Client Alert

February 2023

Notice 2023-2: IRS and Treasury Department Issue Initial Guidance on the New Stock Buyback Excise Tax

The Inflation Reduction Act of 2022 (the "IRA") was signed into law by President Biden on August 16, 2022. The IRA added Section 4501 to the Internal Revenue Code (the "Code") imposing a 1% non-deductible excise tax (the "Stock Buyback Excise Tax") on certain repurchases of corporate stock occurring after December 31, 2022. On December 27, 2022, the U.S. Treasury Department issued Notice 2023-2 (the "Notice") to provide initial guidance on the application of the Stock Buyback Excise Tax.

In general, the Stock Buyback Excise Tax imposes a 1% non-deductible excise tax on the fair market value of any stock repurchased by a covered corporation during a taxable year. A "covered corporation" is any domestic corporation the stock of which is traded on an established securities market, and a "repurchase" is either a redemption of stock or a transaction that is economically similar to a redemption of stock ("Economically Similar Transaction"). The Stock Buyback Excise Tax may also apply to publicly traded foreign corporations under certain circumstances.

The Notice provides guidance that clarifies many of the complex issues relating to whether or how the Stock Buyback Excise Tax should apply to many types of corporate transactions, such as leveraged buyouts, spin-offs and split-offs, redemptions, liquidations, liquidations of special purpose acquisition companies ("SPACs"), and tax-free reorganizations.

I. <u>Redemptions</u>

The Notice provides an exclusive list of two types of redemptions that are not treated as repurchases:

- Payments of cash by a covered corporation in lieu of fractional shares in connection with a tax-free reorganization, a tax-free spin-off, or settlement of an option or other financial instrument, and

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- Certain corporate transactions, where, in general, a controlled corporation acquires the shares of a second controlled corporation from the person controlling both corporations.

Any other redemption of stock for tax purposes will be a repurchase for purposes of the Stock Buyback Excise Tax.

II. Economically Similar Transactions

The Notice provides an exclusive list of five Economically Similar Transactions that are, in general, treated as repurchases for purposes of the Stock Buyback Excise Tax:

1. Acquisitive reorganizations. The tax-free exchange of stock by shareholders of a target covered corporation for consideration in an acquisitive reorganization is an Economically Similar Transaction and, subject to exceptions described below, the excise tax base is increased by the fair market value of such exchange.

2. Recapitalizations. In the case of a tax-free recapitalization, the reshuffling of a covered corporation's capital structure within its existing framework is an Economically Similar Transaction.

3. "F" reorganizations. In the case of a tax-free reorganization that is a mere change in identity, form, or place of organization, the exchange by shareholders of a covered corporation of their stock for stock in the post-change corporation is deemed an Economically Similar Transaction.

4. Split-offs. In the case of a distribution of stock of a subsidiary corporation in redemption of the stock held by the distributing corporation's shareholders in the latter corporation, the distribution is generally deemed an Economically Similar Transaction.

5. Complete liquidations. In the case of a complete liquidation of a covered corporation whose parent corporation owns 80% or more, but less than 100%, of its stock, the distribution to the minority shareholders, in general, is considered an Economically Similar Transaction, whereas the distribution to the parent corporation is not.

Additionally, the Notice provides a nonexclusive list of two transactions that are not economically similar to a redemption:

1. Any complete liquidation that is not described in Item II.5 above as an Economically Similar Transaction, and

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2. any tax-free distribution of a subsidiary corporation's stock that is not described in Item II.4 above as a split-off.

III. Exceptions to imposition of the Stock Buyback Excise Tax

The value of stock repurchases subject to the Stock Buyback Excise Tax can be reduced if any of the repurchases fall within one of the six statutory exceptions, which include, in addition to those discussed in more detail below, repurchases by dealers in securities in the ordinary course of business, repurchases by RICs and REITs, and repurchases treated as dividends. The other notable exceptions include:

1. Qualified Property Exception. To the extent that a repurchase is part of a tax-free reorganization and no gain or loss is recognized on that repurchase (i.e., the exchange is for qualified property), the covered corporation's excise tax base is, in general, reduced by the fair market value of the qualified property.

2. De minimis repurchase. The Stock Buyback Excise Tax will not apply where the total value of the stock repurchased during the taxable year does not exceed $1,000,000.

3. Contributions to employee stock plans. The fair market value of stock repurchased, or an amount of stock equal to the value of the stock repurchased, that is contributed to employee stock plans, such as employer sponsored retirement and stock option plans, in general, reduces the covered corporation's excise tax base.

IV. Netting Rule

The statute provides for another reduction to the base amount subject to the Stock Buyback Excise Tax. This adjustment, described in the Notice as the Netting Rule, provides, in general, that the base amount subject to the excise tax is reduced by the fair market value of newly issued stock, including the fair market value of any stock issued or provided to employees of the covered corporation during the taxable year (without duplication for amounts already taken into account in Item III.3. above). Stock is treated as issued or provided to an employee as of the date that the employee is treated as the beneficial owner of the stock for federal income tax purposes.

V. Valuation

Under the Notice, the fair market value of the repurchased stock is generally the market price of the stock on the date of the repurchase, to be determined under one of the four acceptable methods described in the Notice.

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VI. Reliance, applicability, and forthcoming proposed regulation

The Notice states that regulations will be proposed in the future with rules that are consistent with the Notice. Covered corporations may rely on the Notice until the issuance of the forthcoming regulations. Those regulations are expected to apply to repurchases of stock of a covered corporation made after December 31, 2022.

If you have any questions regarding the Stock Buyback Excise Tax and the matters discussed above, please contact the Olshan attorney with whom you regularly work or the attorneys listed below.

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