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The 1% Excise Tax on Stock Repurchases (Buybacks)

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SUMMARY

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The 1% Excise Tax on Stock Repurchases (Buybacks)

The law commonly known as the Inflation Reduction Act of 2022 (P.L. 117-169) includes a 1% excise tax on stock repurchases by publicly traded corporations. Stock repurchases are a way to distribute income to shareholders and, compared to dividends, have favorable tax treatment. The Joint Committee on Taxation estimates this provision to raise $74 billion over the FY2022-FY2031 period.

A stock repurchase or buyback occurs when a firm buys its own shares, and it is an alternative to dividends as a way of distributing earnings. Stock repurchases can take a number of forms, but the most common method is a purchase on the open market. Buybacks were nearly nonexistent in 1982 when the Securities and Exchange Commission made open market repurchases easier; they have grown rapidly and now exceed the value of dividends. Yardeni Research, a sell-side consulting firm, estimated around $1 trillion in repurchases occurred in 2022 compared to $550 billion in dividends.

The excise tax imposes a 1% rate on share repurchases by publicly traded corporations, effective for repurchases after December 31, 2022. The tax also applies to stock purchases by certain affiliates of the corporation. The value of stock issued to the public or to employees reduces the taxable base. The tax does not apply to firms with repurchases of $1 million or less and does not apply to regulated investment companies (RICs, such as mutual funds) or real estate investment trusts (REITs). Exceptions to the tax include (1) repurchases that are part of tax-free corporate reorganizations; (2) repurchases that are contributed to an employee pension plan, an employee stock ownership plan, or other similar plans; (3) repurchases that are treated as dividends; and (4) purchases by a securities dealer in the ordinary course of business. The excise tax is not deductible from the income tax.

Firms repurchase shares for a variety of reasons; for example, to distribute free cash flow in the face of declining investment opportunities, to signal that their stock is undervalued, or to offset the dilution of shares from contributions of stock to employees. From an economy-wide standpoint, repurchases are desirable if they reallocate investment more efficiently. However, repurchase is not necessary to distribute cash, which can also be distributed via dividends or repaying debt.

Three reasons are advanced for discouraging repurchases: (1) they reduce investment and increase debt, leading to short-termism (i.e., immediate profit at the expense of long-term investment); (2) they benefit managers by increasing earnings per share and bonuses for executives or make stock options more valuable; and (3) they are tax-favored compared to dividends. Some evidence supports the first two effects, although those findings have been disputed. The tax favoritism arises because dividends are taxed in full, whereas capital gains are taxed to the seller only to the extent that price exceeds basis (the original purchase price of the stock).

A number of repurchase issues still need clarification in Internal Revenue Service (IRS) and Treasury regulations and guidance. On December 27, 2022, the IRS issued interim guidance on most of the issues that commentators had previously highlighted. For example, the guidance explains how and when the tax would be collected (annually). Certain corporate reorganizations (split-offs) that were not specifically referenced in the law are excluded from the tax, and only the amounts not recognized (stock but not cash or property used to repurchase stock) are excluded for all tax-free corporate reorganizations. Repurchases associated with complete liquidations are excluded (this treatment is important to special purpose acquisition companies, or SPACs, that liquidate because they do not find a business to invest in). The guidance also covers repurchases of preferred stock, although the IRS has asked for comments about whether special rules should apply in some cases. In addition, the interim guidance addresses a number of other issues and further guidance is expected.

Contents

What Is a Stock Repurchase? ... 1
The Growth of Stock Repurchases ... 1
Explanation of the New 1% Tax ... 2
- Repurchase Defined ... 2
- Application to Affiliates ... 2
- Netting Rule ... 3
- Tax Exceptions ... 3
- Regulations and Guidance ... 3
- Nondeductibility for Income Tax Purposes ... 3

Economic Issues Relating to a Tax on Stock Repurchases ... 3
- Do Stock Repurchases Reduce Investment and Increase Debt? ... 5
- Stock Repurchases and Executive Compensation ... 6
- Favorable Tax Treatment of Stock Repurchases ... 7

Regulatory Issues ... 8
- Tax Computation and Payment ... 9
  - Form and Timing ... 9
  - Fair Market Value ... 9
  - $1 Million Exception ... 9
- Redemptions That Are Not Repurchases ... 9
  - Brother-Sister (Section 304) Purchases ... 9
  - Fractional Shares ... 10
- Corporate Liquidations and Special Purpose Acquisition Companies ... 10
- Reorganizations and Split-ups ... 10
- Leveraged Buyouts ... 11
- The Exception for Redemptions Treated as Dividends ... 11
- Netting Issues ... 12
  - In General ... 12
  - Stock Issued to Employees (Including Affiliates' Employees) ... 12
- Special Classes of Stock and Preferred Stock; Other Securities ... 12
- Comments Requested for Certain Issues ... 12

Contacts

Author Information ... 13

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What Is a Stock Repurchase?

A stock repurchase or buyback occurs when a firm buys its own shares. A repurchase is an alternative to paying dividends for distributing earnings to shareholders. This repurchase can be made through several different methods:[2]

- a fixed-price tender offer (repurchase tender offer or RTO), where shareholders are offered a fixed price, usually above the market price;
- a Dutch auction offer to shareholders, where shareholders indicate the lowest price they will accept and the company chooses the highest price it will sell all the shares offered;
- a purchase on the open market;
- a transferable put right option, where the firm offers the shareholder a right to sell at a fixed price within a stated period, with the right transferable (traded on the market); and
- targeted stock repurchases (direct negotiation), where shares are purchased from shareholders of large blocks.

