

January 10, 2023

IRS Issues Initial Guidance on Stock Buyback Tax

IRS Notice Could Impact SPACs, Tax-Free Reorganizations, Intercompany Loans, and Accelerated Stock Repurchases

SUMMARY

On December 27, 2022, the IRS and the Department of the Treasury issued Notice 2023-2 (the “Notice”) providing initial guidance on the application of Section 4501 of the Internal Revenue Code, which imposes a 1% excise tax on certain repurchases of corporate stock (such tax, the “Excise Tax”).¹ Notable provisions in the Notice include:

- Redemption of preferred stock are subject to the Excise Tax.
- Redemptions in complete liquidation generally are exempt from the Excise Tax (of particular relevance to SPACs).
- Certain tax-free reorganizations and split-offs are subject to the Excise Tax to the extent of taxable “boot”.
- Repurchases of foreign corporate stock may be subject to the Excise Tax if a related domestic entity “funds” the repurchase.
- Leverage that is taken on by the target in common leveraged buyout structures are subject to the Excise Tax.

BACKGROUND

On August 16, 2022, President Biden signed the Inflation Reduction Act into law, which included the imposition of the Excise Tax on certain repurchases of corporate stock after December 31, 2022. The Excise Tax applies to domestic corporations whose stock is traded on an established market (such a corporation, a “Covered Corporation”).² Under the statute, the Excise Tax is equal to 1% of the fair market value of “repurchases” with respect to stock of the Covered Corporation, generally including redemptions

by the Covered Corporation and transactions that Treasury determines to be “economically similar” to redemptions,³ subject to certain statutory exceptions including for repurchases in connection with tax-free reorganizations.⁴ The statute also provides that the amount of redemptions subject to the Excise Tax in a taxable year is reduced by the fair market value of stock issuances made within the same year by the Covered Corporation (the “Netting Rule”).⁵ The statute also included regulatory powers to carry out the purposes of the Section, including addressing special classes of stock and preferred stock.⁶

DISCUSSION

A. REDEMPTIONS AND ECONOMICALLY SIMILAR TRANSACTIONS

1. Scope of “Repurchases”

The Excise Tax generally applies to “repurchases”, which include both redemptions of Covered Corporation stock for cash or other property (“Section 317(b) Redemptions”) and any transactions economically similar to Section 317(b) Redemptions.⁷ The Notice, by way of an example, also confirms that Section 317(b) Redemptions include leveraged buyouts and other acquisitions funded by the target.⁸ Therefore, such transactions (e.g., when the consideration is traced back to the balance sheet of the target or to new debt incurred by a merger subsidiary and assumed by the target in a reverse subsidiary merger) would generally be subject to the Excise Tax to the extent such transaction was target-funded. The Excise Tax generally will not apply if the debt was incurred by the acquiror and not assumed by the target. The Notice provides an exclusive list of transactions that are economically similar to a Section 317(b) Redemption which include, as described further below, certain “tax-free” reorganizations, split-offs and certain liquidating distributions to minority shareholders of Covered Corporations with controlling 80% shareholders.

There had been speculation that the guidance would include exceptions for redemptions of preferred stock, especially in light of the explicit regulatory authority for the IRS to issue such regulations and the fact that non-convertible preferred stock does not implicate the stated policy reasons behind the enactment of the Excise Tax. However, the Notice did not provide any specific relief for preferred stock,⁹ even if such stock is not publicly traded and even if such redemption occurs pursuant to the terms of the preferred stock.¹⁰

2. Tax-Free Reorganizations

The Notice generally treats exchanges of shares of a Covered Corporation by its shareholders in an “acquisitive reorganization”, an “E” reorganization or an “F” reorganization as repurchases economically similar to Section 317(b) Redemptions and thus subject to the Excise Tax to the extent of taxable “boot”. Subject to certain exceptions, the Notice treats all amounts, whether or not funded by the Covered Corporation and including such amounts in exchange for tax-free consideration (in the form of acquiror stock), as repurchases. However, the “Qualifying Property Exception” then allows the Covered Corporation to reduce the Excise Tax base by the fair market value of the repurchased stock to the extent such repurchase is for property (e.g., acquiror stock) permitted to be received without recognition of gain or loss

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(such property, “Qualifying Property”).¹¹ Taken together, these provisions effectively limit the Excise Tax to cash consideration or other taxable “boot” in the reorganization.

“Acquisitive reorganizations” include statutory mergers, including forward and reverse triangular mergers qualifying as “A” reorganizations, and certain asset reorganizations qualifying as “C” or “D” reorganizations.¹² In contrast, tax-free “Section 351” contributions are not treated as economically similar, nor are taxable stock purchases.¹³ The diverging treatment of economically similar transactions may on the margins affect whether and how to structure certain transactions as tax-free.

