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Excise Tax on Share Repurchases: A Provision Searching for Its Purpose

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BACKGROUND

On August 16, 2022, President Biden signed into law the Inflation Reduction Act of 2022 (the “Act”),¹ which aims to mitigate climate change, lower health care costs, and reduce the national deficit. The Act’s spending measures are funded by imposing additional taxes on corporations, including a 1% excise tax on certain share repurchases (the “Excise Tax”). The Excise Tax was originally included in President Biden’s “Build Back Better” legislative package as both an entirely new source of revenue and as a means to encourage corporations to reinvest in their business and employees rather than repurchase shares.² Proponents of the Excise Tax also sought to address perceived tax

avoidance at the shareholder level effected by the use of a corporation’s earnings to reacquire its shares rather than make dividend distributions.³ Originally projected to generate \$124 billion over 10 years, in the weeks preceding enactment, the Joint Committee on Taxation revised its prior projection, estimating that the Excise Tax will generate \$74 billion over 10 years.⁴

As further discussed below, the broad statutory language, coupled with its sparse legislative history, could lead to unexpected applications of the Excise Tax outside of its presumed purpose. This article examines the statutory elements of the Excise Tax, explores the breadth of transactions to which it may apply and identifies areas in need of regulatory guidance from the IRS and Treasury. An example is also included to illustrate the tax impact of a special dividend as compared to a share repurchase.

STATUTORY OVERVIEW

Codified at §4501,⁵ the Excise Tax generally imposes a 1% excise tax on the “fair market value” of any stock that is “repurchased” by a “covered corpo-

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¹ Pub. L. No. 117-169.

² Section 4501 had its origin in a Bill sponsored by Senators

Wyden and Brown (S.2758 — 117th Cong. (2021-2022)) (the “Stock Buyback Accountability Act”), a revised version of which was passed by the House of Representatives as part of H.R. 5376 (the “Build Back Better Act”) on November 19, 2021. The provision was not described in any accompanying committee report and its purposes beyond providing revenue must be gleaned from statements made by Senators Wyden and Brown upon introduction of S. 2758.

³ See, e.g., Press Release, *Brown, Wyden Unveil Major New Legislation to Tax Stock Buybacks* (Sept. 10, 2021) (“Stock buybacks are currently heavily favored by the tax code, despite their skewed benefits for the very top and potential for insider game-playing. Our bill simply ends this preferential treatment and encourages mega-corporations to invest in their workers.”).

⁴ See Report of Joint Committee on Taxation, JCX-18-22 (Aug. 9, 2022); Report of Joint Committee on Taxation, JCX-45-21 (Nov. 4, 2021).

⁵ All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

ration” after December 31, 2022.⁶ Uncovering the meaning of these terms (as well as the intended objectives) is essential to understand the scope of the Excise Tax. As such, the following discussion explores the express statutory language to discern (i) the taxpayers upon whom the Excise Tax is imposed, (ii) the base upon which the Excise Tax is applied, and (iii) the transactions subject (or potentially subject) to the Excise Tax.

Covered Corporation

The Excise Tax applies to a taxpayer that is a “covered corporation,” which is defined as “any domestic corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)).”⁷ Section 7704(b)(1) does not define an established securities market, however the regulations under that section provide that such term includes:

- (1) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);
- (2) A national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) because of the limited volume of transactions;
- (3) A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in paragraph (b)(1) or (2) of this section (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange);
- (4) A regional or local exchange; and
- (5) An interdealer quotation system that regularly disseminates firm buy or sell quotations by iden-

tified brokers or dealers by electronic means or otherwise.⁸

Of particular note, although a covered corporation is defined by reference to whether its stock is traded on an established securities market, the statute does not distinguish between a covered corporation’s repurchase of its publicly or nonpublicly traded stock in determining whether the Excise Tax applies. Thus, in the absence of regulations to the contrary, it would appear the Excise Tax applies even where a covered corporation repurchases privately held stock after December 31, 2022. We note, however, the statute grants broad regulatory authority to the IRS and the Treasury to prescribe regulations and other guidance as “necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of this section,” including regulations and other guidance to address special classes of stock and preferred stock.⁹

