

Stock Repurchases Under the Build Back Better Act's Excise Tax

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In this article, the authors examine the proposed excise tax on some stock repurchases by corporations and how it might apply to various transactions.

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An excise tax on some stock repurchases by corporations has been proposed in Congress. On September 20, 2021, Sen. Sherrod Brown, D-Ohio, introduced the Stock Buyback Accountability Act (S. 2758, the SBA Act) with Senate Finance Committee Chair Ron Wyden, D-Ore., as his cosponsor. The SBA Act would add section 4501 to the Internal Revenue Code to impose a 2 percent excise tax. According to an accompanying press release, the SBA Act would end preferential treatment granted under the code to stock repurchases by large corporations, which are viewed as inflating their stock prices to the benefit of their wealthiest investors and executives.¹ In the House, the proposal, with a 1 percent rate, is in section 138102 of H.R. 5376, the Build Back Better

Act,² which passed the House on November 19, 2021.³

The proposed excise tax isn't expected to result in significant tax liability, at least in the context of a specific transaction. For a \$500 million stock buyback, for example, a 1 percent excise tax would amount to \$5 million, which seems relatively modest in comparison with the transaction value.⁴ However, the tax isn't nothing, and it would require a redeeming corporation to make a cash payment to Treasury (not its shareholders), presumably something the board of directors of a redeeming corporation would want to consider before authorizing a redemption.

We explain the provisions of the proposed excise tax and discuss the scope of its potential application regarding both (1) transactions clearly intended to fall within its purview, and (2) transactions that appear to be subject to the tax, but that taxpayers and practitioners might not expect to be subject to the tax. We don't address the policy arguments for or against the proposal; rather, we focus on technical issues implicated by the current versions of the proposal. It's important for taxpayers and practitioners to be aware of those issues because, although the future of the Build Back Better Act may be uncertain, we

¹ See Brown, "Brown, Wyden Unveil Major New Legislation to Tax Stock Buybacks" (Sept. 10, 2021) ("Rather than investing in their workers, mega-corporations used the windfall from Republicans' 2017 tax cuts to juice their stock prices and reward their wealthiest investors and their executives through massive stock buybacks. Stock buybacks are currently heavily favored by the tax code, despite their skewed benefits for the very top and potential for insider game-playing. Our bill simply ends this preferential treatment and encourages mega-corporations to invest in their workers."). See also Brown's floor speech on S. 2758: 167 *Cong. Rec.* S6451 (Sept. 13, 2021).

² H.R. 5376, at section 138102, as reported in House Rules Committee Print 117-18. See 167 *Cong. Rec.* H6375, H6541 (Nov. 18, 2021).

³ H.R. 5376 was approved by the House with a 220 to 213 vote. 167 *Cong. Rec.* H6659 (Nov. 19, 2021) (roll call 385).

⁴ Overall, the House proposal (at a 1 percent rate) was estimated to raise a significant amount — just under \$125 billion over a 10-year budget window. Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions of Title XIII — Committee on Ways and Means, of H.R. 5376. The 'Build Back Better Act,' as Reported by the Committee on the Budget, With Modifications (Rules Committee Print 117-18)," JCX-45-21, at 5 (Nov. 5, 2021).

anticipate that the proposed excise tax may be enacted in response to future searches for revenue.⁵

Mechanics and Scope

The Build Back Better Act's proposed excise tax generally would impose on a "covered corporation" a nondeductible excise tax of 1 percent of the fair market value of any stock of the corporation that it repurchases during the tax year.⁶ For this purpose, a "covered corporation" means a domestic corporation (for federal tax purposes)⁷ whose stock is traded on an established securities market.⁸ The proposed excise tax would also apply to purchases of stock of a covered corporation effected by a "specified affiliate" of such corporation (that is, a purchase of such stock by a corporation or partnership directly or indirectly controlled by such covered corporation).⁹

