ROPES & GRAY

ALERT

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IRS Guidance Answers Certain Questions for SPACs on Applicability of Excise Tax, but Some Uncertainty Remains

On December 27, 2022, the IRS released initial guidance on the stock buyback excise tax ("Excise Tax") enacted as part of the Inflation Reduction Act in August 2022, as discussed in our prior Alert. Notice 2023-2 (the "Notice") provides interim guidance on which taxpayers may rely pending issuance of regulations, and addresses several ambiguities in the application of the Excise Tax. This Alert discusses the impact of this interim guidance on special purpose acquisition company ("SPAC") operations and transactions.

The Excise Tax was enacted in August 2022, under Section 4501 of the Internal Revenue Code of 1986, as amended,[1] and generally imposes a 1% excise tax on net stock buybacks by publicly-traded U.S. corporations, beginning in 2023. Very generally, the tax equals 1% of the excess of the fair market value of a corporation's applicable non-excepted repurchases during its tax year over the fair market value of its applicable stock issuances during the taxable year (such excess, the "Excise Tax Base," and such netting, the "Netting Rule"). In the SPAC context, the Excise Tax could affect shareholders by leading to a reduction in the amount in the trust account available to pay redemptions or otherwise available to the combined company following a de-SPAC.

Following the enactment of the Excise Tax, there was legal and market uncertainty regarding whether the Excise Tax would apply to SPAC redemptions, and notably whether the Excise Tax might apply to SPAC liquidations, as well as who would economically bear the cost of the Excise Tax. In reaction, many SPACs whose term would have expired in early 2023 opted to accelerate their liquidation into 2022, or opted to seek an extension during 2022 so that the redemptions associated with the extension process would occur during 2022. However, uncertainty remained for SPAC sponsors and shareholders regarding liquidations that may occur after 2022, including who would bear the incidence of the Excise Tax if it reduced the amount available to be redeemed from the trust account or otherwise available to the combined company following a de-SPAC.

Significantly, the Notice clarifies that the Excise Tax **will not** apply to complete corporate liquidations within the meaning of Section 331. There is reason to believe that this exception is intended to apply to the wind up of a SPAC. Nonetheless, it may be unclear whether the wind up of a SPAC would constitute a liquidation under Section 331 without careful attention to planning with respect to the liquidation. In general, the Notice also helpfully provides protection for de-SPAC transactions to the extent shares issued by the SPAC during the year exceed repurchases otherwise subject to the Excise Tax. While some open questions remain regarding the treatment of other repurchases by a SPAC, including redemptions in connection with an extension, the Notice overall provides helpful guidance for SPACs.

Discussion

SPAC Liquidations. As noted above, the Excise Tax does not apply to complete liquidations to which Section 331 applies. In this regard, the exemption can favorably affect the wind up of a SPAC, as we would expect that the trust account redemptions could be structured as part of a complete liquidation to which Section 331 applies. Nonetheless, there could be technical questions as to whether Section 331 can apply to such redemptions where not all shareholders receive amounts upon the liquidation. Accordingly, careful consideration should be given to specific facts and the process of liquidating a U.S. SPAC for both Excise Tax and income tax purposes. Liquidating distributions for this purpose should generally include redemptions made as part of the SPAC's liquidation, provided that the liquidation process is properly implemented by, for example, ensuring that redemptions from the trust account are made pursuant to a plan of liquidation formally adopted by the SPAC's board prior to effecting such redemptions, and ensuring that the SPAC is fully liquidated for U.S. federal income tax purposes during the same tax year as the redemptions take place.

[1] All Section references herein are to the Internal Revenue Code.

SPAC Extensions. If a SPAC redeems shares in connection with an extension process, the SPAC may be subject to the Excise Tax in respect of those redemptions, but whether and to what extent the Excise Tax applies will not be determined until the end of the tax year in which the redemptions occur. Specifically:

- If a SPAC completes a de-SPAC transaction during the tax year in which the redemptions occur, then application of the Netting Rule to the de-SPAC transaction (as discussed below) would likely reduce the SPAC's Excise Tax Base and may well result in no Excise Tax being due even on the earlier redemptions during that tax year.

- If a SPAC completely liquidates during the tax year in which the redemptions occur, there is ambiguity in the Notice. It is unclear if the liquidation rule will exempt the SPAC from the Excise Tax in respect of the earlier redemptions.

- If a SPAC neither completes a de-SPAC transaction nor liquidates during the tax year in which the redemptions occur, absent further guidance, the Excise Tax will be payable in respect of the redemptions. Note that although a portion of the redemptions may be treated as dividends for U.S. federal income tax purposes that are not subject to the Excise Tax, we do not expect this to meaningfully affect the amount of the Excise Tax payable by the SPAC.

