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Senate approves tax on stock buybacks and corporate minimum tax

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On August 7, 2022, the United States Senate approved the Inflation Reduction Act of 2022 (H.R. 5376), an energy and healthcare bill that includes new tax provisions, including a new corporate minimum tax and a tax on stock buybacks, as well as funding for enhanced IRS enforcement. This update describes the new tax provisions and highlights important considerations for taxpayers.

On August 7, 2022, the Senate voted to approve the “Inflation Reduction Act of 2022” (the Reconciliation Bill). The tax provisions in the Reconciliation Bill would (i) impose a 1% excise tax on certain stock buybacks (and similar transactions) by publicly traded corporations, (ii) impose a 15% corporate alternative minimum tax on the adjusted book income of corporations with over $1 billion of adjusted book income (the Corporate AMT), and (iii) increase funding for IRS enforcement. The Reconciliation Bill does not include (A) the changes to the rules governing “carried interest” that were included in a prior version of the bill or (B) changes to the proposed Corporate AMT that were included in an interim version of the Reconciliation Bill and that might have operated to aggregate the portfolio companies of a private equity fund in determining whether the companies met the $1 billion threshold applicable under the AMT.[1] The Reconciliation Bill will now be sent to the House of Representatives.

I. Excise tax on stock repurchases

Targets “repurchases” of the stock of corporations, the stock of which is traded on an established securities

market, that occur after December 31, 2022

The Reconciliation Bill would generally impose a new excise tax on a “covered corporation” equal to 1% of the fair market value of the stock of the covered corporation that is “repurchased” during the taxable year. This excise tax would apply with respect to repurchases that occur after December 31, 2022. For this purpose, a “covered corporation” is a domestic corporation the stock of which is traded on an established securities market,[2] and a “repurchase” is defined as (i) a redemption of stock within the meaning of Section 317(b) (that is, any repurchase or ordinary buyback by a corporation of its stock, or an acquisition of stock by the issuing corporation from its shareholders in exchange for property, whether or not the stock is cancelled, retired or held as treasury stock) and (ii) any transaction determined by the Secretary of the Treasury to be economically similar to such a redemption of stock.

The excise tax would be payable by the corporation redeeming the stock, and would equal 1% of the fair market value of corporation’s stock repurchased in a taxable year, reduced by the fair market value of stock that the corporation issued in that taxable year (including as compensation). The tax would not be deductible for U.S. federal income tax purposes.

The excise tax would also apply to acquisitions of covered corporation stock by “specified affiliates” of the covered corporation (i.e., generally, a corporation or partnership more than 50% owned, directly or indirectly, by the covered corporation). The Reconciliation Bill would apply similar rules to repurchases or acquisitions of stock by certain foreign corporations that have engaged in material acquisitions of U.S. businesses on or after September 2021 and are treated as “expatriated entities” under the U.S. “inversion” rules. In the case of any other publicly-traded foreign corporation, the excise tax would apply if that foreign corporation’s stock is acquired or repurchased by certain domestic and partnership affiliates.

Important exceptions to the excise tax

Under the Reconciliation Bill, the excise tax on repurchases of covered corporation stock would not apply:

- To the extent the repurchase is part of certain forms of so-called tax-free and tax-deferred reorganization transactions, in which no gain or loss is recognized on such repurchase by the shareholder.
- If the stock repurchased (or an amount of stock of equivalent value) is contributed to

an employer-sponsored retirement plan, employee stock ownership plan or similar plan.

- If the total value of the stock repurchased in the taxable year does not exceed $1 million.
- Under regulations, if the repurchase is by a dealer in securities acting in the ordinary course of business.
- If the covered corporation is a regulated investment company (RIC) or real estate investment trust (REIT).
- If the repurchase is treated as a dividend for U.S. federal income tax purposes.

Treasury given broad regulatory authority

Under the Reconciliation Bill, the Treasury Department is directed to write regulations and other guidance that are necessary or appropriate to carry out, and to prevent the avoidance of, the purposes of the new excise tax provisions, including:

- To prevent abuse of the exceptions to the tax;
- To address special classes of stock and preferred stock; and
- To provide rules for the application of the provisions applicable to foreign corporations.

