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IRS and Treasury Provide Guidance on the Excise Tax on Repurchases of Corporate Stock under Section 4501

Tax Talks on **February 1, 2023**

On December 27, 2022, the Internal Revenue Service ("IRS") and the U.S. Department of the Treasury (the "Treasury") released Notice 2023-2 (the "Notice"), which provides guidance regarding the application of the 1% excise tax on corporate stock buybacks under recently enacted section 4501 (the "Tax").[1] Taxpayers may rely on the Notice until proposed regulations are published. The Notice also contains a request for comments on the rules included in the Notice and rules not included in the Notice.

The Treasury and the IRS took a literal interpretation of the statute; thus, the Tax applies broadly to stock repurchases and other transactions that are not traditionally viewed as stock buybacks, including a repurchase of mandatorily redeemable preferred stock (even if such stock was issued before January 1, 2023). Special purpose acquisition companies ("SPACs") will need to analyze whether a transaction is subject to the Tax under the general rules as the Notice does not include any special guidance for SPACs. However, SPACs did receive comfort that redemptions that take place in the same year as a "complete liquidation" under section 331 are not subject to the Tax.

Scope

Section 4501 was enacted as part of the Inflation Reduction Act of 2022 (the "IRA") in August 2022. Generally, section 4501 imposes a nondeductible 1% excise tax on stock repurchases by publicly traded corporations and certain "surrogate foreign corporations". [2] The Tax applies to repurchases of stock after December 31, 2022. Generally, repurchases that are (i) dividends for federal income tax purposes, (ii) part of tax-free reorganizations (under Section 368(a)) and no gain or loss is recognized by the shareholder, (iii) made to contribute stock to an employee pension plan or ESOP, (iv) made by a dealer in securities in the ordinary course of business, or (v) made by a RIC or a REIT are not subject to the Tax. A corporation with total stock repurchases of less than $1 million in a year is not subject to the Tax (the "De Minimis Exception"). For further background, please see our prior blog post President Biden Signs Inflation Reduction Act into Law.

For purposes of the De Minimis Exception, the $1 million is calculated using the fair market value of the repurchase and whether the De Minimis Exception applies is calculated before applying (1) any statutory exception (as further discussed below) and (2) any adjustments under the netting rule (as explained below).

The Notice clarified that redemptions of preferred stock, including participating preferred stock, are subject to the Tax if the redeemed instrument is stock for federal income tax purposes and the transaction is a section 317(b) redemption. A 317(b) redemption is a transaction in which a corporation acquires its stock from a shareholder (and is not a dividend for federal income tax purposes).

The Notice has important implications for M&A activity. It draws unintuitive distinctions between transactions (admittedly based on the literal interpretation of the statute), some of which distinctions may necessitate structuring discussions. On the one hand, where an acquisition of a covered corporation features a mix of stock and cash consideration but qualifies as a "reorganization" (because among other things the stock consideration exceeds certain thresholds), the cash component is subject to the Tax – regardless of the sourcing of the cash. On the other hand, for acquisitions of covered corporations that do not qualify as reorganizations (so-called "fully taxable acquisitions"), the source of the cash determines the extent of the Tax. Fully taxable acquisitions funded by the covered corporation's cash, or a leveraged buyout of a covered corporation financed with the covered corporation's debt (including debt of a merger subsidiary that is assumed by a covered corporation in a taxable reverse subsidiary merger), are subject to the Tax to the extent of the cash sourced to the covered corporation. However, to the extent the fully taxable acquisition is financed with acquirer cash or debt, the Tax generally does not apply. It remains to be seen whether the IRS attempts to extend the Tax to cash borrowed by an acquirer in certain situations – e.g., where the acquirer is a shell and the target guarantees the debt. Take private transactions with leverage typically involve direct borrowing by the target or merger subsidiary, but the potential tax savings may warrant discussions with lenders as to this alternative form of borrowing.[3]

Calculation and Reporting

The Notice provides that a corporation that is subject to the Tax calculates the liability amount by multiplying 1% times the "stock repurchase excise tax base." The "stock repurchase excise tax base" is the aggregate fair market value of all the corporation's repurchases of its stock for the taxable year minus the statutory exceptions (as discussed below) minus the fair market value of the stock issued by the corporation (or provided to employees of the covered corporation or a specified affiliate) during the taxable year, as calculated under the netting rule (explained below).

Generally, fair market value of repurchased stock is the market price on the date the stock is repurchased. The Notice allows a corporation to determine market price of stock that is traded on an established securities market on the date of repurchase using the (i) daily volume-weighted average price, (ii) closing price, (iii) average of the high and low prices, or (iv) trading price at time of repurchase. If the date of repurchase is not a trading day, the corporation must use the immediately preceding trading day. Also, the corporation must use the same method for calculating fair market value for all stock repurchased and stock issued during the taxable year. For stock not traded on an established securities market, market price is determined based on the section 409A regulations, which generally permit the use of a reasonable valuation method, subject to certain rules and presumptions.

