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IRS Guidance on Excise Tax on Buybacks Clarifies Some Benefits Issues

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New Section 4501 of the Internal Revenue Code imposes a 1% excise tax on certain corporate stock repurchases or “corporate buybacks” in excess of \$1 million in the taxable year. The new tax is imposed on the fair market value (“FMV”) of any stock repurchased by a “covered corporation” during the tax year, effective for repurchases after December 31, 2022. Section 10201 of the Inflation Reduction Act (Pub. Law 117-169, Aug. 16, 2022) (the “Inflation Reduction Act”). However, certain reductions to the FMV are permitted in connection with stock issued to employees or stock contributed to employee benefit plans.

On December 27, the IRS released Notice 2023-2 (the “Notice”) to provide initial guidance on a number of issues in anticipation of future proposed regulations.^[1] We highlight the portions affecting employee benefit programs below.

A. Brief Background

“Covered corporations,” generally defined under Section 4501(b) as domestic corporations or publicly traded partnerships that trade on US public markets or an international established securities market, are subject to the new tax. The tax is nondeductible.

Colloquially referred to as a “buyback,” a “repurchase” under Section 4501(c) generally occurs when a corporation acquires its own stock from a shareholder, and in exchange the corporation gives the shareholder money, securities or other property. Under this definition, corporate redemptions (Code sec. 317(b)) generally would be considered a buyback subject to the new tax.

Section 4501(c)(3) provides for an adjustment to the repurchase amount subject to the new tax, allowing corporations to reduce such amount by the FMV of certain “stock issued” by the corporation during that tax year. Under the statute, for purposes of this adjustment, the phrase “stock issued” includes the FMV of any stock issued or

provided to the corporation’s employees by the corporation or provided to employees in response to their exercise of a stock option.

Congress also recognized that companies may issue or contribute stock to fund various employee benefit plans. Thus, even if a company's buyback involves a repurchase under Section 4501(c), the tax does not apply if the stock (or an amount equal to the FMV of such stock) is contributed to "an employer-sponsored retirement plan, employee stock ownership plan, or a similar plan."

The Notice provides the following guidance on the above provisions.

B. Guidance on Netting Adjustment for Stock Issued to Employees

Section 3.08 of the Notice provides initial guidance on the "netting" adjustment for stock issued to employees of the covered corporation or of a specified affiliate. For this purpose, stock is generally deemed to be issued or provided at the time ownership of the stock transfers to the recipient for federal income tax purposes. In general, this is when the employee is treated as the beneficial owner, typically when the stock is "substantially vested" under the rules of Code section 83, including through an employee's "83(b) election."

Key points covered by the Notice include the following:

- The "netting" adjustment generally applies when stock is issued or provided "as compensation for services performed by an employee." This includes stock under qualified (Code Sec. 421) and nonqualified (Code Sec. 83) stock options. Qualified options include both incentive stock options (Code Sec. 422) and options under employee stock purchase plans (Code Sec. 423). Note that stock issued to company directors is not covered.
- Stock withheld by an employer to cover income tax withholding, or to satisfy the exercise price of shares, is not counted in the adjustment. However, stock subject to a "sell to cover" qualifies for netting.
- In the case of stock appreciation rights ("SAR"), the stock counts for netting purposes when the employee exercises the SAR and stock is issued to him or her.

The above rules (and others) are illustrated by Examples 22-26 of Section 3.09 of the Notice.

Section 3.06 of the Notice provides four acceptable methods for determining the FMV of repurchased stock traded on an established securities market.

C. Guidance on Exception for Stock Contributed to Certain Employee Plans

Under Section 3.07(3) of the Notice, "employer sponsored retirement plan" includes "a retirement plan maintained by a covered corporation that is qualified under Code section 401(a), including an employee stock ownership plan described in Code section 4975(e)(7)." Thus, stock contributions to all qualified defined benefit and defined contribution plans are covered. IRS requests comments on whether any other plans should be included.

The Notice provides a limited "relation back" rule (similar to the rule for qualified plan deduction purposes) under which stock contributed "during or on account of" the taxable year may be excluded. Under this rule, only stock contributed in the first quarter of the succeeding tax year may be excluded in computing the tax for the prior tax year.

D. Guidance on When the Buyback Tax is Reported and Paid

Section 4 of the Notice provides that the excise tax should be reported and paid on Form 720 within 30 days of the end of the first quarter after the close of the taxable year. (New draft Form 7208, intended as an attachment to Form 720, was released earlier, but without any instructions so it is not especially helpful.) No extensions will be permitted. Thus, the first return will be due April 30, 2024, for a calendar year company subject to tax for 2023.