

Excise Tax on Corporate Stock Repurchases Under the Inflation Reduction Act

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Background

On August 16, 2022 President Biden signed the Inflation Reduction Act of 2022 (the “IRA”) into law, which contains revenue-generating tax provisions intended to pay for energy, climate and healthcare priorities of Congress. This article focuses on the new excise tax (the “Excise Tax”) included in the IRA under Section 4501.¹ The Excise Tax imposes a non-deductible one percent excise tax on certain repurchases of stock of publicly traded U.S. and certain non-U.S. corporations made after December 31, 2022. The Excise Tax was advertised primarily as applying to buybacks of publicly traded stock, but the statutory language of the Excise Tax indicated that it may have a wider impact. Section 4501 provides that the U.S. Treasury Department has the authority to issue regulations or provide other guidance that may be necessary or appropriate to carry out the purposes of the Excise Tax. The Internal Revenue Service (the “IRS”) published interim guidance (until publication of forthcoming proposed regulations) in IRS Notice 2023-2 on December 27, 2022 addressing the application of the Excise Tax (the “Notice”). The Notice confirms that the Excise Tax affects both conventional buybacks and a significant spectrum of M&A transactions, which this article will describe.

Excise Tax Is an Entity-Level Tax

The Excise Tax is an entity-level excise tax that applies to publicly traded corporations without any market cap threshold. Also, the Excise Tax applies regardless of the profitability of the publicly traded corporations. Section 4501 would apply whether or not the applicable transaction results in a gain (or a loss), although a carveout exception was built into Section 4501 for reorganizations in which no gain or loss was recognized. Finally, no deduction to the corporation is allowed for the payment of the Excise Tax.

A corporation subject to the Excise Tax is defined as a “covered corporation.” A covered corporation is generally a U.S. corporation the stock of which is traded on an established securities market (e.g., the NASDAQ), but as noted below certain entities are deemed to be covered corporations for purposes of the Excise Tax. The Excise Tax is equal to one percent of the fair market value of any stock repurchased by the covered corporation during its taxable year, with a downward adjustment (as further described below) for certain statutory exclusions and for issued stock.

Non-publicly traded corporations and partnerships are generally not within the scope of the Excise Tax. However, a covered corporation that does not actually repurchase its stock nonetheless may be subject to the Excise Tax if such stock is repurchased by a “specified affiliate” of such covered corporation from a person other than the covered corporation or such specified affiliate. A specified affiliate for this purpose is, with respect to any covered corporation, (i) any corporation more than 50 percent (by vote or by value) of the stock of which is owned (directly or indirectly) by such covered corporation, or (ii) any partnership more than 50 percent of the capital or profits interest of which is held (directly or indirectly) by such covered corporation.

The Excise Tax is also imposed on repurchases involving specified affiliates of publicly traded non-U.S. corporations. In that case, the Excise Tax is imposed on specified affiliates that are U.S. corporations, U.S. partnerships or non-U.S.

¹ All references to Sections are to Sections of the Internal Revenue Code, as amended (the “Code”).

partnerships having a direct or indirect partner that is a “domestic entity” that acquire stock of their publicly traded non-U.S. parent corporation from a person other than such publicly traded non-U.S. corporations or the specified affiliate thereof. Such specified affiliates are deemed to be covered corporations for purposes of the Excise Tax. Thus, for example, it appears that a specified affiliate treated as a partnership would be subject to the Excise Tax in an applicable stock acquisition. Moreover, the Notice applies the Excise Tax to an acquisition or repurchase transaction funded by a specified affiliate of a publicly traded non-U.S. corporation by any means with a principal purpose of avoiding the Excise Tax. A principal purpose is deemed to exist when an entity funded by the specified affiliate by any means (other than through distributions) acquires or repurchases stock of a publicly traded non-U.S. corporation within two years of such funding. Finally, the Excise Tax is imposed on any U.S. corporation or U.S. partnership and certain of their related U.S. entities (which are all deemed to be covered corporations for purposes of the Excise Tax) that inverted into a publicly traded non-US corporation after September 20, 2021, but only with respect to any repurchase of stock of such non-U.S. corporation either by such non-U.S. corporation or any of its specified affiliates.

