

IRS issues interim guidance on the stock repurchase excise tax

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On Tuesday, December 27, the IRS released a notice that describes proposed regulations that the IRS intends to issue addressing the application of the 1% stock repurchase excise tax that goes into effect on January 1, 2023. The notice contains guidance on a number of issues, including the application of the excise tax to acquisitive reorganizations, spin-offs and split-offs, and SPAC liquidations. This update describes the new guidance and highlights important considerations for taxpayers.

On Tuesday, December 27, the Internal Revenue Service (IRS) released a notice (“Notice 2023-2” or the “Notice”) that describes proposed regulations that the IRS intends to issue addressing the application of the 1% stock repurchase excise tax that was enacted as part of the Inflation Reduction Act of 2022. The IRS also released interim guidance on the corporate alternative minimum tax, and we have circulated a separate update on that guidance.

Notice 2023-2 contains important guidance on a number of issues, including the application of the excise tax to acquisitive reorganizations, spin-offs and split-offs, and SPAC liquidations, but notably does not contain other sought-after exceptions, such as an exception for redemptions of preferred stock, or conventions for valuing stock repurchases and issuances which would permit taxpayers to mitigate the effects of timing mismatches between repurchases and issuances.

Key takeaways

- No exception for preferred stock. There is no exception for redemptions of preferred stock, including straight preferred stock or preferred stock with a mandatory redemption date, although the IRS has requested comments from taxpayers on this topic.
- Application to SPACs. Complete liquidations (including liquidations of SPACs) are generally exempt from the excise tax, as are redemptions that occur in the same taxable year as the liquidation. Redemptions of SPAC stock as part of a de-SPAC transaction would be treated as repurchases subject to the excise tax, subject to offset under a “netting” rule for stock (such as a PIPE) issued by the SPAC in the same taxable year.
- Exception for certain reorganizations. Acquisitive reorganizations (which do not include stock-for-stock B reorganizations or bankruptcy G reorganizations but somewhat surprisingly do include reverse subsidiary merger (a)(2)(E) reorganizations), E reorganizations (recapitalizations) and same-company F reorganizations are effectively exempt from the excise tax, but only to the extent the consideration issued in the transaction consists of stock eligible for nonrecognition treatment (which, in certain cases, would exclude preferred stock). This is accomplished through a two-step calculation in which the value of the acquired or “redeemed” stock both increases and reduces the tax base for the excise tax.
- Exception for split-offs. Exchanges by a distributing corporation’s shareholders of distributing corporation stock solely for the stock of a controlled corporation in a “split-off” transaction governed by section 355 are effectively exempt from the excise tax, whether or not the split-off is part of a D reorganization. This is accomplished through a two-step calculation in which the value of the distributing stock retired in the exchange both increases and

reduces the tax base for the excise tax.

- Stock valued solely on the date of repurchase or issuance. With a limited exception for stock issued to employees as compensation, the value of stock that is repurchased or issued is based on the market price of the stock on the date the stock is repurchased or issued, which means that a company may have an excise tax liability even if it repurchases the same number of shares during the taxable year as the number of shares that were issued to employees.
- Reporting and payment of the excise tax. The Notice states that the excise tax will be reporting on IRS Form 720, Quarterly Federal Excise Tax Return, but only once per taxable year on the Form 720 that is due for the first full quarter after the close of the taxpayer's first taxable year, with the excise tax for the taxable year being due at the same time. For a calendar-year taxpayer, this means that the first return filing and payment deadline for the payment of the excise tax will be April 30, 2024.
- Effective date. As described in more detail below, the Notice provides that, until the issuance of proposed regulations (which the IRS anticipates will generally apply to repurchases made after December 31, 2022), taxpayers may rely on the rules set forth in the Notice.

Basic rules for domestic corporations

Subject to a \$1 million de minimis exception, the amount of the stock repurchase excise tax imposed on a “covered corporation” (generally, any domestic corporation the stock of which is traded on an established securities market, as such term is defined in regulations under section 7704¹) for any taxable year is equal to the product of 1% and the “stock repurchase excise tax base” for such year. In general, the “stock repurchase excise tax base” for a taxable year is equal to:

- the fair market value of all of the repurchases of the covered corporation's stock during the year, *reduced by*
- the sum of (i) the aggregate fair market value of stock of the covered corporation repurchased during the year that qualifies for a “statutory exception” described in the Notice, and (ii) the aggregate fair market value of stock issued by the covered corporation during the year under a specified “netting” rule in the Notice.