The Growth of Stock Repurchases

In 1982, the Securities and Exchange Commission (SEC) provided a safe harbor from market manipulation claims for open market purchases, as long as they do not exceed 25% of average daily trading value.[3] Currently, open market purchases are the dominant form of share repurchases.[4]

With the 1982 change, stock repurchases began to grow substantially compared to dividends. Share repurchases were almost nonexistent before 1982 and grew slowly and then more rapidly

[1] Joint Committee on Taxation, *Estimated Budget Effects Of The Revenue Provisions Of Title I – Committee On Finance, Of An Amendment In The Nature Of A Substitute To H.R. 5376, "An Act To Provide For Reconciliation Pursuant To Title II Of S. Con. Res. 14," As Passed By The Senate On August 7, 2022, And Scheduled For Consideration By The House Of Representatives On August 12, 2022*, JCX-18-22, August 9, 2022, https://www.jct.gov/publications/2022/jcx-18-22/.

[2] See Liyu Zeng and Priscilla Luk, "Examining Share Repurchasing and the S&P Buyback Indices in the U.S. Market," S&P Dow Jones Indices, March 2020, https://www.spglobal.com/spdji/en/documents/research/research-sp-examining-share-repurchases-and-the-sp-buyback-indices.pdf; and "Stock Buyback Methods," Corporate Finance Institute, October 23, 2022, https://corporatefinanceinstitute.com/resources/management/stock-buyback-methods/.

[3] Securities and Exchange Commission (SEC), "Issuer Repurchases: Rule 10b-18," at https://www.sec.gov/divisions/marketreg/repurchases and Skadden "Capital Markets: Rule 10b-18 Safe Harbor for Stock Repurchases," at https://www.skadden.com/-/media/files/publications/2020/03/trading-issues-arising-out-of-market-disruptions/rule_10b_18_safe_harbors.pdf. The rule also provided for price ceilings.

[4] Liyu Zeng and Priscilla Luk, "Examining Share Repurchasing and the S&P Buyback Indices in the U.S. Market," S&P Dow Jones Indices, March 2020, at https://www.spglobal.com/spdji/en/documents/research/research-sp-examining-share-repurchases-and-the-sp-buyback-indices.pdf.

beginning in the mid-1990s.[5] In 1998, stock buybacks and dividends were around the same magnitude (under $150 billion) for the Standard & Poor's 500. In 2022, buybacks were almost twice as large: $1 trillion for buybacks and $550 billion for dividends.[6]

In 2021, the top five firms with buybacks were Apple, Meta Platforms (formerly Facebook), Alphabet (the parent company for Google), Microsoft, and Oracle. These five firms accounted for 28% of buybacks. Apple, with $881 billion in buybacks, was responsible for 10% of all buybacks.[7] Following the passage of the law commonly known as the Tax Cuts and Jobs Act (P.L. 115-97),[8] buybacks grew substantially in 2018, growing from $519 billion in 2017 to $806 billion in 2018; they declined slightly in 2019 and substantially in 2020, then increased in 2021 and 2022.

Explanation of the New 1% Tax

The new provision imposes a 1% tax on the repurchase of stock by a publicly traded corporation. The tax is an excise tax (and thus not contained in the income tax provisions of the U.S. tax code) contained in Section 4501 of the Internal Revenue Code (IRC). It is effective for repurchases after December 31, 2022.

Repurchase Defined

Repurchase is defined as a redemption (i.e., stock received from shareholders in exchange for property, generally cash) under Section 317 of the IRC or any transaction determined by the Secretary of the Treasury to be economically similar. Section 317 specifies that a redemption applies whether stock is retired, canceled, or held as treasury stock. Treasury stock is stock that remains in existence and can be issued in the future but is not paid dividends and does not count in measuring earnings per share.

Application to Affiliates

The excise tax would apply to purchases of a corporation's stock by a subsidiary of the corporation (i.e., a corporation or partnership that is more than 50% owned, directly or indirectly, by the parent corporation). The tax also applies to purchases by a U.S. subsidiary of a foreign-parented firm if the foreign firm is publicly traded. In addition, it applies to "surrogate" U.S. firms owned by a foreign parent, commonly referred to as inverted firms that moved their headquarters abroad but retained enough U.S. ownership to be subject to special restrictions.[9]

[5] Liyu Zeng and Priscilla Luk, "Examining Share Repurchasing and the S&P Buyback Indices in the U.S. Market," S&P Dow Jones Indices, March 2020, at https://www.spglobal.com/spdji/en/documents/research/research-sp-examining-share-repurchases-and-the-sp-buyback-indices.pdf.

[6] Edward Yardeni, Joe Abbott, and Mali Quintana, "Corporate Finance Briefing: S&P 500 Buybacks & Dividends," Yardeni Research, Inc., December 1, 2022, at https://www.yardeni.com/pub/buybackdiv.pdf.

[7] "S&P 500 Buybacks Set Quarterly and Annual Record," March 15, 2022, S&P Dow Jones Indices, at https://www.prnewswire.com/news-releases/sp-500-buybacks-set-quarterly-and-annual-record-301502561.html.

[8] The surge in buybacks after the corporate tax cuts in the Tax Cuts and Jobs Act (P.L. 115-97) may have been part of the impetus for the stock buyback tax.

