March 20, 2023

The Honorable Janet L. Yellen
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Initial guidance on the excise tax on repurchase of corporate stock

Dear Secretary Yellen:

The Alliance for Competitive Taxation ("ACT") is a coalition of leading American companies from a wide range of industries that supports a globally competitive corporate tax system that aligns the United States with other advanced economies.

Attached are ACT's comments on the initial guidance regarding the application of the excise tax on repurchases of corporate stock under section 4501 of the Internal Revenue Code (Notice 2023-2).

We appreciate your consideration of these comments. ACT representatives welcome future discussion of these comments with your staff.

Yours sincerely,

Alliance for Competitive Taxation

cc: Lily Batchelder, Assistant Secretary (Tax Policy), U.S. Treasury Department
Tom West, Deputy Assistant Secretary (Tax Policy), U.S. Treasury Department
William M. Paul, Principal Deputy Chief Counsel, Office of Chief Counsel, IRS
Samuel G. Trammell, Office of the Associate Chief Counsel (Corporate), IRS

COMMENTS BY THE ALLIANCE FOR COMPETITIVE TAXATION

I. Introduction

This document sets forth ACT's comments on the initial guidance regarding the application of the excise tax on repurchases of corporate stock under section 4501 of the Internal Revenue Code (Notice 2023-2) (the "**Notice**").

II. Comments Relating to Certain Aspects of the Notice

1. Definition of "Stock" for Purposes of Section 4501

Section 4501

Section 4501(a) provides that a covered corporation[1] is subject to "a tax equal to 1 percent of the fair market value of any stock of the corporation which is repurchased by such corporation during the taxable year" (the "**Excise Tax**"). The Excise Tax applies to repurchases of stock which occur after December 31, 2022. Therefore, the Excise Tax generally applies to stock "repurchases"[2] by publicly traded domestic corporations after December 31, 2022, regardless as to whether the stock repurchased is itself traded on a listed market or exchange.

For purposes of the Code, "stock" includes shares in an association, joint-stock company, or insurance company.[4] Section 4501 does not identify any forms of stock which are excepted from being subject to the Excise Tax. However, section 4501(f)(2) provides that "[t]he 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 [section 4501], including regulations and other guidance . . . to address special classes of stock and preferred stock."

The Notice

The Notice provides that, for purposes of section 4501, the term stock means "any instrument issued by a corporation that is stock or that is treated as stock for [U.S.] federal tax purposes at the time of issuance, regardless of whether the instrument is traded on an established securities market."[5] While the Notice does not prescribe any specific rules regarding the treatment of any special classes of stock or of preferred stock, Example 1 of Section 3.09 of the Notice provides that mandatorily redeemable preferred stock that is stock for U.S. federal tax purposes is stock that could be subject to the Excise Tax. However, in the Notice, Treasury and the IRS requested comments regarding whether there are circumstances under which special rules should be provided for redeemable preferred stock or other special classes of stock or debt.

In general, the Notice determines the Excise Tax for any taxable year to be equal to 1 percent of the excise tax base for the taxable year ("**Excise Tax Base**"),[6] which is the amount equal to: (i) the aggregate fair market value of all repurchases (as determined under Sections 3.04 through

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[1] Under the statute, a "covered corporation" generally includes any publicly traded domestic corporation. *See generally* sections 4501(a) & (b).
[2] Section 4501(c)(1)(A)-(B) generally defines a "repurchase" to include a redemption (within the meaning of section 317(b)) of stock of the covered corporation as well as any transaction Treasury determines to be economically similar to such a redemption.
[4] Section 7701(a)(7).
[5] Section 3.02(25).
[6] *See* Section 3.03(1)(a)-(b) of the Notice.

3.06 of the Notice) of the covered corporation's stock during its taxable year ("**Initial Repurchase Base**"),[7] (ii) less an amount equal to the fair market value of any repurchases during the covered corporation's taxable year to the extent any statutory exceptions in section 4501(e) in accordance with Section 3.07 of the Notice (the "**Statutory Exception Amount**"),[8] (iii) less an amount equal to the aggregate fair market value of covered corporation stock issued or provided by the corporation under the netting rule in section 4501(c)(3) (the "**Netting Rule**") in accordance with Section 3.08 of the Notice (the "**Netting Rule Reduction Amount**").[9]

ACT Recommendation

As discussed further below, ACT recommends that the definition of "stock" for purposes of section 4501 exclude nonparticipating preferred stock (*i.e.,* stock that is limited and preferred as to distributions and liquidation proceeds and does not participate in corporate growth to any significant extent) ("**NP Preferred Stock**"). Alternatively, if ACT's primary recommendation is not accepted, ACT recommends that the definition of "stock" for purposes of section 4501 exclude NP Preferred Stock which was issued and outstanding on or before December 31, 2022 (*i.e.,* the effective date of section 4501).

