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Perspectives on Tax Law & Policy aims to provide a variety of perspectives on important policy-related issues in the tax system, with the goal of fostering informed, accessible commentary that bridges the gap between tax professionals, policy makers, and the general public. The views expressed in the articles in this newsletter by any particular author are solely the personal views of that author. They should not under any circumstances be construed as reflecting in any way the views of the organization with which such author is affiliated or of any other person or entity.

The New US Stock Repurchase Excise Tax

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Background

On August 16, 2022, US President Joseph Biden signed the Inflation Reduction Act of 2022 (IRA) into law. The legislation enacted, among a host of other revenue-raising measures, a 1 percent excise tax on stock repurchases by public companies occurring after December 31, 2022. The government estimated that the excise tax will raise $74 billion through 2031. In late December 2022, days before the new tax became effective, the US Department of the Treasury released a notice providing additional rules that will apply to the tax. In this article, I explain some basic elements of the tax and explore areas where taxpayers will need more clarity from Treasury's rule-making process. I also comment briefly on the implications of the tax for Canadian policy makers who are considering enacting a similar measure in Canada.

Stock repurchases—sometimes called "stock buybacks" —are a common corporate transaction in which a corporation redeems its stock from its shareholders, usually for cash. Imposing an excise tax on such repurchases has at least three policy justifications: (1) it will encourage reinvestment of prof-its into the business; (2) it will deter executives from using buybacks to support or increase earnings per share, a metric on which executive compensation is often based; and (3) it will reduce the relative tax preference that now exists for re-demptions over dividends. On this last point, redemptions are generally more favourable than dividends, from a US federal income tax perspective, because redemptions allow sharehold-ers to recover their basis in their redeemed shares, with any excess cash being recognized as long-term capital gains. For non-US shareholders, capital gains are generally exempt from US tax. Dividends, on the other hand, although often taxed at the same rate as long-term capital gains, do not allow for basis recovery, and non-US holders are subject to a 30 percent withholding tax on dividends, which may be reduced—but generally not eliminated—under an applicable treaty.

Under US law, distributions by a company with retained earnings are generally treated as dividends without regard to the legal form of the distribution. Unlike the ITA, US tax law does not permit a profitable company to arrange to have a distribution treated as a return of capital for tax purposes by structuring the distribution as a return of paid-up capital under applicable corporate law.

The development and implementation of the excise tax have been controversial. Some commentators have noted that if Congress considered stock repurchases to give corporate executives a skewed incentive to provide returns to shareholders rather than to invest in the corporation's business, non-tax proposals would have better aligned corporate incentives. For example, 2019 proposals by Senator Chuck Schumer (D-New York) and Senator Bernie Sanders (I-Vermont) would have banned all buybacks unless a corporation implemented a $15-an-hour minimum wage.

Other critiques have noted that a 1 percent tax is likely not large enough to change incentives, though the rate could obviously be changed. An earlier proposal would have imposed a 2 percent rate—the rate at which the Canadian government's proposed new tax on corporate buybacks would be imposed. In the 2023 State of the Union address, President Biden proposed to quadruple the rate of the buyback tax to 4 percent.

Finally, whatever disincentive the tax creates for corporate stock buybacks will likely be reduced by the fact that, for accounting purposes, under both international financial reporting standards and US generally accepted accounting principles, the tax is not an expense that reduces earnings per share.

Whether or not it achieves its goals, the tax is expected to raise significant revenue, as noted above, and perhaps that was inducement enough for a president and legislators eager to enact other provisions in the IRA.

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Description of the Excise Tax

The excise tax applies mainly to publicly traded US corporations. It does not apply to foreign corporations (unless they are the product of inversions of US companies) or to private companies.

The tax applies to a "repurchase," which generally means a non-pro-rata reduction in a shareholder's interest in a corporation. The term also includes all "economically similar" transactions, but the statute fails to define what "economically similar" means. A fundamental problem with the statute is that, on its face, it is very broad, covering things that are not normally considered stock repurchases, such as complete liquidations and a portion of the proceeds of leveraged buyouts. The notice released by the Treasury has clarified things a bit, but uncer-tainty remains, and future guidance is needed. It would have been better for the statute to have been clearer in the first place.

