

EXCISE TAX ON SHARE REPURCHASES

Sep 13, 2022

This post is based on an article by Cathryn R. Benedict and Philip B. Wright, [Excise Tax on Share Repurchases: A Provision Searching for Its Purpose](#), 63 Tax Mgmt. Memo. No. 19 (Sept. 12, 2022).

Background

On August 16, 2022, President Biden signed into law the Inflation Reduction Act of 2022 (the “Act”), 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 Joint Committee on Taxation estimates that the Excise Tax will generate \$74 billion over 10 years.

The broad statutory language, coupled with its sparse legislative history, could lead to unexpected applications of the Excise Tax outside of its presumed purpose.

Statutory overview

The Excise Tax generally imposes a 1% excise tax on the “fair market value” of any stock that is “repurchased” by a “covered corporation” after December 31, 2022. Those key terms dictate: (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.

Affected taxpayers – covered corporations

The Excise Tax applies to a “covered corporation,” meaning “any domestic corporation the stock of which is traded on an established securities market.” Under IRS regulations, an established securities market generally includes national securities exchanges, certain foreign securities exchanges, regional or local exchanges and certain interdealer quotation systems. The Excise Tax does not apply to RICs or REITs and applies to foreign corporations in limited circumstances.

The statute does not distinguish between publicly or nonpublicly traded stock in determining whether the Excise Tax applies to repurchases by a covered corporation. 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.

Base upon which the Excise Tax is applied – fair market value

The Excise Tax applies to the fair market value of stock repurchased by a covered corporation (as reduced by the fair market value of stock issued by the covered corporation in the same taxable year). “Fair market value” is undefined, but 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 the case of stock issued in a public offering, fair market value of stock issued could be either the offering price paid by the purchaser 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 may not be as readily determinable – e.g., where the stock is repurchased via a derivative transaction with an underwriter or agent.

Transactions subject to the Excise Tax – repurchases

The Excise Tax is triggered upon a repurchase, which generally is defined as:

- a redemption within the meaning of 317(b); and
- any transaction determined by the IRS to be economically similar to such a redemption (an “Economically Similar Transaction”).

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, there are several statutory exceptions that exclude certain repurchases from 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. Further, while we presume the Economically Similar Transaction provision is not self-executing, one might expect regulatory guidance to apply the Excise Tax to any transaction where the economic result is the extraction of corporate equity without a taxable dividend.

Statutory exceptions

The Excise Tax does not apply to the following (collectively, the “Statutory Exceptions”):

- (1) ***certain reorganizations*** — 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 by reason of such reorganization (the “Reorganization Exception”),
- (2) ***employee stock/benefit plans*** — 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) ***small annual repurchases*** – in any case in which the total value of the stock repurchased during the taxable year does not exceed \$1,000,000,

(4) ***ordinary course by dealer*** – 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) ***RICs and REITs*** – to repurchases by a regulated investment company or a real estate investment trust, or

(6) ***dividends*** – to the extent that the repurchase is treated as a dividend for federal income tax purposes (the “Dividend Exception”).

Most of these exceptions require regulations or other administrative guidance to define their scope and application. In particular, the Reorganization Exception and the Dividend Exception raise several issues:

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*. . .” The key question is whether the receipt of “boot” (i.e., cash or other non-qualifying consideration) 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 we would hope this will be addressed in forthcoming guidance.

Dividend exception

The Excise Tax does not apply to the extent that the repurchase is treated as a dividend, which, for federal income tax purposes, generally refers to any distribution of property by a corporation to its shareholders out of the corporation’s current or accumulated earnings and profits (E&P).

Where a covered corporation has E&P, any redemption by such corporation that fails to qualify as an exchange should be excepted from the Excise Tax to the extent dividend treatment applies. That

is, if a redemption is taxable as a dividend, then the Excise Tax should not apply.

Observations and conclusions

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 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.

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.

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