Reasons for ACT Recommendation

NP Preferred Stock is limited as to dividends, does not participate in corporate growth to any significant extent, and has redemption and liquidation rights that generally do not exceed the issue price of such stock. Thus, issuances and repurchases of NP Preferred Stock are highly analogous to the issuance and repayment of debt.

Indeed, NP Preferred Stock is merely a form of mezzanine financing (*i.e.,* financing which is subordinate to senior creditors and senior to common equity) which commercial markets view as an alternative to subordinated debt. NP Preferred Stock may provide a number of material commercial benefits as a financing mechanism, including: the potential to raise additional capital from a wider investment pool to the extent that conventional senior or subordinated lending is unavailable, the ability to utilize bespoke investment terms which may not be acceptable in a comparable lending transaction, and the ability of investors to acquire a relatively secure investment with a fixed rate of return without the complexity of attaching the issuer's underlying assets as collateral.

Subjecting repurchases of NP Preferred Stock to the Excise Tax thus introduces the potential to materially alter commercial financing transactions and the cost of (and ability to obtain) mezzanine financing in the capital markets. For example, the application of the Excise Tax to NP Preferred Stock is likely to cause those seeking to raise capital through mezzanine financing to prefer the use of subordinated debt rather than NP Preferred Stock. Substituting subordinated debt for preferred stock would increase tax deductible interest expense and insolvency risk.

Further, the above commercial rationales for utilizing NP Preferred Stock in lieu of subordinated debt as a financing mechanism apply equally to companies whose stock is publicly traded and those whose stock is not publicly traded ("**Private Companies**"). Applying the Excise Tax to repurchases of NP Preferred Stock of a publicly traded domestic corporation thus amounts to an

[7] *See* Section 3.03(3)(a)(i) of the Notice.
[8] *See* Section 3.03(3)(a)(ii) of the Notice.
[9] *See* Section 3.03(3)(a)(iii) of the Notice.

asymmetrical, incremental mezzanine financing cost imposed merely due to the issuer's incidental status as a publicly traded company.[10] As well, NP Preferred Stock is a common financing mechanism for private companies and such NP Preferred Stock is commonly repurchased by the issuer with funding received in an IPO transaction. As a result, the application of the Excise Tax should also be expected to cause a material disruption to commercial financing decisions for private companies due to the expectation that such companies may technically be publicly traded when the NP Preferred Stock is retired.

Adopting a rule that excludes NP Preferred Stock from the definition of "stock" for purposes of the Excise Tax appears to be most consistent with the commercial status of NP Preferred Stock as a debt-like instrument that in the financial markets constitutes an alternative to subordinated debt. By granting such an exclusion rule for NP Preferred Stock, Treasury and the IRS can best ensure that the Excise Tax does not create unforeseen and potentially material costs and restrictions associated with the ability to obtain mezzanine financing in the commercial markets.

Further, the Code itself acknowledges the debt-like treatment of NP Preferred Stock, notwithstanding that NP Preferred Stock is generally respected as equity for U.S. federal income tax purposes. For example, stock with the characteristics of NP Preferred Stock is generally (i) treated as nonstock consideration (*i.e.,* boot) when issued in the context of a potential section 351 exchange,[11] and (ii) ignored for purposes of determining consolidation under section 1504.[12] As a result, from an administrability perspective, Treasury and the IRS should be well-positioned to draft an administrable rule that excludes NP Preferred Stock from the definition of "stock" for purposes of the Excise Tax by defining such excluded NP Preferred Stock by reference to stock that meets the conditions set forth in section 351(g)(2) or section 1504(a)(4). Such a rule could be implemented through, for example, a regulatory provision that specifically excludes Section 317(b) Redemptions of NP Preferred Stock from inclusion in the Initial Repurchase Base. We acknowledge that if such a rule is adopted consistency would require issuances of NP Preferred Stock to be excluded from the Netting Rule Reduction Amount.