Stock issuances in a tax-free reorganization that qualify for the Qualifying Property Exception are excluded from the Netting Rule as such stock is already taken into account under the Qualifying Property Exception – limiting the acquiring corporation’s ability to rely on the stock issued in the reorganization for the purposes of the Netting Rule if such acquiring corporation redeems stock in the same taxable year as the reorganization.¹⁴ The Notice further provides that a payment of cash in lieu of fractional shares by a Covered Corporation in a tax-free reorganization is not treated as a Section 317(b) Redemption if the cash received represents a rounding off or is carried out solely for administrative convenience.¹⁵ Such deemed issuances of fractional shares are also excluded for purposes of the Netting Rule.

3. Spin-offs and Split-offs

Spin-offs are not economically similar to Redemptions under the Notice and therefore are not subject to the Excise Tax.¹⁶ Split-offs (which typically involve an exchange of stock of the “parent” for the stock of the “spin-co”) are considered to be economically similar to 317(b) Redemptions whether or not there is taxable “boot”, and are therefore treated as repurchases.¹⁷ However, as the aforementioned “Qualifying Property Exception” also applies to split-offs, the exchange by parent shareholders of their parent stock for Qualifying Property (e.g., stock of the spin-co) is not subject to the Excise Tax, effectively exempting split-offs solely for stock of the spin-co from the Excise Tax.

4. Complete Liquidations

If a Covered Corporation completely liquidates and dissolves, distributions in such complete liquidation and other distributions by such Covered Corporation in the same taxable year in which the final distribution is made generally are not repurchases.¹⁸ However, if the Covered Corporation has controlling shareholders holding 80% of the Covered Corporation by vote and value such that the liquidation is tax-free to such controlling shareholders under Section 332, the Notice applies the Excise Tax to liquidating distributions to the non-controlling shareholders.¹⁹

5. SPAC Considerations

Although the Notice did not provide specific guidance for special purpose acquisition companies (“SPACs”), the complete liquidation rule excludes redemptions in connection with a complete liquidation of SPACs from being subject to the Excise Tax, assuming that there is no 80% controlling corporate shareholder at the

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time of liquidation. Although no such exclusion exists for redemptions in the absence of a complete liquidation, it appears that if there are any non-liquidating redemptions in the same taxable year that the SPAC eventually completely liquidates (such as redemptions in connection with a business combination or an extension vote), such redemptions appear to not be subject to the Excise Tax, whether or not formally part of the complete liquidation.

A business combination will often feature both redemptions by the public SPAC shareholders and issuance of new shares in connection with private investment in public equity (“PIPE”). The Excise Tax is not likely to apply to the business combination if the target is a private corporation, as a private target generally will not meet the requirement that the company stock must be traded on an established securities market to be a Covered Corporation. If the target is a public corporation, the issuance of new shares would generally qualify under the Qualifying Purchase Exception and reduce the amount of the Excise Tax. Furthermore, as the Notice does not have a successor rule that would allow later stock issuances by the new company to offset the repurchases by its predecessor, stock issuances in a “double dummy” or “up-C” context will probably not qualify under the Netting Rule to limit the Excise Tax liability arising from repurchases of target stock.

B. FUNDING RULE

Generally, if a corporation or a partnership that is more than 50% owned, directly or indirectly, by a Covered Corporation (such entity, “Specified Affiliate”) acquires stock of the Covered Corporation from a third party, such acquisition is treated as a repurchase of the Covered Corporation stock by the Covered Corporation.²⁰ In addition, if stock of a foreign corporation traded on an established securities market (an “Applicable Foreign Corporation”) is acquired by a U.S. Specified Affiliate (an “Applicable Specified Affiliate”), such acquisition is also treated as a repurchase with the Applicable Specified Affiliate being treated as the Covered Corporation.²¹

The Notice would significantly expand the scope of the Applicable Specified Affiliate rule with potential impacts on repurchases by foreign corporations without the direct involvement of U.S. entities. Under the Notice, an Applicable Specified Affiliate is treated as acquiring the stock of the Applicable Foreign Corporation if (i) such Applicable Specified Affiliate “funds” the stock acquisition through any means (including through distributions, debt, or capital contributions), and (ii) such funding is undertaken for a principal purpose of avoiding the Excise Tax.²² The Notice also creates a *per se* rule to deem a principal purpose of avoiding the Excise Tax if the acquisition or repurchase occurs within two years of the funding (other than funding through distributions).²³ This is likely to impact intercompany loans made by a U.S. subsidiary within foreign parented-groups, potentially including cash pooling arrangements, as such amounts may be deemed to have a principal purpose to avoid the Excise Tax if there is an acquisition or repurchase of foreign parent stock by a funded foreign group member within two years of the issuance of such loans.