[9] See CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle for a discussion. Surrogate corporations are corporations that are 60% to 80% owned by the shareholders of the inverted company. Corporations that are 80% or more owned are treated as U.S. firms.

Netting Rule

The amount subject to tax is reduced by any new issues to the public or stock issued to employees (referred to as the netting rule).

Tax Exceptions

There are six exceptions to the excise tax:

1. repurchases that are part of a tax-free reorganization under Section 368(a) of the IRC (mergers, acquisitions, divisions, or other specified reorganizations), where no gain or loss is recognized to shareholders;
2. repurchases contributed to an employee pension plan, an employee stock ownership plan, or other similar plans;
3. repurchases of $1 million or less during the year;
4. purchases by a securities dealer in the ordinary course of business;
5. repurchases by regulated investment companies (RICs, such as mutual funds) or real estate investment trusts (REITs); and
6. to the extent that repurchases are treated as dividends for tax purposes.[10]

Regulations and Guidance

The Secretary of the Treasury is generally authorized to provide guidance and specifically to prevent the abuse of exceptions, address special classes of stock and preferred stock, and address the application of the excise tax to foreign corporations.

Nondeductibility for Income Tax Purposes

In general, excise taxes can be deducted to determine profits subject to the corporate tax, which would reduce the tax at the corporate tax rate (21%). That is, for a profitable corporation each dollar of excise tax reduces corporate income taxes by 21 cents. The Inflation Reduction Act specifies (by amending Section 275 of the IRC) that this 1% excise tax would not be deductible, thus there would be no corporate profits tax offset.

Economic Issues Relating to a Tax on Stock Repurchases

Firms repurchase shares for numerous reasons, including to[11]

[10] The circumstances in which a stock redemption is treated as a dividend are in Section 302 of the Internal Revenue Code. In general, the issue is whether the redemption is disproportionate to shareholders and whether the shareholder holds less than 50% of the shares after the redemption.

[11] Liyu Zeng and Priscilla Luk, "Examining Share Repurchasing and the S&P Buyback Indices in the U.S. Market," S&P Dow Jones Indices, March 2020, at https://www.spglobal.com/spdji/en/documents/research/research-sp-examining-share-repurchases-and-the-sp-buyback-indices.pdf; CFI Team, "Stock Buyback Methods," Corporate Finance Institute, December 14, 2022, at https://corporatefinanceinstitute.com/resources/management/stock-buyback-methods/; Jesse M. Fried, "Open Market Repurchases: Signaling or Managerial Opportunism?" *Theoretical Inquiries in Law*, vol. 2 (2001), pp. 865-894, at http://www.law.harvard.edu/faculty/jfried/Open_Mkt_Shared_Resources.pdf; and

- distribute free cash flow in the face of declining investment opportunities;
- increase earnings per share by reducing the number of shares;
- purchase stock when it is undervalued and can subsequently be sold at a higher price;
- signal that the stock is undervalued (although such signaling can be achieved through increased dividends, stock repurchases may be more effective);
- realize tax benefits compared to dividends (because shareholders pay tax only on the price less basis, or the original purchase price, as compared to dividends that are taxed in full);
- provide financial flexibility, because all announced shares do not have to be repurchased and do not involve all shareholders, whereas dividends are normally at fixed times and distributed to all shareholders, and markets do not react as negatively to a reduction in repurchases as to a reduction in dividends;
- offset the increase in outstanding shares through exercises of employee stock options;
- defend against hostile takeovers by achieving control of shares;
- quickly adjust a firm's capital structure, by reducing equity (and in repurchases financed by borrowing, increase debt); and
- preserve and enhance the value of stock options.

These reasons may be desirable for the firm or its managers but not for broader purposes. From an economy-wide perspective, stock repurchases are desirable if they lead to a more efficient allocation of capital. This effect would occur when firms have significant excess cash flows without desirable investments available. Returning funds to shareholders would allow the shareholders to invest in more profitable projects. An extensive debate has developed over whether stock repurchases serve this purpose, or reduce investment and innovation, and enrich executives by increasing incentive pay that is based on increases in earnings per share or by increasing the value of stock held by these executives. These latter concerns led to proposals to ban stock buybacks or impose other restrictions on buybacks.[12] They also led to proposals for an excise tax on stock repurchases. An earlier proposal would have imposed a 2% excise tax.[13]

An article reviewing the literature indicated that share repurchases were associated with a firm moving from a growth pattern characterized by ample investment opportunities and limited cash flow to a more mature stage with more cash and fewer investment opportunities. The evidence suggested that stock buybacks were more common for firms with more volatile earnings, consistent with the flexibility of repurchases over dividends. The review also found evidence that

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Alvin Chen and Olga A. Obizhaeva, *Stock Buyback Motivations and Consequences: A Literature Review*, CFA Research Foundation, 2022, at https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2022/rflr-stock-buybacks.pdf.

[12] For an overview of this debate, see Joshua Zelen, "Goodbye Buybacks: Why Recent Stock Buyback Reform Proposals Go Beyond What is Necessary," *Fordham Journal of Corporate and Financial Law*, vol. 28 (2022), pp. 01-326, at https://ir.lawnet.fordham.edu/jcfl/vol27/iss1/7/. The author proposes regulatory changes to increase disclosure. President Biden also proposed to prohibit executives from selling shares in the years after a buyback. See Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2023*, p. 16, at https://www.whitehouse.gov/wp-content/uploads/2022/03/budget_fy2023.pdf.