The proposed excise tax would apply to stock that is "repurchased," which is defined as a redemption within the meaning of section 317(b). Such a redemption encompasses a corporation's acquisition of its stock from a shareholder in exchange for money and other forms of consideration (other than stock in the distributing corporation). The proposed excise tax would also apply to any transaction determined by the Treasury secretary to be economically similar to such a transaction.¹⁰

Two special rules apply to foreign corporations. First, covered surrogate foreign corporations (that is, expatriated entities) would

be treated as covered corporations, and thus repurchases of the stock of such entities and purchases of such stock by specified affiliates of such entities would be subject to the proposed excise tax.¹¹ Second, the excise tax would extend to a domestic corporation's or partnership's purchase of stock of its foreign parent, when such entity is a "specified affiliate" (that is, a directly or indirectly controlled subsidiary) of the foreign parent, and the foreign parent is an "applicable foreign corporation."¹²

The amount on which the excise tax would be imposed (that is, the FMV of the stock repurchased or treated as repurchased) would be reduced by the FMV of any stock issued by the covered corporation during the tax year, including any stock issued to employees, irrespective of whether the stock is issued in response to the exercise of an option to purchase such stock.¹³ However, in the case of a domestic specified affiliate's purchase of the stock of an applicable foreign corporation, the reduction would be limited to the FMV of stock issued to the employees of the domestic specified affiliate.¹⁴ Similarly, in the case of a covered surrogate foreign corporation, the reduction would be limited to the FMV of stock issued by the expatriated entity to its employees.¹⁵

The Build Back Better Act would create six exceptions to the excise tax. First, the tax wouldn't apply to a repurchase that is part of a reorganization within the meaning of section 368(a) to the extent that no gain or loss is recognized by the shareholder by reason of the

⁵ The excise tax wasn't explicitly included in President Biden's proposed fiscal 2023 budget; however the proposed budget appears to assume enactment of the Build Back Better Act. See Office of Management and Budget, "Budget of the U.S. Government Fiscal Year 2023" (2022); and Treasury, "General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals" (Mar. 2022) (the green book).

⁶ Build Back Better Act, section 4501(a) (imposition of tax) and section 138102(b) (nondeductible).

⁷ For example, a domestic corporation includes a domestic eligible entity that, by default, is classified as an entity disregarded as separate from its single owner or as a partnership for federal income tax purposes (such as a limited liability company) that files an election to be classified as an association taxable as a corporation for such purposes. Reg. section 301.7701-2(b)(2) and -3(a).

⁸ Build Back Better Act, section 4501(b).

⁹ *Id.* at section 4501(c)(2).

¹⁰ *Id.* at section 4501(c)(1).

¹¹ Build Back Better Act, section 4501(d)(2). For this purpose, a covered surrogate foreign corporation is defined by reference to the definition in section 7874(a)(2)(B) of the inversion rules (substituting a Sept. 20, 2021, inversion date), the stock of which is traded on an established securities market (defined by reference to section 7704(b)(1)), but only regarding tax years that include any portion of the applicable 10-year period following the inversion under section 7874(d)(1).

¹² Build Back Better Act, section 4501(d)(1). For this purpose, a "specified affiliate" has the same definition set forth in section 4501(b) of the act, and an "applicable foreign corporation" is a foreign corporation whose stock is traded on an established securities market (defined again by reference to section 7704(b)(1)).

¹³ Build Back Better Act, section 4501(c)(3).

¹⁴ *Id.* at section 4501(d)(1)(C). Unlike the Build Back Better Act, the SBA Act doesn't limit the reduction to stock issued to employees. SBA Act, section 4501(c)(3).

