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IRS and Treasury Issue Interim Guidance on 1% Stock Buyback Tax

On December 27, 2022, the IRS and Treasury issued Notice 2023-2 (the “Notice”), which provides guidance relating to the application of the new excise tax on repurchases of corporate stock (the “Stock Buyback Tax”) under Section 4501 of the Internal Revenue Code of 1986, as amended (the “Code”).¹ Among other things, the Notice provides detailed rules for calculating the amount of the Stock Buyback Tax as well as rules relating to the reporting and payment of the tax. In general, under the Notice, the Stock Buyback Tax applies broadly to stock repurchases (including repurchases of preferred stock) and to certain “economically similar” transactions. Notably, although the Notice does not include any rules specifically addressing special purpose acquisition companies (“SPACs”), it does provide some relief to SPACs by excluding certain liquidations from the scope of the Stock Buyback Tax.

GENERAL

The Stock Buyback Tax generally applies to certain “repurchases” of corporate stock by publicly traded U.S. corporations (“covered corporations”), or certain of their affiliates, after December 31, 2022.² The term “repurchase” is defined broadly by reference to Section 317(b), which generally includes any acquisition of stock by a corporation in exchange for cash or property other than its own stock or stock rights. For this purpose, a “repurchase” also includes certain “economically similar” transactions, which the Notice defines to include only (i) certain types of reorganization transactions, (ii) split-off transactions (as opposed to pro rata “spin-off” transactions) and (iii) certain complete liquidations (generally, liquidations of a covered corporation whose shareholders include an 80% or greater parent corporation as well as minority shareholders). Complete liquidations not described in the preceding sentence are not subject to the Stock Buyback Tax.



CALCULATION METHODOLOGY

The Stock Buyback Tax is imposed at a rate of 1% on the “stock repurchase excise tax base” of a covered corporation, which is equal to:

- i. the aggregate fair market value of all repurchases of a covered corporation’s stock during the taxable year; *less*
- ii. the fair market value of such repurchases to which one of the statutory exceptions described below applies; *less*
- iii. the aggregate fair market value of stock of the covered corporation issued by the covered corporation during its taxable year under the “netting rule” (described below).

De Minimis Exception

Under a *de minimis* exception, the Stock Buyback Tax does not apply if the aggregate fair market value of a covered corporation’s repurchases of its stock during a taxable year does not exceed \$1,000,000.

Statutory Exceptions for Certain Repurchases

The statutory exceptions (which reduce the stock repurchase excise tax base) include:

- repurchases in “economically similar” transactions, to the extent qualifying for tax-deferred treatment (more specifically, to the extent the shareholder receives property that is permitted (under Section 354 or Section 355) to be received without the recognition of gain or loss);
- repurchases by a dealer in securities in the ordinary course of business;
- repurchase by a regulated investment company (RIC) or by a real estate investment trust (REIT);
- repurchases that are treated as dividends for federal income tax purposes (under Section 301(c)(1) or Section 356(a)(2)); and
- repurchases, to the extent the repurchased stock (or an amount of stock equal to the fair market value of the repurchased stock) is contributed to an employer-sponsored retirement plan.

Netting Rule

Under the “netting rule,” the fair market value of stock repurchased during the taxable year generally is reduced by the value of any new issuances of stock by the covered corporation (including stock issuances to employees) during the same taxable year. For a corporation with a taxable year that includes, but does not end on, December 31, 2022, stock issuances during the portion of its taxable year prior to January 1, 2023, are taken into account under the netting rule, even though repurchases prior to January 1, 2023 are not included in the calculation of its stock repurchase excise tax base.

Under the Notice, certain issuances of stock are disregarded for purposes of the netting rule and therefore are not taken into account as a reduction to a covered corporation’s stock repurchase excise tax base. Such disregarded issuances include stock distributions by a covered corporation with respect to its stock (i.e., a stock dividend) and stock issued by a covered corporation to certain of its affiliates. In addition, to avoid a double benefit to taxpayers, stock issued in connection with a repurchase described in the first bullet above under “Statutory Exceptions for Certain Repurchases” generally is not taken into account under the netting rule. Other disregarded issuances include (i) deemed issuances under Section 304(a)(1) (relating to certain related-party stock sales), (ii) certain deemed issuances of fractional shares, (iii) issuances by a covered corporation that is a dealer in securities, to the extent the stock is issued in the ordinary



course of the dealer's business of dealing in securities and (iv) issuances by a target corporation in a reverse subsidiary merger that is governed by Section 368(a)(2)(E).