Observations

If the Reconciliation Bill is enacted in its current form, the excise tax represents an additional cost imposed on corporate issuers that will need to be considered by companies planning to buy back equity. Additionally, companies may pivot towards distributing cash in the form of dividends to shareholders, which would avoid the excise tax but likely result in more current taxable income to the recipient shareholders and have different capital markets impacts.

There are a number of uncertainties as to the intended scope and application of the excise tax. For example, it is unclear whether or how the excise tax would apply to transactions that are deemed to be treated as redemptions for tax purposes (even if they are not redemptions in form), including certain corporate liquidations and stock acquisitions by corporations under common control. Additionally, the Reconciliation Bill charges the Treasury Department with authority to apply the excise tax to other transactions that it determines are "economically similar" to stock redemptions, which leaves the ultimate sweep of the provision unclear. Clarifying revisions (or other guidance) in these and other areas would be welcome.

Moreover, the text of the Reconciliation Bill would apply the excise tax to a broader universe of transactions than traditional stock buybacks, including certain transactions that do not appear to be stock buybacks at all or to raise the same policy issues implicated by traditional stock buybacks. The following transactions are notable:

Redemptions of preferred stock. Preferred stock issuances have become an increasingly common tool for companies to raise financing. Although the terms of preferred stock take many forms, many include mandatory or optional redemptions. The Reconciliation Bill in its current form would apply the excise tax to the redemptions of any stock of publicly traded corporations, regardless of whether the particular class of stock being redeemed is publicly traded. However, the Reconciliation Bill grants the Treasury Secretary authority to issue regulations addressing the application of the excise tax to special classes of stock, including preferred stock. In the absence of regulations or other guidance providing a specific exemption, the redemption of preferred stock by a covered corporation would give rise to the proposed excise tax. The Reconciliation Bill does not include any rule grandfathering special classes of stock that are currently outstanding, although this is a point that Treasury could seek to address quickly using its regulatory authority.

Certain taxable and tax-deferred M&A transactions. The excise tax would apply to certain common forms of M&A transactions, and the additional cost may cause an acquiring company to reconsider its acquisition structure. Specifically:

— The excise tax can be expected to apply to cash consideration in taxable stock purchases (or reverse subsidiary mergers with cash consideration) to the extent that cash is funded from the target's balance sheet. This can include cash funded from new debt financing raised (or assumed) by the target as part of the transaction.

— The excise tax may apply where a mix of cash and stock is used as consideration in certain forms of tax-free or tax-deferred acquisitions, including so-called tax-free asset acquisitions, and forward and forward subsidiary mergers. Moreover, there is some uncertainty as to how the rules may apply to such transactions. Specifically, the text of the Reconciliation Bill is unclear as to whether it applies to the total value of the consideration issued (including stock and cash), solely the cash consideration, or only a portion of the cash consideration. Although the arguably most natural reading suggests it should be limited to (but apply to all) cash consideration, to the extent the cash consideration is viewed as having been paid in a "redemption" transaction in the first instance, clarifying guidance would be helpful.

SPAC transactions. In connection with deSPAC transactions in which a SPAC acquires the business of a target company, it is common for SPAC shareholders to have an election to redeem their SPAC stock. However the SPAC also may issue new stock to the target's shareholders and also, frequently, to PIPE investors. Because the excise tax applies to only the net amount of redemptions (i.e., as reduced by the fair market value of stock issued during the same taxable year), many deSPAC transactions may not trigger the excise tax. However, if the Reconciliation Bill is enacted in its current form, careful consideration of the excise tax consequences of a deSPAC transaction, including how those consequences may vary based on the form and timing of the deSPAC transaction, will be required. Additionally, as noted above, the text of the Reconciliation Bill suggests that the excise tax may apply in the case of corporate liquidations, including liquidations of a SPAC, which would impose additional financial burdens on a corporation that is in the process of unwinding.