C. ACCELERATED SHARE REPURCHASE

The Notice clarifies that a repurchase occurs when tax ownership of the stock transfers to the Covered Corporation or the applicable acquiror (as appropriate),²⁴ and the fair market value of the repurchase is the market price of the stock on the date of repurchase.²⁵

Notably, the Notice provides guidance applicable to the application of the Excise Tax to accelerated share repurchase (“ASR”) transactions entered into prior to the effective date of the Excise Tax. In a typical ASR transaction, a company enters into a forward contract with a dealer. On the “prepayment date”, the company delivers the prepayment amount and receives a certain percentage of the total to-be-repurchased shares based on the market price of the shares on the prepayment date. Depending on the market price on the final settlement date, the dealer may deliver more shares to the company, or the company may return shares or cash to the dealer on the final settlement date. Prior to issuance of the Notice, the extent to which the Excise Tax would apply to shares repurchased under the ASR with a prepayment date that precedes the effectiveness of the Excise Tax but a final settlement date following such effectiveness was not entirely clear. The Notice clarifies by way of an example that such an ASR transaction generally will be treated as two separate repurchases, one on the prepayment date (not subject to the Excise Tax) and the other on the final settlement date (subject to the Excise Tax).²⁶

D. DEALERS IN SECURITIES

The Notice excludes repurchases by a dealer in securities in the ordinary course of business from the Excise Tax.²⁷ Such exception is available to the extent the dealer accounts for the stock as securities held primarily for sale to customers in the dealer’s ordinary course of business, disposes of the stock within a time period consistent with the holding of the stock for sale to customers in the ordinary course of business, and does not sell or otherwise transfer the stock to an applicable acquiror or the Covered Corporation, as applicable, other than a sale or transfer to a dealer that otherwise satisfies the requirements of the exception.²⁸ Furthermore, stock issued by a Covered Corporation that is a dealer in securities in the ordinary course of business of dealing in securities is disregarded for purposes of the Netting Rule.²⁹

E. REQUEST FOR COMMENTS

The Notice contains a request for comments on the rules included and not included in the Notice, including (i) whether there should be special rules for redeemable preferred stock or other special classes of stock or convertible debt, (ii) whether there should be additional methods for rebutting the presumption that a repurchase is not a dividend, and (iii) whether there should be special rules for bankrupt or troubled companies. There was no specific request for comments regarding the Funding Rule.³⁰

F. EFFECTIVE DATE AND RELIANCE

The Notice states that the forthcoming proposed regulations on the Excise Tax will provide rules consistent with the rules in the Notice, and generally will apply to repurchases and issuances of a Covered Corporation

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stock made after December 31, 2022; but with respect to the funding rule, the Notice will apply to repurchases and acquisitions of Covered Corporation stock made after December 31, 2022, that are funded on or after December 27, 2022.³¹ The taxpayers may rely on the rules set forth in the Notice until the issuance of the forthcoming proposed regulations.³²

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ENDNOTES

- 1 References herein to a “Section” are to sections of the Internal Revenue Code and the Treasury regulations (“Treasury Regulations” or “Treas. Reg.”) promulgated thereunder. All “§” references are to sections of Notice 2023-2.
- 2 Section 4501(a), (d)(2). The Excise Tax also applies in a manner generally similar to a domestic corporation to a corporation that became a surrogate foreign corporation under Section 7874(a)(2)(B) (the so-called “anti-inversion rules”) after September 20, 2021.
- 3 Section 4501(c)(1).
- 4 Section 4501(e).
- 5 Section 4501(c)(3).
- 6 Section 4501(f).
- 7 Section 317(b) defines redemption as the corporation acquiring “its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock”. Section 317 defines “property” as money, securities, and any other property other than the corporation’s own stock (and the rights to acquire such stock).
- 8 § 3.09(1), Examples 3, 4.
- 9 § 3.02(25).
- 10 § 3.09(1), Example 1. The same example also confirmed the lack of an exception for redemptions under a binding agreement entered before January 1, 2023.
- 11 § 3.07(2)(b).
- 12 § 3.02(1). A stock acquisition qualifying as a “B” reorganization not involving a statutory merger is not an acquisitive acquisition, even though an economically similar reverse triangular merger is treated as an acquisitive reorganization under the Notice.
- 13 Unless such Section 351 transactions also qualify as an acquisitive reorganization.
- 14 § 3.08(4)(d).
- 15 § 3.04(4)(b)(ii).
- 16 § 3.04(4).
- 17 § 3.09(1), Examples 6, 9.
- 18 § 3.04(4)(b)(i).
- 19 See Sections 332, 1504(a)(2); § 3.04(4)(a)(v).
- 20 Section 4501(d), § 3.05(1).
- 21 § 3.05(2)(a)(i).
- 22 § 3.05(2)(a)(ii)(A).
- 23 § 3.05(2)(a)(ii)(B).
- 24 § 3.06(1)(a).
- 25 § 3.06(1)(b)(2). The Notice state that the fair market value of the repurchase is the market price of the stock on the date of the repurchase. For stock traded on an established securities market (or of the same class and issue of stock that is so traded), the Notice specifies four acceptable methods to determine the market to determine the market price: (i) daily VWAP on the date of repurchase; (ii) closing price on the date of repurchase; (iii) average of the high and low prices on the date of repurchase; and (iv) trading price at the time of the repurchase. The market price of stock not

ENDNOTES (CONTINUED)

traded on an established securities market is determined as of the date the stock is issued under the principles of Treasury Regulations Section 1.4095A-1(b)(5)(iv)(B)(1).

26 § 3.09(1), Example 15.

27 § 3.07(4)(a).

28 § 3.07(4)(b).

29 § 3.08(4)(g).

30 § 6.01, 6.02.

31 § 3.08.

32 § 2.07(2).

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