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In this article, Mazawey and Ferguson examine proposed regulations on the stock buyback tax, focusing on how the new rules would affect stock-based compensation plans and the funding of tax-qualified plans.

A key element of the Biden administration's 2022 corporate tax changes is the 1 percent excise tax on certain corporate stock repurchases or "buybacks" exceeding $1 million in the tax year. The new tax, under section 4501, is imposed on the fair market value of any stock repurchased by a covered corporation during the tax year, effective for repurchases after December 31, 2022. In December 2022 the IRS released the initial guidance under Notice 2023-2, 2023-3 IRB 374, which taxpayers could rely on in computing their excise tax liability until proposed regulations were issued.

On April 12 Treasury and the IRS released detailed proposed regulations[1] providing guidance on numerous substantive and procedural issues concerning the tax. Taxpayers can generally rely on the proposed rules until final regulations are published. Comments and requests for a public hearing are due by June 11 for the general excise tax regulations (REG-115710-22) and were due by May 13 for the procedure and administration regulations (REG-118499-23).

We highlight below the portions of the proposed regulations affecting employee benefit programs.

Brief Background

The new tax applies to "covered corporations" — generally defined under section 4501(b) as domestic corporations or publicly traded partnerships that trade on U.S. public markets or an international established securities market. The tax is nondeductible.

Colloquially referred to as a buyback, a repurchase under section 4501(c) generally occurs when a corporation acquires its own stock from a shareholder and, in exchange, the corporation gives the shareholder money, securities, or other property. Under this definition, corporate redemptions under section 317(b) would generally be considered buybacks subject to the new tax, along with any transaction economically similar to a such a redemption.

Section 4501(c)(3) allows corporations to net, or reduce, the amount of the repurchase amount subject to the new tax by the amount of the FMV of certain stock issued by the corporation during that tax year (the netting rule). Under the statute, for purposes of the netting rule, the phrase "stock issued" includes the FMV of any stock issued or provided by the covered corporation or its specified affiliate to certain persons during the tax year (as further explained below), including stock issued or provided in connection with the exercise of a stock option.

Congress also created an exception to the buyback tax under section 4501(e) for repurchased stock that is contributed to fund certain employee benefit plans — "an employer-sponsored retirement plan, employee stock ownership plan, or similar plan" (the stock contribution

[1] REG-115710-22 and REG-118499-23.

exception). Thus, even if a covered corporation's buyback involves a repurchase as defined under section 4501(c), the tax does not apply to stock (or an amount equal to the FMV of that stock) that is contributed to certain employee benefit plans.

The proposed regulations generally provide that the stock repurchase excise tax base is calculated as follows:

1. Determine the FMV of all the covered corporation's stock repurchases (buybacks) during the tax year; *then*
2. subtract the amount equal to the FMV of the covered corporation's buybacks that qualify for the statutory exceptions listed in section 4501(e); *then*
3. further subtract the aggregate FMV of the stock counted for purposes of the netting rule in section 4501(c).

For purposes of calculating the new tax, the proposed regulations provide that the $1 million de minimis exception applies after step 1.

The proposed regulations build on the statute (and Notice 2023-1), providing the following guidance on the above provisions. We first discuss the netting rule under section 4501(c), followed by the stock contribution exception under section 4501(e)(2).

Netting Rule

Under the netting rule, the base amount subject to the excise tax is adjusted (or netted) for the FMV of stock issued or provided to employees of a covered corporation or its specified affiliate. For this purpose, stock is generally deemed to be issued or provided (as applicable), thus reducing the amount subject to the buyback tax based on the FMV of the stock at the time ownership of the stock transfers to the recipient for federal income tax purposes.

The proposed regulations define "issued or provided" for purposes of the netting rule as follows: The term "issued" refers to the covered corporation's direct *issuance* of its stock to its employees or other non-employee service providers, while the term "provided" refers to the covered corporation's transfer of its stock to a specified affiliate to be *provided to* the specified affiliate's employees — that is, specified affiliates cannot "issue" covered corporation stock. Notably, the netting rule applies to transfers to a specified affiliate only if the covered corporation stock is provided to a specified affiliate's employee.