The Excise Tax does not modify the tax treatment of shareholders who transfer their shares to the corporation in connection with the stock repurchase. The general tax treatment of shareholders will continue to be determined under pre-IRA law, taking into account the special tax status (if any) of the repurchased shareholders. Thus, non-U.S. shareholders of publicly traded corporations may continue to prefer a repurchase over a dividend distribution even though they economically bear the Excise Tax indirectly, while exempt shareholders may now prefer dividends to avoid indirectly bearing the Excise Tax.

It should be noted that even though the Excise Tax applies to publicly traded corporations, the Notice makes it clear that the particular class of stock of publicly traded corporations that triggers the Excise Tax on repurchase does not need to be publicly traded.

Meaning of “Repurchase” for Purposes of the Excise Tax

The liability for the Excise Tax is triggered only if stock is “repurchased” — i.e., only if there is a “redemption” or any transaction determined by the U.S. Treasury Department to be “economically similar to” a redemption for U.S. tax purposes.

U.S. tax law treats a redemption as occurring if a corporation acquires its stock from a shareholder in exchange for money and any other property (other than stock in such corporation). Nevertheless, the Notice describes two transactions, even though otherwise redemptions, that are not repurchases for purposes of applying the Excise Tax. Transactions under Section 304(a)(1) that involve acquisition of stock among certain related parties are not subject to the Excise Tax. In addition, the Notice provides that a typical payment by a covered corporation of cash in lieu of a fractional share that is carried out as part of a transaction that qualifies as a reorganization under Section 368(a) or as a distribution to which Section 355 applies, or pursuant to the settlement of an option or similar financial instrument, is not a repurchase for purposes of the Excise Tax.

A key feature of the Notice is that the Notice provides an exclusive list of transactions that are “economically similar” to a redemption for purposes of the Excise Tax, thus limiting the scope of the Excise Tax. These transactions (“Qualifying Transactions”) are as follows:

- **Acquisitive Reorganizations** – the exchange by target covered corporation shareholders of their stock as part of a reorganization under Section 368(a)(1)(A) (including forward and reverse triangular mergers), Section 368(a)(1)(C) or Section 368(a)(1)(D) (if the reorganization satisfies the requirements of Section 354(b)(1)).
- **Recapitalizations** – the exchange by covered corporation shareholders of their covered corporation stock as part of a recapitalization (described in Section 368(a)(1)(E)).
- **F Reorganizations** – the exchange by covered corporation shareholders of their covered corporation stock as part of a Section 368(a)(1)(F) reorganization.
- **Split-offs** – the exchange by the distributing corporation shareholders of their distributing corporation stock for controlled corporation stock and, if applicable, other property (including securities of the controlled corporation) or money governed by Section 355.
- **Partially Tax-Free Complete Liquidations** – taxable distributions to minority shareholders in complete liquidation of the covered corporation, which liquidation is otherwise not subject to tax under Section 332 for the controlling shareholder.

By providing an exclusive list, the Notice thereby excludes some transactions that concerned practitioners, including distributions in complete liquidation of a corporation (aside from a limited situation involving minority shareholders), from

the Excise Tax.

Calculation of the Excise Tax

The Excise Tax liability under the Notice is equal to the “stock repurchase excise tax base” of the covered corporation (calculated as described below) multiplied by one percent.

1. The starting point for the calculation of the stock repurchase excise tax base is the aggregate fair market value of all repurchases of the covered corporation’s stock by the covered corporation during its taxable year.
2. If such repurchases do not exceed \$1 million, then the Excise Tax does not apply. If such repurchases exceed \$1 million, the calculated value of repurchased shares is then reduced by the fair market value of stock of the covered corporation repurchased during its taxable year that fall under any statutory exceptions (described further below).
3. The value of repurchased shares is thereafter further reduced by the aggregate fair market value of stock of the covered corporation issued or provided by the covered corporation during its taxable year (as further described below). If the net value of the repurchased shares is negative (in which case there will be no Excise Tax in the applicable taxable year), such net value cannot be carried forward to future tax years or carried back to prior tax years.