¹⁵ Build Back Better Act, section 4501(d)(2)(C). Note that unlike the Build Back Better Act, the SBA Act doesn't limit the reduction to stock issued to employees. SBA Act, section 4501(c)(3).

reorganization. Second, the tax wouldn't apply when the stock repurchased or an amount equal to the value of such stock is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan. Third, the tax wouldn't apply when the total value of the stock repurchased during the tax year doesn't exceed \$1 million.¹⁶

Fourth, the tax wouldn't apply when the stock repurchase is undertaken by a dealer in securities in the ordinary course of business under regulations to be prescribed by the Treasury secretary. Fifth, the tax wouldn't apply to stock repurchases by a regulated investment company as defined in section 851 or a real estate investment trust. Finally, the tax wouldn't apply to the extent that a stock repurchase is treated as a dividend.¹⁷

The government would be granted regulatory authority, including to prevent abuse of the foregoing exceptions, address special classes of stock and preferred stock, and apply the legislation to covered surrogate foreign corporations and applicable foreign corporations.¹⁸ As mentioned above, the excise tax wouldn't be deductible¹⁹ and would apply to stock repurchases occurring after December 31, 2021.²⁰

Differences Between the Proposals

The proposed excise tax in the Build Back Better Act differs from the version in the SBA Act in six notable ways.²¹ First, the SBA Act would

impose a 2 percent tax on the value of the stock repurchased, whereas the Build Back Better Act would impose a 1 percent tax.²² Second, the SBA Act defines the term "repurchase" to include the acquisition by a corporation of a right to acquire its stock, whereas the Build Back Better Act does not.²³

Third, the SBA Act would apply to transactions regarding the stock of covered surrogate foreign corporations without regard to the date on which the corporation becomes such and without regard to whether the applicable subsequent 10-year period under section 7874(d)(1) has elapsed, whereas the Build Back Better Act would apply only to such transactions of corporations that become covered surrogate foreign corporations after September 20, 2021, and during such 10-year period.²⁴

Fourth, the SBA Act would restrict the application of the excise tax to a purchase of stock of a covered corporation by a domestic specified affiliate, whereas the Build Back Better Act would apply the tax to such a purchase by any specified affiliate (domestic or foreign) of a covered corporation or a covered surrogate foreign corporation and also would apply the tax to such a purchase by a specified affiliate of an applicable foreign corporation that is a foreign partnership with a domestic entity as a direct or indirect partner.²⁵

Fifth, in the case of a covered transaction regarding the stock of a covered surrogate foreign corporation or applicable foreign corporation, the SBA Act would reduce the amount on which the tax is imposed by the value of any newly issued stock of the applicable purchasing entity during the tax year (including stock issued to employees of the applicable purchasing entity), whereas the

¹⁶ Build Back Better Act, section 4501(e). While the amount on which the excise tax imposed would be reduced by the FMV of stock issued by a covered corporation or its specified affiliate (or to employees in the case of a covered surrogate foreign corporation or a specified affiliate of such a corporation or of an applicable foreign corporation), the exception for total repurchases not greater than \$1 million does not contain a similar offset for issuances. Thus, for example, if a corporation were to repurchase \$1.1 million of its stock and issue \$500,000 of its stock during the same tax year, it appears that the \$1 million exception may not apply.

¹⁷ Build Back Better Act, section 4501(e)(4)-(6).

¹⁸ *Id.* at section 4501(f).

¹⁹ *Id.* at section 138102(b).

²⁰ *Id.* at section 138102(d). Given that the provision was not enacted in 2021, we would anticipate that consideration will be given to modifying the effective date if the provision advances in the 2022 legislative process or in a later year.

²¹ It is unclear to us whether the differences between the versions of the proposal in the SBA Act and the Build Back Better Act reflect different policy choices, or whether the policy considerations are the same and the Build Back Better Act simply reflects a revised version of the SBA Act proposal.

²² Compare SBA Act, section 4501(a), with Build Back Better Act, section 4501(a).

²³ Compare SBA Act, section 4501(c)(1)(B)(i), with Build Back Better Act, section 4501(c)(1). However, the Build Back Better Act (like the SBA Act) would grant authority to determine that transactions economically similar to redemptions within the meaning of section 317(b) constitute redemptions for purposes of section 4501; thus, a determination could be made that repurchase treatment should be applied to acquisitions by a corporation of the right to acquire its stock under the Build Back Better Act. See Build Back Better Act, section 4501(c)(1)(B).