[13] Senator Sherrod Brown, "Brown, Wyden Unveil Major New Legislation to Tax Stock Buybacks," press release, September 10, 2021, at https://www.brown.senate.gov/newsroom/press/release/brown-wyden-tax-stock-buybacks.

repurchases occurred when share prices were lower and that they were associated with the use of stock options.[14]

In general, proponents of a tax on repurchases give three reasons for discouraging stock repurchases: (1) they divert capital from investment and encourage debt finance (which encourages short-termism that harms long-term investment);[15] (2) they benefit corporate executives and insiders;[16] and (3) they are tax favored compared to dividends while accomplishing the same purpose of distributing earnings.

Although the tax-favorability issue is clear, other arguments are difficult to assess. For example, stock buybacks could be associated with declining investment, but whether that is because declining investment opportunities lead to buybacks or buybacks reduce funds available for investment is not easy to determine (although there are statistical techniques that attempt to address this issue).[17] Similarly, large buybacks may be more common in firms that rely heavily on stock options, but buybacks could be employed to reverse the dilution of stock with the exercise of stock options or they could be used to enhance the value of stock when executives are planning to sell stock.

Do Stock Repurchases Reduce Investment and Increase Debt?

In 2016 and 2017, an estimated 30% of buybacks were financed by debt. In these cases, a firm does not acquire assets to create profits to pay interest on the debt.[18] However, the tax law favors debt finance and rebalancing the relationship between debt and equity may be desirable for the firm.

Some studies have suggested that buybacks do discourage investment and increase debt, although the evidence is mixed.[19] An International Monetary Fund study indicated that debt funded payouts weaken credit quality and that the increase in dividends and buybacks slow investment.[20] Other studies have also concluded that share repurchases reduce investment.[21] In addition, some

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[14] Alvin Chen and Olga A. Obizhaeva, *Stock Buyback Motivations and Consequences: A Literature Review*, CFA Research Foundation, 2022, at https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2022/rflr-stock-buybacks.pdf.

[15] See CRS In Focus IF11393, *Stock Buybacks: Concerns over Debt-Financing and Long-Term Investing*, by Gary Shorter.

[16] See CRS In Focus IF11506, *Stock Buybacks and Company Executives' Profits*, by Gary Shorter.

[17] When the dependent and independent variables are mutually related, this effect is termed *endogeneity*. Endogeneity is sometimes addressed by using lagged values for the independent variable or using instrumental variables (i.e., a variable that is correlated with the independent variable but not the dependent variable).

[18] William Lazonick, Mustafa Erdem Sakinç, and Matt Hopkins, "Why Stock Buybacks Are Dangerous for the Economy," *Harvard Business Review*, January 7, 2020, pp. 2-7, at https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy.

[19] See CRS In Focus IF11393, *Stock Buybacks: Concerns over Debt-Financing and Long-Term Investing*, by Gary Shorter, which reviews some of the evidence.

[20] International Monetary Fund, *Global Financial Stability Report*, October 2019, at https://www.imf.org/en/Publications/GFSR/Issues/2019/10/01/global-financial-stability-report-october-2019.

[21] See Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, "The Real Effects of Share Repurchases," *Journal of Financial Economics*, vol. 19, iss. 1 (January 2016), pp. 168-185. A working paper version is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2276156. See also Alok Bhargava, Executive Compensation, Share Repurchases and Investment Expenditures: Econometric Evidence from US firms, *Review of Quantitative Finance and Accounting*, vol. 40 (2013), pp. 403-442; Douglas O. Cook and Weiwei Zhang, "CEO Option Incentives and Corporate Share Repurchases," *International Review of Economics and Finance*, vol. 78 (March 2022), pp. 355-376, at https://www.sciencedirect.com/science/article/abs/pii/S1059056021002501; and Germán Gutiérrez and Thomas

evidence shows that repurchases suppress innovation[22] and are associated with a short-term focus.[23] However, another study found that, in the aggregate, taking into account new issues of stock, stock repurchases were 41% of earnings, leaving ample funds for investment.[24]

While there is evidence that repurchases reduce investment, it is less clear whether this is an undesirable effect, as it depends on the relative returns to displaced and new investment. However, firms could return funds to stockholders by paying higher dividends, so that repurchases are not necessary to achieve the goal of distributing cash when viable investment opportunities are not available.

Moreover, another way of distributing cash is to pay back debt, so that debt-financed repurchases or repurchases with the existence of debt would not appear to be required for the purpose of using free cash flow.

Stock Repurchases and Executive Compensation

Evidence also suggests that buybacks may benefit executives in two different ways. First, bonuses may be based on earnings per share that can be enhanced by stock buybacks. Second, for executives holding shares, stock buybacks increase the value of shares.[25]

A 2008 study found a close relationship between stock repurchases and stock option compensation. The study found that a large share of past repurchases had been to reduce the dilution of stock due to exercising stock options and that firms chose repurchases over dividends because dividends reduced stock values and repurchases increased those values, which has the further effect of encouraging the exercise of stock options.[26] Another study indicated that the primary reason for stock repurchases was to offset the dilution of shares from stock options and that the cost should be considered part of employee compensation.[27]

Philippon, "Ownership, Concentration, and Investment," *AEA Papers and Proceedings, American Economic Review*, vol. 108 (2018), pp. 432-437.

[22] Tim Swift, "Do Stock Buybacks Suppress Innovation," *International Journal of Innovation Management*, vol. 26, no. 6 (August 2022), at https://www.worldscientific.com/doi/epdf/10.1142/S1363919622500372. The working paper version can be accessed at https://www.researchgate.net/publication/326275372_Do_Share_Buybacks_Suppress_Corporate_Innovation.