For this purpose, a covered corporation's “stock” is defined to include all of the instruments issued by the covered corporation that are treated as stock for U.S. federal income tax purposes at the time of issuance, whether or not the instrument is publicly traded. The Notice does not contain any exceptions – such as for preferred stock – to the definition of stock.

A “repurchase” means (i) subject to exceptions for deemed redemptions under section 304 and certain payments of cash in lieu of fractional shares, a redemption under section 317(b) (which includes repurchases or redemptions of shares by the covered corporation, regardless of whether the shares are cancelled or held as treasury stock), and (ii) an “economically similar” transaction as described in the Notice.² The Notice sets forth an exclusive list of economically similar transactions, as well as a nonexclusive list of transactions that are not economically similar transactions. The exclusive list of economically similar transactions consists of the following transactions:

- Acquisitive reorganizations: exchanges of stock by target shareholders in an “acquisitive reorganization” – a merger reorganization under section 368(a)(1)(A) (including a forward or reverse subsidiary merger qualifying under section 368(a)(2)(D) or section 368(a)(2)(E)), and asset reorganizations under section 368(a)(1)(C) or under section 368(a)(1)(D) – of a covered corporation;
- E reorganizations: exchanges of stock by recapitalizing shareholders in a reorganization under section 368(a)(1)(E);
- F reorganizations: exchanges of stock by transferor corporation shareholders in a reorganization under section 368(a)(1)(F) (which includes a mere change in corporate form or jurisdiction, and certain charter amendments);

- Split-offs: exchanges of stock by distributing corporation shareholders of their distributing corporation stock for controlled corporation stock and, if applicable, other property in a transaction governed by section 355; and
- Section 331/332 overlap liquidations: in the case (but only in the case) of a complete liquidation of a covered corporation to which both sections 331 and 332(a) apply – i.e., where the covered corporation has a parent corporation that owns 80% or more, but less than 100%, of the stock of the covered corporation and minority shareholders – each distribution to minority shareholders to which section 331 applies (but not any distribution to the controlling parent to which section 332(a) applies).

It is important to note that, notwithstanding this broad list of economically similar transactions, the Notice provides a list of statutory exceptions – described in greater detail below and which cover repurchases occurring pursuant to acquisitive reorganizations, E reorganizations, F reorganizations and split-offs – that, in whole or in part, reduce the stock repurchase excise tax base, and, to that extent, effectively exclude such transactions from the excise tax.

Transactions that are not economically similar transactions include – but are not limited to – a complete liquidation of a covered corporation that qualifies solely under section 331 or section 332(a), any redemption that occurs in the same taxable year as a complete liquidation to which section 331 applies, and a distribution of controlled corporation stock in a section 355 transaction that is not a split-off. Under the foregoing rules, liquidating distributions made by a SPAC to its shareholders as part of (or in the same taxable year as) the complete liquidation of the SPAC will not be treated as repurchases, and will not be subject to the excise tax.

An acquisition of stock of a covered corporation by a “specified affiliate” – generally, any corporation or partnership 50% or more of which is owned directly or indirectly by the covered corporation – from a third party is treated as a repurchase of the stock of the covered corporation by the covered corporation.

Timing and valuation rules

The Notice provides specific rules for determining (i) when stock is treated as repurchased or issued, and (ii) the fair market value of such stock.

Timing. Stock is generally treated as repurchased at the time at which ownership of the stock transfers to the covered corporation or applicable acquiror for U.S. federal income tax purposes, except that, in the case of economically similar transactions, stock treated as repurchased in the transaction is treated as repurchased at the time the shareholders of the covered corporation exchange their stock in the covered corporation. Stock is generally treated as issued at the time at which ownership of the stock transfers to the recipient for U.S. federal income tax purposes (subject to special rules for stock issued to employees which, for example, treat stock received pursuant to the exercise of an option or stock appreciation right as issued as of the date of exercise and treat restricted stock as to which an election is made under section 83(b) as issued on the effective date of the election).