Fair Market Value

Pursuant to §4501(a), the base to which the Excise Tax applies is the fair market value of the stock repurchased. However, §4501(c)(3) further provides:

*The amount taken into account under [§4501(a)] with respect to any stock repurchased by a covered corporation shall be reduced by the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation during the taxable year, whether or not such stock is issued or provided in response to the exercise of an option to purchase such stock.*¹⁰

The most logical reading of this provision is to limit the base on which the Excise Tax is imposed to an amount by which the fair market value of repurchased shares exceeds the fair market value of issued shares in a particular taxable year (the “Netting Rule”).¹¹

The Act does not define fair market value for purposes of determining the base on which the Excise

⁶ Note that the effective date provision does not exempt any repurchase by a covered corporation that occurs after December 31, 2022, regardless of whether such repurchase occurs pursuant to a plan or issuance that was in existence prior to enactment of the Act. *See* the Act, §10201(d).

⁷ §4501(b). In general, the Excise Tax does not apply to foreign corporations even if the stock of such foreign corporation is traded on a domestic exchange. This rule is subject to an exception in the case of an acquisition by certain specified affiliates of the foreign corporation and certain foreign corporations that become a surrogate foreign corporation as defined in §7874(a)(2)(B) after September 20, 2021. In addition, the Excise Tax does not apply to RICs or REITs. *See* §4501(e)(5).

⁸ Reg. §1.7704-1(b).

⁹ §4501(f). Such provision also suggests regulations or other guidance may be necessary to prevent abuse of the Statutory Exceptions and to apply the rules with respect to foreign corporations set forth in §4501(d). *Id.*

¹⁰ §4501(c)(3) (emphasis added).

¹¹ An alternative reading of §4501(c)(3) would reduce the Excise Tax by the fair market value of issued shares; however, such a taxpayer-friendly interpretation of the statute would be inconsistent with the definition of “repurchase,” which, as further discussed below, contemplates a net reduction of issued shares or an economically similar result.

Tax is imposed or the Netting Rule. Presumably, any repurchases on the open market by a covered corporation or through its agent would be determined based on the price paid for the stock (including any associated fees). In applying the Netting Rule, the fair market value of stock issued to the public could be either the offering price paid by the purchaser of the stock in a public offering or the net proceeds received by the covered corporation, the difference being the costs of issuance (which can be significant). In other cases, the fair market value of shares of a covered corporation may not be as readily determinable – e.g., where the stock is repurchased via a derivative transaction with an underwriter or agent. With respect to the Netting Rule, query how fair market value should be measured when shares are issued as a result of the exercise of an investment warrant or conversion of a debt instrument – should the stock be considered issued at the time the warrant or debt instrument was issued or upon exercise or conversion? We presume the latter (consistent with the statute’s treatment of compensatory issuances). In that case, should the fair market value of the issued stock for purposes of the Netting Rule be limited to the aggregate amount of proceeds received by the covered corporation upon exercise of the warrant or the adjusted issue price upon conversion of the debt instrument? Further, the timing of the issuance is relevant for purposes of the Netting Rule.

Repurchase

The Excise Tax is triggered upon a repurchase, which generally is defined as (i) a redemption within the meaning of §317(b) and (ii) any transaction determined by the IRS to be economically similar to such a redemption (an “Economically Similar Transaction”).¹² This definition is deceptively straightforward – not only does the statute expand the scope of a “repurchase” to include certain acquisitions of a covered corporation’s stock by a specified affiliate,¹³ there are several “Statutory Exceptions” that exclude certain

¹² §4501(c)(1).

¹³ §4501(c)(2)(A). Specifically, a repurchase includes the acquisition of a covered corporation’s stock by a specified affiliate from a person other than such covered corporation or a specified affiliate of such covered corporation. For this purpose, a “specified affiliate” means any corporation which is more than 50% owned (by vote or value and directly or indirectly) by a covered corporation and any partnership which is more than 50% owned (by capital or profits interests and directly or indirectly) by a covered corporation. §4501(c)(2)(B). A number of questions arise with respect to the specified affiliate rule. In particular, does it matter when the relationship is created? For example, assume that an acquiring corporation wants to reduce its outstanding shares without incurring the Excise Tax. If a target corporation borrows money to buy shares of the acquiring corporation on the open market, and then such shares are reacquired by the acquiring corporation by virtue

repurchases from the scope of the Excise Tax, as well as transactions that create an actual or hypothetical redemption potentially treated as a repurchase for purposes of the Excise Tax.

