

Memorandum

IRS Releases Interim Guidance on Stock Buyback Excise Tax

January 4, 2023

Introduction

On December 27, 2022, the Internal Revenue Service (“IRS”) released Notice 2023-2 (the “Notice”), which provides interim guidance on the application of the new stock buyback excise tax under Section 4501 of the Internal Revenue Code (the “Code”).¹

Section 4501, which was enacted as part of the Inflation Reduction Act of 2022, imposes a non-deductible, 1% excise tax on the fair market value of stock repurchased by covered corporations (generally, certain publicly-traded domestic corporations and surrogate foreign corporations) during the taxable year, net of issuances of stock in the same taxable year and subject to certain other adjustments and exceptions (the “Excise Tax”). The Excise Tax applies to stock repurchases of such covered corporations beginning on January 1, 2023.

The Notice provides interim guidance on several key topics regarding the application of the Excise Tax, including the scope of transactions that are subject to the Excise Tax and important rules for calculating the Excise Tax. The Notice also includes several examples of how the Excise Tax will apply to certain corporate transactions, including reorganizations, acquisitions, spin-offs and split-offs, and addresses anticipated reporting and payment requirements. The Notice indicates that the Treasury Department and the IRS intend to issue proposed regulations regarding the application of the Excise Tax, but that taxpayers may rely on the rules set forth in the Notice until the issuance of such forthcoming proposed regulations.

Clarification on the Scope of Transactions Subject to the Excise Tax

In general, Section 4501 provides that “repurchases” subject to the Excise Tax include redemptions within the meaning of Section 317(b) (“Section 317(b) Redemptions”) as well as transactions determined by Treasury to be “economically similar” to a Section 317(b) Redemption. The Notice provides important awaited clarifications regarding the scope of “repurchases” that are subject to the Excise Tax.

ECONOMICALLY SIMILAR TRANSACTIONS

The Notice provides an exclusive list of such economically similar transactions that are subject to the Excise Tax. The list includes exchanges of stock as part of (1) acquisitive reorganizations under Section 368(a), (2) recapitalizations under Section 368(a)(1)(E), (3) reorganizations under Section 368(a)(1)(F), (4) split-offs and (5)

¹ All “Section” references are to the Code.

complete liquidations to which both Section 331 and Section 332(a) apply (but only with respect to the portion attributable to a liquidation under Section 331). However, while this list is on its face extremely broad and applies regardless of whether there is any cash in these otherwise tax-free transactions, the Notice also includes exceptions which in effect materially limit the application of the Excise Tax to certain of these corporate transactions. Specifically, the Notice provides that the value of the repurchased stock that is attributable to property that can be received without recognition of gain under Sections 354 or 355 (such as stock) can be excluded from the Excise Tax base (the “Qualifying Property Exception”). Thus, only the value of the repurchased stock that is attributable to non-qualifying property such as cash will be included in the computation of the Excise Tax base. It is worth noting that sourcing the cash to the acquiror rather than the target does not make a difference for purposes of this analysis. The Notice provides a number of examples illustrating the application of the Qualifying Property Exception to various tax-free reorganizations, with the main takeaway being that stock can generally be received in such transactions without increasing the corporation’s Excise Tax base.

TRANSACTIONS THAT ARE NOT ECONOMICALLY SIMILAR

The Notice also provides a non-exclusive list of transactions that are not economically similar to Section 317(b) Redemptions and therefore are not subject to the Excise Tax. The list includes (1) complete liquidations to which either Section 331 or 332(a) apply (except transactions to which both Section 331 and Section 332(a) apply, as discussed above) and (2) tax-free spin-offs. Note that the liquidation of a SPAC in a single transaction that qualifies as a Section 331 liquidation should therefore generally be exempt from the Excise Tax; however, there does not appear to be any exception for a redemption by a SPAC that occurs other than in connection with a complete liquidation. For example, redemptions in the context of a de-SPAC transaction would generally be subject to the Excise Tax, although redemptions in a de-SPAC transaction may generally be reduced by the issuances of stock (such as issuances to PIPE investors) in the same year as such redemptions pursuant to the Netting Rule (as described in more detail below). The Notice provides that if a covered corporation effects a final distribution in complete liquidation to which Section 331 applies during any taxable year, no distribution by such corporation in that taxable year will be subject to the Excise Tax. This provides some relief for a covered corporation for repurchases in the year of a liquidation, even where they are not contemporaneous. For example, in the SPAC context, it would not be unusual for redemptions to occur in connection with a liquidation but in advance of the final mandatory liquidating redemption, but neither set of redemptions should be subject to the Excise Tax so long as they occur in the same taxable year (although attention should be paid to the timing to ensure they do not span a taxable year).