Alternatively, if a rule that excludes NP Preferred Stock from the definition of "stock" for purposes of the Excise Tax is not adopted generally, we recommend the adoption of a rule which excludes NP Preferred Stock issued on or before December 31, 2022, from the definition of "stock" for purposes of the Excise Tax. This type of limited exclusion rule would not broadly address the issues above. However, such a rule would acknowledge the practical reality that NP Preferred Stock is in many cases mandatorily redeemable pursuant to its terms and that NP Preferred Stock issued prior to the effective date of section 4501 (and outstanding after the effective date) was—in the vast majority of cases—issued in financing transactions where the participants did not have the opportunity to consider the potential application of the Excise Tax in choosing a financing instrument.

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[10] Stock with the characteristics of NP Preferred Stock is also generally ignored as equity in the computation of earnings per share under generally accepted accounting principles. Specifically, under Accounting Standard Codification Topic 260 (ASC 260), which governs the computation of earnings per share, basic earnings per share is calculated by dividing a company's net income by the weighted average of common shares outstanding, and diluted earnings per share accounts for all potential dilution of common shares that could occur from stock-based compensation, warrants, and other instruments convertible into common stock. Therefore, the number of shares of NP Preferred Stock outstanding is disregarded in calculating basic or diluted earnings per share.

[11] *See* section 351(b) and (g).

[12] *See* section 1504(a)(4).

Based on the language of section 4501(f)(2) that the Secretary "shall" prescribe regulations to address special classes of stock and preferred stock with respect to the Excise Tax, there appears to be a Congressional mandate for Treasury and the IRS regarding this matter. This language implies that Congress viewed these classes of preferred stock as different from common stock and delegated its authority to Treasury and the IRS to develop specific rules to address special classes of preferred stock.[14] Adopting a rule that excludes NP Preferred Stock from the definition of "stock" for purposes of the Excise Tax appears to be consistent with this mandate and Congressional intent.

2. Taxable Reverse Triangular Mergers

"Repurchases" in Taxable Stock Acquisitions

For purposes of the Excise Tax, a "repurchase" includes (1) a redemption within the meaning of section 317(b) with regard to the stock of a covered corporation (a "**Section 317(b) Redemption**"), except as provided in Section 3.04(3) of the Notice,[15] and (2) transactions that are economically similar to Section 317(b) Redemptions described in Section 3.04(4) of the Notice ("**Economically Similar Transactions**").[16] The Notice includes only two types of transactions that are considered Section 317(b) Redemptions but not "repurchases" for purposes of the Excise Tax: (1) a transaction to which section 304(a)(1) applies, and (2) the payment by a covered corporation of cash in lieu of fractional shares.

Section 3.09 of the Notice provides an example ("**Example 3**") in which a deemed redemption for U.S. federal income tax purposes resulting from the acquisition by one corporation of the stock of a target corporation, the consideration of which is partially funded by the target corporation, is considered a Section 317(b) Redemption. Because such Section 317(b) Redemption is not specifically excluded from the types of Section 317(b) Redemptions treated as a repurchase for purposes of the Excise Tax, such Section 317(b) Redemption is considered a "repurchase" and, thus, subject to the Excise Tax.

Specifically, in Example 3, Corporation X acquires all of Target's outstanding stock, the aggregate value of which is $100x, by (1) forming a new corporation (Merger Sub) and funding it with $40x, and (2) causing Merger Sub to merge with and into Target, with Target surviving the merger. In the merger, Target's shareholders exchange all their Target stock for $100x of cash, $60x of which is funded by Target and $40x of which is funded by Corporation X (via the contribution to Merger Sub). Because Merger Sub is transitory, its formation is disregarded, and the transaction is treated as though (1) Target redeemed 60 percent of its outstanding stock for $60x, and (2) Corporation X acquired the remaining 40 percent of Target stock for $40x.

The Notice provides that, because Target's deemed redemption of 60 percent of its outstanding stock is a Section 317(b) Redemption, and "Target's redemption is not included in the exclusive list of transactions . . . that are treated as a [Section] 317(b) Redemption but are not a repurchase," such deemed redemption is a repurchase for purposes of the Excise Tax. Example 3 concludes that Target's Excise Tax Base is increased by $60x (*i.e.,* equal to the increase to Target's Initial Repurchase Base).

