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## *New Stock Buyback Tax: Some Questions Answered, Others Remain*

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One of the headline tax changes in the Inflation Reduction Act of 2022, Public Law 117-169, is a 1% excise tax on stock repurchases by public companies. New Section 4501 of the Internal Revenue Code<sup>1</sup> applies a non-deductible 1% excise tax to the fair market value of net stock repurchases by certain publicly traded corporations that take place after December 31, 2022. As we described in our previous client alert, [Surprises and Questions Around the New Stock Buyback Tax](#), after the new law's enactment, there were many questions regarding the application of the excise tax to certain common transactions, such as tax-free reorganizations and liquidations. In late December, the Treasury Department issued [Notice 2023-2](#), which addresses some of these questions, but others remain unanswered.

In general, the Notice takes a technical approach to interpretation of the statute and does not interpret the statute by applying the principles underlying the purpose of the excise tax. As a result, the Notice makes clear that the excise tax under Section 4501 is not limited to traditional stock buybacks by public companies. The below summarizes significant points addressed in the Notice that we think will be of particular interest to our clients. Our tax specialists are available to evaluate and to advise on the potential application of this tax to any transaction involving the purchase, exchange or transfer of public company stock.

### *De Minimis Rule*

Pursuant to Section 4501(e), the excise tax will not apply when the total value of the stock repurchased by a covered corporation in a tax year is \$1 million or less. A covered corporation is generally a US corporation whose stock is traded on an established securities market (also referred to herein as a public company). As described below, Section 4501 contains a netting rule under which issuances of stock by a covered corporation are netted against repurchases by the corporation that take place in the same tax year. The statute is not clear as to whether the excise tax applies if a covered corporation's gross repurchases exceed \$1 million but its net repurchases

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<sup>1</sup> All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

do not. The Notice clarifies that the *de minimis* threshold applies to gross repurchases (i.e., prior to netting). The Notice also provides that the *de minimis* threshold is applied without considering any statutory exceptions that may exclude certain repurchases from tax. Applying the rule in this manner severely limits the relief that might otherwise have been provided by a broader interpretation of the *de minimis* rule.

## *Netting Rule*

Section 4501 contains a netting rule under which issuances of stock by a covered corporation are netted against repurchases by the corporation that take place in the same tax year. Pursuant to the Notice, stock is treated as issued or provided by a covered corporation at the time at which, for federal income tax purposes, ownership of the stock transfers to the recipient. Stock distributed to a covered corporation's shareholders in respect of its stock and stock issued by a covered corporation to certain affiliates are not treated as issued for purposes of the netting rule. The Notice also clarifies that a fiscal year corporation applying the netting rule may take into account stock issuances for the entirety of its fiscal year that includes January 1, 2023, even though the repurchases subject to tax will be limited to those occurring on or after January 1, 2023. In addition, the Notice contains a number of rules that govern the specific application of the netting rule to stock issued to an employee as compensation for services.

*Restricted Stock.* Unvested restricted stock is not treated as issued until it vests, unless the employee makes a valid election under Section 83(b), in which case the stock is treated as issued to the employee as of the transfer date.

*Tax Withholding/Net Exercise.* Stock withheld by the covered corporation or certain affiliates to satisfy the employer's tax withholding obligations is not treated as issued for purposes of the netting rule. Similarly, stock withheld to satisfy the exercise price of a stock option is not treated as issued.

*Sell-to-Cover Transactions.* If a third party advances to the employee the exercise price or cash to fund the employer's tax withholding obligation (or pays the exercise price or withholding obligation on the employee's behalf), for example in a broker-assisted sale, stock transferred to the employee or third party is treated as issued for purposes of the netting rule.

## *Fair Market Value*

The Notice provides that for purposes of applying the *de minimis* rule and netting rule described above, as well as calculating the excise tax, the fair market value of issued or repurchased stock (other than stock issued to employees) is the market price of the stock on the date the stock is issued or repurchased (not necessarily the price at which the issued or repurchased stock was purchased).

For stock that is traded on an established securities market, the Notice provides four acceptable methods for determining market price:

- (1) the daily volume-weighted average price determined on the date the stock is issued/repurchased,
- (2) the closing price on the date the stock is issued/repurchased,
- (3) the average of the high and low prices on the date the stock is issued/repurchased, and
- (4) the trading price at the time the stock is issued/repurchased.

