Alert | Tax

August 2022

The Inflation Reduction Act – Key Tax Considerations

On Aug. 16, 2022, President Biden signed into law the Inflation Reduction Act of 2022 (IRA). The key revenue-raising provisions under the IRA include: a 15% Corporate Alternative Minimum Tax imposed on certain large corporations (expected to raise $222 billion over 10 years), a 1% excise tax on repurchase of corporate stock by certain domestic publicly traded corporations (expected to raise $74 billion over 10 years and also to offset any loss of revenue from the removal of the proposed changes to carried-interest rules in an earlier Senate draft), and a $79.6 billion increase for the Internal Revenue Service (IRS) appropriations and enforcement (expected to raise $204 billion over 10 years). The IRA also includes several green energy and environmental tax credits that will require an investment of $369 billion with an aim to substantially reduce carbon emissions by 40% by 2030.

This GT Alert provides a high-level summary of key tax provisions of the IRA.

One Percent Excise Tax on Corporate Repurchases

Overview:

The IRA enacts a new Chapter 37 and Section 4501 of the Internal Revenue Code (the Code) that imposes on a "covered corporation" (generally, a publicly traded U.S. corporation) a non-deductible excise tax equal to 1% of the fair market value of the stock of the corporation that is considered "repurchased" by the corporation during the tax year. For purposes of the excise tax, the fair market value of the stock repurchased is reduced by the fair market value of the stock issued (or provided to employees) by the covered corporation during the tax year.

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A repurchase by a covered corporation of its stock includes: (i) any redemption within the meaning of Section 317(b) of the Code (including any transaction considered by the Secretary to be economically similar to a redemption), and (ii) any acquisition of the stock of a covered corporation by a "specified affiliate" from an unrelated person. A specified affiliate is generally any corporation or partnership that is owned (directly or indirectly) more than 50% (by vote or value/capital interests or profits interests, as applicable) by a covered corporation.

Exceptions:

The excise tax would not apply to the following transactions:

i. Any repurchase from a shareholder that is part of a reorganization under Section 368(a) of the Code, provided that no gain or loss is recognized by the shareholder.

ii. Any repurchased stock (or an equivalent value of stock) contributed to certain retirement, stock ownership or similar plans.

iii. The total value of the stock repurchased during the tax year is less than $1 million.

iv. Certain repurchases by dealers in securities in the ordinary course of business.

v. Any repurchase by regulated investment companies or real estate investment trust.

vi. Any repurchase characterized as a dividend for federal income tax purposes.

Special Rules for the Application of the Excise Tax to Certain Foreign Corporations:

Foreign corporations generally are not subject to the excise tax, except in specific situations. The 1% excise tax would also apply to situations where a U.S.-organized specified affiliate (as described above) of a publicly traded foreign corporation (an "applicable foreign corporation") acquires the stock of the applicable foreign corporation from any person other than the applicable foreign corporation or its specified affiliate. The acquiring U.S.-specified affiliate will be treated as a "covered corporation" and the 1% excise tax would apply based on the fair market value of the acquired stock of the applicable foreign corporation less the value of the stock issued by or provided to the employees of the specified affiliate (i.e., no adjustment would apply with respect to any stock issued by or provided to the employees of the applicable foreign corporation).

The 1% excise tax would also apply to certain stock repurchases by surrogate foreign corporations (generally, corporations subject to the anti-inversion rules under Code Section 7874) or an acquisition of the stock of a surrogate foreign corporation by a specified affiliate of such corporation.

Potential Consequences of the Excise Tax:

The excise tax would apply regardless of whether the stock is repurchased from taxable or tax-exempt shareholders who generally would pay no tax on capital gains or dividends (or foreign shareholder who generally would pay no capital gains tax or a reduced tax rate on dividends under applicable tax treaties). There is no minimum threshold, such as gross receipts, market cap, earnings and profits, etc., for the application of the excise tax. While there is a specific exemption for a repurchase treated as a dividend, this exemption largely would be inapplicable, as it would not be practical for public companies with a large number of shareholders whose relative interest in the corporation is minimal and who exercise no control over the affairs of the corporation to determine whether any repurchase would qualify as a dividend. In an old revenue ruling, the IRS ruled that in the case of minority shareholders of a public corporation even a small reduction of their interest in the corporation would result in the exchange treatment and would not be "essentially equivalent to a dividend."

Further, the excise tax may potentially apply to transactions that are not specifically described under the IRA, as there is no specific exemption for transactions where a covered corporation would be mandatorily required to repurchase its shares. For example, if a public company goes private, shares repurchased by the public company would be subject to the excise tax. Similarly, in a merger transaction if a target repurchases its stock, it would be subject to the excise tax, resulting in an increased cost of the merger transaction. The excise tax could similarly impact other numerous mergers and acquisition transactions, such as payments made to a shareholder upon exercising their appraisal rights.