Valuation. The fair market value of repurchased stock is the market price of the stock on the date the stock is repurchased (regardless of whether the price at which the stock is actually repurchased differs from the market price). For repurchased stock that is 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 for determining the market price on the repurchase date:

- daily VWAP;
- closing price;
- average of the high and low prices; and
- trading price at the time of the repurchase.

The market price of repurchased stock that is traded on an established securities market must be determined by applying one (but not more than one) of the above methods to all repurchases during the covered corporation's taxable year. The market price of stock that is not traded on an established securities market is determined as of the date the stock is issued under the principles of the regulations under section 409A with respect to such stock (which generally permit the use of a reasonable valuation method, subject to certain rules and presumptions).

Similar rules apply to the determination of the market price of all stock issued under the netting rule during the same year.

Statutory exceptions that reduce the stock repurchase excise tax base

As described above, if stock is repurchased by a covered corporation in a "repurchase" to which a so-called "statutory exception" applies, the fair market value of the stock both increases and reduces the covered corporation's stock repurchase excise tax base, and, to that extent, effectively exclude such repurchase from the excise tax. These exceptions are as follows:

Qualifying property exception for acquisitive reorganizations, E reorganizations, F reorganizations and split-offs. The fair market value of stock repurchased by a target corporation or a covered corporation, as applicable, in an acquisitive reorganization, an E reorganization, an F reorganization or a split-off (whether or not part of a D reorganization) reduces the covered corporation's stock repurchase excise tax base to the extent that such repurchase is for property permitted by section 354 or section 355 to be received without the recognition of gain or loss ("qualifying property"). The effect of this rule is that common stock consideration (and perhaps warrants) transferred or distributed to target or covered corporation shareholders, as applicable, in any of these transactions generally does not give rise to a repurchase subject to the excise tax, but any cash or other nonstock consideration transferred or distributed does give rise to a repurchase subject to the excise tax. Because a shareholder may be subject to tax under section 354 on the receipt of preferred stock in a reorganization (e.g., if the shareholder receives nonqualified preferred stock ("NQPS") for stock that is not NQPS), whether preferred stock consideration transferred or distributed in any of these transactions will be treated as qualifying property for purposes of this exception will need to be determined on a case-by-case basis.

Stock contributions to an employer-sponsored retirement plan. The fair market value of stock repurchased by a covered corporation reduces the covered corporation's stock repurchase excise tax base if the stock that is repurchased, or an amount of stock (including stock of a different class) equal to the fair market value of the stock repurchased, is contributed to an employer-sponsored retirement plan. A covered corporation may treat stock contributions to an employer-sponsored retirement plan as having been contributed in the prior taxable year if contributed by the filing deadline for the IRS Form 720, Quarterly Federal Excise Tax Return (see below), that is due for the first full quarter after the close of the taxpayer's taxable year and on account of that taxable year within the meaning of section 404(a)(6).

Repurchases by dealers in the ordinary course of business. The fair market value of stock repurchased by a covered corporation or a specified affiliate that is a dealer in securities reduces the covered corporation's stock repurchase excise tax base to the extent the stock is acquired in the ordinary course of the dealer's business of dealing in securities. To qualify for this statutory exception, the dealer must account for the stock as securities held primarily for sale to customers, must dispose of the stock within a time period that is consistent with the holding of the stock for sale to customers in the ordinary course of business, and must 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 satisfies the requirements of the exception.

Repurchases by a RIC or REIT. A repurchase by a RIC or REIT reduces the RIC's or REIT's stock repurchase excise tax base, effectively taking RICs and REITs out of the excise tax, consistent with the statute.

Repurchase treated as a dividend. The covered corporation's stock repurchase excise tax base is reduced to the extent the repurchase is treated as a dividend under section 301(c)(1) or section 356(a)(3). A repurchase is conclusively presumed not to be treated as a dividend unless the covered corporation (i) reports the repurchase, as applicable, as constituting a dividend, (ii) obtains a certification from the shareholder that the repurchase constitutes a distribution under section 301 or as having the effect of a distribution of a dividend under section 356(a)(2), including evidence that applicable withholding occurred if required, (iii) has no knowledge of facts that would indicate that such certification is incorrect, and (iv) demonstrates that it has sufficient earnings and profits to support dividend treatment. This presumption that a repurchase is not a dividend for purposes of calculating the stock repurchase excise tax base is the opposite of the presumption that would apply for determining whether a repurchase by a domestic corporation from foreign shareholders is a dividend subject to U.S. withholding tax.