The tax applies on the value of stock repurchases, net of the value of any stock issuances during the taxable year, but the statute is silent about how to determine when, and at what value, a repurchase occurs and how to apply this netting princi-ple. The Treasury notice provides that stock is generally treated as repurchased when ownership transfers to the applicable acquiror or when the shareholder no longer holds the stock (in the case of economically similar transactions in which the covered corporation does not take ownership of its own stock). The notice also provides clear mechanical rules for determin-ing the relevant value of a repurchase. Interestingly, the price at which stock was repurchased is not necessarily accepted as the value of the repurchase; instead, the mandated methods look to the trading value of the stock, which may be quite dif-ferent from the repurchase price itself. As to the question of how to net issuances from repurchases, the value of issuances is determined similarly, with four prescribed methods, which must be used consistently. The aggregate value of issuances is netted against the aggregate value of repurchases, and any excess repurchase value becomes subject to the 1 percent tax.

The statute closes with a list of exceptions. First, it exempts repurchases that are completed as part of tax-free reorganization transactions to the extent that there is no gain or loss recognition; if, however, there is non-stock consideration (known as "boot") in the reorganization, the boot is taxable as a deemed redemption. Second, the statute exempts stock contributions to employer-sponsored retirement plans. Third, repurchases that are otherwise treated as dividends for US federal tax pur-poses are exempt. (In this regard, US tax law treats certain repurchases—such as pro rata repurchases—as dividends.) Furthermore, certain corporations are excluded from the tax (notably, regulated investment companies and real estate investment trusts), and exclusions also apply in circumstances where the repurchaser is a dealer in securities as a trade or business. Complete liquidations are exempt, as are redemptions of equity warrants and convertible debt. Finally, there is a de minimis threshold: companies are exempt from the tax if the total value of stock repurchased during the taxable year is less than $1 million.

Implementation Issues

The excise tax statute left the Treasury with significant discretion to promulgate regulations implementing the tax. Practitioners have eagerly provided advice. A report issued in November 2022 by the Tax Section of the New York State Bar Association ("the bar report") noted that the ambiguity of the statute failed to address such problems as (1) the treatment of various forms of preferred stock; (2) the treatment of equity-linked financial instruments, such as options and convertible debt; (3) valuation questions; (4) incidence issues between foreign corporations and specified affiliates; (5) the statute's application to various merger transactions and certain liquidations; and (6) potential transition relief. Others have questioned how the tax might apply to transactions involving so-called special-purpose acquisition companies (SPACs).

The bar report considered public statements made by lawmakers during the legislative process to propose solutions. The excise tax's exception for dividends and other pro rata distributions reveals a policy goal of preventing dividend tax avoidance through the targeting of the basis-recovery and capital-gain-recognition aspects of redemptions. The bar report endorsed solutions consistent with this policy goal. One of these solutions included exempting redemptions of non-convertible preferred stock. Although redemptions of preferred stock generally constitute redemptions for tax purposes, preferred shares with a fixed term and a limited dividend rate are more debt-like and do not participate in corporate growth in the way that other classes of equity do. As such, the bar report argued, these debt-like preferred shares are more like the repayment of a class of debt and thus should not be subject to an excise tax aimed at redemptions of stock. Since convertible preferred stock, in contrast, does participate in corporate growth because of its ability to convert into common stock, those repurchases should fall within the scope of the tax.

The Treasury notice addressed many of these issues but did not, in defining the scope of the tax, follow the bar report's emphasis on public statements made by lawmakers. Instead, it closely followed the statute's text. For example, it did not adopt the bar report's recommendation to exempt redemptions of debt-like preferred stock. Rather, it decided that the types of instruments covered by the tax should include any instrument

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considered "stock" for US federal tax purposes. Under that definition, all repurchases of preferred stock were taxable, without regard to whether that result is sound as a policy matter.

Conclusions and Implications for Canadian Policy Makers

The excise tax is new, and policy discussions will continue. The Treasury notice itself reflects only the Treasury's current intentions for promulgating regulations in the future; those intentions are subject to change. And while taxpayers and their advisers can rely on the notice, they can and will continue to make suggestions to the government regarding rules that might bring the implementation of the tax into closer alignment with the lawmakers' original policy goals. Already, in just six short months since the IRA was enacted, all of the back-and-forth reflects how deceptively complex such an excise tax is, both in terms of lawmaking (writing laws) and in terms of implementing new laws in a practical way.

The implication for Canadian policy makers is relatively clear. An excise tax on repurchases may look simple, and the prospect of raising revenue in a politically advantageous way is obviously appealing, but there are many details that need to be considered. Any proposals should start with a clear sense of the goal to be achieved. In President Biden's recent appeal (in the State of the Union speech) for a 4 percent rather than a 1 percent excise tax on buybacks, he focused on encouraging corporations to do the "right thing" by making long-term investments rather than rewarding CEOs and shareholders. It is fair to ask whether such a tax is a better way to achieve this goal than are other legislative measures. ■

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