Redemptions and Economically Similar Transactions

Section 317(b) provides that “stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.”¹⁴ Given a repurchase is defined by reference to a redemption, it appears the Excise Tax is intended to charge a toll on nondividend distributions that reduce the covered corporation’s equity from a balance sheet perspective. That is, one might expect an Economically Similar Transaction to include transactions where a covered corporation does not actually or hypothetically reacquire its shares if the economic result of the transaction is the extraction of corporate equity and such extraction is not taxable as a dividend.

Assuming the Economically Similar Transaction provision is not self-executing, and absent additional guidance, it appears the Excise Tax applies by statute only where a covered corporation actually (or, pursuant to existing authority, hypothetically) reacquires its stock and such acquisition is not covered by one of the Statutory Exceptions. A discussion of transactions potentially within the scope of the Excise Tax due to an actual or hypothetical redemption component follows below.

Bootstrap Zenz Acquisition

A reacquisition of stock by a covered corporation via a *Zenz*-type redemption,¹⁵ even though in the context of the acquisition of such covered corporation,

of its acquisition of the target, does the Excise Tax apply? What are the consequences if an entity held old and cold shares in the covered corporation at the time it is determined to be a specified affiliate?

¹⁴ Property is defined as “money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).” §317(a).

¹⁵ A sale of a portion of the target corporation in connection with a redemption of the seller’s remaining shares, pursuant to a single integrated transaction should, if properly structured, qualify as a sale or exchange transaction (i.e., pursuant to §1001 on the sale and pursuant to §302(b)(3) on the redemption). *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). On the other hand, a pre-sale dividend by a target corporation in which the shareholder does not surrender shares generally will be respected as a dividend, while a distribution from the target corporation to the buyer following the acquisition, either in the form of a regular distribu-

would seem to be subject to the Excise Tax. That is, redemption treatment should follow regardless of whether the acquiring party is or is not a covered corporation. The structure of any debt incurred to finance the acquisition of a covered corporation should be carefully considered to avoid the potential application of the Excise Tax to such a transaction.¹⁶

Acquisitive Reorganizations

An acquisitive reorganization¹⁷ in which stock or assets of a corporation are acquired raises a number of issues as to the potential application of the Excise Tax. As an initial matter, the Excise Tax requires a repurchase (i.e., a redemption) by a covered corporation. The type of reorganization may affect whether there is a repurchase. Absent a *Zenz*-type transaction in connection with a stock-type reorganization, there is no actual redemption.¹⁸ However, in an asset-type reorganization, the target corporation transfers its assets to the acquiring corporation in exchange for the transaction consideration, which consideration is distributed to the target's shareholders in exchange for their target stock.¹⁹ That is, an actual redemption occurs in an asset-type reorganization.²⁰

In an acquisitive reorganization where nonqualified property (boot) is received by the target shareholders,²¹ a hypothetical redemption is created to determine the character of the gain recognized by the

tion or a redemption (where there is not the requisite reduction in interest to qualify as an exchange under §302(b)), will invariably be treated as a dividend to the extent of the target corporation's current and accumulated earnings and profits. See *Durkin's Est. v. Commissioner*, 99 T.C. 561 (1992) (taxpayer was bound by the form of the transaction as a dividend).

¹⁶ In particular, is the covered corporation the true obligor by virtue of the terms of the financing, e.g., the debt is secured by a guarantee or pledge of the target's assets? See *Plantation Patterns v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972).

¹⁷ A reorganization is defined in §368(a)(1). In general, an acquisitive reorganization would take the form of an asset acquisition or a stock acquisition either directly or by merger. In order to constitute a reorganization, some or all of the consideration must be stock of the acquiring corporation.