[23] David Bendig, Daniel Willmann, Steffen Strese, and Malte Brettel, "Share Repurchases and Myopia: Implications on the Stock and Consumer Markets," *Journal of Marketing*, vol. 82 (March 2018), pp. 19-41.

[24] Jesse M. Fried and Charles C.Y. Wang, "Short- Termism and Capital Flows," *Review of Corporate Finance Studie*s, vol. 8, no. 1 (2019), pp. 207-233, at https://www.hbs.edu/faculty/Pages/item.aspx?num=55334.

[25] See CRS In Focus IF11506, *Stock Buybacks and Company Executives' Profits*, by Gary Shorter. See also Douglas O. Cook and Weiwei Zhang, "CEO Option Incentives and Corporate Share Repurchases," *International Review of Economics and Finance*, vol. 78 (March 2022), pp. 355-376; Francine McKenna, "SEC's Jackson Says Research He's Conducted Shows Corporate Insiders Are Using Buybacks To Cash Out," *MarketWatch*, March 6, 2019, at https://www.marketwatch.com/story/secs-jackson-says-research-hes-conducted-shows-corporate-insiders-are-using-buybacks-to-cash-out-2019-03-06; Alok Bhargava, "Executive Compensation, Share Repurchases and Investment Expenditures: Econometric Evidence from US firms," *Review of Quantitative Finance and Accounting*, vol. 40 (2013), pp. 403-442; and "Stock Buyback Ability to Enhance CEO Compensation: Theory, Evidence and Policy Implications," *Lewis and Clark Law Review*, vol. 25, no. 1 (2021), pp. 305-359, at https://law.lclark.edu/live/files/31608-10-shilon-article-251pdf.

[26] David N. Hurtt, Jerry G. Kreuze, and Sheldon A. Langsam, "Stock Buybacks and Their Association with Stock Options Exercised in the IT Industry," *American Journal of Business*, vol. 2, no. 1 (Spring 2008), pp. 13-21, at https://www.emerald.com/insight/content/doi/10.1108/19355181200800001/full/pdf.

[27] Edward Yardeni and Joseph Abbott, *Stock Buybacks: The True Story*, Yardeni Research Inc., May 20, 2019, at https://www.yardeni.com/pub/TS84.pdf.

The findings in some studies that executives sold more stock in the days after a repurchase announcement are considered compelling evidence by some,[28] although it is also understandable that stock repurchases could be used to eliminate the dilution of stock due to the exercise of employee stock options.

Favorable Tax Treatment of Stock Repurchases

Although these first two effects are subject to some dispute, the tax-favored nature of stock repurchases compared to dividends is clear. This advantage has been reduced since dividends and capital gains were subject to the same tax rates in 2003. Nevertheless, capital gains are reduced by the basis (original purchase price), whereas all dividends are subject to tax. Some of this benefit defers the tax if any newly acquired stock is sold, as its basis is increased, but tax can also be forgiven if stock is passed on at death. This tax favoritism had led to a proposal by Senator Marco Rubio to treat stock repurchases as a dividend to all shareholders.[29]

How significant is the 1% tax in reducing the differential between the treatment of capital gains and dividends? The tax is small compared to the overall 23.8% tax rate that applies to the highest income taxpayers (i.e., a 20% rate on dividends and capital gains plus a 3.8% tax on net investment income), increasing the tax rate by about 4%. The 1% tax increases in significance for two reasons. First, the differential tax depends on the basis for stock sold in the repurchase. Although the basis varies significantly, for long-term gain transactions, the average basis was 65% of sales price in the latest year available, 2015.[30] Thus, the overall tax on the amount of income received would be 8.33%, for a 15.47 percentage point difference due to the savings in basis. A 1% tax would narrow that difference by 6%.

Second, a significant share of stock is held by tax-exempt entities and tax-favored accounts, such as pension funds, who pay no capital gains or dividend taxes, or by foreign shareholders who do not pay capital gains tax and typically pay a 15% rate on dividends (although they may pay tax in their own country). Estimates indicate that about 25% of stock is held by taxable shareholders and 40% by foreign shareholders.[31] Thus, the tax on dividends averaged across all shareholders is 11.95% (25% of 23.8% plus 40% of 15%). The average tax rate on capital gains is 2.0825% (25% times 8.33%). Overall, the differential is 9.8675 percentage points. Thus, a 1% tax would reduce the differential by 10%. These calculations assume no tax by foreign countries on capital gains

[28] See, for example, the evidence from a study by SEC Commissioner Robert J. Jackson, Jr., "Stock Buybacks and Corporate Cashouts," news speech, June 11, 2018, at https://www.sec.gov/news/speech/speech-jackson-061118.

[29] Marco Rubio, "America Needs to Restore Dignity of Work," *The Atlantic*, December 12, 2018, https://www.theatlantic.com/ideas/archive/2018/12/help-working-class-voters-us-must-value-work/578032/ and Marco Rubio, Rubio Releases Report Outlining China's Plan for Global Dominance and Why America Must Respond, Press Release, February 12, 2019, https://www.rubio.senate.gov/public/index.cfm?p=Press-Releases&id=BC6C0054-7C4E-4012-A1FD-26A24AE16C0D. For additional details of how the proposal would work, see Matt Egan, Marco "Rubio Wants to End Stock Buybacks' Tax Advantage, CNN Business, February 12, 2019, https://www.cnn.com/2019/02/12/investing/rubio-stock-buybacks-tax/index.html.

