of U.S. Stock Buyback Excise Tax to Foreign-Based Groups

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INTRODUCTION

In August 2022, Congress enacted a new Code §4501, imposing a nondeductible 1% excise tax on repurchases by publicly traded and certain other corporations of their own stock, more colloquially referred to as "stock buybacks."[1] This legislation followed years of criticism from some policy makers and observers to the effect that stock buybacks are somehow pernicious and something to be disincentivized or punished, whereas defenders view the practice as a fairly mundane and useful tool of capital management.[2] Criticisms of stock buybacks become especially pointed when buybacks are carried out by companies that may benefit from particular tax or other economic policy incentives,[3] but it is also fair to say that the use of stock buybacks writ large is considered fundamentally objectionable by some, and that the enactment of the 1% excise tax in 2022 was merely one milestone in what is bound to be a long series of legislative battles over the issue.[4]

This commentary has no ambition of resolving these deep-seated policy disagreements, but instead, recognizing that the excise tax is bound to be legislatively revisited (potentially at higher rates), seeks to advance the discussion of one particular technical aspect of §4501 of interest to non-U.S.-based multinational groups. Specifically, the IRS in Notice 2023-2 has proposed to apply (with immediate effect) the

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[1] *See* §4501, enacted as part of the Inflation Reduction Act of 2002, P.L. No. 117-169 (Aug. 16, 2022) (the "IRA"). Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended and in force at the time of this publication, or to the Treasury regulations promulgated thereunder.

[2] Senator Elizabeth Warren has been among the leading critics, describing stock buybacks as "nothing but paper manipulation." *See* Thomas Franck, "Elizabeth Warren rips stock buybacks as 'nothing but paper manipulation," CNBC (Mar. 2, 2021). Defenders of stock buybacks include the well-known investor Warren Buffett, who stated: "The math isn't complicated: When the share count goes down, your interest in our many businesses goes up. Every small bit helps if repurchases are made at value-accretive prices. . . . Gains from value-accretive repurchases, it should be emphasized, benefit all owners – in every respect." Yun Li, "Warren Buffett calls stock buyback critics 'economic illiterate' in Berkshire Hathaway annual letter," CNBC (Feb. 25, 2023).

[3] See, e.g., Senator Elizabeth Warren Press Release, "Warren, Lawmakers Call on Commerce Dept. to Prevent CHIPS Funds from Being Used to Subsidize Corporate Stock Buybacks" (Feb. 13, 2023).

[4] The Biden administration's fiscal-year 2024 budget submission, for example, has proposed raising the rate of the tax from 1% to 4%. *See* U.S. Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals* (Mar. 9, 2023), at 4 ("Stock repurchases are tax-favored relative to dividends as a means of distributing corporate profits to shareholders. Increasing the excise tax rate on stock repurchases would reduce this disparity. Moreover, raising the tax rate is an administratively simple and progressive way to raise revenue to pay for the Administration's fiscal priorities.").

§4501 excise tax to certain purchases by domestic corporation of the stock of related foreign affiliates, under a new "funding rule" to be issued by regulation.[5] This development may have taken non-U.S.-based multinational groups by surprise, as they may have assumed with some reason—including the statutory language of §4501 itself—that non-U.S.-based groups' capital management practices were not targets of this U.S. policy initiative.

The Funding Rule presents a range of difficult administrability and other tax policy concerns, which require further consideration as Treasury and the IRS proceed with the rulemaking process on this issue, again in an environment in which policy makers can be expected to return to the §4501 excise tax again and again as a potential source of revenue to finance other economic policy objectives. Moreover, the proposed rule provides another example of a trend toward ever-more-aggressive extraterritorial application of a country's tax rules, in the face of what could be formidable, practical, technical, and political challenges. Taxpayers and policy makers alike need to be aware of these issues.

GENERAL OPERATION OF §4501

Section 4501(a) imposes on each "covered corporation" a tax equal to 1% of the fair market value of any stock of the corporation which is repurchased by such corporation during the taxable year. A "covered corporation" is defined generally as any *domestic* corporation the stock of which is traded on an established securities market.[6] A "repurchase" generally includes a redemption as defined under §317(b), as well as any transaction determined by Treasury to be economically similar to such a redemption.[7] The amount of repurchases subject to the tax is reduced to account for any offsetting stock issuances, including issuances under various stock-based compensation plans.[8]

Thus, as far as we've gone, it would appear that Congress's focus was on buybacks of a publicly traded domestic corporation's own stock, by that corporation itself. Tax being tax, there is always concern about the possibility of avoiding any new rule, and thus Congress also saw fit to treat certain other purchases of a covered corporation's stock as a repurchase for §4501 purposes. In particular, §4501(c)(2) treats acquisitions of a covered corporation's stock by a "specified affiliate" of such corporation as a repurchase of the stock of the covered corporation by such covered corporation. A "specified affiliate" for this purpose means any corporation or partnership more than 50% directly or indirectly controlled by (or under common control with) the covered corporation.[9] Assuming it makes sense to impose an excise tax on a publicly traded domestic corporation's repurchase of its own stock, it seems sensible enough to provide a rule to prevent the imposition of the tax via the expedient of having an affiliate make the purchase.