[14] *See, e.g.*, *International Multifoods v. Comm'r*, 108 T.C. 579 (1997); *Traylor v. Comm'r*, 59 T.C.M. 93 (1990); *Occidental Petroleum Corp. v. Comm'r*, 82 T.C. 819 (1984).
[15] Section 4501(c)(1)(A); Notice 2023-2, Section 3.04(2)(a).
[16] Section 4501(c)(1)(B); Notice 2023-2, Section 3.04(2)(b).

Further, Example 4 of Section 3.09 of the Notice ("**Example 4**") contains the same facts as Example 3, except the merger of Merger Sub with and into Target is partially funded by a $60x loan obtained by Merger Sub prior to the merger and assumed by Target in the merger. The Notice provides that, because Merger Sub is disregarded as transitory, Target is treated as directly borrowing the $60x and using the proceeds of the borrowing to redeem $60x of Target stock from its shareholders prior to the merger. Therefore, the Notice provides that, like in Example 3, the deemed redemption in Example 4 is also a repurchase for purposes of the Excise Tax. Example 4 concludes that Target's Excise Tax Base is increased by $60x (*i.e.,* equal to the increase to Target's Initial Repurchase Base).

ACT Recommendation

As discussed further below, ACT recommends that the list of transactions under Section 3.04(3) of the Notice that are treated as Section 317(b) Redemptions but excluded from the definition of a "repurchase" for purposes of section 4501 be expanded to include deemed redemptions resulting from a taxable reverse triangular merger, the consideration of which is partially funded by the target corporation in the merger or a debt obligation assumed by the target corporation.

Reasons for ACT Recommendation

While the deemed redemptions in Example 3 and Example 4 are technically Section 317(b) Redemptions, such deemed redemptions are incidental to a third-party acquisition of a publicly traded target corporation in which the acquiring corporation is using the target corporation's cash on hand or debt capacity to partially fund such acquisition. The deemed redemption, by itself, is not diluting any shareholder's interest in the target corporation—rather, the acquisition is ultimately eliminating the shareholders' entire interests in the target corporation. Moreover, the transactions depicted in Examples 3 and 4 involve a Section 317(b) Redemption which results in the conversion of a publicly traded corporation into a non-publicly traded corporation.

Importantly, the acquisition funding mechanics depicted in Example 3 and Example 4 are commonly used to facilitate target acquisitions (of both private and publicly traded targets) because they are efficient in achieving the *purchaser's* commercial non-tax objectives of avoiding the need to purchase the target's excess cash in the acquisition and establishing a capital structure at the level of the target which locates acquisition debt with the target assets expected to service such debt. But for the potential application of the Excise Tax, a target corporation (publicly traded or private) and its shareholders will generally be indifferent as to (i) whether the cash received in the sale is provided by the purchaser or the target, and (ii) the target's debt profile after the transaction (at which point the target is owned by the purchaser).

The potential application of the Excise Tax to such deemed redemptions will add unnecessary complexity and expense to the way in which acquisitions of publicly traded domestic corporations are funded and structured. For example, rather than undertaking the steps described in Example 3 or Example 4, respectively, Corporation X could instead gross up the Target acquisition price by the amount of cash on Target's balance sheet (*i.e.*, acquire Target stock for $100x in a direct non-redemptive purchase of Target stock not subject to the Excise Tax). Corporation X would be expected to borrow to the extent that (i) Corporation X did not have sufficient cash on hand to pay the incremental purchase price, and (ii) Corporation X determined that the net cost of borrowing at the level of Corporate X (taking into account both financing costs and the presence of tax deductible interest expense) is expected to be less than the potential amount of the Excise Tax.

Adopting a rule that excepts the Section 317(b) Redemptions depicted in Examples 3 and 4 from repurchase treatment for purposes of the Excise Tax acknowledges that such Section 317(b) Redemptions occur pursuant to transactions in which a publicly traded corporation converts into a non-publicly traded corporation. Such a rule also corrects for what otherwise would be the asymmetrical application of the Excise Tax to publicly traded domestic targets merely due to the incidental fact that they happen to be publicly traded (and domestic corporations) before being acquired by a purchaser. Further, such a rule mitigates the potential for the Excise Tax to inject additional complexity, expense, and non-commercial behavior in third-party transactions.