For these purposes, stock is treated as repurchased at the time at which the ownership of the stock transfers to the corporation for U.S. federal income tax purposes or, in the case of certain reorganizations, at the time when the corporation's (or surrogate foreign corporation's) shareholders exchange their stock. The Notice contains special timing rules for stock issued to employees which, for example, treat restricted stock as to which a section 83(b) has been made as issued on the date of the transfer (instead of the vesting date).

The Notice states that the Tax is anticipated to be reported on IRS Form 720, with an attachment. While IRS Form 720 is generally required to be filed quarterly, it is expected that the Tax will be reported only once per tax year on the IRS Form 720 that is due for the first full quarter after the close of the corporation's tax year. Additionally, it is expected that the due date for payment of the Tax will be the same as the filing deadline. This means that, for a calendar year corporation, the first due date for IRS Form 720 and payment of the tax would be April 30, 2024.

Statutory Exceptions

Under the Notice, stock repurchased in connection with acquisitive reorganizations[4], E reorganizations[5], F reorganizations[6], and split-offs are not subject to the Tax to the extent that the repurchase is for property permitted to be received tax-free under section 354 or 355 (the "Qualifying Property Exception"). The Qualifying Property Exception has the effect of basically leaving only the amount of any boot transferred or distributed in an acquisitive reorganizations, E reorganizations, F reorganizations, and split-offs as potentially subject to the Tax. Additionally, repurchased stock (or stock in an amount equal to the repurchase) that is contributed to an employer-sponsored retirement plan, repurchases by a dealer in the ordinary course of business, repurchases by a RIC or REIT and repurchases treated as a dividend under section 301(c)(1) or section 356(a)(3), are not subject to the Tax. Moreover, the Notice creates a rebuttable presumption that a repurchase is not to be treated as a dividend. A corporation can rebut this presumption by (i) reporting that the repurchase constitutes a dividend, (ii) obtaining a certification from the shareholder that the repurchase constitutes a distribution under section 301 or as having the effect of a distribution of a dividend under section 356(a)(2), (iii) having no knowledge of facts that would indicate that the certification is incorrect, and (iv) demonstrating that it has sufficient earnings and profits to treat the section 301 distribution or section 356 receipt of property as a dividend.

Netting Rule

The Notice's netting rule allows a corporation to reduce its stock repurchase excise tax base by the aggregate fair market value of stock issued during the taxable year and stock provided to employees of the covered corporation or a specified affiliate during the taxable year. In other words, a corporation that redeemed and issued and provided to employees equal amounts of stock would not be subject to the Tax. Generally, the same rules as described above regarding the determination of fair market value and timing in connection with a repurchase apply for purposes of the netting rule.

Certain issuances of stock are disregarded for purposes of the netting rule: (1) stock splits; (2) issuances of stock to a specified affiliate[7]; (3) issuances of stock under a section 368 reorganization or a section 355 distribution that qualifies for the Qualifying Property Exception; (4) deemed issuances of stock in section 304(a)(1) transactions (generally a transaction where brother and sister corporation are under common control and the brother corporation acquires the stock of the sister corporation); (5) deemed issuances of fractional shares where cash is paid in lieu of fractional shares; (6) stock issued by a dealer in securities used to satisfy obligations to customers, in the ordinary course of business; and (7) target corporation stock issued by the target corporation to the merged corporation in a transaction qualifying under section 368(a)(2)(E) (i.e., a reverse subsidiary merger).

Economically Similar Transactions

A repurchase also includes certain transactions that are economically similar to a section 317(b) redemption, and thus subject to the Tax. The *exclusive* list of economically similar transactions contained in the Notice are the following: (1) acquisitive reorganizations; (2) E reorganizations; (3) F reorganizations; (4) split-offs; and (5) complete liquidations to which both section 331 and section 332 apply.

Additionally, the Notice contains a *non-exclusive* list of transactions that are *not* economically similar (and thus not subject to the Tax): (1) complete liquidations to which section 331 or section 332 apply, (2) redemptions of shares that occur in the same taxable year as a complete liquidation to which Section 331 applies, and (3) divisive transactions under section 355 other than split-offs.

Acquisitions of Applicable Foreign Corporation Stock

A transaction where a domestic specified affiliate (i.e., domestic subsidiary) of a publicly traded foreign corporation acquires stock of the publicly traded foreign corporation from an unrelated third party is subject to the Tax. Furthermore, a domestic specified affiliate is also treated as acquiring stock of the publicly traded foreign corporation if the domestic specified affiliate funds the acquisition or repurchase of stock of the publicly traded foreign corporation by any means (including through a distribution, debt or capital contributions), and the funding is undertaken for a principal purpose of avoiding the Tax. A principal purpose to avoid the Tax is deemed to exist if the acquisition or repurchase occurs within two years after the funding (other than a funding through distributions). The fair market value of the stock treated as acquired is limited to the funded amount. The Notice also applies similar rules to repurchases or acquisitions of stock of a "covered surrogate foreign corporation" (i.e., foreign corporations that are subject to the anti-inversion provisions of section 7874).