In general, the time when stock is treated as issued or provided is when the employee or service provider is treated as the beneficial owner, typically when the stock is substantially vested under the rules of section 83, including through a section 83(b) election. The preamble to the proposed regulations clarifies that the IRS and Treasury do not view stock transferred to a rabbi trust as "issued or provided" for purposes of the netting rule unless and until ownership of the stock transfers to that person for tax purposes.

Key points covered by the proposed regulations include the following:

- The netting adjustment generally applies when stock is "issued or provided in connection with the performance of services." This includes qualified stock options[2] and nonqualified stock options.[3] Qualified options under section 421 are defined to include both incentive stock options[4] and options under qualified employee stock purchase plans.[5] However, stock issued to company directors is not covered.
- Stock withheld by a payer to cover income tax withholding or to satisfy the exercise price of shares is not counted in the adjustment. However, stock subject to a "sell to cover" qualifies as an issuance or provision of stock for purposes of the netting rule.
- In the case of stock appreciation rights, the stock counts for netting rule purposes when the right is exercised and the stock is issued to that person.
- As mentioned above, several new rules minimize the gamesmanship and potential pitfalls in their application. For example, there are rules to avoid double-counting stock that is both issued by the covered corporation and provided by the specified

[2] Section 421.

[3] Section 83.

[4] Section 422.

[5] Section 423.

affiliate; rules to avoid applying both the stock contribution rule and the netting rule; and rules to prevent the netting rule from swallowing up the requirement in section 4501(c)(2) that a specified affiliate's purchase of a nonrelated shareholder's covered corporation stock be treated as a repurchase subject to the new buyback tax.

The proposed regulations provide generally that the value of the stock is the "market price of the stock on the date the stock is issued or provided." Prop. reg. section 58.4501-4(e) provides four acceptable methods for determining the FMV of repurchased stock traded on an established securities market, and it explains that privately held corporations should value the stock as of the date the stock is issued by looking to the principles in reg. section 1.409A-1(b)(5)(iv)(B)(1) for nonqualified deferred compensation.

The proposed regulations also address whether and when a forfeiture or clawback of stock is treated as a repurchase subject to the buyback tax (or instead as a capital contribution under section 118, not subject to the buyback tax). The proposed regulations put the covered corporation in the position it would have been in if the netting rule had never applied. If, under the netting rule, there is a reduction in the buyback tax owed at the time the stock is issued or provided, and that stock is later forfeited or clawed back, the stock is generally treated as a repurchase subject to the buyback tax. For example, if stock is counted under the netting rule through a section 83(b) election, a later forfeiture (because the employee didn't satisfy the vesting condition) should be treated as a repurchase.

Note that stock received under a clawback agreement — which contractually requires an employee to return vested stock to the issuer — is viewed as economically similar to forfeited restricted stock. If the stock was counted under the netting rule (reducing the buyback tax), the FMV of the clawed back stock is treated as repurchased (and subject to the buyback tax). Under the proposed regulations, the date of the forfeiture or clawback is treated as the date of repurchase for purposes of the buyback tax.

Stock Contribution Exception

The proposed regulations clarify the stock contribution exception, which reduces the buyback tax for repurchased stock that is contributed to an "employer sponsored retirement plan, employee stock ownership plan, or similar plan" as follows:

- The term "employer-sponsored retirement plan" means "a retirement plan that is qualified under section 401(a)," including an employee stock ownership plan described in section 4975(e)(7) "that is maintained by a covered corporation or a specified affiliate of the covered corporation." The inclusion of plans maintained by specified affiliates is an expansion of the definition used in Notice 2023-2.
- The proposed regulations add a special provision for leveraged ESOPs, which are section 401(a) qualified defined contribution plans designed to invest in certain employer securities (including through an ESOP loan) and meet other code requirements.
- The preamble clarifies that the stock contribution exception does not include executive compensation arrangements — highlighting that the definition used in the proposed regulations is generally limited to qualified plans.
- The proposed regulations add to the definition of "similar plans" certain broad-based foreign plans funded through a secular trust or a similar arrangement. The IRS and Treasury request comments on the specific types of foreign-based plans that should be included in the definition.