3. Acquisitive Reorganizations

“Repurchases” in Acquisitive Reorganization Transactions

Section 4501 provides that “repurchases” for purposes of the Excise Tax include transactions that the Secretary identifies as economically similar to a Section 317(b) Redemption (*i.e.,* Economically Similar Transactions). The statute does not provide an affirmative list of Economically Similar Transactions but does indicate that an exchange of target stock pursuant to a section 368 reorganization may be an Economically Similar Transaction by providing that section 4501(a) does not 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 under chapter 1 by reason of such reorganization.”[17]

Section 3.04(4)(a)(i) of the Notice specifically identifies any exchange of target corporation stock by target shareholders pursuant to a reorganization under section 368(a)(1)(A) (including by reason of section 368(a)(2)(D) or section 368(a)(2)(E)), section 368(a)(1)(C), or section 368(a)(1)(D) (if the requirements of section 354(b)(1) are satisfied) (each an “**Acquisitive Reorganization**”) as an Economically Similar Transaction (and thus a repurchase for purposes of the Excise Tax).

Thus, under the Notice, an Acquisitive Reorganization involving a target that is a covered corporation (“**Covered Target Corporation**”) results in an increase to the Covered Target Corporation’s Initial Repurchase Base equal to the aggregate fair market value of all Covered Target Corporation stock surrendered by target shareholders in the transaction (regardless as to whether the Covered Target Corporation stock is surrendered for acquiring corporation stock or non-qualifying consideration).

The Notice then implements the above statutory exception by providing that the Statutory Exception Amount for the Covered Target Corporation includes the fair market value of any stock repurchased by the Covered Target Corporation in an Acquisitive Reorganization to the extent that the repurchase occurs in exchange for property permitted to be received without the recognition of gain or loss under section 354, *i.e.,* shares of the acquiring corporation (or, in a triangular reorganization, the parent corporation) other than those which constitute nonqualified preferred stock within the meaning of section 351(g) (the “**Qualifying Property Exception**”).[18]

As a practical matter, under the Notice formulation a Covered Target Corporation’s Excise Tax Base generally increases by the amount of “boot” consideration received by its shareholders in an

[17] *See* section 4501(e)(1).

[18] *See* Section 3.07(1) and (2)(a) of the Notice. The Notice also generally provides that acquiring corporation stock issued in an Acquisitive Reorganization and to which the Qualifying Property Exception applies is not treated as issued for purposes of determining the Netting Rule Reduction Amount. *See* Section 3.08(4)(d).

Acquisitive Reorganization (regardless as to whether the "boot" is funded by the acquiring corporation or the Covered Target Corporation). Two examples in Section 3.09 of the Notice illustrate this result.

In Section 3.09(6), Example 6 ("**Example 6**"), Target, a covered corporation with stock worth $100x, merges into Corporation X, also a covered corporation, in an Acquisitive Reorganization in which Target's shareholders receive $60x Corporation X common stock and $40x cash in exchange for their Target stock (the "**Target Merger**").[19]

With respect to Target, Example 6 concludes that Target's Excise Tax Base is increased by a net amount of $40x due to the Target Merger, as determined based on the difference between the $100x increase to Target's Initial Repurchase Base (equal to the $100x of Target stock exchanged in the Target Merger) and the $60x Qualifying Property Exception amount (equal to the $60x of Target stock value surrendered in exchange for Corporation X common stock).

With respect to Corporation X, Example 6 determines that the issuance of Corporation X stock is not treated as an issuance in determining Corporation X's Netting Reduction Rule Amount because the issuance of Corporation X stock occurred in a transaction to which the Qualifying Property Exception applies. Thus, Example 6 concludes that Corporation X is not permitted to take the issuance of Corporation X stock in the Target Merger into account as a reduction under the Netting Rule in determining its own Excise Tax Base for the taxable year of issuance.[20]

In Section 3.09(19), Example 19 ("**Example 19**"), Corporation X acquires all of Target's outstanding stock in a transaction which qualifies as a reorganization under sections 368(a)(1)(A) and (a)(2)(E) (the "**Reverse Merger**"). The following transactions occur to effectuate the Reverse Merger: (i) Corporation X contributes $80x Corporation X common stock and $20x cash (the "**Merger Consideration**") to Merger Sub, a newly formed corporation, (ii) Merger Sub merges into Target (whose stock has a fair market value of $100x on the date of the Reverse Merger), with Target surviving. In the Reverse Merger, $80x of Target stock is exchanged for Corporation X common stock and $20x of Target stock is exchanged for $20x cash.