As written, the provision also appears to apply to redemptions by Special Purpose Acquisition Corporations (SPACs). The base for the tax would presumably be reduced by a Private Investment in Public Equity (PIPE) issuance by the SPAC in that same taxable year. However, sometimes the SPAC itself is not the issuer of the PIPE, and instead the PIPE investors directly come into the target company upon the business combination or a newly formed corporation that becomes the new public parent company. Under such circumstances, it appears that the base for the excise tax to SPAC redemptions may not be reduced, since the issuer of the PIPE is a different entity.

Effective Date:

The 1% excise tax would apply to repurchases of stock after Dec. 31, 2022.

Corporate Alternative Minimum Tax

Overview:

The IRA introduces the corporate alternative minimum tax (Corporate AMT) of 15% targeted at certain large U.S. corporations if such corporation's adjusted financial statement income (AFSI), which is similar to book earnings prepared in accordance with U.S. GAAP, exceeds certain threshold amount.

Specifically, the Corporate AMT would apply to "applicable corporations" that are U.S. corporations (other than regulated investment companies, real estate investment trusts, and S corporations) with the average annual AFSI for the three-taxable-year period ending with the taxable year at issue exceeding $1 billion (the "Income Test"). The Income Test does not take into account any net operating losses carried forward. Special rules apply for short corporate tax years and corporations in existence for less than three years. Further, for purposes of applying the Income Test, all AFSI of persons treated as a single employer with a corporation under subsection (a) or (b) of section 52 will be treated as AFSI of the corporation.

An applicable corporation is subject to the 15% Corporate AMT on its "tentative minimum tax" (as described immediately below) over its regular tax (including any base erosion minimum tax imposed under Section 59A of the Code) for the taxable year. The tentative minimum tax is the excess of 15% of the AFSI of an applicable corporation reduced by certain corporate AMT foreign tax credits that are taken into account on the corporation's AFSI and paid or accrued (for tax purposes) to a foreign jurisdiction.

Generally, once a corporation is determined to be an applicable corporation, it would remain an applicable corporation in perpetuity, unless (A) the corporation has a change in ownership, (B) the corporation has a specified number (to be determined by the Treasury Department) of consecutive taxable

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years, including the most recent taxable year, in which the corporation does not meet the Income Test, and (C) the Treasury determines that it would not be appropriate to continue to treat the corporation as an applicable corporation.

Applicable to U.S. Corporations with Foreign-Parented Multinational Group:

If a corporation is a member of a "**foreign-parented multinational group**" (as described below), two requirements must be met: (1) the group's average annual AFSI for the three-taxable-year period ending with the taxable year at issue must exceed $1 billion **and** (2) the corporation's average annual AFSI for the three-tax-year period ending with the same taxable year must be $100 million or more.

Foreign-parented multinational group means, with respect to a taxable year, two or more entities if (a) at least one entity is a domestic corporation and another entity is a foreign corporation, (b) these entities are included in the same applicable financial statement for the taxable year, and (c) the common parent of the entities is (or is deemed, under future regulations, to be) a foreign corporation.

Further, if a foreign corporation is engaged in a U.S. trade or business, such trade or business is treated as a separate corporation wholly owned by the foreign corporation, and the rules described above would apply to such deemed U.S. corporation accordingly.

Rules for the Computation of AFSI:

ASFI is generally the net income or loss of the taxpayer set forth on its applicable financial statements for the taxable year, with following adjustments:

a. **Financial statement covering period other than the taxable year**. Appropriate adjustments must be made if an applicable financial statement covers a period other than the taxable year.

b. **Owner of a disregarded entity**. The taxpayer's AFSI shall include AFSI of any disregarded entity owned by the taxpayer.

c. **Partner of a partnership**. If the taxpayer is a partner in a partnership, its distributive share of the ASFI of a partnership is taken into account.

d. **U.S. shareholder of a Controlled Foreign Corporation (CFC)**. If the taxpayer is a U.S. shareholder of one or more CFCs, its pro rata share of the AFSI of the CFC is taken into account. If this results in a negative adjustment, no adjustment will be made for the taxable year, but it will reduce any income determined under this section in a succeeding taxable year.

e. **Foreign corporation**. If the taxpayer is a foreign corporation, only the income that is effectively connected with the conduct of a U.S. trade or business is taken into account.

f. **Depreciation**. AFSI will be reduced by depreciation deductions allowed under Section 167 with respect to property to which Section 168 applies.

g. **Taxes**. Federal income taxes with respect to a foreign country or U.S. possession that are taken into account on the taxpayer's financial statement will be disregarded. However, to the extent provided by the Treasury, this rule does not apply if the taxpayer does not elect to use the foreign tax credit.