¹⁸ See *McDonald v. Commissioner*, 52 T.C. 82 (1969) (*Zenz* analysis applied to treat a redemption of preferred stock in connection with a reorganization pursuant to §368(a)(1)(B) as entitled to sale or exchange treatment). But see Rev. Rul. 75-360 (explaining IRS position with respect to *McDonald* that, as an integrated transaction, it did not qualify as a "B" reorganization due to the receipt of nonstock consideration).

¹⁹ §361(c). In an "A" reorganization, such transfers are deemed to occur by operation of law. See, e.g., Rev. Rul. 69-6 (deemed transfer of assets from target to acquiring followed by a liquidating redemption of target shareholders in the context of a forward cash merger).

²⁰ See text accompanying Note 25, below.

²¹ Nonrecognition of gain or loss pursuant to a reorganization

shareholders. Specifically, in *Clark v. Commissioner*,²² the Supreme Court applied the principles of §302 to determine the character of the gain to the exchanging shareholders by treating the acquiring corporation as issuing shares in the transaction equal to the amount of nonstock consideration and then treating those shares as redeemed in a hypothetical redemption. Would the purposes of the Excise Tax be furthered by applying it to an acquisitive reorganization with boot on the basis of *Clark*? Does an acquisition where stock is in fact issued bear any resemblance to a corporate repurchase of shares? If anything, such a transaction operates to the contrary. Furthermore, if the *Clark* analysis holds to treat the acquiring corporation as having issued and then redeemed shares, the Netting Rule would seem to eliminate any possibility of the Excise Tax applying solely as a result of a *Clark* mandated redemption. To the contrary, in an asset reorganization, the Netting Rule does not seem to apply to limit the Excise Tax because the redeeming corporation (i.e., target) is not the corporation that issues shares in the reorganization.

If the Excise Tax does apply to an acquisitive reorganization with boot, at least three alternatives exist for determining the base to which the Excise Tax applies (subject to the Netting Rule): (i) 100% of the fair market value of the stock repurchased is counted, (ii) the fair market value of the stock repurchased is counted up to the fair market value of the boot, or (iii) the fair market value of the stock repurchased is counted up to the gain recognized.²³ Given that gain is determined at the shareholder level with respect to an individual shareholder's basis in the shares exchanged in the reorganization the third alternative would be challenging to determine in the absence of a safe harbor, e.g., permitting estimation of the gain recognized based on statistical analysis.²⁴

Section 355 Split-Off Transaction

Is a §355 split-off transaction in which stock of the controlled corporation is distributed in exchange for stock of the distributing corporation a redemption under §317(b)? The definition of redemption would

applies only if qualified property (i.e., stock or securities in a corporation a party to the reorganization) is exchanged for the shareholders' target stock. §354(a)(1).

²² 489 U.S. 726 (1989).

²³ For clarity, the stock repurchased in an asset reorganization refers to target's liquidating redemption, whereas the stock repurchased in a *Clark* analysis is limited to the acquirer's shares deemed issued and redeemed with respect to the boot.

²⁴ See Rev. Proc. 2011-35 (statistical sampling permitted to determine the acquiring corporation's basis in target stock in a reorganization under §368(a)(1)(B)).

seem to capture such a transaction.²⁵ While a §355 transaction would ordinarily be pursuant to a reorganization under §368(a)(1)(D), §355 could apply to a transaction outside of a reorganization.²⁶ Further, even if the §355 split-off transaction were part of a reorganization the distribution could fall outside the Reorganization Exception, described below, if a distributee recognized gain in the transaction. If the purpose of the Excise Tax is to impose a toll charge on a non-dividend reduction in the equity of the covered corporation, a distribution that satisfies the requirements of §355 should not be subject to the Excise Tax whether or not it is in connection with a reorganization – although the equity of the covered corporation has been reduced, such equity remains in corporate solution and potentially subject to the Excise Tax with respect to any share repurchase by the controlled corporation.

