

Initial Guidance for New U.S. Excise Tax on Stock Repurchase Transactions: IRS Substantially Expands Scope of Applicable Canadian Companies

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In our blog post dated August 22, 2022, we discussed the one percent (1%) excise tax on certain stock repurchase transactions by certain publicly traded corporations enacted as part of the Inflation Reduction Act of 2022 (the “Excise Tax”). The Excise Tax became effective on January 1, 2023.

The Internal Revenue Services (the “IRS”) issued initial guidance describing future Treasury Regulations expected to be promulgated regarding the Excise Tax that, when finalized, are expected to be effective retroactive to the beginning of 2023. That initial guidance is contained in Notice 2023-2. (the “Notice”).

Among other changes and clarifications, the Notice substantially expands the scope of Canadian corporations that may be subject to the Excise Tax. Prior to the publication of the Notice, it was anticipated that only Canadian corporations subject to the “anti-inversion” rules of Code Section 7874 or that effected stock repurchase transactions directly through “specified affiliates” (defined for these purposes as includes any U.S. corporation or partnership which is more than 50 percent owned, directly or indirectly, by the Canadian parent corporation and certain non-U.S. partnerships that have a U.S. entity as a direct or indirect partner) would be subject to the Excise Tax on such repurchase transactions.

Pursuant to the Notice, if a specified affiliate funds, or is treated as funding, by any means (including through distributions, debt, or capital contributions) a share repurchase transaction of a Canadian corporation by the Canadian corporation or certain other specified affiliates, and if the “funding” is undertaken for a principal purpose of avoiding the Excise Tax, the “funding” specified affiliate will be subject to the Excise Tax with respect to the share repurchase transaction as if it had completed the repurchase transaction directly.

For these purposes, the fair market value of stock treated as acquired by the “funding”

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specified affiliate is limited to the amount funded by the “funding” specified affiliate. And, for these purposes, a specified affiliate will be deemed to have a principal purpose of avoiding the Excise Tax if such specified affiliate funds by any means (other than a distribution) a share repurchase transaction within two years of such funding.

The following is an example that illustrates this new “funding” rule. X is a publicly-traded Canadian corporation with one wholly-owned U.S. subsidiary corporation, Y. X is not subject to the anti-inversion rules of Code Section 7874. X redeems directly \$20 million worth of its issued and outstanding stock. Within the two years prior to such repurchase: (i) Y paid X \$10 million as repayment of principal with respect to certain intercompany debt obligations owed to X; and (ii) Y also paid X a dividend in the amount of \$5 million. Y didn’t otherwise pay or distribute any other amounts to X in the two years preceding the share repurchase transaction. Pursuant to the funding rule, Y would be deemed to have had a principal purpose of avoiding the Excise Tax in connection with such share repurchase transaction completed by X insofar as the \$10 million paid to X. Y would also be treated as funding an additional \$5 million of the share repurchase transaction by X if it were determined that the \$5 million dividend was paid with a principal purpose of avoiding the Excise Tax. Assuming that the \$5 million dividend was not paid with a principal purpose of avoiding the Excise Tax, Y would be subject to an excise tax of \$100,000 (1% of \$10 million - the amount of X’s share repurchase transaction deemed to be funded by Y under the “funding” rule) as a result of X’s share repurchase transaction.

Many Canadian companies with U.S. subsidiaries or affiliates may be inadvertently subjecting their U.S. subsidiaries or affiliates to the Excise Tax in connection with share repurchase transactions. The scope of transactions deemed to constitute a share repurchase transaction for purposes of the Excise Tax is considerably broad (including, without limitation, certain acquisitions of Canadian corporations, recapitalizations or other exchanges by shareholders of a Canadian corporation for new, different or a different number of shares of such Canadian corporation, changes to a Canadian corporation’s province of incorporation, split-offs and certain other distributions effected by Canadian corporations, and certain liquidations of Canadian corporations).

The U.S. Treasury Department is accepting comments in response to the Notice until March 20, 2023. It is expected that Treasury Regulations will be proposed sometime thereafter. Subject to the promulgation of Treasury Regulations, Canadian corporations with U.S. subsidiaries or affiliates or otherwise subject to the anti-inversion rules of Code Section 7874 that directly or indirectly repurchase stock or otherwise engage in various corporate transactions (including, without limitation, those listed above) should seek advice to avoid or limit the potential application of the Excise Tax.