[30] Janette Wilson and Christopher Williams, "Sales of Capital Assets Data Reported on Individual Tax Returns, Tax Years 2013-2015," Internal Revenue Service Statistics of Income Bulletin, winter 2022, at https://www.irs.gov/pub/irs-prior/p1136—2022.pdf#page=134.

[31] Steve Rosenthal and Theo Burke, "Who's Left to Tax? US Taxation of Corporations and Their Shareholders," presented at the New York University Tax Policy Colloquium, October 27, 2020, at https://www.law.nyu.edu/sites/default/files/Who%E2%80%99s%20Left%20to%20Tax%3F%20US%20Taxation%20of%20Corporations%20and%20Their%20Shareholders-%20Rosenthal%20and%20Burke.pdf.

and dividends. If the tax differential were the same as U.S. taxable shareholders, the differential would be about the same, 10% (65% of 15.47%).

In both cases, the differential would be slightly different because some taxable shareholders are not taxed at the top rate (reducing the differential) and some shares may be short-term and taxed at ordinary rates (increasing the differential). Generally, however, these shares would be relatively small and the effects roughly offsetting.

Because the additional tax is relatively small, the effect on paying out dividends would be expected to be relatively small. A 2021 study estimated that a 1% tax would increase dividends by 1.5%.[32]

This number only reflects averages based on observations of aggregate capital gains behavior and stock holding. For firms where the capital gains advantage is especially small, the tax would be more significant, whereas for other firms it would be smaller.

Regulatory Issues

There has been extensive and detailed commentary about guidance needed to implement the excise tax, including comments by the American Bar Association (ABA) and the New York State Bar Association (NYSBA) tax sections.[33] Three issues had been identified as particularly urgent for practitioners: how and when to pay the tax; the treatment of certain split-offs in corporate reorganizations and special purpose acquisition company (SPAC) liquidations; and the characterization of preferred stock.[34] Another commentator specifically identified two issues as important: (1) split-offs, the treatment of corporate reorganizations with compensation in both stock and boot (i.e., cash or property) and (2) certain leveraged buyout transactions that take a company private.[35]

The Internal Revenue Service (IRS) subsequently provided interim guidance.[36] This guidance addressed the issues noted above and others such as exceptions from redemptions in Section 317 of the IRC, a list of transactions deemed economically similar and those deemed not

[32] Thornton Matheson and Thomas Brody, *1% Buyback Tax Could Lead to Higher Dividend Payouts*, Tax Policy Center, December 20, 2021, at https://www.taxpolicycenter.org/taxvox/1-buyback-tax-could-lead-higher-dividend-payouts.

[33] American Bar Association (ABA), Section on Taxation, "Comments on Section 4501 Excise Tax," December 7, 2022, at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2022/120722comments.pdf; and New York State Bar Association (NYSBA), *Report on the Section 4501 Excise Tax on Repurchases of Corporate Stock*, Report No. 1469, November 1, 2022, at https://nysba.org/app/uploads/2022/11/1469-Report-on-the-Section-4501-Excise-Tax-on-Repurchases-of-Corporate-Stock.pdf.

[34] See David van den Berg, "3 Issues Tax Pros Want Clarified In Buyback Tax Guidance," Law 360, October 12, 2022, at https://www.law360.com/tax-authority/articles/1539127/3-issues-tax-pros-want-clarified-in-buyback-tax-guidance.

[35] Donald Bakke, Marc Countryman, and Shane Kiggen, "Inflation Reduction Act Revised To Include Excise Tax On Stock Buybacks," Ernst and Young, LLP, August 8, 2022, at https://taxnews.ey.com/news/2022-1206-inflation-reduction-act-revised-to-include-excise-tax-on-stock-buybacks.

[36] Internal Revenue Service, "Initial Guidance Regarding the Application of the Excise Tax on Repurchases of Corporate Stock under Section 4501 of the Internal Revenue Code," Notice 2023-2, December 27, 2022, at https://www.irs.gov/pub/irs-drop/n-23-02.pdf. For a more detailed discussion that links to sections of the notice, see Paul/Weiss, "IRS Issues Guidance on Excise Tax on Stock Repurchases and Corporate Alternative Minimum Tax," December 29, 2022, at https://www.paulweiss.com/practices/transactional/tax/publications/irs-issues-guidance-on-excise-tax-on-stock-repurchases-and-corporate-alternative-minimum-tax?id=45658. See also DavisPolk, "IRS Issues Interim Guidance On the Stock Repurchase Excise Tax," December 28, 2022, https://www.davispolk.com/insights/client-update/irs-issues-interim-guidance-stock-repurchase-excise-tax.

economically similar, statutory exceptions, and fair market value. However, it omitted other concerns, which may be dealt with in future guidance.

Tax Computation and Payment

Form and Timing

The excise tax is not part of income tax provisions, so there are no automatic rules for how the tax is to be paid, or how often. The IRS interim guidance indicates that the tax will be paid annually on the excise tax Form 720 due the first quarter after the end of the firm's taxable year. The IRS guidance notes that while the tax on repurchases is effective after December 31, 2022, repurchases are offset by new issues of stock during the taxable year. Thus for taxpayers with a tax year straddling the effective date, all new issues during that tax year will be used to offset post December 31, 2022 repurchases. (This is part of the IRS's explanation of the law and not regulatory guidance.)

