IRS Issues Initial Guidance for New Excise Tax on Stock Buybacks and Corporate Alternative Minimum Tax

Skadden

12 / 30 / 22

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Paul Schockett
Partner / Washington, D.C.
202.371.7815
paul.schockett@skadden.com

Thomas F. Wood
Partner / Washington, D.C.
202.371.7538
thomas.wood@skadden.com

Scott H. Rabinowitz
Counsel / Washington, D.C.
202.371.7335
scott.rabinowitz@skadden.com

Leo Greenberg
Associate / Boston
617.573.4853
leonard.greenberg@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

On December 27, 2022, the IRS issued two notices providing key initial guidance for the new excise tax on corporate stock buybacks and the new corporate alternative minimum tax (CAMT). Both the excise tax and the CAMT were enacted as part of the Inflation Reduction Act that Congress passed in August 2022.[1]

The guidance — Notice 2023-2 addressing the excise tax and Notice 2023-7 addressing the CAMT — describe future regulations under these provisions that are expected to be retroactive to the beginning of 2023, when both regimes generally become effective. The rules in these notices have important ramifications for the scope and application of both provisions, including their impact on SPACs, mergers, spin-offs, reorganizations, liquidations and other transactions.

Notice 2023-2: Excise Tax Guidance

The excise tax generally applies to "repurchases" of stock by publicly traded corporations after December 31, 2022. In certain respects, Notice 2023-2 provides welcome clarification and relief for corporations regarding the excise tax. However, the rules in the notice would apply the excise tax quite broadly to transactions that do not involve the traditional stock buyback programs that were Congress' apparent target in enacting the excise tax — including, very significantly, certain payments of cash or other taxable "boot" made in M&A transactions and redemptions of preferred stock.

Corporate liquidations and SPACs: Notice 2023-2 generally excludes distributions in complete liquidation of a corporation from the base of the excise tax, addressing concerns expressed by companies and tax practitioners that the excise tax statute could be interpreted to impose the excise tax on corporate liquidations. This provides welcome relief, particularly for liquidating special purpose acquisition companies (SPACs) that are unable to consummate a successful de-SPAC transaction. In addition, the notice appears to exclude from the scope of the excise tax any distribution made during the taxable year in which a corporation fully liquidates and dissolves, even if a distribution precedes the formal decision to liquidate. This rule could provide further flexibility for SPACs that liquidate during a taxable year in which redemptions were previously made. Otherwise, the notice generally does not provide relief for non-liquidating redemptions by SPACs (*e.g.*, redemptions made in connection with a de-SPAC transaction or an extension request).

Section 355 transactions: Notice 2023-2 explicitly excludes tax-free spin-offs and split-offs from the base of the excise tax, except to the extent cash or other boot is received as part of a non-pro rata split-off. This is another area where practitioners had previously expressed concern that the excise tax could apply as a technical matter, even if that result made little policy sense.

Payments of boot in reorganizations: Under Notice 2023-2, partially tax-free reorganizations are included in the base of the excise tax to the extent of taxable boot paid in the reorganization. For this rule, the source of the boot — *i.e.*, whether the boot is funded by the acquiring corporation or the target corporation — is irrelevant. This broad rule means that the excise tax may apply to many M&A transactions involving a mix of cash and stock consideration.

[1] See our September 21, 2022, client alert, "Senate Passes Landmark Bill With Climate, Tax, Energy and Health Care Implications," and our December 13, 2022, article, "New Corporate Minimum Tax and Stock Repurchase Tax Will Take Effect in 2023, but Questions Remain."

IRS Issues Initial Guidance for New Excise Tax on Stock Buybacks and Corporate Alternative Minimum Tax

"Bootstrap" acquisitions and leveraged buyouts: Under Notice 2023-2, fully taxable acquisitions are treated as repurchases subject to the excise tax to the extent the consideration is funded by cash on the target's balance sheet or a borrowing by the target or a transitory merger subsidiary that merges into the target. Surprisingly, taxable acquisitions are thus treated more favorably than reorganizations under the notice, in that all boot in reorganizations (regardless of its source) is apparently subject to the excise tax, whereas a taxable acquisition is generally subject to the excise tax only to the extent the consideration is traceable to the target corporation or a new borrowing that target incurs or assumes in the transaction.

Preferred stock: Although the main statutory grant of rulemaking authority in the excise tax statute invites the IRS to issue guidance on preferred stock and other special classes of stock, Notice 2023-2 treats redemptions of preferred stock as fully subject to the excise tax. Many commentators had requested an exclusion from the excise tax for preferred stock based on the typically limited equity features of such stock, and this aspect of the notice is disappointing and particularly unfavorable to companies in regulated industries that frequently issue preferred stock. Furthermore, the notice does not provide any grandfathering relief for preferred stock issued prior to the excise tax's effective date. The notice does, however, request comments on the treatment of preferred stock, indicating that the IRS may consider including relief for preferred stock in future guidance.

