Surprises and Questions Around the New Stock Buyback Tax

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One of the headline tax changes in the Inflation Reduction Act of 2022, Public Law 117-169, is a 1% excise tax on stock repurchases by public companies. Public issuers should be aware that the new tax, which applies beginning January 1, 2023, extends broadly to situations beyond run-of-the-mill share repurchases, and the provision for netting new issuances against repurchases can operate in unexpected ways. Companies should analyze the potential application of this tax to any transaction involving the purchase, exchange, or transfer of their stock. Our tax specialists are available to evaluate and to advise on mitigation strategies.

We cover the following topics below:

- What companies are subject to excise tax under new Section 4501 of the Internal Revenue Code of 1986, as amended (the “Code”).
- The technical provisions defining taxable repurchases and providing for netting of new issuances.
- Available exceptions from the tax.
- Transactions other than buy-backs that may be subject to the tax, including
    - Some traditional M&A transactions,
    - Many corporate split-offs,
    - Preferred stock retirements and redemptions in initial business combinations for SPACs.
- Complications in applying Section 4501’s netting provision.

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Technical Scope of the Excise Tax

Code Section 4501, applies a non-deductible 1% excise tax to the fair market value of net stock repurchases by certain publicly traded corporations that take place after December 31, 2022.

Corporations Subject to the Tax

The excise tax applies to U.S. corporations whose stock is traded on an established securities market ("covered corporations").[1] Repurchases of stock of a covered corporation by a "specified affiliate" of such covered corporation are treated as repurchases by the covered corporation itself, with the resulting tax imposed on the covered corporation. A "specified affiliate" is a corporation or partnership that is majority owned, directly or indirectly, by the covered corporation.[2]

The excise tax may also apply to the repurchase of stock of a non-U.S. corporation whose stock is traded on an established securities market, if the stock is repurchased by a specified affiliate that is organized in the U.S. (or a specified affiliate that is a foreign partnership that has one or more direct or indirect U.S. partners). In such cases, the excise tax is imposed on the specified affiliate as if it were a U.S. corporation that repurchased its own stock.

Finally, the excise tax applies to repurchases of stock by—or by specified affiliates of—a non-U.S. corporation that was the acquirer in a so-called "inversion transaction"[3] occurring after September 20, 2021, if the corporation's stock is traded on an established securities market and if the repurchase occurs during the 10-year period for which Section 7874 of the Code applies with respect to the inversion. In such cases, the excise tax is imposed on the U.S. target of the inversion transaction[4] as if it had repurchased its own stock.

Taxable Repurchases and Netting

Section 4501(c)(1) broadly defines "repurchase" to include any acquisition of a covered corporation's stock by such corporation or a specified affiliate for money, securities or any other property (other than stock of the covered corporation) and any transaction determined by the Secretary of the Treasury to be economically similar to such a transaction. The Treasury

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[1] "Established securities market" is defined by reference to Section 7704(b)(1) of the Code, and includes national securities exchanges such as the Nasdaq Stock Market, certain foreign securities exchanges, and regional or local exchanges. Although the statute is not explicit on the point, it would appear that a publicly traded partnership that is taxed as a corporation under the Code will be treated as a corporation for purposes of the excise tax.

[2] The relevant thresholds for majority ownership are ownership of more than 50% of the stock of a corporate specified affiliate or more than 50% of the capital interests or profits interests of a partnership specified affiliate.

[3] I.e., an entity that is a "surrogate foreign corporation" under Section 7874(a)(2)(B) of the Code.

[4] I.e., the entity that is the "expatriated entity" under Section 7874(a)(2) of the Code.

Department and the Internal Revenue Service will need to issue guidance as to the types of transactions that will be treated as “economically similar” to repurchases.

In determining the amount of repurchases subject to the excise tax, a covered corporation is allowed to reduce the fair market value of its repurchases by the fair market value of any stock that the covered corporation issued during the same tax year. The amount of this reduction includes the fair market value of stock issued to employees of the covered corporation or of a specified affiliate during the tax year, including stock issued on the exercise of compensatory stock options.

However, the netting provision is strictly limited in the case of repurchases involving a non-U.S. public company: because the tax in that case is imposed on the specified affiliate involved in the repurchase (or in the case of an inversion transaction, on the inverted U.S. subsidiary), the only issuances taken into account are those to employees of the specified affiliate (or of the inverted U.S. subsidiary).