Fair Market Value

The interim guidance specifies that the value of the purchase is the market price on the date the shares ownership is transferred, which is the trade day for issues and repurchases. Market price may be a volume weighted daily average, the closing price, the average of the high and low price, or the trading price at the time of sale. This guidance, thus, addresses circumstances when prices actually paid differ from fair market prices, including accelerated share repurchases where a firm enters into a contract with an investment bank to purchase a large block of shares when the contractual price may differ from the market value, or tender offers that exceed market prices. The market price will determine the basis for the tax.

For repurchased stock contributed to employee retirement plans under the exception to the tax, the value of stock is the fair market value when repurchased up to the amount of the total repurchases in the year if the stock is in the same class. If the stock class contributed differs from that repurchased, the value of the shares contributed is the market value at the time of contribution.

$1 Million Exception

The determination of the exemption from the tax if repurchases are $1 million or less is made before the reduction for exceptions and before the netting out of issues, that is, gross repurchases.

Redemptions That Are Not Repurchases

A redemption is receipt of a stock from a shareholder for property (e.g., cash). Two cases are identified in the interim guidance where a redemption will not be considered a repurchase.

Brother-Sister (Section 304) Purchases

The excise tax applies to subsidiaries that purchase the parent stock, but there was a question about whether the tax would cover brother-sister corporations (i.e., two corporations controlled by the same shareholders). Under the interim guidance, brother-sister stock purchases (where a corporation purchases stock of another corporation from shareholders that control both corporations) will not be considered repurchases (even though such a purchase is treated as a redemption for other purposes) and will be exempt from the tax.

Fractional Shares

Cash for fractional shares is not included in the tax if part of a reorganization or settlement of an option or other financial instrument.

Corporate Liquidations and Special Purpose Acquisition Companies

A firm may repurchase shares in a full liquidation (which means the firm ceases to operate), a partial liquidation in accordance with a plan of full liquidation, or a partial liquidation where part of the businesses ceases. Qualifying liquidations are taxed as if shares are sold and thus taxed as capital gains, although payments in a partial liquidation to corporate shareholders are treated as dividends. The interim guidance indicates that complete liquidations are not generally subject to the excise tax.[37] However, repurchases from individual shareholders are subject to the tax when connected with the liquidation of a subsidiary where one of the shareholders is a corporation that controls at least 80% of shares.

In earlier comments, the ABA had taken the position that a pro rata (although not a non-pro rata) partial liquidation should be excluded from the tax, whereas the NYSBA had argued that all pro rata distributions be excluded, thus taking a similar position on partial liquidations.[38] The interim guidance indicates that partial liquidations will be subject to the tax.

Commentators were particularly concerned about the treatment of special purpose acquisition companies (SPACs).[39] SPACs are formed to generate cash by investors (through an initial public offering) for the purpose of buying active businesses within a specified period, generally two years. If no business is purchased, the stock is repurchased (which would be a complete liquidation). In addition, stockholders generally have the right to sell their shares (e.g., if they do not like the business acquired) back at the original price.

The exemption of complete liquidations addresses concerns raised about SPACs that do not acquire businesses. The ABA recommended that in addition to exempting stock in liquidation, a SPAC's repurchase of shares, where the holder has a put right (i.e., a right to sell at a specified price), be excluded from the tax, as these repurchases are not causing the problems that motivated the tax. The NYSBA does not make specific recommendations but proposes transition relief for SPACS formed prior to the effective date. The interim guidance did not indicate an exception for these repurchases under put rights or transition relief for SPACs.

Reorganizations and Split-ups

The law specifically excludes tax-free corporate reorganizations outlined in Section 368(a) of the IRC, which include mergers, acquisition, divisions, and other forms of reorganization. In tax-free reorganizations, gain is not generally recognized when compensation is in stock (e.g., shareholders of the target company in an acquisition redeem their stock for stock of the acquiring

[37] However, distributions to shareholders that are also associated with a liquidation of a subsidiary are subject to the tax.

[38] The ABA had indicated a case could be made for the exclusion of non-pro rata partial liquidation distributions to noncorporate shareholders, although it would complicate the identification of exempt and nonexempt repurchases through pass-through entities that may have both individual and corporate partners.

[39] See CRS In Focus IF11655, *SPAC IPO: Background and Policy Issues*, by Eva Su for a discussion of SPACs.

company). Gain is recognized to the extent shareholders are compensated in cash or other property (called "boot").

Commentators raised two issues. One is whether reorganizations will be completely exempt from the tax or only stock compensation and not boot would be excluded. The other concern is certain split-offs that are governed by another section of the tax code, Section 355. Divisions can take place under either section and constitute the same type of distribution, but the statute only refers to Section 368. Divisions can take place as spin-offs (where stock of a subsidiary is distributed pro rata to the shareholders), which does not involve a repurchase. However, divisions can take place as split-offs where the subsidiary's stock is exchanged for the parent company's stock, which may also involve payment of cash or property (boot).

The regulation and examples clarify that the exception for tax-free reorganizations under Section 368 excludes stock transferred in these reorganizations from the tax but not any boot that is exchanged for stock and subject to gain. It also confirms that Section 355 split-ups are subject to the exclusion as well.

Leveraged Buyouts

When a private equity company uses a leveraged buyout to take a public firm private, the mechanics of the operation may result in the target being treated as borrowing the funds and payments to the target's shareholder from the target's debt proceeds are treated as redemptions.[40] The ABA suggests that the excise tax should not apply to redemptions if, after the transactions, the firm's shares are no longer publicly traded. This treatment also would allow firms to use simpler, rather than more complicated, methods to take firms private. However, the example in the interim guidance indicates that these types of leveraged buyouts will be subject to the excise tax.

