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Inflation Reduction Act Imposes Corporate Minimum Tax and an Excise Tax on Stock Repurchases

On Sunday, August 7, the Senate passed the Inflation Reduction Act of 2022 (H.R. 5376) (the “IRA”). The IRA includes a number of green energy and prescription drug pricing provisions, supported by income tax revenue-raising provisions that are the focus of this memorandum. In addition, the IRA provides \$80 billion of increased funding to the IRS for enforcement. The House is expected to pass the IRA on Friday, August 12, and President Biden has indicated that he will sign it into law shortly thereafter.

Key Takeaways

- Prior proposals changing how carried interest is taxed are not included in the IRA.
- The IRA includes a 1% excise tax on stock repurchases, and economically similar transactions, of U.S. publicly-traded corporations. The statute is very broadly drafted and the tax could affect a wide range of M&A transactions in unexpected ways.
- The IRA also includes a 15% corporate alternative minimum tax (“AMT”) on the adjusted financial statement income that applies to large corporations that are profitable from a book perspective but that pay little to no taxes under the current federal income tax regime.

This memorandum discusses the technical details of these new income tax provisions, along with certain implications of their statutory language.¹

Carried Interest Reform Not Included

A prior version of the IRA would have revised section 1061 of the Internal Revenue Code of 1986, as amended (the “Code”) (the provision providing for a three-year holding period to receive long-term capital gains treatment on carried interest) including, among other things, by extending the holding period requirement for long-term capital gain treatment to at least five years (and, as a practical matter, longer than five years in many cases because of the novel ways in which the five-year holding period was to be measured). These provisions were not included in the final version of the IRA that passed the Senate. Senator Sinema, the hold-out responsible for the removal of such revisions, has indicated, however, that she will continue to work on carried interest reform, separate from the IRA.

1% Excise Tax on Stock Repurchases

¹ The IRA also extends by two years the disallowance of excess business losses for noncorporate taxpayers under section 461(l) of the Code to include taxable years beginning before January 1, 2029.

The IRA imposes a non-deductible 1% excise tax on the repurchases (including purchases by certain affiliates and other economically similar transactions) of any stock of any U.S. corporation that has any shares that are publicly-traded (a “Covered Corporation”).² The excise tax is imposed on the fair market value³ of the stock “repurchased” (or deemed repurchased) minus the fair market value of any stock “issued” by such corporation during the taxable year,⁴ and applies to repurchases that occur after December 31, 2022.

Repurchase is defined as a redemption within the meaning of section 317(b)⁵ and any economically similar transaction (as determined by the Secretary of the Treasury).⁶ Acquisition of a Covered Corporation’s stock by certain affiliates of such Covered Corporation from a third-party also constitutes a repurchase. In addition, repurchase appears to encompass transactions that are treated as redemptions for tax purposes, including in certain mergers and leveraged buyouts (to the extent the payments are funded out of the target’s existing cash resources or by target borrowing). Acquirors may consider whether to avoid pushing debt proceeds into the target until there is guidance on how the excise tax will apply in these transactions, though that may be challenging from a financing perspective in certain cases.

Exceptions. The IRA contains several exclusions from the excise tax, but they are generally narrow and in many cases may not be helpful given the broad potential sweep of the excise tax and its application to any transaction that is “economically similar” to a redemption.

- First, the excise tax applies only if the total value of repurchased stock in a given tax year exceeds \$1 million. This appears to be a gross threshold that does not take into account offsetting stock issuances that are discussed below.
- Second, the excise tax does not apply to repurchases occurring as part of a reorganization under section 368(a) where no gain or loss is recognized by the shareholder. Therefore, as written, this exclusion would not apply to reorganizations with boot (including many reorganizations that use cash in lieu of fractional share issuances). As written, the exception also does not extend to split-offs that are not part of a section 368(a) reorganization.
- Third, repurchases, to the extent they are treated as dividends by the Code (*e.g.*, under section 302) are excluded. Corporations may not know the particular dividend versus redemption treatment applicable to each shareholder. Accordingly, this exception likely requires information collection, diligence and consistent reporting covenants.⁷

Even outside of typical redemptions, the excise tax could apply to and affect a wide range of public transactions and other corporate actions, including redemptions in SPAC transactions, repurchases from departing employees, payments to dissenting shareholders and even the redemption of preferred shares (though Treasury is directed to address the latter through regulations).

² The excise tax also applies to certain corporations that have expatriated and are subject to the “inversion rules” of section 7874.

³ The IRA does not define fair market value for this purpose, leaving unanswered the particulars of when and how it should be measured.

⁴ Specifically, stock issued by a Covered Corporation or certain of its affiliates counts for this purpose, including stock issued to employees of a Covered Corporation or of such affiliates (such as in response to option exercise).

⁵ All section references are to the Code, as amended.

⁶ Section 317(b) applies to a corporation acquiring its stock from a shareholder in exchange for property (but excluding exchanges for the corporation’s own stock or rights to acquire the corporation’s stock).

⁷ Other exclusions include repurchased stock where such stock or its equivalent value is contributed to an employer-sponsored retirement plan (including ESOPs); repurchases made by securities dealers in the ordinary course of business; and repurchases by RICs and REITs.