Repurchases Not Subject to the Excise Tax

Section 4501(e) provides a number of exceptions to the application of the excise tax. The tax will not apply

- to the extent the stock repurchase is part of a “reorganization,” as defined in Section 368(a) of the Code, in which no gain or loss is recognized by shareholders;
- if the repurchased stock (or stock of equal value) is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan;
- to the extent the repurchase is treated as a dividend under the Code;
- when the total value of the stock repurchased in a tax year is $1,000,000 or less;
- to repurchases by regulated investment companies (mutual funds and most ETFs) or real estate investment trusts;
- to the extent provided in regulations, to repurchases in the ordinary course of business by dealers in securities.

Unanticipated Breadth of the Excise Tax and Outstanding Questions

As noted above the excise tax under Section 4501 is not limited to traditional stock buybacks by public companies. Because the tax applies to any acquisition of stock from a stockholder in exchange for money or other property (other than stock of the covered corporation itself), it would apply by its terms to, among other transactions:

- Certain M&A transactions, particularly those in which the consideration paid to target stockholders is treated for tax purposes as flowing from the target corporation;
- Cash paid for fractional shares or in satisfaction of dissenters' rights in M&A transactions;
- Split-off transactions in which stock of a subsidiary is distributed to some stockholders in exchange for a reduction in their proportionate holdings of parent company stock;
- De-SPAC transactions in which shareholders exercise redemption rights; and
- Redemptions or repayment at maturity of non-publicly traded securities such as preferred stock.

Both the scope of the tax and the application of the netting provisions raise questions that the Treasury Department and the Internal Revenue Service may wish to address in administrative guidance interpreting Section 4501.

The ostensible purpose of the excise tax is to reduce traditional buybacks, in which a public company, either through a tender offer or open market purchases, uses available cash to repurchase some of its outstanding stock, reducing its "float," or shares available for public trading. There are two principal economic criticisms that policy makers have advanced as reasons for discouraging buybacks. First, policy makers and others have argued that buybacks prioritize investor returns over investments in labor and tangible assets. Second, because buybacks typically increase per-share prices even without a concomitant increase in earnings, they have been criticized as a "market manipulation" that can unjustly benefit executives who have received substantial equity compensation.[5] Whatever the merits of those economic criticisms, they are directed specifically at cash buybacks of publicly traded shares, and they do not provide a justification for taxing the other types of corporate transactions that come within the scope of Section 4501's very broad definition of a stock repurchase.

Potential Application to M&A Transactions

For instance, a corporate acquisition in which a purchaser takes a public company private may be structured in one of two ways: (a) in a manner that is treated for tax purposes as a redemption by the public company of its outstanding stock and an issuance of new debt and equity to the purchaser or (b) in a manner that is treated as a purchase of the public company's stock by a new private company owned by the purchaser.

If the purchaser adopts the first type of structure, the cash flowing to the former stockholders of the acquired company (including both holders of publicly-traded shares and any persons holding non-traded, privately placed stock of the company) would be treated as a repurchase potentially subject

[5] Some observers also criticize the income tax rules that may allow stockholders selling shares in a buyback to recover their tax basis in those shares before realizing gains, by contrast to a taxable dividend, which is taxed without any recovery of basis. However, the tax law already has a set of rules under Section 302 of the Code that are designed to decide whether a particular stock repurchase is similar enough to a dividend that it should be taxed as such.

to the excise tax.[6] This type of transaction would not appear to raise concerns similar to those that have been raised about stock buybacks. The acquired company will continue to operate its business and to retain all of the same working capital that it held prior to the transaction; the transaction may even augment the resources available for investment in the business. And there is no potential for stock price manipulation, since the stock of the target company will no longer be publicly traded after the transaction. But, in the absence of administrative guidance to the contrary, such a transaction would be subject to excise tax on the same terms as a buyback. And this is true even though the tax clearly does not apply to the alternative form of the same transaction in which a new private company is treated as buying the stock of the acquired company.

Along similar lines, it is possible for certain forms of public-public M&A transactions to be treated for tax purposes as involving a redemption of stock by the target company, either for cash, for stock of the acquiring company, or for a combination of the two. If such a transaction is structured as a tax-free reorganization and all of the consideration is common stock of the acquiring company, then any repurchase of the target's shares that is deemed to occur is exempt from the excise tax under the exception for Code Section 368 reorganizations. The situation is less clear, however, if any consideration is paid to the target shareholders in the form of cash, non-qualified preferred stock, or other so-called "boot." Does the exception under Section 4501(e)(1) "to the extent that" a repurchase is part of a reorganization and no gain or loss is recognized apply to the portion of the consideration paid in qualifying stock, while the boot is subject to excise tax? Or does the exception not apply at all, because the recognition of any gain or loss in the transaction takes it outside the scope of the exception?