Cash in lieu of fractional shares. Tax-free reorganizations (including recapitalizations, such as reverse stock splits) very often include cash payments to holders for fractional shares. The Bill would appear to treat those cash payments as redemptions subject to the excise tax (except to the extent they are taxed to the shareholders as dividends).

Certain tax-free split-off transactions. In a split-off transaction (where shareholders of a public company may elect to surrender a portion of their shareholdings in the public company in exchange for equity of a company that previously was a subsidiary of the public company), the exchange of parent shares for subsidiary shares typically takes the form of a redemption transaction. As drafted, the excise tax would apply to the full value of the subsidiary stock distributed in some (and perhaps all) of these transactions, except to the extent that the transactions are eligible for the tax-free reorganization exemption described above (although the application of that exemption to split-offs is unclear). It is also far from clear whether this result was intended. Clarification from the IRS would be helpful here as well.

Routine anti-dilution buybacks. As noted above, the excise tax applies to the fair market value of shares repurchased in a year, less the fair market value of shares issued during that same year. The Reconciliation Bill does not specify the time at which the fair market value of repurchased (or issued) stock is determined for purposes of calculating this excise tax base, although the most natural reading is that each redemption and issuance is valued when the particular transaction occurs. On that reading, corporations that use stock buyback programs to manage their shares outstanding to avoid the dilutive effect of, for example, stock issued to employees under incentive compensation programs, may be subject to the excise tax even where the number of shares issued and redeemed in a particular year is identical. Guidance from Treasury would be welcome on this issue.

II. Modifications to the Corporate AMT

The original bill included a Corporate AMT provision that that would impose a 15% minimum tax on the adjusted book income of corporations with over $1 billion of adjusted book income. The Corporate AMT provision in the Reconciliation Bill is similar to the corresponding provision in the original bill, with two notable changes relating to (i) accelerated depreciation and (ii) amortization of certain acquisition costs for wireless spectrum.

Targets corporations with more than $1 billion in book income

The Reconciliation Bill would impose the Corporate AMT on an "applicable corporation," which is any corporation that meets a $1 billion minimum book income test.[3] More specifically, the corporation's average annual "adjusted financial statement income" (or AFSI) for three consecutive years must exceed $1 billion. A corporation's AFSI is the net income reported on its consolidated financial statement, subject to certain adjustments (discussed in more detail below).

An aggregation rule provides that, for purposes of determining whether the $1 billion test is met, the income of all corporations in a controlled group, or otherwise under common control (at a 50% threshold in each case) is aggregated.[4]

A domestic corporation that is a member of a foreign-parented group is an applicable corporation only if two separate tests are met. First, the AFSI of the group that *includes* all the foreign group members must exceed $1 billion. Second, the AFSI of the group that *excludes* all the foreign group members must equal or exceed $100 million. (In the latter test, the domestic corporation would still take into account its *pro rata* share of its CFCs' income.) For this purpose, if a non-U.S. corporation is engaged in a trade or business in the United States, that trade or business is treated as a separate, wholly owned domestic subsidiary of the non-U.S. corporation.

Special computational rules apply to corporations in existence for less than three years or with short taxable years.

Once an applicable corporation, always an applicable corporation

Once a corporation meets the $1 billion test, it remains an applicable corporation indefinitely, even if its AFSI drops below the $1 billion threshold.

The sole exception to this rule appears to require a determination by Treasury that continued treatment as an applicable corporation would not be appropriate.[5] Moreover, it would be available only to corporations that undergo a change of control or the AFSI of which drops below $1 billion and stays below that threshold for a specified number of years.

If Treasury determined that a corporation was no longer an applicable corporation, it would nevertheless become an applicable corporation again once its AFSI increased back above $1 billion in a later year.

Corporate AMT is calculated as 15% of AFSI

An applicable corporation must calculate its "tentative minimum tax," which is equal 15% of its AFSI, *less* the corporate AMT foreign tax credit for the year.

The Corporate AMT liability is any excess of the tentative minimum tax over the sum of the applicable corporation's regular tax liability plus its "base erosion and anti-abuse tax" (or BEAT) liability.