With respect to Target, Example 19 concludes that Target's Excise Tax Base is increased by a net amount of $20x due to the Reverse Merger, as determined based on the difference between the $100x increase to Target's Initial Repurchase Base (equal to the $100x of Target stock exchanged in the Target Merger) and the $80x Qualifying Property Exception amount (equal to the $80x of Target stock value surrendered in exchange for Corporation X common stock).

With respect to Corporation X, Example 19 determines that the issuance of Corporation X stock is not treated as an issuance in determining Corporation X's Netting Reduction Rule Amount because the issuance of Corporation X stock occurred in a transaction to which the Qualifying Property Exception applies. Thus, Example 19 concludes that Corporation X is not permitted to take the issuance of Corporation X stock in the Reverse Merger into account as a reduction under

[19] The statutory exception in section 4501(e)(6) does not apply to the Target Merger in Example 6 because Section 3.09 of the Notice clarifies that none of the Target shareholders are treated as having exchanged their Target stock for cash boot in an exchange which has the effect of a distribution of a dividend under section 356(a)(2).

[20] *See also* Section 3.09(8), Example 8, of the Notice (which reaches the same conclusions as in Example 6 in an Acquisitive Reorganization which occurs by way of a two-step stock acquisition and upstream merger but is characterized in the same manner as the Target Merger in Example 6 for U.S. federal income tax purposes.

the Netting Reduction Rule in determining its own Excise Tax Base for the taxable year of issuance.

ACT Recommendation

As discussed further below, ACT recommends that all exchanges of Covered Target Corporation stock pursuant to an Acquisitive Reorganization be excluded from the list of Economically Similar Transactions under Section 3.04(4)(a) of the Notice that are treated as a "repurchase" for purposes of section 4501.

In addition, ACT recommends that the acquiring (or, in the case of a triangular reorganization, parent) corporation in an Acquisitive Reorganization be permitted to include the aggregate fair market value of qualifying consideration in its Netting Rule Reduction Amount for its taxable year in which the Acquisitive Reorganization occurs.

Reasons for ACT Recommendation

Taxable and non-taxable acquisitions are inherently economically equivalent in that each transaction accomplishes the acquisition of a target business via an asset or stock acquisition regardless as to whether the transaction achieves tax-free treatment to the parties. In addition, in many cases target shareholders may achieve an economically similar result with respect to continuing ownership in the acquiring corporation in a target acquisition which is treated as taxable due to a failure to meet the minimum continuing ownership requirements necessary to qualify the transaction as an Acquisitive Reorganization.

For example, the Reverse Merger in Example 19 would be treated as an acquisition of the stock of Target by Corporation X in a non-Acquisitive Reorganization if Corporation X instead provided $79x shares of Corporation X common stock and $21x of cash to Target's shareholders in the transaction.[21]

If the Reverse Merger in Example 19 were characterized as an acquisition of Target stock by Corporation X outside of an Acquisitive Reorganization, Target would appropriately have no increase to its Excise Tax Base as a result of the Reverse Merger (because Corporation X, rather than Target, provided the cash consideration to Target's shareholders in the transaction) and Corporation X would appropriately be permitted to increase its Netting Reduction Rule Amount by the fair market value of the Corporation X stock issued in the Reverse Merger (because the Corporation X stock was not issued in a transaction that meets the Qualifying Property Exception).

Similarly, if the Target Merger in Example 6 did not qualify as an Acquisitive Reorganization (*e.g.*, due to a failure to meet the Treas. Reg. § 1.368-1(e) continuity of shareholder interest requirement in the event Corporation X sufficiently reduced the proportionate share of total consideration that constituted Corporation X stock), the transaction may instead be treated as an acquisition of Target's assets by Corporation X in exchange for Corporation X common stock and cash followed

[21] *See, e.g.,* Treas. Reg. § 1.368-2(j)(6), Examples 4 and 5; Rev. Rul. 2001-46, Situation 1, 2001-42 I.R.B. 321, 2001-2 C.B. 321 (September 25, 2001). Such stock acquisition may be treated as an exchange under section 1001, section 351, or section 304(a)(1) depending on the particular facts.