Section 351 Transactions

Could the Excise Tax apply to certain §351 contributions?²⁷ As a base case, if a covered corporation (Target) were to form a new holding company (Newco) and Newco issues shares of its stock to Target's shareholders solely in exchange for shares of Target, there is no actual or hypothetical redemption, because the shareholders are not receiving property from Target. Presumably, Newco becomes a covered corporation as a result of the exchange. If so, does the issuance of shares by Newco in this exchange offset any later redemptions by Newco in such taxable year pursuant to the Netting Rule? It seems inappropriate for the Netting Rule to apply in such fact pattern as it would permit a repurchase by Newco in the year of formation that would otherwise have been subject to the Excise Tax if undertaken by Target. The same policy considerations would exist if Newco offered Target's shareholders the choice of receiving cash in exchange for all or part of the Target shares. This alternative of the transaction would seem to fall within the scope of §304, thereby potentially creating a hypothetical issuance and redemption that could subject

²⁵ See GCM 36302 (June 9, 1975) (concluding §311 should not apply to create corporate level gain under prior law in a split-off qualifying under §355 even though the transaction was a redemption); GCM 38882 (Mar. 30, 1982) (concluding that the surrender of target stock in an asset-type reorganization pursuant to §354 or §356 was a redemption for purposes of §317 and a prior version of §311).

²⁶ See §355(c).

²⁷ Section 351 generally provides that no gain or loss shall be recognized on a transfer of property to a corporation if the shareholders are in "control" of the corporation to which the property is transferred. If the transferred property is stock in a corporation the transaction could also constitute a reorganization under §368(a)(1)(A)/§368(a)(2)(E) or §368(a)(1)(B).

Newco to the Excise Tax subject to application of the Netting Rule.²⁸

Finally, consider whether the Excise Tax applies (or should apply) if one or more covered corporations were to combine under a new holding company in a global §351 transaction. Again, in the absence of boot, there is no actual or hypothetical redemption, but the provision of cash or other property to a shareholder of a covered corporation could give rise to a hypothetical redemption to the extent §304 applies. The application of the Netting Rule to except this variation of the transaction from the Excise Tax does not appear to raise the same concerns as compared to the base case because the global §351 transaction presumably effects a combination of two businesses whereas the base case is economically indistinguishable from a share repurchase.

STATUTORY EXCEPTIONS

As noted above, the statute includes six exceptions that limit the application of the Excise Tax (collectively, the Statutory Exceptions). Specifically, §4501(e) provides that the Excise Tax shall not apply:

- (1) — to the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 by reason of such reorganization [the "Reorganization Exception"];
- (2) — in any case in which the stock repurchased is, or an amount of stock equal to the value of the stock repurchased is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan;
- (3) — in any case in which the total value of the stock repurchased during the taxable year does not exceed \$1,000,000;
- (4) — under regulations prescribed by the Secretary, in cases in which the repurchase is by a dealer in securities in the ordinary course of business;
- (5) — to repurchases by a regulated investment company (as defined in section 851) or a real estate investment trust; or
- (6) — to the extent that the repurchase is treated as a dividend for purposes of this title [the "Dividend Exception"].

Certain of these exceptions are fairly clear as to how they modify the scope of the Excise Tax, that is,

²⁸ See §304(a)(1)(B).

§4501(e)(3) establishes a \$1,000,000 threshold which must be exceeded in a year before the Excise Tax applies and §4501(e)(5) effectively carves out RICs and REITs from the definition of a “covered corporation.” However, other Statutory Exceptions will require regulations or other administrative guidance to define the scope and application of each exception. In particular, the Reorganization Exception and the Dividend Exception raise several issues, as discussed in further detail below.

Reorganization Exception

The Excise Tax does not apply “to the extent that the repurchase is part of a reorganization . . . and no gain or loss is recognized on such repurchase *by the shareholder. . .*”²⁹ A fundamental question is whether the receipt of boot by *any* shareholder renders the Reorganization Exception inapplicable to the transaction as a whole or only with respect to such shareholder. For example, assume a covered corporation is acquired in an asset-type reorganization with a cash election feature. If the Reorganization Exception applies on a shareholder-by-shareholder basis, then the Excise Tax should apply only to the redemptions of covered corporation stock from shareholders that receive (in whole or in part) cash for their shares. On the other hand, if availability of the Reorganization Exception is dependent upon no gain or loss being recognized by any shareholder, then the Excise Tax would seem to apply with respect to the fair market value of 100% of the target’s stock in an asset reorganization, since 100% of the target stock is redeemed for stock of the acquiring corporation and/or cash. It is hard to imagine this result was intended and would hope to be addressed in forthcoming guidance.