The excise tax treatment of an M&A transaction should not depend (1) on whether the parties adopt a form that the tax law treats as a redemption rather than as a purchase of target stock by the buyer or (2) on whether all or any portion of the transaction qualifies for nonrecognition under Section 368. As with the "going private" purchase, this sort of M&A transaction does not by its nature raise concerns about manipulating the market in the target company's shares or about depleting the assets available to invest in the target company's business, and it does not make sense to treat it as equivalent to a standalone stock buyback.

Even in a Section 368 reorganization that is not otherwise treated as a redemption for tax purposes, there is some question as to whether the payment of boot may be treated as a redemption in the case of a stockholder who receives only boot. If treated as a repurchase by a public target company, the payment of boot to such stockholders would then be subject to the excise tax, even though it does not originate from the target company and is economically equivalent to the payments received from the acquiring company by other stockholders whose payments are not subject to the tax.

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[6] The tax liability may be reduced, under Section 4501's netting rule, by the value of stock treated as issued by the target company to the purchaser, subject to the limitations on that rule that are noted below.

Finally, regardless of the structure adopted for an M&A transaction, two types of cash payments that typically receive little attention may be subject to the excise tax even though they, like the transaction as a whole, do not raise the considerations attendant to stock buybacks. The first is the payment of cash to stockholders of a public acquired company who exercise dissent or appraisal rights under applicable corporate law. The second is the payment—in transactions where some or all of the consideration for an acquisition is paid in the form of stock of a public acquiring company—of cash in lieu of fractional shares that would otherwise need to be issued in order to distribute the consideration to the stockholders of the acquired company on a pro rata basis. Since payments to dissenters are treated for tax purposes as redemptions by the acquired company and cash in lieu of fractional shares is treated for tax purposes as a redemption by the acquiring company, such payments would be subject to the excise tax if, in combination with any other repurchases during the same year, they exceed the $1 million threshold under Section 4501.

Inconsistent Application to Corporate Split-Offs

Public split-off transactions, that is, distributions of stock of a corporate subsidiary in which some shareholders participate (receiving subsidiary stock in exchange for some of their parent company stock) and others do not, are subject to similar arbitrary distinctions under new Section 4501. By their nature, these transactions cannot raise the same concerns as cash stock buybacks, since no cash is leaving the company and the impact on stock price depends on factors relevant to the underlying business and how it is divided between the two resulting companies, not on a reduction in float. They accordingly should not in principle be subject to the excise tax. However, the tax likely will apply to some split-offs in the absence of favorable administrative guidance.

A split-off that is taxable (i.e., treated for income tax purposes as a taxable exchange of subsidiary stock for parent stock) will be subject to tax under the literal terms of Section 4501 except in the very unusual case that it is treated in its entirety as a dividend. A split-off that is tax-free under Section 355 of the Code could qualify for the exception for Section 368 reorganizations if the parent company forms a new subsidiary in connection with the split-off.[7] But a tax-free split-off of an existing subsidiary generally would not qualify for that exception, and there is no separate exception for transactions described in Section 355. And if such a transaction were structured as a pro-rata spinoff of the subsidiary, rather than a split-off, it generally would not be subject to the excise tax. There is no apparent justification for these distinctions in treatment among transactions that are economically similar to one another and economically distinct from the buyback transactions that are the intended object of the excise tax.

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[7] Tax-free spinoffs involving a new subsidiary typically constitute reorganizations described in Code Section 368(a)(1)(D).

Repurchases Pursuant to the Terms of An Instrument — SPAC Initial Combinations and Preferred Stock

Redemptions in de-SPAC transactions and repurchases of preferred stock (either at scheduled retirement or pursuant to integrated redemption rights) raise yet another issue in the application of the excise tax. Although these transactions do resemble traditional repurchases in that cash leaves the issuing company, they differ in that they take place under the terms of the very instruments under which that cash came into the company in the first place. As a result, such redemptions arguably should never be treated as a reduction in corporate capital of the type that the excise tax is meant to discourage, since the redemption provisions were one of the terms on which the capital was originally raised. For this and the reasons discussed below, the Treasury Department and the Internal Revenue Service may wish to limit or clarify the application of the excise tax to such redemptions in administrative guidance under Section 4501.

A "SPAC," or special purpose acquisition company, is a corporation that issues publicly-traded stock to raise capital with which to undertake a corporate acquisition. One of the terms of that stock, in some cases, is that stockholders of the SPAC who do not approve of the acquisition that is ultimately completed (the initial business combination or "de-SPAC" transaction) are entitled to have their capital returned by the SPAC at the time of the acquisition. The right to receive those funds, by electing to have the SPAC redeem the stockholder's Class A shares, is part of the terms on which the SPAC raises capital, and is economically distinct from buybacks that are initiated by a public company itself.