Netting rule

The stock repurchase excise tax base with regard to a taxable year of a covered corporation is reduced by the aggregate fair market value of stock of the covered corporation that is (i) issued or provided to employees of the covered corporation or a specified affiliate or (ii) issued to other persons, in each case during the taxable year.

Special rules apply to stock issued or provided to employees pursuant to compensation arrangements, including transfers of stock governed by section 83, including pursuant to a nonqualified stock option, or pursuant to a qualified stock option described in section 421. Stock withheld to satisfy an employer's income tax or payroll tax withholding obligations is not treated as stock issued or provided to an employee. Stock that is withheld to satisfy the exercise price of a net-exercised option is also not treated as stock issued or provided to an employee, but if a broker or other third party advances any amount to an employee to fund the exercise price of a stock option or such withholding obligation (or pays such amount directly on behalf of the employee), any stock transferred to the employee or third party is treated as stock issued or provided to the employee.

Certain issuances of stock are disregarded for purposes of the netting rule, including:

- stock splits;
- issuances of stock by a covered corporation to a specified affiliate;
- generally, stock issued as part of a section 368 reorganization or a section 355 distribution that qualifies for the qualifying property exception (because, in each such case, such stock is effectively already taken into account in the calculation of the stock repurchase excise tax base by reason of the statutory exceptions);
- deemed issuances of stock in section 304(a)(1) transactions;
- deemed issuances of fractional shares where cash is paid in lieu of fractional shares;
- stock issued by a covered corporation that is a dealer in securities to the extent the stock is issued, or otherwise used to satisfy obligations to customers, in the ordinary course of business of dealing in securities; and
- target corporation stock that is issued by the target corporation to the merged corporation in a transaction qualifying under section 368(a)(2)(E).

Acquisitions of foreign corporation stock

Generally, if a domestic specified affiliate (an “applicable specified affiliate”) of an “applicable foreign corporation” (generally, a foreign corporation the stock of which is traded on an established securities market) acquires stock of the applicable foreign corporation from an unrelated third party, the acquisition is brought within the scope of the excise tax by treating (i) the applicable specified affiliate as a covered corporation with respect to the acquisition, and (ii) the acquisition as a repurchase of stock of a covered corporation by the covered corporation.

An applicable specified affiliate is also treated as acquiring stock of the applicable foreign corporation if the applicable specified affiliate funds by any means (including through a distribution, debt or capital contributions) the acquisition or repurchase of stock of the applicable foreign corporation by the applicable foreign corporation or a specified affiliate that is not also an applicable specified affiliate, and such funding is undertaken for a principal purpose of avoiding the excise tax (the “funding rule”). The amount of any such acquisition is limited to the amount so funded. A principal purpose to avoid the excise tax is deemed to exist if the acquisition or repurchase occurs within two years after the funding (other than a funding through distributions).

Similar rules apply to repurchases by, with or respect to any corporation that is a “covered surrogate foreign corporation” (generally, any surrogate foreign corporation under section 7874(a)(2)(B) that became a surrogate foreign corporation after September 20, 2021 and the stock of which is traded on an established securities market, but only with respect to taxable years that include any portion of the 10-year “applicable period” described in section 7874(d) (1)). If a covered surrogate foreign corporation or a specified affiliate of such corporation repurchases or acquires, as applicable, the stock of the covered surrogate foreign corporation, (i) the expatriated entity with respect to such covered surrogate foreign corporation is treated as a covered corporation with respect to such repurchase or acquisition, and (ii) the repurchase or acquisition is treated as a repurchase of stock of a covered corporation by the covered corporation.

Application of the netting rule to fiscal year corporations

The stock repurchase excise tax base does not include any stock repurchased before January 1, 2023, but the netting rule does include any stock that is issued before such date but during a taxable year that ends after such date. As a result, a covered corporation with a taxable year that does not end on December 31 will effectively be able to reduce the amount of the excise tax that would otherwise apply in its year ending after December 31, 2022, by taking into account, for purposes of the netting rule, stock that is issued during such taxable year but before January 1, 2023.