The Exception for Redemptions Treated as Dividends

The excise tax does not apply to a repurchase that is treated as a dividend. A dividend is a payment in cash or property and under certain circumstances a repurchase (where the payment is made in exchange for stock) is also treated as a dividend. One of those circumstances occurs when repurchases are substantially proportionate to shares. A dividend is taxed as dividend income up to the earnings and profits in the year in which the dividend is paid (a tax dividend). If the dividend is larger than earnings and profits, it reduces the basis of stocks and if it exceeds basis generates a capital gain (a non-dividend distribution).

Commentators raised the issue of whether non-dividend distributions would be subject to the tax. The interim guidance indicates that only the part of the repurchase that is actually taxed as a dividend will reduce share repurchases subject to the tax and not the part that reduces basis or capital gain.[41] This treatment is consistent with a motivation relating to the tax-preferred nature of repurchases.

[40] This type of acquisition involves an acquiring company that creates a subsidiary that then merges into the target, and the target borrows funds to repurchase the shares. This method is also called a "bootstrap acquisition."

[41] Both the ABA and NYSBA addressed whether non-dividend distributions should be subject to the tax (as they do not give rise to dividend taxes). The ABA indicates that non-dividend distributions that arise from simple payments in cash or property (normal dividends) should not be covered, as they do not affect the shares of stock outstanding. However, it suggests that non-dividend distributions that arise from redemptions that are treated as dividends should be included as they affect the number of shares. This is the position taken in IRS's interim guidance. The NYSBA takes the general

Netting Issues

In General

Some issuances of stocks are not counted for purposes of netting against repurchases. These include circumstances (such as corporate reorganizations, brother-sister transactions, and fractional shares) that also are not included in repurchases. It also excludes distributions of stock to the corporation's shareholders and issuances of stock to subsidiaries. Offsetting issues cannot be carried back or forward, but apply only in the taxable year of the purchases.

Stock Issued to Employees (Including Affiliates' Employees)

Restricted stock subject to vesting is counted as issued when vested, although if the employee elects to include the amounts in income when granted, the stock is considered issued when granted. Withholding of shares to account for income and employment taxes reduces issues. For stock options, stock is issued when the option is exercised. If the exercise price is provided in cash, the full amount of the shares are issued, but if there is withholding of shares to cover the exercise price, the issue is reduced by those shares.

Special Classes of Stock and Preferred Stock; Other Securities

Commentators raised numerous issues about what types of securities would be covered by the tax, such as preferred stock (both straight and convertible), convertible debt, and warrants. The interim guidance appears to apply the repurchase rules to all stocks, including preferred stock, although the IRS requested comment on this issue.

Comments Requested for Certain Issues

The interim guidance has numerous issues where commentary is invited (both on issues discussed and not discussed in the interim guidance), some quite technical in nature but others relating to broader policy issues.

Among the issues mentioned is the treatment of special issues of securities, including preferred stock and convertible debt, as well as options. With respect to the treatment of financial instruments, the NYSBA recommended that unexercised options not be treated as issued. It also recommended that redemptions of straight preferred stock be excluded from the excise tax but not participating preferred stock (including convertible preferred stock). It suggested that guidance clarify that, in general, convertible debt and distressed debt are not "stock" subject to the excise tax. The ABA requested guidance that debt instruments be categorized under common principles (convertible debt is generally characterized as debt, not equity) and that options and warrants (rights to buy at a specified price) be included at exercise and at fair market value. The ABA also noted that a class of preferred stock that allows the issuer to repurchase on its own terms (a call option) be included under the tax but that a preferred stock or common stock option that allows the owner to sell at a particular price (a put option) not be included.

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position that all 100% pro-rata distributions should be excluded because they do not affect the proportionate interests of shareholders. These choices reflect the various importance of ownership dilution, changes in the number of shares, and the relative tax treatment. Cash dividends do not dilute ownership or affect shares but may not always be taxed. Non-dividend distributions treated as dividends out of earnings and profits do not dilute ownership, do increase shares, but are taxed in full. Non-dividend distributions that are treated as dividends and exceed earnings and profits do not dilute ownership but do increase shares and are not taxed in full.

Comments were requested on some matters relating to price, including whether a value other than market price should be used, how to deal with pricing of stocks traded in multiple markets, and dealing with cases where multiple classes are repurchased and contributed to employee plans. The ABA discussion indicates that the term fair market value is a reference to trading price, rather than a negotiated price. The NYSBA indicates that the statute implies that the price be the actual price received (if reflecting an arms-length negotiation with an unrelated party) and otherwise market price.

The interim guidance also requested comments relating to various aspects of the exceptions and exclusions, including whether exceptions for employer-provided retirement plans should include plans that are not qualified (under Section 401 of the IRC); the nature of evidence needed to demonstrate that a redemption is treated as a dividend; and special rules for redemptions of bankrupted or troubled companies. The ABA recommended treatment be extended to nonqualified plans.

Comments were requested on a variety of other issues as well. These issues included determining indirect ownership for purposes of defining an affiliate, treatment of repurchases in the period before a company becomes a covered corporation or after it is no longer covered, allocation of repurchases among components of inverted surrogate companies, treatment of foreign partnerships, definition of established securities market, and treatment of trading through depository receipts.

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