Non-stock instruments: Helpfully, Notice 2023-2 takes a "shares in, shares out" approach to computing the excise tax base that is generally based on repurchases and issuances of instruments treated as "stock" for income tax purposes. Accordingly, repurchases and issuances of debt instruments (including convertible and exchangeable debt instruments), warrants and options, and other equity-linked financial instruments and derivatives are generally outside the scope of the excise tax under the notice. The notice, though, does request comments on the treatment of non-stock financial instruments, and it is possible that subsequent IRS guidance could ultimately take a different approach.

Dividend-equivalent redemptions: Notice 2023-2 provides very limited relief for dividend-equivalent redemptions, which the statute generally exempts from the excise tax. Under the notice, all redemptions — even if made on a completely pro rata basis — are presumptively treated as repurchases subject to the excise tax. Although the notice proposes a shareholder certification procedure for rebutting this presumption, the procedure is likely to provide little practical relief as it will be virtually impossible to apply in situations involving repurchases from the public.

"Funding" rule for non-U.S. corporations: The notice dramatically broadens the situations in which the excise tax can apply to publicly traded non-U.S. corporations, capturing certain repurchases of stock by such corporations if they are indirectly funded by cash from their U.S. subsidiaries. The breadth of this rule will likely make the excise tax a more active tax compliance consideration for non-U.S. corporations, even if it does not ultimately cause them or their U.S. subsidiaries to owe significant excise tax.

Reliance/applicability: Covered corporations can rely on Notice 2023-2 pending the issuance of proposed regulations codifying the rules previewed in the notice. The notice provides that those proposed regulations are expected to be retroactive to the beginning of 2023 to the extent that they reflect the rules in Notice 2023-2.

Notice 2023-7: CAMT Guidance

The CAMT generally requires corporations to pay at least a 15% minimum rate of U.S. federal income tax on their adjusted financial statement income (AFSI), if the corporation's controlled group averages over $1 billion in AFSI during any prior three-year period. Notice 2023-7 announces forthcoming proposed regulations and provides key guidance on certain provisions of the CAMT in time for taxpayers to evaluate the CAMT's impact on their financial reporting and estimated tax payments for Q1 2023. As with Notice 2023-2, taxpayers may rely on Notice 2023-7 until proposed regulations are issued.

Applicable corporation status: Under the CAMT, a corporation generally must strip out the financial results of its affiliates from its consolidated financial statements and then apply a series of adjustments to determine its AFSI. Then, if a corporation, together with the other members of its controlled group, has over $1 billion in average annual AFSI over a three-year testing period — and, in the case of a foreign-parented multinational group, the U.S. corporate subsidiary's average annual AFSI is $100 million or more — the corporation is an "applicable corporation" (*i.e.*, subject to the CAMT).

Notice 2023-7 provides a transitional simplified safe harbor method for determining applicable corporation status for a corporation's first taxable year beginning after December 31, 2022. Under this safe harbor, AFSI is generally determined by referring only to the corporation's consolidated financial statements, with limited adjustments. If, using this simplified methodology, the corporation's controlled group's average annual AFSI is $500 million or less (and, in the case of a foreign-parented multinational group, the U.S. corporate subsidiary's average annual AFSI is less than $50 million) over the three-year testing period, the corporation is not an applicable corporation and therefore is not subject to the CAMT. The safe harbor may be applied to a corporation's fiscal year financial statements where the corporation's fiscal and taxable years differ.

This simplified safe harbor method will not help corporations that are close to the $1 billion threshold, but it should ease compliance burdens on many corporations that are not as close to the threshold but would otherwise need to undertake significant computational work in order to demonstrate that fact.

The notice also clarifies that, where a corporation is a partner in a partnership, and the partnership is not a member of the corporation's controlled group for CAMT purposes, the corporation's distributive share of partnership financial statement income or loss is not taken into account for determining applicable corporation status.

M&A and corporate restructurings: Notice 2023-7 provides important guidance for taxpayers pursuing M&A transactions and internal restructurings. The notice generally provides that, where a transaction would be wholly tax-free with regard to a corporation or partnership (as appropriate) for federal income tax purposes under certain specified corporate or partnership rules, it will also be wholly tax-free with regard to the corporation or partnership for purposes of determining AFSI, even where gain or loss is otherwise recognized for financial accounting purposes.