The proposed regulations also explain when stock contributed is considered "on account of" the tax year for purposes of the stock contribution exception. Under Notice 2023-2, the stock contribution exception applied to contributions made to an employer-sponsored retirement plan in the prior tax year if the stock was contributed by the filing deadline for Form 720, "Quarterly Federal Excise Tax Return," which is due the first full quarter after the close of the taxpayer's tax year and "on account of" the tax year as defined by section 404(a)(6) (the timing rule for when qualified plan contributions are deemed made for deduction purposes). Under the proposed regulations, however, stock contributions are not required to be treated as on account of the preceding tax year as defined under section 404(a)(6). For example, a covered corporation may claim a deduction for the stock in the tax year of contribution to the employer-sponsored retirement plan (under the regular deduction timing rules for qualified plans) but claim an offset of the same stock contribution to a plan for purposes of the buyback tax in the prior tax year (under the stock contribution exception to the new buyback tax).

For a stock contribution made to a plan after the close of the tax year to count for purposes of the stock contribution exception during the prior tax year:

- the stock must be contributed to the plan by the filing deadline of the Form 720 in which the stock repurchase tax must be reported; and
- the plan must treat the stock in the same manner that the plan would have treated a contribution received on the last day of the prior tax year.

When the Buyback Tax Is Reported and Paid

The procedure and administration proposed regulations address the reporting and payment of the new tax. Under those regulations, covered corporations must report the stock repurchase excise tax on Form 720 and attach Form 7208, "Excise Tax on Repurchase of Corporate Stock." According to the preamble, the IRS intends to publish a new Form 7208 with draft instructions to calculate the amount of the stock repurchase excise tax.

The proposed regulations extend the deadline to file and pay the excise tax — the tax need not be reported or paid until after the final regulations are published in the *Federal Register*. For tax years ending before publication of the final regulations, no tax is required to be paid or reported until the Form 720 is due for the first full calendar quarter after the publication of the final regulations.

The proposed regulations include the following examples to illustrate the effective date of the payment and reporting requirements: If the final regulations are published in September 2024 (the third calendar quarter), for a calendar-year covered corporation subject to the new tax in tax year 2023, the Form 720 would be due by January 31, 2025 (the due date for a fourth quarter Form 720), and the Form 720 for 2024 would be due by April 30, 2025 (the date the form is usually due). The proposed regulations also include a streamlined reporting requirement for the first year the Form 720 is due for covered corporations that have more than one tax year ending during the transition period — that is, the period after the effective date of the buyback tax (December 31, 2022) but before the final regulations are published. In that case, a covered corporation should file one Form 720 and attach separate Forms 7208, one for each year. If the final regulations are published this year, the streamlined reporting approach applies to fiscal-year taxpayers (not calendar-year taxpayers).

Next Steps

Taxpayers have some breathing room on paying the tax and filing their returns. However, they would be well advised to make calculations of the excise tax payable for net purchases in 2023 — and to maintain the necessary records for 2024 — to avoid a crunch when final regulations are published. Indeed, while Treasury and the IRS may act quickly to finalize the rules once the comment period closes this June, it seems doubtful that final rules will be published before the end of 2024.

A key element of compliance with the buyback tax is maintenance of the necessary records to apply the various rules, such as the netting calculation. We suspect that a team of tax, finance, and accounting personnel will be needed to develop the necessary systems.

We note also that, depending on the upcoming elections, the buyback tax rate may be increased. The latest Biden administration budget proposal would increase the tax from 1 percent to 4 percent of net buyback amount. ■