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What Compensation Professionals Need to Know About the Inflation Reduction Act of 2022

In 2023, stock buybacks will face a new one percent tax; however, by communicating and educating participants on the equity compensation that they are receiving, companies can motivate, reward and retain workforces.

On August 16, 2022, President Biden signed into law the Inflation Reduction Act of 2022 (the Act). Equity compensation professionals should be aware that for fiscal years commencing after December 31, 2022, the Act introduces a 1 percent excise tax that will be applied to the fair market value of the firm's stock repurchases, sometimes called share "buybacks," during the fiscal year.

This article:

- Alerts readers around the new tax on buybacks
- Alerts readers around how broad-based stock programs can offset part of the tax
- And presents the expected impact on broad-based stock programs

Background and Application of the Excise Tax

The Act specifies that a 1 percent excise tax will apply to the fair market value of net repurchases made by, generally, publicly traded US corporations. However, the taxable amount can be reduced by issuances of equity to employees, meaning that firms can deduct the aggregate fair market value of any shares provided to employees, including as part of employee awards, an employer-sponsored retirement plan or as part of an employee stock ownership plan.

While the Act is meant to apply to firms engaging in share repurchase programs, the Act carves out specific instances where the excise tax would not apply, including when a firm's buyback total is less than one million dollars or when the shares purchased are part of a reorganization like a spin-off (i.e., the buybacks do not make a net positive impact to shareholders).

> Aon observes that, once again, legislators have sought to codify favorable treatment for firms with Employee Stock Purchase Plans ("ESPP"). IRC 423-qualified ESPPs represent efficient ways for employees to share in the firm's stock price appreciation and, further, help foster a broad culture of employee ownership. According to Aon's published data, 49 percent of the S&P 500 firms had an ESPP, whereas 38.5 percent of Russell 3000 firms had an ESPP in 2020.

Rationale Behind and Investor Response to Buyback Programs

Firms return value directly to shareholders in several ways, including in the form of dividend payments, though increasingly share buybacks have gained favor among shareholders and investors due to the tax-advantaged way of returning value vis-à-vis dividend payments. That is, shareholders receiving a dividend payment will need to pay tax on the dividend payment for the calendar year they are received. However, when a firm uses a share buyback instead of a dividend, the benefit of the share appreciation is not taxed until an individual sells their shares.

There might be additional reasons that a firm might engage in buybacks, including counteracting regular dilution that occurs through, for example, the exercise of employee stock options. In fact, the large institutional investor State Street notes as part of their policy on repurchases that in instances where a firm makes the clear connection between a share repurchase program and its desire to offset dilution created from employee grants, their calculation of a firm's dilution might be adjusted to include the impact of the share repurchases.

In general, many large institutional investors do not oppose repurchase programs as part of a well-run capital management strategy, though they often want transparency and assurances that metrics like earnings per share (EPS) will be excluded from LTI or adjusted to avoid any impact that the repurchases might have on executive compensation.

Proxy advisors are generally supportive of share repurchase programs, though there is some nuance to their position. For example, Institutional Shareholder Services has supported approximately 89 percent of management-proposed share repurchase programs since 2018 and generally recommends that shareholders vote against shareholder proposals that intend to limit repurchases. However, as part of their general recommendation, they cite instances where they will not support management-proposed repurchase programs, including where greenmail is occurring, where use of buybacks limit the long-term viability of the firm and where the use of the buyback program inappropriately manipulates executive incentive payouts.

Overall, the degree to which buyback programs represent a worthwhile investment generating positive returns over time for shareholders or represent an overly short-term focus on share price by executives remains a matter of academic debate that includes individuals across political alignments likely being able to point to different examples to support their opinion.

Implications for Incentives and Equity Compensation

From a human capital perspective, Aon believes that there are many strategic benefits to implementing and expanding broad share ownership initiatives, including with employee stock purchase plan and other broad and large-scale employee grants. Because the Act specifically allows for the taxable basis of share repurchases to be reduced by share issuances to employees, we do not believe that the Act will hamper a firm's efforts to motivate, reward and retain workers using equity compensation. Instead, we believe this might further spur investment in broad-based equity ownership programs.

From a short-term incentive design perspective, in instances where a firm has set their incentives in such a way that included future share buybacks, but now, if the excise tax might adversely impact those goals, such firms might need to reconsider their goal-setting approach in upcoming cycles. From a long-term incentive perspective, Aon observes that in designing awards, the best practice is to require the board to make an adjustment to payout with changes to legislation. While we do not expect to see boards adjusting long-term incentive payouts based on the introduction of this Act, if, however, a firm's award agreements and plan document does not require the adjustment of metrics in situations like this and the compensation committee decides to apply discretion, there could be ramifications.

In instances of positive discretion, this would be a financial accounting modification, and the firm would need to take additional compensation expense.

Finally, because the excise tax applies to firms and not individuals, Aon's continued holistic view is that firms need to take care to communicate and educate participants on the equity compensation that they are receiving. These efforts raise the perceived value of awards received by participants and maximizes equity's intended effect. Potentially communicating to participants around how a firm believes that share buyback programs generate value for shareholders and participants might be a relevant talking point for firms who regularly engage in share buybacks and who issue equity broadly.

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