SECTION 317(b) REDEMPTIONS THAT ARE NOT REPURCHASES

The Notice further provides an exclusive list of transactions that are Section 317(b) Redemptions, but are not repurchases subject to the Excise Tax. The list includes (1) deemed distributions that occur under Section 304(a)(1) and (2) payments of cash in lieu of fractional shares if the payment is part of a Section 368(a) reorganization or Section 355 distribution or pursuant to the settlement of an option or similar financial instrument (*e.g.*, a convertible bond or convertible preferred share) and certain other requirements are met.

Because the exclusive list does not include mandatory redemptions or redemptions that are pursuant to a holder put, holder puts exercised by SPAC holders will continue to be within the scope of the Excise Tax. There is also no exclusion for repurchases of preferred stock (including repurchases pursuant to its terms), and mandatory redemptions of preferred stock are expressly described as subject to the Excise Tax in the Notice.

Rules for Calculating the Excise Tax Base

The Notice provides operating rules for calculating the tax base that is subject to the Excise Tax, including the determination of fair market value and the application of the Netting Rule.

DETERMINATION OF FAIR MARKET VALUE

The Excise Tax imposed on a covered corporation is the product of 1% and the “stock repurchase excise tax base.” The Notice provides that the stock repurchase excise tax base is determined as follows: the taxpayer must first determine the aggregate fair market value of all stock repurchased during the taxable year, which is then adjusted for any statutory exceptions and reduced by the amount of stock issued pursuant to the Netting Rule as described below.

The fair market value of repurchased stock is the market price of the stock on the date the stock is deemed to be repurchased. The Notice clarifies that for this purpose stock is deemed to be repurchased at the time ownership of the stock is transferred or exchanged. For example, as illustrated by Example 15 in the Notice, in the case of an accelerated share repurchase, the stock is deemed to be repurchased on the date of delivery and therefore included in a covered corporation’s stock repurchase excise tax base in the taxable year that includes the delivery date. The market price of repurchased stock that is traded on an established securities market must be determined based on one of four methods provided in the Notice, and the method selected must be consistently applied to all repurchases (as well as generally to stock issuances under the Netting Rule described below) effected in the same taxable year.

THE NETTING RULE

To determine the stock repurchase excise tax base, the aggregate fair market value of a covered corporation’s repurchased stock is reduced by the fair market value of its stock issuances during the taxable year (the “Netting Rule”). The Notice provides an exclusive list of issuances that are disregarded for purposes of the Netting Rule, including stock that is issued as part of a transaction to which the Qualifying Property Exception applies, as discussed further above.

Importantly, the Notice did not expand the Netting Rule to permit redemptions to be offset by the issuance of shares by a different but related entity, which is not uncommon in certain corporate transactions.

Additional Examples

The Notice provides several examples of how the Excise Tax will apply and be computed with respect to certain corporate transactions, including reorganizations, acquisitions and spin-offs. In addition to the examples discussed above, note in particular that Examples 3 and 4 of the Notice confirm that acquisitions that are partially funded by the target corporation are taken into account in the Excise Tax base to the extent that the cash received by target shareholders in exchange for target stock is treated as being sourced in the target (*e.g.*, in a reverse subsidiary merger where the cash is viewed as coming from the target). This outcome will apply in the leveraged buyout context if the transitory merger subsidiary or the target is the borrower. To mitigate this result, consideration should be given as to whether to use tiers of corporate entities (for example, with any leverage incurred at the level of the acquiror as opposed to at the level of the target or a transitory merger subsidiary).

Anticipated Reporting and Payment Requirements

The Notice indicates that it is anticipated that the Excise Tax will be required to be reported annually on the IRS Form 720 (Quarterly Federal Excise Tax Return) that is due for the first full quarter after the close of a taxpayer's taxable year (note that IRS Form 720 is otherwise required to be filed quarterly). Payment of the Excise Tax is expected to be due at the same time. No extensions are expected to be permitted for either reporting or paying the Excise Tax. A draft Form 7208 was posted by the IRS on December 28, 2022 (<https://www.irs.gov/pub/irs-dft/f7208--dft.pdf>).

Open Questions and Further Guidance

While the Notice provides useful guidance on several issues regarding the application of the Excise Tax which were unclear following the enactment of Section 4501, a number of questions remain open. Notably, the Notice does not address whether special rules should apply to redeemable preferred stock, convertible debt instruments, and other equity-linked instruments. The Treasury Department and IRS are soliciting comments on these questions, as well as the rules described in the Notice more generally.

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