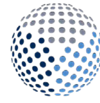

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IRA—Stock Buyback

September 2022

Houlihan Lokey is pleased to present its tax insights on the Inflation Reduction Act of 2022 (IRA). This insight is the first in a series from Houlihan Lokey's M&A Tax team diving into areas of the IRA that may impact clients.

Introduction

On August 12, 2022, the U.S. Congress voted to pass the IRA. The IRA contained several provisions that could impact tax liability, one of which regards share repurchases made by publicly traded domestic corporations and certain U.S. subsidiaries of publicly traded non-U.S. corporations. Specifically, the IRA created a new share buyback excise tax (SBET) that applies when certain corporations repurchase shares from their shareholders. This article will explain the implications of the share buyback excise tax, including i) how it is calculated, ii) situations in which the SBET is triggered, and iii) potential ways the SBET could alter corporate behaviors, including impacts on foreign shareholders.

What Is the SBET, and When Does It Apply?

The SBET levies a 1% tax on the fair market value of stock of a publicly traded U.S. corporation (or a specified affiliate) that the corporation repurchases during the taxable year, if the total amount of repurchases during the year is more than $1 million. A "specified affiliate" is one in which the corporation owns a 50% or greater equity interest (by vote or value). If the corporation also issues new shares during the same year, such issuances are netted against the repurchases and the SBET only applies to the excess of the value repurchased over the value issued. Additionally, the IRA specifies that payments made for the SBET are not deductible and will therefore not reduce taxable income, unlike other excise taxes.

For purposes of the SBET, a "repurchase" includes a redemption (generally defined in the tax code as an acquisition of stock by the corporation in exchange for cash or property other than the corporation's own stock or stock rights) and any other "economically similar" transaction. Unless the IRS and/or Department of the Treasury issues guidance on what constitutes an economically similar transaction, the ambiguous nature of that language may lead to confusion.

Despite the lack of guidance, the IRA does explicitly exclude certain transactions from the purview of the SBET. As previously mentioned, if the aggregate value of shares repurchased within the year does not exceed $1 million, the SBET does not apply to any of the repurchases. Moreover, reorganizations that do not result in gain or loss to the shareholders do not give rise to the SBET. Additionally, any repurchases that are treated as a dividend for U.S. tax purposes will not be subject to SBET. Another exception exists for instances where the repurchased stock (or an amount of stock equal to the value of the stock repurchased) is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan. Finally, the SBET will not apply if the repurchase is made by a dealer in securities in its normal course of business, a regulated investment company, or a REIT.

As will be discussed in the next section, the broad definition of repurchases and economically similar transactions may lead to traps for unsuspecting corporations undertaking transactions that are not conventional share buybacks.

Traps for the Unwary

The SBET is expected to be a consideration for publicly traded corporations when weighing the overall costs and benefits of their stock repurchase programs. However, because of the provision's broad definition of "repurchase" and the use of "economically similar" language, companies need to consider the SBET when evaluating other corporate transactions (including M&A activity) that do not appear to involve "stock repurchases," as that term is commonly understood. The following are a few examples of transactions that may trigger the SBET despite not being strictly repurchases made pursuant to a company's stock repurchase plan:

- Payments of cash to the target's shareholders in a merger to the extent those payments are funded out of the target's existing cash resources or with the proceeds of debt that is incurred or assumed by the target in the transaction (i.e., a leveraged buyout);
- Cash payments in lieu of fractional shares in a stock-for-stock merger to the extent the cash is sourced from the acquirer instead of from sales of fractional shares into the market;
- Redemptions of preferred stock that are not treated as equivalent to dividends for tax purposes;
- Boot or cash payments to target shareholders in partially tax-free reorganizations;
- Cash consideration in certain taxable stock acquisitions in which there is significant shareholder overlap between the acquirer and the target;

- Distributions by a corporation undergoing a complete or partial liquidation; and
- Redemptions of stock in connection with a SPAC's initial business combination or "de-SPAC" transaction.

Potential Corporate Behavioral Changes

Prior to the IRA, stock buybacks were generally preferred by shareholders over dividends because stock buybacks are taxed at the more favorable capital gains rate. This is especially true for non-U.S. shareholders because they are generally not required to pay or withhold for U.S. capital gains tax when they sell stock (including stock buybacks), but they are taxed on dividends they receive from U.S. corporations.

Disincentivizing share buybacks may address certain nontax issues that some people have identified, such as using repurchases to inflate share prices and concentrating stock among corporate insiders by repurchasing shares on the open market. Regardless, a tax-related purpose of the SBET is to narrow the gap in relative tax treatment between repurchases and dividends. As a result, imposing the SBET while not increasing taxes on dividends could discourage repurchases of stock and encourage dividend payments. Such a shift may reduce U.S. tax advantages for foreign shareholders and lead to additional U.S. tax liabilities, depending on tax treaties.

Conclusion

The SBET is a 1% excise tax levied on certain stock repurchases by publicly traded U.S. corporation and specified affiliates. Imposition of an excise tax on share buybacks may cause some corporations to look to dividends as their preferred method of distributing earnings. Such a shift would create tax consequences (especially for foreign shareholders) and would simultaneously address the concerns some politicians and economists have regarding share buybacks.

Per the language in the IRA, the SBET applies to repurchases and other economically similar transactions. Such ambiguous language apparently applies the SBET to a wide variety of transactions other than conventional repurchases of shares by a corporation. As such, until guidance is provided, corporations should consider the potential impact of the SBET when undertaking any transaction that impacts the shares held by its shareholders.

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