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Should SPACs Be Spooked By the Excise Tax on Stock Buybacks?

By Michael Kliegman and Joshua Williams[*]
Akin Gump Strauss Hauer & Feld LLP
New York, NY

INTRODUCTION

On August 16, the Inflation Reduction Act of 2022[1] (Act) became law. The bill, passed along party lines in the House and the Senate under the arcane budget reconciliation rules, reflected numerous last-minute changes, leaving us with legislative language but without the tools that we as tax practitioners and IRS and Treasury officials ordinarily rely on to understand what Congress intended, namely Congressional committee reports and the Joint Committee's explanation.

One of the last-minute additions to the law was a 1% excise tax on corporate share repurchases (the so-called stock buyback tax). There are undoubtedly a number of open issues for government and private tax advisors to parse, but in this article our focus is on how the law potentially applies to special purpose acquisition companies, commonly known by the acronym ''SPACs,'' or by the descriptive name blank check companies. We will lay out the principal relevant provisions of the new excise tax, briefly describe the typical transactions in the life cycle of a SPAC, and examine how the excise tax may apply to those transactions.[2]

The Act gives us new §4501.[3] Section 4501(a) imposes a tax ''on each covered corporation . . . equal to 1 percent of the fair market value of any stock of the corporation which is repurchased by such corporation during the taxable year.'' A ''covered corporation'' is any domestic corporation the stock of which is traded on an established securities market.[4] In what will be a key area of focus, the statute defines ''repurchase'' as:

> (A) a redemption within the meaning of section 317(b) with regard to the stock of a covered corporation, and
>
> (B) any transaction determined by the Secretary to be economically similar to a transaction described in subparagraph (A).[5]

The amount of otherwise taxable stock repurchases is reduced by the fair market value of stock issued by the corporation during the taxable year.[6]

Section 317(b) provides:

> For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

''Property'' is defined in Section 317(a) as ''money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).''

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[*] Michael Kliegman is a senior counsel and Joshua Williams is a partner at Akin Gump Strauss Hauer & Feld LLP. The opinions expressed herein are those of the authors only and do not indicate the views of Akin Gump. The authors are grateful to John Clayton and Douglas Scott for their guidance and input.

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[1] Pub. L. No. 117-169.

[2] Our focus here is on SPAC transactions in particular. For a broader examination of the excise tax on share repurchases, see Cathryn R. Benedict and Philip B. Wright, *Excise Tax on Share Repurchases: A Provision Searching for its Purpose*, 63 Tax Mgmt. Memo. No. 19, 241 (Sept. 12, 2022).

[3] *See also* Act, §10201. All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[4] §4501(b).

[5] §4501(c)(1).

[6] §4501(c)(3).

(VERY) BRIEF PRIMER ON SPACS

When a SPAC goes public, an investor typically purchases for $10 a unit consisting of one share of common stock and a fraction of a warrant to purchase common stock. Often on the 52nd day following the date of registration, the warrant begins trading separately from the common stock.[7] Generally, the SPAC commits to complete a qualifying ''initial business combination'' (a so-called de-SPAC) within 24 months of the IPO or, alternatively, to return the investors' money, which it has held in trust (subject to certain operating expenses).[8] At the time of the de-SPAC a public stockholder can choose to redeem all or a portion of its shares for an amount equal to its pro rata share of the amount held on deposit in the trust account. It is intended that there will be sufficient cash to pay $10 per share to investors exercising the redemption right, but the amount available may be reduced as a result of paying expenses but also by amounts required to be paid in connection with the de-SPAC.

Timing and other aspects of the redemption right are affected by the nature of the de-SPAC and whether there is a shareholder vote for the transaction. For example, a merger likely would involve a vote of the SPAC shareholders, whereas a stock purchase of a target likely would not. If there is no shareholder vote, the redemption is effected by way of a tender offer by the SPAC to the investors. If there is a shareholder vote, redemptions are offered in connection with the proxy solicitation process.[9] If the amount of cash required to satisfy all redemption requests plus the amount of cash committed to the de-SPAC exceeds the amount held by the SPAC, it will not go through with the business combination.[10]

Provisions governing the exercise of warrants can be complicated. Once they become exercisable (generally, the later of 30 days after the de-SPAC or 12 months after the IPO), the SPAC may effectively force exercise by redeeming them for a penny per warrant following 30 days' notice of redemption, but only if the stock has recently traded for $18 or more per share. If the stock has been trading at between $10 and $18, the company may eventually redeem the warrants for 10 cents each provided the holders are given the opportunity to exercise their warrants on a cashless basis prior to redemption.

Typically, SPAC IPO proceeds are held in a trust account. The SEC describes the SPAC trust account as analogous to an escrow arrangement when buying a house, with the IPO proceeds held by a third party until (i) the SPAC can complete a business combination, or (ii) the SPAC is liquidated for not having completed an initial business combination within a specified period of time.[11] IPO proceeds invested in the trust account are typically net of certain fees and expenses and invested in relatively safe, interest bearing instruments. When SPAC shareholders exercise their right in connection with a de-SPAC transaction to redeem their shares rather than become shareholders of the combined company, or when a SPAC liquidates without completing a business combination, the shareholders are the beneficiaries of the trust and entitled to their *pro rata* share of the aggregate amount then on deposit in the trust account.

APPLICATION OF EXCISE TAX TO SPAC TRANSACTIONS

The estimable Professor Martin Ginsburg used to quip that when interpreting tax law we first consult the legislative history and look at the statute only when the legislative history is unclear. Perhaps he might have added that in a case where there is no legislative history but only a statute, what tax lawyers need to do is panic. Indeed, to some degree it seems that this is what many tax practitioners have been doing with regard to §4501's potential applicability to SPAC transactions.