²⁴ Compare SBA Act, section 4501(b)(2), with Build Back Better Act, section 4501(d)(3)(B).

²⁵ Compare Build Back Better Act, section 4501(c)(2), (d), with SBA Act, section 4501(c)(2).

Build Back Better Act would limit such reduction to the value of the stock issued to employees of the applicable purchasing entity during such year.²⁶ Finally, the SBA Act contains no exception to the application of the tax to covered transactions undertaken by a RIC or a REIT.²⁷

Observations

Incidence. The proposed excise tax would be imposed on the covered corporation (or entity treated as such), not on the shareholder.²⁸ While this situation might be a relief for shareholders who are aware of the proposal, it won't be welcome to redeeming corporations, which presumably would prefer to write checks to their shareholders rather than Treasury. Corporations might choose to reduce the amount or value of stock that they would otherwise repurchase to take into account the incremental 1 percent cost of the excise tax.

The excise tax isn't limited to publicly traded stock. The proposed excise tax would apply to repurchases (or purchases treated as such) of "any stock" of a covered corporation (or entity treated as such).²⁹ Thus, while the excise tax would apply only to transactions involving the stock of corporations whose stock is traded on an established securities market,³⁰ the imposition of the tax wouldn't be confined to repurchases of stock traded on an established securities market (or even to stock of the same class).

Example 1: The common stock of X Inc. is publicly traded on a national stock exchange. X also has a class of 5 percent preferred stock outstanding, which is required to be redeemed in 2023. The X preferred stock was issued in a private placement and isn't publicly traded. X's redemption of its preferred stock at maturity would be subject to the proposed excise tax.

²⁶ Compare SBA Act, section 4501(c)(3), with Build Back Better Act, section 4501(c)(3), (d)(1)(C), (d)(2)(C).

²⁷ Compare SBA Act, section 4501(f), with Build Back Better Act, section 4501(e)(5).

²⁸ If the tax is imposed as a result of the purchase by a specified affiliate of the stock of its parent corporation, the tax would be imposed on the specified affiliate (the entity furnishing the consideration for the repurchase).

²⁹ SBA Act, section 4501(a).

³⁰ SBA Act, section 4501(b), (d)(3).

The grant of regulatory authority in the proposal contemplates regulations that would "address special classes of stock and preferred stock," which indicates that Treasury could issue regulations to exempt X Inc.'s redemption of its preferred stock (for example, by restricting the imposition of the excise tax to stock that is traded on an established securities market or creating an exception for redemptions of preferred stock at maturity). In some industries, corporations frequently issue various classes of preferred stock for reasons that don't implicate the concerns expressed in Sen. Brown's press release — that is, that corporations may engage in stock buybacks to artificially inflate share prices and benefit corporate insiders. It is hoped that if the excise tax proposal advances in the legislative process, some additional guidance could be provided in legislative history that would clarify the congressional intent underlying this grant of regulatory authority.

The excise tax would apply to the net amount of stock repurchased. The excise tax would be based on the amount of stock repurchased in a specific tax year, reduced by the amount of stock issued in the tax year, including stock issued to employees of the covered corporation or a specified affiliate of the covered corporation.³¹ Accordingly, the timing of stock repurchases and stock issuances should be considered.

Example 2: SPAC Inc., a blank check company that is a calendar-year taxpayer, is organized and undergoes an initial public offering of its stock in August 2022. SPAC Inc. identifies Target Corp. as a business that it intends to acquire, and the acquisition closes on December 28, 2022. In connection with the acquisition, several of SPAC Inc.'s shareholders are redeemed immediately after closing. For purposes of calculating the excise tax, the amount of SPAC Inc. stock redeemed is reduced by the amount of SPAC Inc. stock issued earlier in the same year.

Example 3: The facts are the same as in Example 2, except that (1) SPAC Inc.'s acquisition of Target Corp. closes in January 2023, and (2) in connection with the acquisition, a private investor acquires a significant block of stock in SPAC Inc.