A corporation that pays the Corporate AMT will receive a credit that it can use to offset its regular tax liability and BEAT liability in future tax years, but the credit cannot reduce this liability below the tentative minimum tax for any future year.

AFSI is adjusted book income

To calculate AFSI, an applicable corporation starts with the net income or loss reported on its "applicable financial statement," or "AFS." The AFS is generally a GAAP or IFRS financial statement used for reporting to the SEC or equivalent foreign agency (or, for corporations that do not report to those agencies, that is used for credit purposes or reporting to shareholders).

In computing AFSI. the Reconciliation Bill includes a series of adjustments to financial statement income, including the following:[6]

- The AFSI aggregates all items from members of the corporation's consolidated US tax group;
- The AFSI includes the group's distributive share of any partnership income and a *pro rata* share of the income of any CFC with respect to which a member is a U.S. shareholder;
- Book items related to defined benefit plans are excluded and, instead, amounts are taken into account under federal income tax principles; and
- If an applicable corporation is foreign, its AFSI takes into account only its effectively connected income, and if it is tax-exempt, its AFSI takes into account only its unrelated trade or business income.

In addition, and in a departure from the original version of the bill, the Reconciliation Bill would preserve two categories of tax benefits:

- Corporate taxpayers would keep the benefit of accelerated depreciation used in computing their taxable income, rather than being required to use book depreciation. Manufacturers are among the taxpayers poised to benefit significantly from this provision; and
- Wireless telecommunications carriers would keep the benefit of amortization deductions used in computing their taxable income, rather than being required to use book amortization, for wireless spectrum acquired after December 31, 2007, and before the date of enactment of the Reconciliation Bill.

AFSI is reduced by financial statement net operating loss carryovers, which are capped at 80% of AFSI (before the deduction).[7] Financial statement net operating loss carryovers are net book losses incurred for a taxable year ending after December 31, 2019, and they can be carried forward indefinitely.

Corporate AMT represents another tax imposed on a different base

A U.S. corporation already must calculate its regular tax liability each year and, if it is subject to the BEAT, it must calculate a separate tax base and apply a different rate to determine its BEAT liability.[8] If the Corporate AMT is enacted, then a U.S. corporation would need to calculate a third tax, imposed on yet another tax base.

Moreover, if OECD “Pillar Two” is implemented as planned, then a U.S. corporation would have a fourth set of calculations to perform. Pillar Two would impose a 15% minimum tax on the book income of multinational groups with annual revenue of at least €750 million. While this tax may seem similar to the Corporate AMT, there are important differences in how the tax base would be computed under each regime. As a result, it would be entirely possible for a U.S. corporation that is subject to the Corporate AMT to be subject to additional tax under Pillar Two.

[1] The budget effects of the removal of this AMT aggregation provision were offset by an extension of the limitation on deductibility of excess business losses under Section 461(l), which was originally to expire for tax years beginning after January 1, 2026.

[2] Generally, for this purpose an “established securities market” includes national securities exchanges in the United States and, if they satisfy analogous regulatory requirements, securities exchanges in other countries, certain regional or local exchanges, and certain interdealer quotation systems.

[3] S corporations, Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) are excluded.

[4] Under current law, portfolio companies managed by a fund operating in partnership form are generally not aggregated together for this purpose unless the fund is considered to be engaged in a trade or business. The Build Back Better Act, and an interim version of the Reconciliation Bill, would have broadened the aggregation rules to apply if the fund were engaged in any activity for the production of income. The Reconciliation Bill passed by the Senate does not contain a similar rule.

[5] It is unclear whether Treasury would make the determination on a case-by-case basis in response to taxpayer requests or would issue general guidance.

[6] Certain of these adjustments are not taken into account in determining whether a corporation meets the $1 billion threshold described above.

[7] In contrast to the original version of the bill, loss carryovers are not taken into account in determining whether a corporation meets the $1 billion threshold.

[8] A corporation is subject to the BEAT if it meets a gross receipts test and a “base erosion percentage” test.

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