A public company must apply a single acceptable method consistently throughout its tax year to value both issuances and repurchases.

To value stock that is not traded on an established securities market, taxpayers must determine the market price of such stock under the principles of Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(1) (generally, by the reasonable application of a reasonable valuation method). The fair market value of stock issued to an employee is the fair market value of such stock as determined under Section 83 on the date the stock is issued to the employee.

### *Tax-Free Reorganizations*

Pursuant to the Notice, many tax-free reorganizations in which a public company is acquired will be treated as repurchases subject to the excise tax to the extent that the shareholders of the public company receive cash or other non-stock consideration (commonly referred to as “boot”), and even reorganizations without boot may affect the application of the *de minimis* rule.

The excise tax applies to “repurchases,” which are defined in Section 4501(c)(1) to include redemptions under Section 317(b) and any transactions determined by the Secretary of the Treasury to be “economically similar” to such redemptions. The Notice provides that acquisitive reorganizations and recapitalizations under Section 368(a)(1)(E) and changes in identity, form or place of incorporation under Section 368(a)(1)(F) will be treated as economically similar transactions. An acquisitive reorganization is a transaction that qualifies as a reorganization under Section 368(a)(1)(A) (including by reason of Section 368(a)(2)(D) or 368(a)(2)(E)), Section 368(a)(1)(C) or Section 368(a)(1)(D) (if the D reorganization satisfies the requirements of Section 354(b)(1)). Many acquisitive tax-free reorganizations of public companies are structured as reorganizations under Section 368(a)(1)(A).

The Notice further provides that the acquired public company will be treated as repurchasing its stock; the acquirer is not treated as repurchasing its stock. Therefore, the excise tax would not apply to the acquisition of a private company by a public company in an acquisitive reorganization. In addition, the public company will be treated as repurchasing all of its stock exchanged in the reorganization regardless of whether the stock is exchanged for stock permitted to be received tax-free under the relevant provisions of the Internal Revenue Code or for cash or other boot (even though, as described in the next paragraph, only the value of the stock exchanged for boot is intended to be subject to tax). As a result, for purposes of the *de minimis* exception, the fair market value of all of the stock exchanged in the reorganization will be treated as repurchased. This is a potential trap for the unwary—for example, a recapitalization or “F” reorganization by a public

company (with no boot) could cause the public company to exceed the *de minimis* threshold, in which case any repurchases by the public company in other transactions (after netting issuances and reducing for statutory exceptions) would be subject to the excise tax.

Importantly, for purposes of calculating the value of the repurchases subject to the excise tax, the fair market value of the stock repurchased will be reduced by the fair market value of the stock exchanged for acquirer stock (or stock of the recapitalized or reorganized corporation) permitted to be received tax-free under the relevant Internal Revenue Code provisions. Accordingly, the excise tax will only apply to the value of stock actually exchanged for cash or other boot.

To prevent an unintended benefit, the stock issued by the acquirer (or the recapitalized or reorganized corporation) in the transaction and received tax-free by the public company's shareholders will not be treated as an issuance for purposes of applying the netting rule. In addition, any stock issued by the corporation acquired in a Section 368(a)(2)(E) transaction to the acquirer or its subsidiaries will not be treated as issued.

### *Cash in Lieu of Fractional Shares*

In a welcome development, the Notice provides that the payment of cash in lieu of fractional shares in a tax-free reorganization, in a distribution to which Section 355 applies, or pursuant to settlement of an option or similar financial instrument (for example, a convertible bond or convertible preferred share) will not be treated as a repurchase for purposes of the excise tax if the cash is not separately bargained-for consideration, the payment is solely for administrative convenience, and the amount of cash paid to a shareholder in lieu of a fractional share does not exceed the value of one full share of stock.

### *Spin-Offs and Split-Offs*

Pursuant to the Notice, a distribution by a public company of stock of a controlled corporation that qualifies under Section 355 and is not a split-off is not a repurchase for purposes of the excise tax. A split-off is a distribution qualifying under Section 355 pursuant to which the shareholders of the distributing corporation exchange stock of the distributing corporation for stock of the controlled corporation and, if applicable, other property or money. The Notice provides that a split-off is an economically similar transaction that will be treated as a repurchase by the distributing corporation, and similar rules as described above with respect to tax-free reorganizations will apply.