Corporations that engage in "split-off" transactions (which may generate gain or loss for financial accounting purposes but may be tax-free for federal income tax purposes) will welcome this guidance. Any corresponding increase or decrease in the financial accounting basis of property subject to the transaction is ignored for AFSI purposes. Taxpayers engaging in these transactions will, however, now be required to separately track their financial accounting basis, their "regular" tax basis, and their CAMT tax basis in affected assets, increasing compliance burdens for affected taxpayers. The treatment of transactions that are partially tax-free (*e.g.*, tax-free reorganizations in which boot is paid, or transactions between partners and partnerships that are treated partly as a tax-free contribution and partly as a taxable sale) remain uncertain, and the IRS has requested comments on the treatment of such transactions.

Notice 2023-7 also provides much-needed guidance for taxpayers in the M&A market that were uncertain about the additional tax planning and diligence issues raised by the CAMT. Under the notice, when a target or target group is acquired, its status as an "applicable corporation" (*i.e.*, a corporation subject to the CAMT) terminates, and its AFSI (in the case of a purchase of a target group) or its allocable portion of its group's AFSI (in the case of a purchase of a target out of a combined reporting group) is added to the acquirer group's AFSI. (AFSI allocated to a target leaving a group does not reduce or otherwise affect the rest of the group's AFSI for any year of the three-year testing period.) Similar rules apply to corporations that engage in spin-offs and split-offs.

Troubled corporations: In the area of troubled corporations, Notice 2023-7 again follows federal income tax rules over financial accounting rules to provide taxpayer-favorable relief. Specifically, in certain circumstances where a discharge of indebtedness would be excluded from income for federal income tax purposes — *e.g.*, where the corporation is insolvent or in title 11 bankruptcy proceedings — but would result in gain for financial accounting purposes, taxpayers can exclude the financial accounting gain from AFSI. However, taxpayers will be required to reduce certain attributes for CAMT purposes, similar to the attribute-reduction requirement for federal income tax purposes when discharge of indebtedness income is excluded from gross income. Which CAMT attributes must be adjusted and the methodology and ordering for adjusting them is not provided in the notice; the IRS requests comments in the notice on those questions. Likewise, any gain recognized or basis adjustments resulting from a corporation's emergence from bankruptcy for financial accounting purposes are ignored for CAMT purposes.

Depreciation: Under the CAMT, in general, the taxpayer's book depreciation expense is replaced by the tax depreciation that is deducted for regular tax purposes (*i.e.*, pursuant to Internal Revenue Code sections 167 and 168) (the AFSI depreciation adjustment). Notice 2023-7 clarifies that the AFSI depreciation adjustment also applies to depreciation that is capitalized to inventory and recovered as part of cost of goods sold. The notice further clarifies that the AFSI depreciation adjustment only applies to depreciation pursuant to the regular tax depreciation rules, not to cost recovery rules under other sections (*e.g.*, section 181). Thus, if a taxpayer does not depreciate any portion of a property under the regular tax depreciation rules, the AFSI depreciation adjustment does not apply to that property. Similarly, the notice provides that the AFSI depreciation adjustment does not apply to amounts that are deducted as a repair for tax purposes, but that are capitalized as an improvement for book purposes.

In addition, the notice provides that, if a taxpayer disposes of property subject to the AFSI depreciation adjustment, the taxpayer must redetermine its gain or loss for purposes of determining AFSI by adjusting the property's basis by its current and prior AFSI depreciation adjustments, including those that would have been made in taxable years prior to the effective date of the CAMT if the CAMT had applied in those years.

Open issues: Notice 2023-7 invites comments on any issues relevant to the guidance provided, including, as noted above, the treatment of transactions that are partially tax-free, and other general comments on the CAMT or issues that should be addressed in future guidance, including 20 specific questions on issues not addressed in the notice, such as proper adjustments to AFSI in the event of a transaction resulting in a financial statement consolidation or deconsolidation of a member of a financial reporting group. Issues regarding the availability of a deduction for dividends received from non-consolidated U.S. and non-U.S. corporations and the treatment of partnerships for CAMT purposes, including the application of the controlled group aggregation rules to private equity portfolio companies, remain among the most significant unanswered questions.

Taxpayers in the insurance industry can take comfort from language in the notice that forthcoming guidance will address the treatment for CAMT purposes of items that are marked-to-market for financial statement purposes such as life insurance company separate account assets and certain financial products; the treatment of certain items reported in other comprehensive income; and the treatment of embedded derivatives arising from certain reinsurance contracts. This additional interim guidance could help to avoid substantial unintended adverse consequences to the insurance industry and certain other industries.