Dividend Exception

The Excise Tax does not apply to the extent that the repurchase is treated as a dividend (the “Dividend Exception”).³⁰ Section 316 generally defines a dividend as any distribution of property by a corporation to its shareholders out of the corporation’s current or accumulated earnings and profits (E&P). Oddly, the exception does not define dividend by reference to §316 leaving future guidance to determine whether a covered corporation with no E&P may meet the Dividend Exception. For example, query whether a pro-rata distribution by a covered corporation that has no E&P might still be considered a dividend for purposes of the Dividend Exception. Alternatively, perhaps the Dividend Exception is not needed in a pro-rata distri-

bution because no shares are surrendered (i.e., there is no “repurchase”). This raises the further question of whether the “meaningless gesture doctrine” may apply to create an exchange without an actual surrender of shares.³¹ Given the form of a transaction as a dividend or exchange generally is followed it appears inappropriate to apply the meaningless gesture doctrine in this context.³²

Where a covered corporation has E&P, any redemption by such corporation that fails to qualify as an exchange under §302(b) should be excepted from the Excise Tax to the extent dividend treatment applies. That is, if a redemption is taxable as a dividend under the provisions of §302(a) and §301(c)(1) (dividend equivalency), then the Excise Tax should not apply.³³ Given the application of §302 is made at the shareholder-level to determine whether a redemption is taxable as a dividend, the Dividend Exception is unlikely to provide a covered corporation comfort in the context of a share repurchase in the ordinary course.

Presumably, the Dividend Exception would also apply to carve out any constructive distribution treated as a dividend by virtue of §304, §305, or §306. Likewise, the Dividend Exception would seem to apply to the portion of any gain treated as a dividend under the reorganization provisions.³⁴ Any distribution that is treated as a separate transaction notwithstanding occurring in connection with a reorganization may be within the scope of the Dividend Exception.³⁵

EXAMPLE

The following example provides an illustration of how the tax consequences of a special dividend would

³¹ See, e.g., *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961) (operating assets transferred to an existing corporation in which taxpayer held all of the shares was treated as an exchange as the receipt of shares would have been a meaningless gesture).

³² See text accompanying Note 15, above.

³³ If a corporation “redeems” its stock, the redemption is treated as a distribution in part or full payment in exchange for the stock (exchange treatment) if the redemption: (1) is not essentially equivalent to a dividend; (2) is a substantially disproportionate redemption; (3) is a complete termination of a shareholder’s interest; or (4) qualifies as a redemption of stock held by a non-corporate shareholder in partial liquidation of the distributing corporation. §302(a), §302(b).

³⁴ See text accompanying Note 21, above. If, in addition to qualified property, boot is received in the reorganization, gain, if any, is recognized but in an amount not in excess of the value of the boot. §356(a). Section 356(a)(2) provides that if an exchange has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount that is not in excess of his or her ratable share of E&P. In *Clark v. Commissioner*, 489 U.S. 726 (1989), the Supreme Court applied the principles of §302 to determine if a distribution had the effect of a dividend, based on the target shareholder’s ownership interest in the acquiring corporation following the reorganization.

³⁵ Reg. §1.301-1(j).

²⁹ §4501(e)(1) (emphasis added).

³⁰ §4501(e)(6). See also text accompanying Note 21, above.

compare to a share repurchase subject to the Excise Tax:

Assumed Facts. A covered corporation is considering a repurchase of \$1 billion of its shares versus a special dividend of \$1 billion to its shareholders. The investor base is 30% individual investors all subject to tax at the highest marginal rate (20% plus 3.8% (tax on investment income)). The remaining shareholders are exempt entities (qualified plans or shareholders exempt from taxation on dividends). Any foreign shareholder that would be subject to a withholding tax on the receipt of a special dividend would tender the shares before the shareholder record date with respect to the special dividend. In the case of a repurchase, no shareholder would tender their shares if that sale would result in a taxable gain with respect to the tendered shares. The dividend would constitute a “qualified dividend”³⁶ to the individual shareholders.