If a significant percentage of SPAC investors elect to redeem their shares in connection with an extension, the potential Excise Tax could meaningfully affect the dynamics of the extension process. More specifically, as the Excise Tax will be imposed on the SPAC and due following the SPAC's tax-year-end, absent other measures, the remaining shareholders that did not elect to redeem in effect would economically bear the impact of the Excise Tax. This assumes SPACs will not attempt to reduce the redemptions paid on the extension by a 1% reserve, since if the SPAC did so, that would put pressure on the shareholders to vote against the extension and thereby force a liquidation instead. Practically, the desire to avoid triggering such a liquidation may put pressure on SPAC sponsors to increase their contribution to the trust account in connection with an extension process in an amount sufficient to pay the potential Excise Tax (or perhaps to loan an additional amount sufficient to pay the potential Excise Tax) or find other "solutions" that minimize adverse incentives to not extend (for example, by equitably splitting the economic burden of the potential Excise Tax on shareholders irrespective of whether they redeemed their shares as part of the extension process, liquidation or a de-SPAC transaction).

De-SPAC Transactions. The extent to which the Excise Tax may apply as a result of redemptions in connection with a de-SPAC transaction will depend on the particular structure and facts of the transaction. Generally, redemptions will presumptively be treated as repurchases and increase the Excise Tax Base. Application of the Netting Rule may reduce the Excise Tax Base on account of issuances to PIPE investors and target shareholders. This potentially could result in little or no Excise Tax being due, as long as the SPAC makes the issuances and the issuances are large enough to offset the redemptions.

We expect that <u>most</u> typical de-SPAC transactions will not result in an Excise Tax as a result of the SPAC redemptions, with notable exceptions:

- *Up-C de-SPACs*. In an Up-C de-SPAC transaction (also sometimes referred to an "Up-SPAC" transaction), target holders hold their economic interests in a partnership or LLC entity below the publicly-traded holding company (formerly the SPAC entity), and thus the value of those interests would not be counted in the Netting Rule. Accordingly, Excise Tax will be due unless the aggregate value (as defined in the Notice, see below) of the PIPE investment in the SPAC and any interests issued to target holders in the SPAC (potentially including any value ascribed to their non-economic voting shares in the former SPAC) at least equals the value (as defined in the Notice) of the SPAC redemptions.

- *Double-Dummy and certain other de-SPAC transaction structures*. Depending on the corporate structure by which the de-SPAC is effected, the issuances of shares to the target shareholders and on account of the PIPE investment may not be treated as made by the SPAC, in which case they would not be counted in the Netting Rule. For example, consider a "double dummy" structure, which is frequently used for business combinations involving a U.S. SPAC and a non-U.S. target that will not domesticate as part of the combination. As part of the combination, a newly formed non-U.S. holding company forms two merger subsidiaries; one of the merger subsidiaries merges with the non-U.S. target with the non-U.S. target surviving, followed by the second merger subsidiary merging with the SPAC with the SPAC surviving. Following these mergers, former shareholders of the non-U.S. target and the SPAC, along with any PIPE investors, will be shareholders of the new non-U.S. holding company. On these facts, it seems that the shares issued to non-U.S. target shareholders and PIPE investors would not be available to net against the SPAC redemptions because the issuances and redemptions are not made by the same corporation—i.e., the SPAC makes the redemptions, but the non-U.S. holding company issues the shares.

The application of the Netting Rule is highly technical and should be carefully considered in any de-SPAC transaction.

Valuation. The Notice also provides guidance on the valuations that should be used to calculate the value of redemptions and issuances in determining the Excise Tax Base and thus the amount of the Excise Tax. Applied to de-SPAC transactions, these rules are non-intuitive and may have unexpected results, although, in the current market, distortions created by these rules could favor SPACs. Specifically, the valuation of SPAC redemptions and of issuances in the de-SPAC transaction generally will be based on the public trading price on the closing date of the de-SPAC transaction, and <u>**not**</u> on the amount paid in redemptions, agreed to as the target valuation in the transaction agreements, or invested by PIPE investors (with some open ambiguity in the Notice regarding PIPE investors). For example, if a SPAC redeems 20 million shares for $200 million from the trust account and the public trading price on the closing date is $15, the SPAC will be treated as having redeemed $300 million worth of shares; alternatively, if the public trading price is $5, the SPAC will be treated as having redeemed only $100 million.

As the de-SPAC transaction redemptions and issuances are both valued based on the closing date trading price, the outcome under the valuation rules should be the same as what the outcome would have been if the actual amounts paid had been used as long as issuances exceed redemptions (because both valuations would rise or fall in proportion). If, however, redemptions exceed issuances and the SPAC will be subject to the Excise Tax, the amount of the Excise Tax would be impacted by the trading price and could be substantially more or less than would be expected based on the actual amounts redeemed and invested.

Moreover, the Notice permits a SPAC to choose among four valuation methodologies based on the closing date trading price: (i) the daily volume-weighted average price as determined on that day, (ii) the day's closing price, (iii) the average of high and low prices, and (iv) the price at the actual time of closing. The outcome under these methods may vary substantially if the trading price is volatile on the closing date. The SPAC apparently may choose the most beneficial method, however it must consistently use a single method for all redemptions and issuances in a given tax year.

For more information on the details discussed in this Alert, please reach out to your usual Ropes & Gray contacts.