³¹ Build Back Better Act, section 4501(c)(3). Compare Build Back Better Act, section 4501(c)(3), (d)(1)(C), (d)(2)(C), with (e)(2).

in a private investment in public equity (PIPE).³² For purposes of calculating the excise tax, the amount of SPAC Inc. stock redeemed is not reduced by the amount of SPAC Inc. stock issued in 2022. However, it is reduced by the amount of SPAC Inc. stock issued in the PIPE (as well as by any stock issued later in the year).

As discussed above, the amount of stock repurchased subject to the excise tax is reduced by the value of the stock issued by a covered corporation (or by the value of the stock issued by a specified affiliate, a covered surrogate foreign corporation, or an applicable foreign corporation to its employees during the tax year), regardless of whether it is in response to the exercise of an option.³³ Also, the tax doesn't apply when the stock repurchased (or an amount of stock equal to the value of the stock repurchased) is contributed to an employer-sponsored retirement plan, ESOP, or similar plan.³⁴ There appears to be no restriction regarding the timing for such a contribution.³⁵

The exception for tax-free reorganizations is inherently ambiguous, although its intent appears reasonably clear. An exception to the excise tax would apply "to the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder."³⁶ To understand how the exception might apply, it is necessary to understand what it is an exception to. Recall that the excise tax would apply to a repurchase, which is defined by reference to the section 317(b) definition of redemption. A redemption is the acquisition by a corporation of its stock for consideration other than its own stock. In general, a stock reorganization³⁷ isn't implemented with such a stock redemption, and the excise tax isn't implicated in such a

transaction.³⁸ However, the tax fictions that apply to an asset reorganization necessarily imply a redemption,³⁹ and thus implicate the proposed excise tax.

Example 4: The common stock of Acquiring Inc. is publicly traded on a national securities exchange. Acquiring Inc. seeks to purchase the business conducted by Target Corp., another publicly traded corporation. After negotiations, the parties agree to a two-step merger transaction, under which (1) Acquiring Inc. will form (and directly own) a transitory merger subsidiary and a domestic limited liability company that will be classified as a disregarded entity⁴⁰ (the LLC), and (2) the transitory merger subsidiary will merge into Target Corp., followed immediately by the merger of Target Corp. into the LLC.⁴¹

In the first merger, the Target Corp. stock is canceled and converted into a right to receive a mix of stock of Acquiring Inc. (40 percent of the acquisition price) and cash (60 percent of the acquisition price).⁴² The mergers, taken together, qualify as a reorganization within the meaning of section 368(a)(1)(A) of Target Corp. into Acquiring Inc.⁴³

After completion of the mergers, the assets and liabilities of Target Corp. have become the

³⁸ In a stock reorganization under either section 368(a)(1)(B) or (a)(2)(E), the transaction is regarded as an exchange of the stock of the target corporation for the stock of another corporation. When a subsidiary corporation is formed for the sole purpose of facilitating the acquisition of the stock of a target corporation via a reverse merger of such subsidiary into the target, the transitory existence of the newly formed subsidiary may be disregarded, and the transaction is treated as an acquisition of the stock of the target corporation. See Rev. Rul. 67-448, 1967-2 C.B. 144; Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 90-95, 1990-2 C.B. 67. See also Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts*, at 1402.1.3 (June 2021).

³⁹ See sections 368(a) and 317(b).

⁴⁰ Reg. section 301.7701-1.

⁴¹ If the integrated transactions qualify as a reorganization, the two mergers are expected to be integrated under the step transaction doctrine and treated as though Target Corp. merged directly into Acquiring Inc. See Rev. Rul. 2001-46, 2001-2 C.B. 321; cf. Rev. Rul. 2008-25, 2008-21 IRB 986 (if the integrated transaction doesn't qualify as a reorganization, and integrating the transaction would provide the acquiring corporation with a cost basis in the target's assets in the absence of a deemed asset acquisition election under section 338, the steps may not be integrated).

