New 1% Tax on Stock Buybacks - It's Not As Simple as You Think

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On August 16, 2022, President Biden signed the Inflation Reduction Act (the Act). The Act includes the establishment of a new Section 4501 of the Internal Revenue Code (the Code) which, beginning in 2023, will impose a nondeductible tax on publicly-traded corporations that repurchase their stock. The new tax equals 1% of the fair market value of the shares repurchased by the corporation or certain "specified affiliates" of the corporation. As with many things, the new tax is simple in principle, but has a number of potential complexities.

What entities are subject to the tax?

Any domestic corporation whose stock is traded on an established securities market (and some foreign issuers) may be subject to the tax if the corporation or certain specified affiliates repurchase the corporation's shares. Importantly, there is no size limitation, so even micro-cap companies will be subject to the new tax.

One open question relates to shares purchased by a rabbi trust established by the corporation or a specified affiliate (the grantor) to informally fund a deferred compensation plan for participants' benefits that are deemed invested in the corporation's stock. Technically, the trust would not fall within the definition of a specified affiliate, so there is an argument that such a purchase would not be subject to the tax. However, because the grantor is treated as the owner of the trust assets for other tax purposes, it is not clear that argument would be successful. Until further guidance is issued, corporations subject to this tax should consider suspending stock purchases by their rabbi trusts after December 31, 2022.

What repurchases are counted when calculating the tax?

The tax applies when the corporation or one of its specified affiliates redeems or otherwise acquires the corporation's stock (not just the publicly traded stock) from a shareholder in exchange for cash or other property.

The tax clearly applies to tender offer purchases and open market purchases made pursuant to a stock repurchase plan.

Shares that are tendered back to the corporation to pay taxes and exercise prices related to equity plan compensatory awards and shares purchased in connection with the administration of an employee stock purchase plan would initially count toward the taxable repurchases, but there is an adjustment provision that reduces the taxable amount by the fair market value of stock issued by the corporation during the year, including any shares “issued or provided” to any employee of the corporation or a specified affiliate during the year. It would appear that this adjustment provision is intended to eliminate taxes on these types of purchases, whether the shares are delivered by issuance of new shares or use treasury shares. Note that the “issued or provided” language is only in the reference to employees. While we hope that treasury shares provided to directors and other service providers would be counted under the adjustment provision, that interpretation is not necessarily required by a strict reading of Code Section 4501.

Although there is an exclusion for shares repurchased as part of a reorganization under Code Section 368 (a), that exclusion would only appear to exclude the shares purchased for replacement shares (i.e., the shares exchanged for other shares in the reorganization). It would not appear to exclude shares purchased with ‘boot.’ Because many transactions are designed to provide up to 20% of the deal value in non-share compensation (‘boot’), this may be a significant hidden tax on this form of transaction. Similarly, leveraged buy-outs and Code Section 355 split-off transactions don’t fit within this exception and, therefore, shares repurchased in these transaction structures appear to count toward this new tax.

There is an express exclusion of shares that are repurchased and contributed to an employer-sponsored retirement plan, an employee stock ownership plan and similar plans. This exclusion will clearly protect shares purchased by qualified retirement plans (401(k) plans and ESOPs) that are allocated in a particular year. The exclusion should also cover leveraged ESOP transactions, in which the plan borrows money to purchase a large number of shares from shareholders and then allocates those shares to employee/participant accounts over a number of years (as the loan is repaid).

One open question is how this exception will be applied to deferred compensation (supplemental retirement) plans. While some plans defer payment until the employee meets a retirement standard, most pay the benefit at any termination of employment, and some pay at a specified date. We would hope that the implementing regulations address which deferred compensation plans can fall within the retirement plan exception. This exception is limited to employees, so, until further guidance is provided, shares purchased for directors’ plans will need to be counted in determining the share repurchases subject to the tax. Deferred compensation plans for employees that are payable in shares may want to consider purchasing shares at the time of payout. That would enable the adjustment provision to exclude the purchase from the tax.

There is an exclusion in “any case in which the total value of the stock repurchased during the taxable year does not exceed $1,000,000.” We think that it is relatively clear this was intended to be applied after the other adjustments. So, if a company repurchased $1,500,000 in shares and contributed $600,000 of those shares to an ESOP, the remaining $900,000 would fall within this exception and no amount would be taxable for that company. It appears that a non-excluded repurchase of shares worth $1,000,001 would trigger a $10,000.01 tax; the full amount would be taxable and not just the portion of the repurchase in excess of $1,000,000.

Shares purchased in connection with the administration of a dividend reinvestment plan would count but the adjustment provision described above would provide an offset for the value of the shares issued under the DRIP. Again, we hope for clarification that provision of treasury shares would count as an issuance for purposes of the adjustment calculation.

How will fair market value be determined?

Disputes about fair market value are common and there is often a wide range of defensible values on a particular date. We hope that the implementing regulations will establish a series of rules for calculating the fair market value, like the following:

- For a cash transaction, the fair market value would be the cash price paid for the shares.
- For shares repurchased in connection with an equity plan, for example to pay withholding taxes and exercise prices, the fair market value would be determined under the plan’s definition.
- For other transactions, refer to the rules of Code Section 409A or Code Section 83(b) which specify a number of alternative methodologies.

Conclusion

This new tax may have a surprise impact on many publicly-traded companies. We will continue to monitor the implementation of this new tax and how these open issues are resolved. If you have questions about how the new tax may impact a transaction related to your stock, contact your Vorys attorneys.