Corporate Alternative Minimum Tax on Book Income

In General. The IRA includes a corporate AMT intended to tax large corporations that are profitable from a book perspective, but are subject to no or low federal income tax, at a minimum rate of 15%. The AMT applies when a corporation's tax liability under the AMT exceeds its regular federal income tax liability.

Generally, the AMT may reduce the benefits realized from certain other tax attributes, which would in some cases reduce or delay payments under tax receivables agreements. Additionally, the IRA AMT is similar mechanically to the former corporate AMT (repealed by the Tax Cuts and Jobs Act of 2017). Among other things, corporations subject to the tax may receive a corporate AMT credit that may be applied against regular income tax in future years.

Applies to Applicable Corporations. The corporate AMT applies to an "applicable corporation", which includes any corporation (other than an S corporation, a RIC or REIT) whose annual "adjusted financial statement income" ("AFSI") exceeds, on average, \$1 billion over the three taxable years ending with the current taxable year (the "Book Income Test"). While the statute is somewhat tangled, only domestic corporations and foreign corporations that are engaged in a U.S. trade or business are subject to the AMT.

Calculating AFSI. AFSI is derived from the net income or loss reported on a corporation's "applicable financial statement" that covers the applicable taxable year, with certain adjustments. For these purposes, an applicable financial statement generally includes an annual report or other SEC-required financial statements, international equivalents and financial statements required to be filed with a federal agency for purposes other than federal income tax purposes.⁸ In particular, ostensibly to support domestic manufacturers, accelerated depreciation deductions not otherwise taken into account in base book income are subtracted from AFSI.⁹

Book Income Test Aggregation. For the purposes of the Book Income Test, a corporation must include the AFSI of all persons with which it is treated as a single employer under section 52(a) or (b).¹⁰ A prior version of the IRA arguably aggregated the income from unrelated portfolio companies under common ownership of an investment fund or partnership resulting in each company, despite individually not meeting the Book Income Test, being subject to the AMT. An amendment by Senator Thune, however, removed such language from the IRA.

Applicable Corporation Duration. Absent additional guidance from Treasury, once a corporation meets the Book Income Test, it will remain subject to the AMT.¹¹

Foreign-Parented Multinational Groups. A domestic member of a foreign-parented multinational group, or a foreign member of a foreign-parented multinational group that is engaged in a U.S. trade or business, is an applicable corporation subject to the AMT if, in addition to such foreign-parented multinational group satisfying the Book Income Test,¹² the member's average AFSI (over the same three-year period) is at least \$100 million. While the IRA is not a model of clarity on this point, the additional

⁸ See section 451(b)(3).

⁹ Other than in the unique case of wireless telecom, amortization under section 197 is not taken into account.

¹⁰ Generally, section 52(a) aggregates a controlled group of corporations that meet the more than 50% common ownership rule in section 1563(a). Section 52(b) functions similarly in the context of entities that are in a trade or business under common control that are not corporations.

¹¹ Once a corporation meets the Book Income Test, it remains an applicable corporation unless (a) Treasury determines such treatment is no longer appropriate and (b) either (i) there is a change in ownership (of an undefined nature) or (ii) its AFSI falls below the relevant threshold for a requisite number of consecutive years, as determined by Treasury.

¹² For members of a foreign-parented multinational group, the \$1 billion Book Income Test threshold calculation includes all income of all group members, whether or not it is ECI.

\$100 million requirement appears to be intended to ensure that the foreign-parented multinational group has a meaningful U.S. tax nexus.

In general, a foreign-parented multinational group exists when a single applicable financial statement includes one U.S. corporation and one foreign corporation and a foreign corporation is the common parent of such entities. Moreover, a foreign corporation that is engaged in a trade or business in the U.S. will be treated as wholly owning a separate domestic corporation that conducts such trade or business. Therefore, a single foreign corporation could be deemed to be a foreign-parented multinational group.

Calculating AMT. The AMT tax base is 15% of a corporation's AFSI minus its corporate AMT foreign tax credit. A corporation's AMT foreign tax credit is such corporation's total creditable foreign taxes plus its pro rata share of any controlled foreign corporation's creditable foreign taxes¹³ (each as determined under section 901).¹⁴

Notably, to calculate a corporation's AFSI for this purpose, AFSI is reduced for "financial statement net operating losses," which are capped at 80% of AFSI. Financial statement net operating losses arise, in part, from net losses on applicable financial statements for tax years ending after December 31, 2019. Accordingly, a corporation can generate financial statement net operating losses in tax years prior to the effective date of the AMT and before such corporation is subject to the AMT.

Effective Date. The corporate AMT will take effect for taxable years beginning after December 31, 2022. Accordingly, income from 2021 and 2022 will be relevant to determining whether the corporate AMT applies.

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¹³ If 15% of the net income of a corporation's controlled foreign corporations is lower than its creditable foreign taxes, then that lower amount applies.

¹⁴ By referencing section 901 without the limitations in section 904, such limitations may not apply, allowing cross-crediting across foreign jurisdictions and avoiding the cap of a corporation's U.S. tax on applicable foreign-source income.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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