Analysis. On these facts, the special dividend would produce a federal income tax to the individual shareholder base of \$71,400,000 [$[\$1,000,000,000 \times 30\%] \times 23.8\%$]. If none of the tendering shareholders would recognize taxable gain upon tender, the incremental tax to the shareholder base as a result of the special dividend would be \$71,400,000. The cost of the Excise Tax to the company on the share repurchase would be \$10,000,000 [$\$1,000,000,000 \times 1\%$]. Thus, on these simple facts the overall tax difference between a share repurchase subject to the Excise Tax versus a dividend to the individual shareholders is \$61,400,000. If taxes were the only consideration the corporation likely would decide to undertake the share repurchase and incur the Excise Tax. Of course, the Excise Tax would be borne by the covered corporation (and, as a result, all shareholders) rather than a certain class of shareholders.³⁷

OBSERVATIONS AND CONCLUSION

The Excise Tax in and of itself is unlikely to alter a company’s share repurchase practices other than at the margins given the relatively modest 1% rate. However, one can foresee a future Congress in need of revenue increasing the rate or subjecting an even broader

number of taxpayers and transactions to the Excise Tax. A company evaluating a redemption versus a special dividend nevertheless should take into account the disparate impact on the classes of shareholders since, as noted above, the Excise Tax is borne by the company, and thus all shareholders, whereas the taxation of a dividend depends on a shareholder’s individual circumstances. A special dividend and the disparate treatment on any shareholders could affect the trading price of the corporation’s stock.

Corporations are unlikely to undertake a significant modification to their capital structure in order to fall within the Dividend Exception to achieve the substantial equivalent of a share repurchase. If a corporation sought to achieve the substantial equivalent of a share repurchase, it might reduce the number of outstanding shares via a reverse stock split in which the overall number of outstanding shares were reduced pro-rata among outstanding shareholders in tandem with the declaration of a special dividend. Further, a corporation contemplating using a material amount of boot as part of the consideration in an acquisitive reorganization should evaluate the merits of a special dividend meeting the requirements of the Dividend Exception in lieu of boot.

Regulatory or other administrative guidance is needed to clarify the scope of transactions subject to the Excise Tax since a broad application to business combinations and divisions seems inappropriate. For example, there is no apparent policy reason to impose the Excise Tax on a transaction merely because it qualifies as a reorganization that creates an actual or hypothetical redemption. In addition, regulatory guidance that mitigates one of the harshest aspects of the Excise Tax – i.e., the application to repurchases occurring after December 31, 2022, without regard to whether such repurchase occurs pursuant to the terms of a plan or an issuance made prior to enactment of the Act – would seem appropriate.

As mentioned above, one of the stated purposes of the Excise Tax is to encourage companies to reinvest in their businesses and employees rather than repurchasing shares. While the statute clearly discourages share repurchases, we note there is nothing in the statute that encourages reinvestment in the business and employees. In fact, the Dividend Exception contradicts the stated purpose, as it permits a covered corporation to distribute excess funds thereby avoiding the Excise Tax. The taxation of corporate distributions is fundamental to the double tax scheme of subchapter C, particularly the character of those distributions as either a §301(c) distribution or as a sale or exchange. The focus of certain Code sections found in subchapter C is whether the transaction at issue is a bail out of corporate equity that is more appropriately treated as a §301(c) distribution rather than a sale or

³⁶ See §1(h)(11)(B).

³⁷ Whether a special dividend distribution does in fact generate more tax revenue than a redemption of shares depends on a number of assumptions regarding the tax consequences to the shareholders from any sale in response to a share repurchase plan versus the tax consequences to the same shareholders of a dividend distribution.

exchange. These same provisions may shed light on how the IRS or Treasury should apply the Excise Tax to a particular transaction that is not treated as a divi-

dend yet reduces corporate equity, thus ending the search for the purpose of the Excise Tax.