⁴² See reg. section 1.368-1(e)(2)(v), Example 1.

⁴³ See reg. section 1.368-2(b)(1)(iii), Example 2. For purposes of the example, we assume satisfaction of all requirements applicable to a reorganization within the meaning of section 368(a)(1)(A), including business purpose, continuity of interest, and continuity of business enterprise.

³² In a PIPE, investors commit to purchasing a specific number of restricted shares from a company at a specified price, and the company agrees to file a resale registration statement so the investors can resell the shares to the public. See SEC, "PIPE Offerings."

³³ Build Back Better Act, section 4501(c)(3).

³⁴ *Id.* at section 4501(e)(2).

³⁵ For example, the exception doesn't indicate that the contribution to such a plan must occur during the same tax year in which the repurchase occurs for the exception to apply. Build Back Better Act, section 4501(e)(2).

³⁶ Build Back Better Act, section 4501(e)(1).

³⁷ See section 368(a)(1)(B) and (a)(2)(E).

assets and liabilities of Acquiring Inc. (through the LLC). Under general tax principles, the two mergers can be integrated and viewed as though Target Corp. transferred its assets, subject to its liabilities, to Acquiring Inc. in exchange for the mix of Acquiring Inc. stock and cash,⁴⁴ followed by Target Corp.'s distribution of the cash and Acquiring Inc. stock to its shareholders in cancellation of their stock in Target Corp.⁴⁵ This latter step is a redemption within the meaning of section 317(b) because Target Corp. is viewed as acquiring its stock in exchange for property (the "property" being both the cash and the Acquiring Inc. stock). If that view would apply for purposes of the proposed excise tax, the full value of the Target Corp. stock would be subject to the excise tax in the absence of an exception for reorganizations.

The exception provides that the excise tax wouldn't apply "to the extent that the repurchase is part of a reorganization . . . and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 [sections 1-1400Z-2] by reason of such reorganization." In Example 4, the repurchase is indeed part of a reorganization. Target Corp. shareholders that realize a gain on the reorganization exchange will recognize their gain, at least to the extent of the cash received. A couple of observations are relevant here. First, the exception ought not to depend on the actual tax consequences to any specific shareholder, but rather should be based on the general tax consequences to the shareholders as a group. If some Target Corp. shareholders have a loss on their Target Corp. stock, and they receive some Acquiring Inc. stock and thus participate in a section 356 exchange, they shouldn't recognize any loss no matter how much boot is paid, because section 356(c) precludes loss recognition.

Target Corp. cannot reasonably be expected to determine the specific tax consequences of each public shareholder, and nothing in Sen. Brown's

⁴⁴ See Rev. Rul. 69-6, 1969-1 C.B. 104, *considered in* GCM 33551 (May 31, 1967); and Rev. Rul. 72-405, 1972-2 C.B. 217. This transfer can be tax free to Target Corp. under section 361(b)(1)(A) and to Acquiring Inc. under section 1032(a).

⁴⁵ This transfer can be tax free to Target Corp. under section 361(c)(1). Target Corp. shareholders would be expected to recognize any gain (but not loss), although not in excess of the amount of cash received, under section 356(a)(1) and (c).

press release indicates that some repurchases of stock would be exempted from the proposed excise tax solely because some of the "wealthiest investors and executives" who own the stock might realize a loss. As a comparison, there is no general exception for the repurchase of stock from a shareholder who realizes a loss, and it seems incongruous that such a categorical exception would apply if the repurchase occurred in the context of a reorganization, but would not if it occurred outside a reorganization.

Second, the "to the extent" clause should be read in relation to the "and no gain or loss is recognized" clause and shouldn't simply modify only the phrase "part of a reorganization." In other words, the "and no gain or loss is recognized" clause isn't an independent requirement, because if it were (and if "no gain or loss is recognized" is read to mean "neither any gain nor any loss is recognized") the exception would be unavailable in every reorganization with boot. After all, it seems reasonable to presume that in every reorganization involving a non-distressed public target corporation in which boot is present, some shareholders will recognize some amount of boot gain on some shares of stock in the target.