Section 4501 provides six statutory exceptions to the Excise Tax which serve as a reduction of the stock repurchase excise tax base under the Notice:

- **Nontaxable Portion of the Qualifying Transactions** – i.e., fair market value of stock repurchased by a covered corporation in a repurchase that is a Qualifying Transaction but only to the extent the shareholders receive property in a Qualifying Transaction that is permitted by Section 354 and Section 355 to be received without the recognition of gain or loss;
- **Employer-Sponsored Retirement Plans Contributions** – i.e., fair market value of stock repurchased by a covered corporation that is contributed to an employer-sponsored retirement plan, including an employee stock ownership plan, qualified under Section 401(a);
- **De Minimis Repurchases** – total value of stock repurchased by a covered corporation during the taxable year not exceeding \$1 million (which would simply eliminate the Excise Tax under the Notice, as described above);
- **Dealer Repurchases** – ordinary course repurchases made by a dealer in securities to the extent the stock is acquired in the ordinary course of the dealer’s business of dealing in securities;
- **RIC and REIT Repurchases** – repurchases made by a regulated investment company or a real estate investment trust, as each term is defined under the Code; and
- **Dividend-Equivalent Repurchases** – repurchases treated as a dividend for U.S. tax purposes. It should be noted that the Notice imposes a rebuttable presumption of no dividend equivalence with respect to a repurchase. While it is possible to overcome this presumption, it is not clear it will be practical for a publicly traded corporation to satisfy its evidentiary burden necessary to establish that a particular redemption or repurchase has the effect of a dividend under Section 302(d) or Section 356(a)(1), as applicable.

Practitioners were increasingly concerned that Section 4501 on its face established a cliff effect with respect to boot (or property that is not permitted by Section 354 and Section 355 to be received without the recognition of gain or loss), in effect subjecting the whole transaction to the Excise Tax if any boot was given as consideration. By reducing the stock repurchase excise tax base in a repurchase that is a Qualifying Transaction, to the extent the shareholders receive property in a Qualifying Transaction that is permitted by Section 354 and Section 355 to be received without the recognition of gain or loss, the Notice provides a welcome clarification that such a cliff effect does not apply to Qualifying Transactions involving boot.

As noted above, under the Notice the stock repurchase excise tax base is further reduced by the aggregate fair market value of stock of the covered corporation issued or provided by the covered corporation during its taxable year (the “netting rule”). However, in the case of entities treated as covered corporations with respect to publicly traded non-U.S. corporations, such reduction only applies to stock issued or provided as a stock-based compensation for the employees of such covered corporations. Under a favorable rule, taxpayers are permitted to apply the netting rule to reduce the fair market value of the covered corporation’s repurchases during that taxable year by the fair market value of all issuances of its stock during the entirety of that taxable year (thus, 2022 issuances of fiscal year taxpayers may reduce the repurchases subject to the Excise Tax).

Reporting of the Excise Tax and Taxpayer Reliance

The Notice notes that the Treasury Department and the IRS anticipate that the forthcoming proposed regulations will provide that the Excise Tax must be reported on IRS Form 720 and paid once per year with the Form 720 that is due for the first quarter after the close of the taxpayer's applicable taxable year. For example, a calendar-year taxpayer would report and pay its Excise Tax for the full 2023 year on IRS Form 720 for the first quarter of 2024, which is currently due on April 30, 2024.

In addition, the Notice indicates that taxpayers will be entitled to rely on the interim guidance set forth in the Notice until the forthcoming proposed regulations are issued.

Concluding Observations

The apparent policy objective of the Excise Tax appears to have been to discourage increases in the value of shares and options of corporate insiders and wealthy investors by means of buyback payments, through increases in demand for the shares and its metrics like earnings per share, rather than retaining the associated cash inside the corporation to grow its business and benefit its workers. However, the Notice confirms the broad scope of Section 4501, potentially increasing the tax cost of many non-buyback transactions not clearly violating the policy objective of the Excise Tax.

Parties in M&A transactions will need to determine whether the Excise Tax could be triggered, and then consider who should bear the economic burden of the Excise Tax. Parties will also need to determine if the applicable M&A transaction could be restructured to avoid the Excise Tax entirely, since the Notice confirms that form (rather than substance) of the transaction often plays a significant role in whether the Excise Tax applies.

If you have any questions regarding the topics discussed in this article, please contact **Andrew Falevich** at afalevich@vedderprice.com, **Robbie Alipour** at ralipour@vedderprice.com, or any Vedder Price tax specialist for further information regarding the application of the Excise Tax.

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