Okay, but how do non-U.S.-based issuers get into the mix? Congress added a rule to impose the excise tax on an acquisition of a publicly traded *foreign* corporation's stock *by a domestic* specified affiliate (generally including a domestic corporation and certain partnerships with a domestic partner).[10] And, as is the fashion nowadays, Congress added a tougher "double secret probation" rule for buybacks involving certain inverted companies, who are in-scope even if a foreign affiliate acquires the stock.[11]

In other words, as far as Congress was concerned, there did not seem to be much for a typical non-U.S.-based group to worry about under the new excise tax. Buybacks of a typical publicly traded foreign corporation's stock by the corporation itself were properly left out-of-scope, and if a U.S. affiliate were to acquire its foreign parent's stock in the market, that would be covered, but at least that would be a readily identifiable action—a direct purchase of publicly traded foreign parent stock by domestic affiliate or covered partnership—as opposed to something that companies might just stumble into without knowing.

However, the story does not end here. Congress also provided Treasury a broad grant of regulatory 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" §4501, including in relevant part "for the application of the rules of [§4501(d), dealing with foreign issuers]."[12] Discerning these "purposes" on Congress's part is a bit of a challenge for Treasury, IRS, and the rest of us, as Congress failed to provide any detailed contempo-

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[5] *See* Notice 2023-2, §3.05(2)(a)(ii) (Dec. 27, 2022) (the "Funding Rule").

[6] *See* §4501(b).

[7] *See* §4501(c)(1). The use of the subchapter C redemption concept to define a repurchase for these purposes has presented a host of difficult technical questions, outside the scope of this commentary. *See, e.g.*, Marc A. Countryman, *A Proposed Factor-Based Approach to the Code Sec. 4501 Excise Tax on Repurchase of Corporate Stock*, Taxes—The Tax Magazine (Mar. 2023), 33.

[8] *See* §4501(c)(3).

[9] *See* §4501(c)(2).

[10] *See* §4501(d)(1).

[11] *See* §4501(d)(2). For the avoidance of doubt, "double secret probation" is not a term used in the statute, but rather a sanction invoked by fictional college dean Vernon Wormer to deal with a nettlesome but already-sanctioned target, arguably analogous to the continued flogging of the inversions issue by lawmakers. *See National Lampoon's Animal House* (Universal Pictures 1978). For what it's worth, the results of the application of the policy in that case were regrettable for all concerned.

[12] *See* §4501(f).

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raneous legislative history in the form of committee or similar reports.

The IRS, to its credit, stepped into the breach by issuing Notice 2023-2 on December 27, 2022, just a few months after the enactment of §4501 and a few days before the provision took effect (§4501 generally applies to repurchases after December 31, 2022). Notice 2023-2 offers a great deal of guidance on a great many questions presented by §4501.

THE NOTICE 2023-2 FUNDING RULE

Unfortunately for non-U.S.-based multinational groups, however, Notice 2023-2 included a particularly aggressive expansion of the application of §4501 to purchases of a foreign publicly traded parent company's stock, in the form of the Funding Rule. Under the Funding Rule, the §4501 excise tax will apply not only to an *actual, direct* acquisition of foreign parent company stock by a domestic affiliate (which the statute itself provides), but also to any acquisition of foreign parent company stock, including by the foreign issuer itself or by a foreign affiliate, if a U.S. affiliate "funds by any means (including through distributions, debt, or capital contributions) the acquisition or repurchase of" the foreign parent company stock, and such funding "is undertaken for a principal purpose of avoiding" the excise tax.[13] However, any comfort that a taxpayer might momentarily have had upon reading the "principal purpose" requirement is quashed by the immediately following language *deeming* such a principal purpose to exist if the U.S. affiliate "funds *by any means*, other than through distributions" a foreign affiliate that acquires or repurchases the foreign issuer stock "within two years of the funding."[14]

Thus, as a result of the Funding Rule issued by the IRS in Notice 2023-2, non-U.S.-based multinational groups need not only to ensure that their U.S. subsidiaries are not acquiring foreign parent company stock in the market (a presumably manageable task), but also to ensure that any foreign parent or foreign affiliate that might acquire foreign parent company stock in the market has not had a relevant "funding" transaction with any U.S. affiliate within two years of the stock acquisition (a very open-ended and probably unmanageable task). While the exact contours of the applicable "funding" concept are unclear, the effect of the new rule may well be to draw a very wide range of foreign-issuer buybacks into the scope of §4501, as opposed to simply backstopping or preventing the avoidance of the tax as applied to U.S. issuers or U.S. purchasers.