It seems unlikely that Congress would intend to subject all the target corporation's stock to the excise tax even if only a small amount of boot is present, especially in the context of a public transaction in which the parties (and the government) aren't necessarily well positioned to determine whether some public shareholders recognize gain. Rather, it seems that the likely intent is that the excise tax would apply to a repurchase that is part of a reorganization, but only to the extent of the amount of boot (and not to the extent of the aggregate shareholder-level gain actually recognized), and not to the extent acquiring stock is given in exchange for the stock of the target corporation. There is a corporate contraction in the transaction, but only to the extent of the amount of boot paid to shareholders.

Also, what about Target Corp. shareholders who choose to exercise dissenter's rights? While redemptions that result from the exercise of dissenter's rights aren't necessarily motivated by the purposes that the proposed excise tax was purportedly designed to counteract (that is,

inflating share value to the benefit of corporate insiders), they appear to be within the ambit of the proposed excise tax. Perhaps regulations will be written to exclude redemptions that are incidental to acquisitive reorganizations.

One can hope that if the provision were to advance in the legislative process, the exception would be modified or clarifying language would be added to the legislative history.

Leveraged buyouts. One context in which the excise tax would appear to apply despite the absence of a formal stock repurchase is when an acquisition is effected with the target's own funds or with leverage that is sourced from, or pushed into, the target corporation.

Example 5: B Corp. seeks to acquire the stock of T Corp., whose stock is publicly traded on an established securities market and is widely held, with a market capitalization of \$1 billion. To facilitate the acquisition, B Corp. forms a transitory merger subsidiary (TMS). To fund the acquisition, B contributes \$400 million to TMS, and causes TMS to borrow \$600 million from unrelated lenders. In the acquisition, TMS merges into T Corp., T Corp. becomes a wholly owned subsidiary of B Corp., T Corp. succeeds to TMS's obligation on the \$600 million of acquisition debt, and T Corp.'s shareholders receive \$1 billion in cash.⁴⁶ Assume that none of the T Corp. shareholders will directly or constructively own any stock in B Corp. after the acquisition.⁴⁷

For federal income tax purposes, the formation of TMS and its merger into T Corp. can be disregarded as transitory if TMS was formed for the sole purpose of enabling B Corp. to acquire T Corp. and TMS doesn't conduct any activities that are unrelated to the acquisition.⁴⁸ Instead, consistent with disregarding TMS, B Corp. can be treated as directly acquiring 40 percent of the stock of T Corp. for \$400 million. Regarding the \$600 million debt-financed portion of the

acquisition price, the debt has become the debt of T Corp. The debt wasn't the debt of B Corp., and we can presume that the lenders were aware of the acquisition structure and understood that T Corp. would step into the shoes of TMS as obligor on the debt. In substance, and as a consequence of disregarding TMS, for federal income tax purposes the transaction is treated as though T Corp. had borrowed \$600 million and used the funds to purchase 60 percent of its stock in a redemption (within the meaning of section 317(b)) to which section 302(a) applies.⁴⁹

In the example, we would expect T Corp. to be subject to the proposed excise tax to the extent of the debt-financed portion of the purchase price that is treated as a redemption, at least if the federal income tax characterization were to apply for purposes of the excise tax. We would anticipate that any regulations to be issued under the provision would make clear whether this sort of leveraged buyout would be subject to the excise tax because the debt-financed portion of the purchase price is viewed as a redemption (or, if not so viewed, because a determination would be made that it is a transaction that is economically similar to a redemption).

Creeping acquisitions. The proposed excise tax could apply to a creeping acquisition of a publicly traded target, depending on how the acquisition is structured.