Such redemptions are covered by the definition of repurchase under Section 4501 even though they do not raise the concerns that accompany typical stock buybacks. The redemptions do not affect the SPAC's ability to pay wages or make other business investments because by definition the SPAC does not conduct its own business.[8] And, since the redemptions occur at the option of the stockholders, not based on a decision by SPAC management, they do not raise concerns about stock price manipulation.

Similarly, when a corporation raises funds by issuing preferred stock, the terms of that stock may provide for its retirement according to a set schedule or pursuant to redemption options on the part of the holder or the issuer.[9] Because those terms are a condition of raising capital, it is not appropriate to treat the resulting repurchases as a voluntary reduction in capital by the issuer subject to the Section 4501 excise tax. They are more comparable to payments upon the early

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[8] The redemptions may or may not affect the assets available for pursuit of the target company's business, depending on whether the de-SPAC transaction has been structured to capitalize the target company as well as to acquire it, or only to consummate the acquisition.

[9] Preferred share classes frequently are not publicly traded, but the excise tax under Section 4501 is not limited to publicly traded share classes so long as the issuer has any class of stock that is traded on an established securities market. Similar considerations to those discussed here apply to non-publicly-traded common share classes that may be subject to redemption rights.

retirement or maturity of debt securities, which are clearly outside the scope of Section 4501. In addition, in many cases (and similarly in this respect to redemptions in a de-SPAC transaction), these repurchases do not have a predictable impact on public share prices and—at least in the case of scheduled retirements and redemptions at the option of the holder—are not even under the control of management.

Issues Regarding Application of the Netting Rule

As noted above, Section 4501 contains a netting rule under which issuances of stock by a covered corporation are netted against repurchases by the corporation that take place in the same tax year. The rule is drafted, however, in a way that does not always accomplish its purpose and may lead to unexpected results.

First, under the terms of the statute, netting is not permitted across tax years. As a result, if a company were to issue stock and repurchase stock as part of a single transaction, but the issuance and the repurchase occurred in different tax years (even if separated only by a short period in absolute terms), it appears that netting would not be permitted. Similar considerations apply to a repurchase paired with the issuance of convertible debt, where the conversion of the debt, while anticipated, will typically occur outside of the tax year in which the issuance and repurchase occur. This limitation undermines the apparent purpose of the netting provision and the Treasury Department and the Internal Revenue Service may wish to consider guidance addressing the application of the netting rule to integrated or otherwise related transactions.[10]

Second, even when issuances and redemptions occur in the same tax year, netting under Section 4501(c)(3) is based on the value of stock issued and repurchased, not based on the number of shares. Changes in the stock prices may therefore cause a tax to be incurred in transactions where a share issuance is paired with a repurchase of the same number of shares, such as antidilution buybacks in connection with equity compensation and stock-settled call spread or capped call arrangements in connection with convertible debt, unless all settlements take place at exactly the same price (or at least on the same date).

Third, it is not 100% clear that the issue of new shares under the terms of a convertible debt instrument even qualifies as an issuance eligible for netting under Section 4501(c)(3). Income tax authorities are inconsistent on the question of whether the conversion of debt to stock pursuant to its terms is treated as an exchange of the debt for stock or a continuation of the same security in a new form. As a policy matter, debt conversions ought to qualify for netting, since they have the effect of increasing the issuer's net worth and outstanding share capital, and guidance to that effect would be helpful.

[10] Such guidance might also apply the netting rule to redemptions that occur pursuant to the terms of a stock instrument, such as the scheduled preferred stock retirements and de-SPAC redemptions discussed above.

Finally, the statute is not clear as to the application of the $1 million threshold in situations involving netting. As described above, the statute provides that the excise tax will not apply when "the total value of the stock repurchased during the taxable year does not exceed" $1 million. The netting provision reduces the amount "taken into account" with respect to stock that is repurchased by the value of the covered corporation's stock issuances. Without further guidance, it is not clear how the statute applies if a covered corporation's gross repurchases exceed $1 million, but its net repurchases do not.

Conclusion

Ironically, while some analysts are suggesting that an excise tax at a rate of 1% may not effectively discourage the cash buybacks that were the intended target of the legislation's sponsors, the new tax may well impede or require the restructuring of other types of corporate transactions, even though those transactions seem to be outside its intended scope.

Public companies should carefully consider the potential application of Section 4501 to any transaction involving the purchase, exchange, or transfer of their stock, and should establish procedures to account for issuances and redemptions in a manner that will facilitate year-end compliance. Companies may also wish to consider the timing of planned transactions in light of the statute's January 1, 2023 effective date.

WilmerHale tax specialists are available to help evaluate the application of the excise tax and to advise on how best to avoid or mitigate its impact.

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