Equity-linked financial instruments

Although the Notice does not treat transactions involving equity derivatives, such as options, or other equity-linked financial instruments as transactions that are “economically similar” to a repurchase, the IRS asks for comments regarding those instruments as well as convertible bonds. As a result, it is possible that the IRS will issue guidance addressing these instruments in the future.

Moreover, while the Notice does not address convertible bonds in any specific way, the approach in the Notice approach to valuation as well as the netting rule means that, in typical “call spread” transactions, the increase in the stock repurchase excise tax base attributable to the value of any stock repurchased by the covered corporation pursuant to the settlement of an option should generally be offset by a reduction in the stock repurchase excise tax base for the value of any stock issued concurrently by the corporation under the convertible bond.

Finally, through an example, the Notice illustrates the consequences of an “accelerated share repurchase” (“ASR”). In the example, the IRS treats an initial repurchase of shares by a covered corporation pursuant to an ASR on October 12, 2022 and a subsequent additional repurchase of shares by the corporation on February 1, 2023 as separate repurchases for purposes of applying the excise tax. As a result, because the initial repurchase is before the January 1, 2023 effective date for the excise tax, the initial repurchase is excluded from the corporation’s stock repurchase excise tax base for its 2023 taxable year, and therefore effectively exempt from the excise tax.

Reporting and payment of the excise tax

The Notice provides that the excise tax will be reported on IRS Form 720, Quarterly Federal Excise Tax Return.

Although Form 720 is filed quarterly, the IRS anticipates that the excise tax will be reported once per taxable year on the Form 720 that is due for the first full quarter after the close of the taxpayer's taxable year (e.g., for a taxpayer with a taxable year ending on December 31, 2023, the excise tax would be reported on the Form 720 for the first quarter of 2024, due on April 30, 2024). The excise tax will be due at the same time as the filing deadline, with no extensions permitted for reporting or paying the excise tax owed.

Effective date

The Notice states that it is anticipated that the proposed regulations will provide that rules consistent with the rules in the Notice will generally apply to repurchases of stock of a covered corporation made after December 31, 2022, to issuances of stock made during a taxable year ending after December 31, 2022, and, with respect to the funding rule, to repurchases and acquisitions of stock made after December 31, 2022 that are funded on or after December 27, 2022. The Notice also provides that, until the date proposed regulations are issued, taxpayers may rely on the rules set forth in the Notice.

Request for comments

The Notice contains a request for comments on the rules included in the Notice (and on rules not included in the Notice), including with respect to:

- whether there should be special rules for redeemable preferred stock or other special classes of stock or debt (including convertible debt);
- whether the fair market value of stock repurchased or issued should be an amount other than the market price;
- the rules for contributions to employer-sponsored retirement plans;
- the method for determining the market price of stock that is traded on multiple established securities markets;
- whether there should be additional methods for rebutting the presumption that a repurchase is not a dividend;
- when should a corporation be treated as becoming or ceasing to be a covered corporation, and how should repurchases and issuance by a corporation during a taxable year that are before or after the date on which it becomes or ceases to be a covered corporation, as applicable, be treated;
- whether there should be special rules for bankrupt or troubled companies; and
- whether there should be special rules with respect to financial arrangements, such as options or other similar financial instruments, to prevent avoidance of the excise tax.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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¹ For purposes of this update, unless the context otherwise requires references to “sections” are to sections of the Internal Revenue Code of 1986, as amended.

² Under general U.S. federal income tax principles, a “redemption” under section 317(b) includes a “bootstrap” acquisition of the stock of a target corporation to the extent the consideration received by the target shareholders is funded by the target corporation (either from cash on hand or debt incurred by the target corporation), a result which is confirmed by examples in the Notice. However, in a welcome development, the Notice does not include a leveraged acquisition of target corporation stock, using debt incurred by the acquiror (such as a newly formed holding corporation) in the exclusive list of “economically similar” transactions, with the result that such an acquisition should not give rise to a repurchase that is subject to the excise tax.