Example 6: Acme Inc. owns 40 percent of the stock of Target Corp.; the remaining 60 percent of Target Corp.'s stock is publicly traded on an established securities market and is widely held. Acme Inc. wants to take Target Corp. private. In an integrated transaction, Acme Inc. and Target Corp. create a transitory merger subsidiary, which Target Corp. funds in part through a combination of cash on hand and new borrowings and Acme Inc. funds in part through its cash. The transitory merger subsidiary is merged into Target Corp., with the public shareholders getting cashed out

⁴⁶ For simplicity, we assume no acquisition premium.

⁴⁷ See Mark R. Hoffenberg, Stephen M. Marencik, and Adam Murphy, "Determining Control in Public M&A Transactions," *Tax Notes Federal*, Dec. 13, 2021, p. 1487.

⁴⁸ See Rev. Rul. 67-448; Rev. Rul. 73-427; Rev. Rul. 78-250; Rev. Rul. 79-273; and Rev. Rul. 90-95. See also Ginsburg, Levin, and Rocap, *supra* note 38.

⁴⁹ See, e.g., Rev. Rul. 78-250 (transfer of cash to minority shareholders in exchange for target stock in a reverse subsidiary cash merger treated as a distribution in redemption of target stock under section 302); *Custom Chrome Inc. v. Commissioner*, T.C. Memo. 1998-317, *rev'd in part, and aff'd on this point*, 217 F.3d 1117, 1126-1127 (9th Cir. 2000) (leveraged acquisition of target stock in a reverse taxable cash merger treated under the step transaction doctrine as a borrowing directly by the target and its distribution of the proceeds in redemption of its stock).

(and Target Corp. surviving as a wholly owned subsidiary of Acme Inc.).⁵⁰ The proposed excise tax would apply to Target Corp.'s purchase of its own stock, to the extent the transitory merger subsidiary was funded with cash from Target Corp. However, the amount of the redemption could be reduced to the extent the cash contribution from Acme Inc. was first made to Target Corp. in exchange for stock in Target Corp.

Example 7: The facts are the same as in Example 6, except that all the cash in the transaction is sourced from Acme Inc.'s cash on hand and borrowings at the Acme Inc. level (and not from Target Corp.). The freeze-out merger is treated as a purchase by Acme Inc. of the remaining Target Corp. stock. Such a purchase is not a redemption within the meaning of section 317(b), and thus isn't subject to the proposed excise tax.⁵¹

The transaction in Example 7 could be subject to the proposed excise tax if Treasury determines it to be economically similar to a redemption.⁵² However, while the transaction at first blush might seem to be economically similar to the one in Example 6, there is a key difference — the source of the funds. A transaction in which a parent corporation acquires additional stock in a subsidiary from unrelated sellers is quite different from the subsidiary's purchase of stock of its parent corporation — a difference implicitly recognized in section 304(a), which treats the latter (but not the former) as a constructive distribution.

Tracing the source of funds in related or temporally proximate transactions may be important to determine whether a transaction is treated as a repurchase subject to the potential excise tax. For example, what if, in Example 7, after the merger, Target Corp. lent or distributed cash to Acme Inc., which either replenished Acme Inc.'s cash balances or allowed Acme Inc. to repay its lenders? Cash, after all, is fungible. Under

those circumstances, could Target Corp. be regarded as effectively repurchasing its stock?

Conclusion

Today the proposed excise tax is just that — a proposal. Whether it will become law (and if so, when and with what effective date) will be determined through the legislative process, and we don't prognosticate about the likelihood that this proposal will make its way into enacted law or analyze the strengths and weaknesses of competing policy arguments. Our purpose is to share our perception regarding the potential application of the excise tax to various transactions, at least as the proposal is now drafted, with the hope that if the excise tax is enacted, it will be accompanied by whatever technical revisions and legislative history the drafters deem appropriate to make sure that the congressional intent is clear.⁵³ ■

⁵⁰ See Rev. Rul. 78-250 (disregarding a transitory merger subsidiary and treating the target shareholders as receiving the cash in a redemption).

⁵¹ See Rev. Rul. 67-448; Rev. Rul. 73-427.

⁵² See Build Back Better Act, section 4501(c)(1)(B) (definition of repurchase).

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