2023 Issue No. 03
8 February 2023

Tax Alert – Canada

US stock buyback excise tax – Potential implications for Canadian public companies

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 27 December 2022, the US Internal Revenue Service (IRS) released Notice 2023-2 (the Notice), which provides interim guidance on the application of the new 1% excise tax on repurchases of certain corporate stock under Internal Revenue Code[1] (IRC) Section 4501. The Notice also announces that the Treasury Department and the IRS intend to issue proposed regulations on the application of the new rules.

The US excise tax applies to stock repurchases made after 31 December 2022.

Background

While IRC Section 4501 generally applies to stock repurchases by publicly traded US corporations, the rule also extends to repurchases of foreign corporation stock by an "applicable specified affiliate"– i.e., a domestic US subsidiary of a publicly traded foreign corporation. While that aspect of the statutory rule is conceptually reasonable in certain circumstances, the Notice introduces a very broad "funding" rule that could deem a US affiliate of a public Canadian corporation to be subject to the 1% excise tax if the affiliate "funds by any means (including through distributions, debt or capital contributions) the acquisition or repurchase" of the Canadian corporation's stock. While the Notice also includes a "principal purpose" test as a condition to the application of the rule in this context, that aspect is deemed satisfied if the funding requirement is met and the funded Canadian entity acquires or repurchases stock within two years of the funding. The Notice provides that the funding rule applies to a funding that occurs on or after 27 December 2022.

[1] All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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Potential implications for Canadian public companies

The Notice could have important implications for Canadian public companies with US affiliates. Many Canadian public companies have active share repurchase programs (including through normal course issuer bids), and those repurchases could be subject to the 1% US excise tax to the extent they are funded by their US affiliates. Furthermore, in 2024, Canadian public corporations may have the same stock repurchase also be subject to the proposed 2% Canadian corporate tax on share buybacks.[2]

As the US regulations will be effective for stock repurchases made after 31 December 2022, Canadian public companies with share buyback programs should take steps now to limit their exposure to the 1% US excise tax. Although the precise application and scope of the "funding" requirement will not be known until the proposed US regulations are released, consideration should be given to potential options to avoid using any US affiliate funding (including employing well-known Canadian planning techniques, such as cash-damming).

See our *US Tax Alert* for a detailed discussion of the interim guidance provided to date with respect to the US stock buyback excise tax.

Learn more

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[2] For more information, see EY Tax Alert 2022 Issue No. 42: *Federal Fall Economic Statement 2022*.

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