by a distribution of such assets received by Target to its shareholder in a taxable section 331 liquidation.[22]

Under this alternative U.S. federal income tax characterization of the Target Merger steps in Example 6, Corporation X would appropriately be permitted to increase its Netting Reduction Rule Amount by the fair market value of the Corporation X stock issued in the Reverse Merger (because the Corporation X stock was not issued in a transaction which meets the Qualifying Property Exception) and Target's liquidating distribution to its shareholders would be directly excluded from treatment as an Economically Similar Transaction (and thus, as a "repurchase" under the Excise Tax) under the rules described in the Notice.[23]

ACT recommends the adoption of rules which apply the Excise Tax provisions to an Acquisitive Reorganization based upon the substantive U.S. federal income tax characterization of the steps of the transaction rather than upon the overall U.S. federal income tax characterization of the transaction as a section 368 reorganization to mitigate the potential for a more onerous result under section 4501 simply because the components of a transaction qualify for reorganization treatment.

Accordingly, ACT recommends the adoption of rules that would, for purposes of the Excise Tax, treat an Acquisitive Reorganization that occurs under sections 368(a)(1)(A) and (a)(2)(E) in the same manner as a direct acquisition of covered corporation stock outside of an Acquisitive Reorganization. Such operative rules would ensure that:

(i) the Covered Target Corporation does not increase its Excise Tax Base by any amount as a result of the receipt of consideration from the acquiring corporation in such Acquisitive Reorganization, and

(ii) the acquiring corporation, if also a covered corporation, is permitted to increase its Netting Reduction Rule Amount by the fair market value of the acquiring corporation stock issued to the Covered Target Corporation's shareholders.

With respect to part (i) of the above recommendation, ACT recommends that such rules also exclude from the Covered Target Corporation's Excise Tax Base any consideration provided directly by the Covered Target Corporation to its shareholders in a Section 317(b) Redemption pursuant to the Acquisitive Reorganization for the same reasons discussed in section II.2 of this letter.

Additionally, ACT recommends the adoption of rules that would, for purposes of the Excise Tax, treat an Acquisitive Reorganization that occurs other than under sections 368(a)(1)(A) and (a)(2)(E) in the same manner as a non-Acquisitive Reorganization transaction in which an acquiring corporation acquires the assets of a covered target corporation in exchange for consideration and the covered target corporation then distributes its assets to its shareholders in complete liquidation. Such operative rules would ensure that:

(i) the Covered Target Corporation does not increase its Excise Tax Base by any amount as a result of the distribution to its shareholders in complete liquidation (except to the

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[22] If the variation of the Target Merger described in Section 3.09(8), Example 8, of the Notice failed to qualify as an Acquisitive Reorganization, Corporation X would likely be treated as acquiring the stock of Target in an exchange under section 1001, section 351, or section 304 depending on the particular facts. *See, e.g.,* Rev. Rul. 2008-25, 2008-21 I.R.B. 986, 2008-1 C.B. 986 (May 8, 2008).
[23] *See* Section 3.04(4)(b)(i)(A) of the Notice.

extent such distribution would otherwise be described in Section 3.04(vi) of the Notice, *i.e.,* as a liquidation described in both sections 331 and 332, if viewed as a single transaction), and

(ii) the acquiring corporation (or the parent corporation in a forward triangular Acquisitive Reorganization), if also a covered corporation, is permitted to increase its Netting Reduction Rule Amount by the fair market value of its stock issued to the Covered Target Corporation's shareholders.

4. Issuances of stock to specified affiliates

Section 4501

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

The Notice

Section 3.08(1) of the Notice reiterates that a covered corporation's Excise Tax Base is reduced by the aggregate fair market value of stock of the covered corporation (i) issued or provided to employees of the covered corporation or employees of a specified affiliate during the covered corporation's taxable year, and (ii) issued by the covered corporation to persons other than such employees during the covered corporation's taxable year (*i.e.*, the Netting Rule). The Notice imposes a limit on the Netting Rule by providing that "[s]tock issued by a covered corporation to a specified affiliate of the covered corporation is not treated as issued."[24]

The function of the Netting Rule is to reduce a covered corporation's Excise Tax liability for a taxable year to the extent that repurchased shares are replaced by other issued shares of the covered corporation. The rule that disregards issuances by a covered corporation to a specified affiliate suggests the drafters' view that a covered corporation should not get credit in computing its Excise Tax Base for shares issued to a related party. However, as currently drafted, the rule does not appear to permit the covered corporation to ever take that issuance into account, even if the specified affiliate subsequently transfers the shares to another party that is not the covered corporation or a specified affiliate of the covered corporation.