SPACs

The Notice does not contain rules specific to SPACs, but a number of its determinations on corporate transactions are highly relevant to SPACs. Two of the more relevant elements are as follows. First, under the Notice, a complete liquidation of a corporation under section 331 is not subject to the Tax.[8] This should apply to insulate redemptions upon the final liquidation of the SPAC and should also apply to insulate distributions by the SPAC during the taxable year of its liquidation (further discussion below). Second, the netting rules give SPACs better visibility as to the implications of redemptions in connection with de-SPAC transactions. Redemptions of SPAC stock (including redemptions of preferred stock) as part of a de-SPAC transaction or extension request would be treated as repurchases subject to the Tax, although the redemptions would be subject to offset under the "netting" rule for stock issued by the SPAC (including issuance under a PIPE) in the same taxable year.

There are some open questions as to the application of the Tax to SPACs. Some practitioners have questioned whether the section 331 liquidation exception would apply if some classes of stock do not receive distributions (for example, founders' shares). Furthermore, it is unclear if redemptions effected before a non-US SPAC domesticates to the United States in advance of a de-SPAC transaction are subject to the Tax.

Additionally, if a SPAC completely liquidates during a tax year in which other redemptions occur, it is not free from doubt that the liquidation rule will exempt the SPAC from the Tax in respect of the earlier redemptions. The Notice's literal language does not require that the distribution be made in connection with the liquidation, it solely requires that the distribution and the liquidation occur in the same taxable year. Therefore, it is a reasonable interpretation that the Tax does not apply to redemptions in the taxable year of liquidation that arise from an extension request prior to the liquidation or where a SPAC redeems its stock in anticipation of the closing of a de-SPAC transaction, the transaction fails and the SPAC instead liquidates in the same taxable year.

Finally, the netting rule will not benefit a SPAC that is not the acquirer in its de-SPAC transaction, nor will it reduce the SPAC's liability in the uncommon case where it acquires a U.S. public company. The first issue surfaces because the Notice does not provide a rule that credits stock issuances by a successor entity against redemptions by a predecessor. This would impact "double dummy"[9] and Up-C de-SPACs[10], where the SPAC itself does not issue shares.

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[1] All references to section are to the Internal Revenue Code.

[2] A surrogate foreign corporation is a foreign corporation (i) that has acquired substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership; (ii) the acquisition of at least 60% of the stock (by vote or value) of the entity is held, (a) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, (b) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership or (c) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership; and (iii) after the acquisition the "expanded affiliated group" which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.

[3] Also, cash paid in a "Section 351 transaction with boot" (whose end result may closely resemble a reorganization) is ordinarily not subject to the Tax, unless the transaction also meets the relevant reorganization requirements.

[4] This includes mergers under section 368(a)(1)(A), both a forward or reverse subsidiary merger under section 368(a)(2)(D) or section 368(a)(2)(E), respectively, and asset reorganizations under section 368(a)(1)(C) and (D).

[5] An E reorganization is a "recapitalization," which is typically a transaction between a corporation and some or all of its shareholders or creditors. Generally, as a part of the transaction, the corporation exchanges some of its outstanding securities (stock or debt) for other securities.

[6] An F reorganization is a mere change in identity, form, or place of organization.

[7] The term "specified affiliate" is defined in the IRA as (i) any corporation in which the taxpayer-corporation directly or indirectly owns more than 50% of the stock by vote or value; and (ii) any partnership in which the taxpayer-corporation directly or indirectly holds more than 50% of the capital or profits interests.

[8] A different rule would apply to a liquidation of a corporation that has an 80% or greater corporate shareholder as well as other minority investors, but SPACs are unlikely to have this ownership structure.

[9] In a double dummy transaction, a newly formed publicly traded holding company acquires both a SPAC and a target. Specifically, the holding company forms two merging subsidiaries, one of which merges into the SPAC and the other merges into the operating target company and the new holding company issues stock to the SPAC shareholders (including PIPE investors, which generally include private equity funds, hedge funds and other private financial investors that acquire minority stakes in a publicly listed SPAC to help finance the target acquisition) and target shareholders. Under the Notice, the issuances from the new holding company to the PIPE investors will not reduce the SPAC's stock repurchase excise tax base.

[10] In an Up-C de-SPAC, the target shareholders hold their interests in a flow-through entity below the publicly traded holding company (formerly the SPAC), and, thus, the value of those interests would not be counted in the netting rule.

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