### *Liquidations*

In another welcome development, the Notice provides that a distribution in complete liquidation of a public company to which either Section 331 or Section 332(a) applies (but not to which both Section 331 and Section 332 apply) will not be treated as a repurchase. Furthermore, if a public company completely liquidates and dissolves during a taxable year, no distribution by the company during that taxable year is treated as a repurchase. Subject to possible concerns about qualification under Section 331, this exception will generally allow special purpose acquisition companies (SPACs) to liquidate without being subject to the excise tax.

Section 331 and Section 332 generally will apply to a transaction where a corporate shareholder owns 80% or more of the public company and there is a minority shareholder. The Notice provides that, in the case of a complete liquidation to which both Section 331 and Section 332 apply to component distributions, each distribution to which Section 331 applies will be treated as a repurchase, but the distribution to which Section 332 applies will not be treated as a repurchase.

### *Redeemable Stock*

The substantive provisions of the Notice do not address the treatment of repurchases pursuant to the terms of stock that is mandatorily redeemable or that may be redeemed at the option of the holder. As we discussed in our prior client alert, there are principled reasons based on the policy of the statute why such repurchases should be exempt from the excise tax. However, the Notice provides no relief for such repurchases, and an example in the Notice confirms that under general tax principles, the repurchase of mandatorily redeemable preferred stock by a public company is a redemption within the meaning of Section 317(b) and is therefore taken into account for purposes of the excise tax. This is true even though the mandatorily redeemable preferred stock is not publicly traded and even if such stock were issued prior to January 1, 2023.

As a corollary, SPACs engaging in business combinations may be required to pay the excise tax with respect to repurchases of stock that is subject to a shareholder redemption right, although application of the netting rule may provide relief.

### *Leveraged Buyouts*

Similarly, the Notice does not provide any relief for leveraged buyouts that include redemptions under general federal income tax principles. Two examples in the Notice confirm that where an acquisition is partially funded by the acquired public company or where the public company (or a subsidiary of the acquirer merged into the public company) borrows money to fund the acquisition in part, under general tax principles, there is a redemption by the public company for purposes of Section 317(b) that must be taken into account for purposes of the excise tax.

### *Exception for Dividends*

Section 4501 provides that the excise tax does not apply to the extent the repurchase is treated as a dividend for tax purposes. The Notice provides that a repurchase to which Section 302 applies (generally, any redemption in form) or to which Section 356(a) applies (regarding recognition of gain with respect to boot) is presumed to be ineligible for this statutory exception. A public company may rebut this presumption with respect to a specific shareholder only by establishing with sufficient evidence that the shareholder treats the repurchase as a dividend on its federal income tax return, which generally requires the company to obtain a certification from the shareholder. As a practical matter, public companies generally will be unable to obtain such certifications from shareholders, so this exception will have limited applicability. The public company must also demonstrate that it has sufficient earnings and profits to treat the repurchase as a dividend. The Notice does not address whether a distribution in form could be treated as a repurchase for

purposes of the excise tax if the public company does not have sufficient earnings and profits to treat the distribution as a dividend. It would be difficult to administer a rule treating such a distribution as a repurchase, given that the shareholder's basis reduces the amount of the distribution treated as a sale or exchange under Section 301(c)(3).

## *Conclusion*

While the Notice addresses many questions resulting from the broad statutory language of Section 4501, a number of questions remain unanswered. Indeed, the Notice includes a laundry list of questions on which Treasury is seeking public comment, including, among others, whether special rules should be provided for redeemable preferred stock or other special classes of stock or debt, whether special rules are necessary regarding taxable years in which a corporation becomes a covered corporation or ceases to be a covered corporation or for bankrupt or troubled companies, the determination of fair market value, and the application of Section 4501 to non-US entities. WilmerHale tax specialists are available to help evaluate the application of the excise tax and to advise on how best to avoid or mitigate its impact.

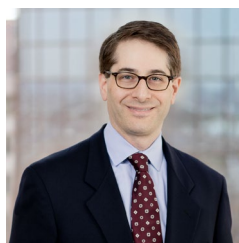
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