ACT Recommendation

ACT recommends that the rule in Section 3.08(4)(c) disregarding issuances to a specified affiliate for purposes of the Netting Rule be modified to permit the issuance to be treated as an issuance if and when such shares are subsequently transferred to a party that is not the covered corporation or another specified affiliate of the covered corporation.

Reasons for ACT Recommendation

The recommended modification is consistent with the general principle of the Netting Rule that a covered corporation's Excise Tax Base is reduced if repurchased shares are replaced by other

[24] Section 3.08(4)(c).

issued shares. The rule disregarding shares issued by a covered corporation to a specified affiliate of the covered corporation is overly broad because it appears to prevent those shares from being taken into account under the Netting Rule permanently. In that regard, the initial issuance is disregarded and any subsequent transfer of the shares to a party other than the covered corporation or another specified affiliate is not technically an issuance. Accordingly, there appears to be no language under which the issued shares can be accounted for under the Netting Rule calculation. This result is not appropriate given that the issuance and subsequent transfer of the shares have the same overall effect as if the covered corporation issued shares to the ultimate transferee, which would be treated as an issuance under the Netting Rule.

The language in section 4501 and the Notice that treats shares "provided to . . . employees of a specified affiliate" as issuances for purposes of the Netting Rule could be interpreted to include shares issued by the covered corporation to the specified affiliate and then transferred by the specified affiliate to its employees. The Notice defines "employee" narrowly: "The term employee means an employee as defined in § 3401(c) and § 31.3401(c)-1 of the Collection of Income Tax at Source Regulations (26 CFR part 31), or a former employee, of the covered corporation or specified affiliate, as applicable."[25] As a result, this language would not apply to many other common situations in which, for example, the specified affiliate uses stock issued to it by the covered corporation to compensate independent contractors, board members, or other services providers, to pay vendors, to donate to charities, or for any other purposes.

The current language might also not capture common transactions to which Treas. Reg. § 1.1032-3 applies. That regulation applies where, among other things, (i) an entity (the "**acquiring entity**") directly or indirectly acquires stock of an issuing corporation (the "**issuing corporation**") in a transaction in which the acquiring entity would otherwise take a carryover basis in the issuing corporation stock under section 362 or section 723, and (ii) the acquiring entity immediately transfers the stock of the issuing corporation in a taxable transaction to acquire cash or other property (including services) from a person other than an entity from which the stock was directly or indirectly acquired. If applicable, the transaction is generally treated as if, "immediately before the acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships)."[26] Such transactions specifically require a corporation to issue shares to a specified affiliate and for the specified affiliate to transfer them to another party.

It is common for a specified affiliate to use the stock of its publicly traded parent corporation as consideration for goods or services or other purposes. Section 4501 and the Notice acknowledge this by emphasizing that shares of a covered corporation issued or provided to employees of a specified affiliate can be treated as issues under the Netting Rule. However, the language in the Notice excluding issuances of covered corporation stock to specified affiliates under the Netting Rule is too broad and would in many cases exclude issuances to specified affiliates, even where those shares are ultimately transferred to a party other than the covered corporation or another specified affiliate. Treating such subsequent transfers as issuances for purposes of the Netting Rule—whether they occur immediately after the issuance or at some later date—is consistent with the language and principles of section 4501 and the Notice and is necessary to prevent

[25] Section 3.02(11).
[26] Treas. Reg. § 1.1032-3(b)(1).

inconsistent treatment with covered corporations that directly issue shares to the ultimate parties, rather than issuing shares first to the specified affiliate.

III. Conclusion

We understand that various details would need to be addressed if Treasury and the IRS accept the recommendations set forth above. ACT member companies have identified a number of these detailed drafting issues and have carefully considered how they might be addressed. ACT representatives would welcome the opportunity to meet with Treasury and the IRS to discuss any of the above recommendations