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Publications

Company Stock in Employee Benefit Plans May Reduce New Excise Tax on Buybacks

ATTORNEYS & PROFESSIONALS

Louis T. Mazawey
lmazawey@groom.com
202-861-6608

Brigen Winters
bwinters@groom.com
202-861-6618

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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." 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").

The new buyback tax is projected to raise $73 billion in revenue over ten years and is aimed at deterring public companies from buying back their stock. The proponents of the original bill view corporate buybacks as a way to further enrich wealthy investors and high-level executives, and thus seeks to discourage corporations from engaging in these buybacks and instead reinvest their capital in productive investments (e.g., its employees).[1]

We highlight below how employee benefit programs may be used to temper the impact of the new tax – and areas where IRS and Treasury guidance would be helpful.

Who Is Subject to the Buyback Tax?

"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.

What Is a "Repurchase" or "Buyback"?

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

However, for the reasons stated below we generally would not expect transactions between the contributing corporation and its "rabbi trusts" to trigger the new tax. That is, in connection with nonqualified deferred compensation plans or "top hat" plans, a corporation may set aside funds for executives in a "rabbi trust" where the funds remain subject to its general creditors. The corporate contributor to the rabbi trust is treated as the owner of the rabbi trust assets under the grantor trust tax rules provided under Sections 671-678. Thus, any contributed shares of the contributing corporation held by the rabbi trust are treated as owned by the contributing corporation for federal income tax purposes. Accordingly, transactions in such shares between the rabbi trust and the contributing corporation do not appear to trigger the new tax since the rabbi trust is not treated as a separate taxpayer from the contributing corporation. However, applying the same logic, purchases of contributing corporation shares from public markets by a rabbi trust could reasonably be expected to be a Section 4501(c) repurchase by the contributing corporation and therefore trigger the new tax.

How Does the Adjustment for Stock Issued to Employees Apply?

Section 4501(c)(3) provides for an adjustment to the 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. (The adjustment also applies if the corporation's stock is issued to employees of a specified affiliate during that tax year.) 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. We note some examples below.

Restricted stock units ("RSUs") compensate employees by awarding them units of company stock or its value, subject to a vesting schedule and sometimes performance goals, intended to motivate employees by tying their performance to the success of their employer. RSUs that are paid out to employees through the issuance of stock would appear to fall within the adjustment provision, which could help reduce the amount subject to the buyback tax.

Along those same lines, many nonqualified deferred compensation plans, especially those that allow or require participants to use company stock as a deemed investment, require deemed investments in company stock to be distributed in shares. A distribution of shares from the nonqualified deferred compensation plan would appear to be a similar adjustment as RSUs issued as stock.

Because the adjustment language refers to stock issued to "employees", it would be reasonable to assume that stock issued to someone else whose rights originate with the employee (such as in the case of an assignment on divorce, or payment to a beneficiary) would meet that requirement, although it would be helpful for future guidance to clarify.

What Are the Exceptions for Stock Contributed to Certain Employee Plans?

Congress recognized that companies may issue or contribute stock to fund various employee benefit plans. Thus, even if a company's buy back is considered a repurchase under Section 4501(c), the new tax does not apply to stock (or an amount equal to the value of such stock) contributed to "an employer-sponsored retirement plan, employee stock ownership plan, or a similar plan." This phrase is somewhat general, so it would be helpful for Treasury to provide guidance clarifying what types of plans are covered by this exception. For example, "employer sponsored retirement plan" under Section 4501(e)(2) should include –

- tax-qualified (Code sec. 401(a)) defined benefit plans (*g.*, traditional or cash balance plans), and
- tax-qualified (Code sec. 401(a)) defined contribution plans. In the latter category, presumably it would include 401(k) plans, profit sharing plans and stock bonus plans.

We would expect stock contributed to all of the above plans to come under the exception. Of course, many legal requirements (beyond the scope of this Alert) apply to each of these plan contributions.

Another set of questions arises under the term "employee stock ownership plans," *i.e.*, presumably, "employee stock ownership plan" ("ESOPs") under Section 4501(e)(2) include plans qualified under Section 401(a) and 409(a). And presumably, "employee stock purchase plans" ("ESPPs"), whether qualified or non-qualified under Code Section 423, would fall within the "similar" plan definition. This treatment would also mean that such programs would have the same impact with respect to the new law regardless of whether shares provided to employees are issued directly by their employer (and therefore the issuance of shares is an adjustment to the repurchased shares (discussed above)) or acquired on the open market and issued to employee plans (in which case the issuance of the shares causes the repurchased number of shares to be excepted from the total).

All of the above arrangements are commonly offered to American workers to, among other reasons, invest in their success and help align their interests with their employer's, all of which would be within the policy of the new tax. Therefore, we would expect Treasury to clarify that such arrangements are generally excepted from the buyback tax.

Treasury is specifically instructed under Section 4501(f) to issue guidance necessary or appropriate to carry out the purpose of the new tax, and specifically, to prevent the abuse of the exceptions listed under Section 4501(e), discussed above. Section 4501(f) also instructs Treasury to issue guidance addressing "special classes of stock and preferred stock." We expect Treasury to address the valuation methodology for special classes or preferred stock, which is important because some employee plans and awards are of this type, and the amount subject to the new tax is based on the FMV of the stock.

Observations

The Inflation Reduction Act provides that the new tax applies to buybacks of stock after December 31, 2022. Thus, Treasury does not have much time to issue rules that clarify the new law, including when and how returns should be filed and the tax paid.

In the meantime, public companies that expect to be subject to the new tax should start thinking about (1) the potential volume of any 2023 buybacks and (2) how the employee compensation "adjustments" to the amount subject to – and employee plan-related contribution exceptions from – the new tax could apply to reduce their buyback tax liability.

Please contact any of our Groom attorneys for assistance in this area, such as for items affecting retirement benefits, incentive plans and stock-based compensation.