[13] *See* Notice 2023-2, §3.05(2)(a)(ii)(A).

[14] *See* Notice 2023-2, §3.05(2)(a)(ii)(B) (emphasis added).

TROUBLESOME ISSUES PRESENTED BY THE FUNDING RULE

Astute readers may find this "funding" concept familiar from some other recent tax policy exercises, including the debt-equity regulations under §385,[15] the "imported mismatch" regulations issued under the §267A anti-hybrid rules,[16] and the §956 anti-abuse rule.[17] All of these rules of course involve their own particular tax policy concerns, but they all, like the Funding Rule set forth in Notice 2023-2, adopt a fairly aggressive and government-favoring approach to questions involving the attribution of a particular expenditure of funds (here, purchasing parent company stock) to a particular source of funds in structures that are likely to involve many and varied transactions moving in multiple directions within a typical multinational group.

The concept of "funding" has been construed fairly broadly in some cases. For example, for §956 purposes, the IRS has taken the position that a funding may occur not just in the form of an intercompany loan, for example, but also through "common business transactions."[18] The IRS responded to concerns about the potential overbreadth of that rule by observing that the §956 funding rule also has a subjective "principal purpose" requirement that must be satisfied in order for the rule to apply, which, according to the IRS, should assuage concerns that, say, typical supply chain sales or services transactions at arm's length terms might be treated as "fundings."[19]

No such luck for taxpayers under Notice 2023-2, however—for §4501 purposes the IRS has kept the very broad funding "by any means" formulation and paired it with an unforgiving per se rule pulling in any such funding within two years of the relevant stock purchase.[20] Thus, a publicly traded foreign parent company of a large, global group with operations and funding sources all over the world could find itself being treated by the IRS as having "funded" its routine stock repurchases on a first-dollar basis from various intercompany lending, licensing, or even standard

[15] *See* Reg. §1.385-1(b)(3).

[16] *See* Reg. §1.267A-4(c)(3).

[17] *See* Reg. §1.956-1(b)(1)(ii) and -1(b)(4); *see also* Reg. §1.304-4 (similar).

[18] *See* CCA 202203013.

[19] *Id.*

[20] *See* Notice 2023-2, §3.05(2)(a)(ii)(B). It is also unclear whether the funding "within two years" applies only to fundings within two years before the stock acquisition or instead might occur within two years later, within effectively a 4-year window. Presumably the former was intended, but the language could be clearer. *See* Brian W. Reed, *Navigating the Complexities of the Funding Rule in Notice 2023-2*, 109 Tax Notes Int'l 1675 (Mar. 20, 2023) (discussing this and other technical issues relating to the operation of the new Funding Rule).

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supply chain sales or services transactions with a U.S. affiliate, even if such transactions are relatively small compared with the funds available to the foreign parent company from its many other investments and operations.

This outcome is very difficult to defend from a general tax policy perspective (as a typical foreign-based group's routine stock repurchases are not of obvious policy concern to the United States), based on the statutory language (as Congress seems to have intended only a narrow application of the tax with respect to foreign issuers), as well as from an administrability perspective (as relevant fact patterns will proliferate in many cases without taxpayers' knowledge). This outcome also could draw objections from our trading partners, coming as it does amid a time of intense debate within and among countries about the extraterritorial application of a country's tax laws, and the appropriate responses to extraterritorial taxes.[21] The stakes of these issues may seem limited in a world in which this excise tax is imposed at only a 1% rate, but query how long that state of play will obtain.

[21] Various digital services taxes and the OECD Pillar Two undertaxed profits rules (''UTPRs'') are some prominent recent examples.

CONCLUSION

The IRS, acting quickly to provide the public badly needed guidance on a brand-new tax, probably overreached in issuing such a broad Funding Rule, arguably with the effect of subjecting foreign-based groups' stock buybacks to the U.S. excise tax as a rule rather than as a narrow exception. The IRS should withdraw the Funding Rule or at least substantially narrow it as the rulemaking process proceeds in this area.[22] In the meantime, non-U.S.-based multinational groups should be aware of this possibly surprising new set of issues and develop their compliance, planning, and advocacy strategies to deal with the issue. Even U.S.-based groups may want to take notice, insofar as other countries might be inspired to enact similar rules targeting buybacks of U.S. issuer stock, with no credit mechanism available to avoid double taxation as we have in the income tax area.

[22] The principles of the anti-conduit rules applicable for tax treaty purposes under Reg. §1.881-3 could be one place to look for a narrower and more fact-sensitive approach. At a minimum, it seems clear that a broad notion of ''funding'' cannot reasonably be paired with a purely time-based per se rule, for reasons suggested by the IRS itself in its §956 CCA discussed above. Another possible approach to the difficulties of dealing with the fungibility of money might be to adopt some sort of pro rata attribution rule that would deem a stock buyback to be funded by all of a purchaser's various sources of funds, rather than on a first-dollar basis from the proscribed source.

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