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h. The IRA also provides specific adjustments for the following taxpayers/situations: a taxpayer that is a member of a consolidated group, cooperatives, Alaska native corporations, amounts treated as tax credits under an election under Sections 6417 and 48D(d), mortgage servicing income of taxpayer other than a regulated investment company, defined benefit pensions, tax-exempt entities, and qualified wireless spectrum.

AFSI as determined above would be reduced by the lesser of (A) the aggregate amount of financial statement net operating loss carryovers after Dec. 31, 2019, to the current taxable year, or (B) 80% of ASFI computed without the deduction allowable under the preceding clause (A). Unapplied adjusted financial statement net operating loss is carried forward.

Potential Consequences of the Corporate AMT:

The Joint Committee on Taxation estimates that nearly 150 corporations would be subject to the Corporate AMT annually. However, other corporations should also carefully conduct an analysis to determine whether the Corporate AMT would apply to them. There are no specific coordination rules between the corporate AMT and the existing transfer pricing allocations between a U.S. subsidiary and its foreign parent. Thus, this provision should be carefully analyzed to situations where a foreign parent's U.S. subsidiary merely sells products in the United States on a limited risk distribution basis, provided the income threshold is met.

Further, as a U.S. corporation is required to include its pro rata share of the AFSI of a CFC, global intangible low taxed income (GILTI) of such CFCs may effectively be taxed at a higher rate of 15% compared to the current effective rate of 10.5% (after the 50% deduction under Section 250 available for domestic corporations). Similarly, the Corporate AMT may also apply to a U.S. corporation that would otherwise not be required to pay tax on a CFC's distributions under Section 245A's participation exemption regime.

For certain taxpayers, the Corporate AMT may be viewed as an acceleration event, as a corporate taxpayer is allowed to claim a credit for corporate AMT paid in prior years against its regular tax liability in future years to the extent the regular tax liability exceeds the tentative minimum tax of a relevant future taxable year. However, for other taxpayers who cannot offset historic financial statement net operating loss carryovers that arose before 2020, the Corporate AMT may be permanent.

Effective Date:

The Corporate AMT is effective for taxable years beginning after Dec. 31, 2022.

Additional Funding for IRS Appropriation and Enforcement

Overview:

The IRA will provide the IRS approximately $80 billion in addition to its regular appropriations through Sept. 30, 2031. It allocates $45.6 billion for enforcement, $25.3 billion for operations support, $4.8 billion for technology modernization, and $3.2 billion for taxpayer services. The Congressional Budget Office estimates the IRS will raise $124 billion in additional revenue through 2031 as a result of this funding.

Close to 60% of the $80 billion is allocated to IRS enforcement activities. These activities include, among other things, (A) the determination and collection of unpaid taxes (B) criminal investigations (including funding for investigative technology), and (C) digital asset monitoring and compliance activities. Treasury

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Secretary Janet Yellen has directed the IRS not to use the additional funding the IRA provides to increase audit rates on small businesses or households making under $400,000 annually.

Potential Consequences to Taxpayers:

For years, the IRS has been criticized for not auditing high-income individuals at the same rate as low-income individuals. Between 2011-2018, audit rates on individuals making over $1 million per year fell by 80%. A 2021 study published by the National Bureau of Economic Research found that the top 1% of Americans failed to report approximately 20% of their income to the IRS.

A 2019 IRS study found that the net tax gap, or the difference between the amount of tax owed and the amount of tax that is actually paid, for tax years 2011-2013 was $381 billion annually. Another study used those numbers to extrapolate that between 2020-2029 the net tax gap will be $750 billion annually. However, an increase in well-targeted enforcement, focusing on audits of high-income individuals, as well as increased information reporting requirements may shrink the tax gap.

It is unclear how the IRS will select high-earners and corporations for these new audits. Recently, the IRS has used campaigns to focus its resources and increase scrutiny on certain compliance issues. Current campaigns include micro-captives, syndicated conservation easements, and virtual currency transactions.

Green Energy and Environmental Tax Credits

The IRA expands numerous environmental and clean energy tax credits to fight climate change and reduce carbon emission by 40% over the next decade. For further discussion related to green energy and environmental tax credits, including the changes to “Investment Tax Credits” and “Production Tax Credits,” please refer to our previous alert on how the IRS may affect the renewable energy industry.

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