Valuation

In general, stock is valued (i) in the case of a repurchase, at the time at which ownership of the repurchased stock (as determined for federal income tax purposes) transfers to the covered corporation and (ii) in the case of an issuance (except for certain issuances to employees), at the time at which ownership of the stock (as determined for federal income tax purposes) transfers to the recipient. Because the tax base is measured by reference to value and not the number of shares issued or repurchased, the Stock Buyback Tax could potentially apply where the number of shares repurchased during a taxable year is the same as the number of shares issued during that year.

In the case of stock that is traded on an established securities market ("publicly traded"), the covered corporation must use one of four methods to determine the value of the stock repurchased or issued, as applicable, specifically (i) the daily volume-weighted average price on the date of issuance or repurchase, (ii) the closing price on the date of issuance or repurchase, (iii) the average of the high and low prices on the date of issuance or repurchase or (iv) the trading price at the time of issuance or repurchase. The selected method generally must be applied consistently to all repurchases and issuances during the taxable year.

Stock that is not publicly traded must be determined as of the date of issuance or repurchase, as applicable, using a reasonable valuation method in accordance with principles set forth in regulations under Section 409A.

RULES FOR REPORTING AND PAYING THE STOCK BUYBACK TAX

The Notice provides for annual reporting of the Stock Buyback Tax on IRS Form 720. To facilitate the computation of the tax, the IRS intends to issue an additional form that taxpayers will be required to attach to the Form 720. Although the Form 720 typically is filed quarterly, the Stock Buyback Tax will be subject to reporting once per taxable year, on the Form 720 that is due for the first quarter after the close of the taxpayer's taxable year. Accordingly, a corporation with a taxable year ending on December 31, 2023 would report its Stock Buyback Tax for 2023 on the Form 720 for the first quarter of 2024, due on April 30, 2024. According to the Notice, it is expected that the deadline for payment of the Stock Buyback Tax would be the same as the filing deadline, and that no extensions would be permitted for reporting or paying the Stock Buyback Tax.

RELIANCE

Taxpayers may rely on the interim guidance under the Notice until the issuance of forthcoming proposed regulations.

OBSERVATIONS

- **SPAC Considerations.** A typical SPAC raises money by issuing stock in an initial public offering for the purpose of acquiring an operating business in what is commonly referred to as a "de-SPAC" transaction. SPAC stock generally is redeemable at the option of a shareholder in connection with a de-SPAC transaction. If a de-SPAC transaction is not consummated within a specified timeframe (typically not more than two years), the SPAC is required to liquidate. These SPAC liquidations generally are governed by Section 331. The Notice provides relief for these liquidations by excluding from the Stock Buyback Tax distributions in complete liquidation under Section 331. However, the Notice generally does not provide relief for redemptions of SPAC stock outside the liquidation context (for example, a redemption in connection with a de-SPAC transaction).
- **Application to Preferred Stock.** Given the objectives of the Stock Buyback Tax (for example, to prevent the use of stock repurchases to manipulate a corporation's stock price or earnings per share), some commentators had recommended a policy-based exception for repurchases of certain types of stock, such as non-convertible preferred



stock that does not participate in corporate growth. The Notice does not include any such exception. To the contrary, the Notice includes an example illustrating that a redemption of mandatorily redeemable preferred stock is a “repurchase” that is subject to the Stock Buyback Tax.

- **Statutory Exception for Repurchases Treated as Dividends.** The statutory exception for a repurchase that is treated as a dividend is narrowly constructed. In order to qualify for the exception, the covered corporation must establish that the shareholder treats the repurchase as a dividend on the shareholder’s federal income tax return. To establish this, the corporation must, among other things, obtain certification from the shareholder that the repurchase is treated, as to that shareholder, as a distribution under Section 301, or has the effect of the distribution of a dividend under Section 356(a)(2). Qualifying for this exception may be difficult in practice.

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¹ References to “section” in this memo are to sections of the Code.

² The Stock Buyback Tax may also apply in certain limited circumstances to repurchases of stock of foreign corporations. This memo does not address the special rules relating to repurchases of stock of foreign corporations.