Section 4501(c) provides one definitive definition of ''repurchase'' — a redemption within the meaning

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[7] The SPAC's sponsor will have initially purchased all of the pre-IPO common stock at a nominal price, and may invest additional funds with public investors at the IPO price.

[8] Many SPAC charters include a provision permitting the SPAC to use interest earned on funds held in the trust account to pay income and franchise taxes. Some commentators, observing that an excise tax is neither an income tax or a franchise tax, argue that funds held in the trust account may not be able to be used to pay the excise tax. A competing view observes that SPAC charters generally condition the amount of any liquidating distribution on the presence of ''lawfully available funds.'' Lawfully available funds, in this context, means funds net of any obligations to creditors, which arguably includes the IRS. Given the uncertainty, some SPACs are including in their risk disclosures that they will not use funds from the trust account to pay potential excise taxes stemming from the Inflation Reduction Act. This leaves open the question of how the tax should be paid, which we address in more detail in the section titled **Liquidating the SPAC — What Do You Do With That One Percent?** below.

[9] Note, however, that a SPAC IPO investor can generally vote in favor of the business combination and still exercise the redemption right.

[10] In most de-SPAC transactions there are additional PIPE (private investment in public equity) investors that invest at the time of the de-SPAC transaction, some having committed prior to and others only after announcement of the de-SPAC transaction.

[11] SEC Investor Alerts and Bulletins, *What You Need to Know About SPACs—Updated Investor Bulletin.*, available at, https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

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of §317(b) — supplemented by a grant of authority to Treasury to expand the scope to any transaction determined to be ''economically similar'' to a §317(b) redemption. One of the two types of SPAC transactions to run through the statutory definition is shareholder redemptions that occur in conjunction with a de-SPAC transaction. These are quite literally redemptions as defined in §317(b) with shareholder treatment determined under the rules of §302.

In a given factual setting, de-SPAC redemptions might not ultimately give rise to the excise tax as a result of the netting adjustment of §4501(c)(3), which reduces the taxable repurchase amount by the fair market value of stock issued by the covered corporation during the taxable year. It is unusual but not impossible that the de-SPAC transaction and related redemptions might occur during the same tax year as the SPAC's IPO. More useful will be the prospect of netting SPAC stock issued to PIPE investors in conjunction with the de-SPAC transaction against stock redeemed. Acquisition structures that do not involve the SPAC issuing its stock to PIPE investors raise significant concerns about benefitting from the netting rules. For example, de-SPAC transactions can take the form of a new holding company acquiring the SPAC and the target company, in which case the PIPE investors would likely be purchasing stock in the holding company rather than the SPAC.

There is certainly work for Treasury and IRS to do in clarifying how these rules operate, including addressing transactions where there is a corporate group restructuring occurring in connection with the de-SPAC related redemptions and stock issuances. There are also good arguments as to why these redemptions should not be subjected to the excise tax, which are not ''self-executing,'' i.e., which will require action by Treasury to add boundaries and criteria not contained in the statute. For example, common or preferred stock that is redeemed pursuant to terms baked into the stock when issued should arguably not be within the scope of the excise tax.[12]

And now we move to where the anxiety is setting in, a SPAC that, being unable to consummate a de-SPAC transaction within the period prescribed by its charter, must distribute all of the cash held in trust and liquidate. Any tax lawyer called upon to rule or opine as to the income tax treatment of this transaction to the corporation and its shareholders will declare that it is a complete liquidation taxable to shareholders under §331 and to the corporation under §336. It is not a redemption as defined under §317(b), which would cause the shareholder treatment to be tested under §302 and the corporation to be subject to potential taxation under §311 rather than §336.[13] We are hard put to identify any firm authority that conflates distributions in complete liquidation of a corporation with redemptions as defined in §317(b).

It seems likely that in tying the core definition of a taxable repurchase to §317(b), legislative drafters deliberately chose a provision that is a ''known quantity'' and has played a clear and consistent role in the corporate tax system since at least 1954. They were well aware that in doing so they were referring to transactions that were well defined, fitting within established and accepted boundaries in Subchapter C.

Yet there is anxiety among advisers to SPACs, reflected both in risk disclosure language in public documents and in reported acceleration of liquidation plans by some SPACs nearing the end of their useful lives, to beat the January 2023 effective date of the excise tax. What is the argument for subjecting liquidating distributions to the excise tax? We think it would have to be that §4501(c)(1) should be read as if it made no reference to §317(b), but merely borrowed the definitional language contained in that provision. One would have to posit that while the drafters could have just written a sentence directly encompassing any and all transactions, including liquidations, wherein a corporation distributes cash or property to one or more of its shareholders in respect of their stock, they thought it would be more convenient from a drafting standpoint to incorporate by reference the language used in §317(b) (and §317 (a)) without pulling in any of the context in which that provision is found.

We think that is unlikely and involves a strained interpretation of the new statute which, if the shoe were on the other foot and a taxpayer sought to take advantage of such a reading of a statute, one would refer to it as a loophole, or worse. We also note that even if one tried to read the statute as incorporating only the language of §317(b) in isolation, the reference to ''a shareholder'' seems particularly inappropriate when applied to a wholesale liquidation of the corporation.

One basis for concern that has been expressed is that, although liquidations may not be captured within the §317(b) definition, what's to stop Treasury from determining that a liquidation is ''economically similar'' to a redemption as authorized by §4501(c)(1)(B)? While a liquidation is clearly economically distinguishable from a redemption, Treasury could opt to expand rather than limit the scope of transactions

[12] *Cf.* Reg. §1.1001-3(c)(1)(ii), providing a general approach not treating an alteration of a legal right or obligation that occurs by operation of the terms of the debt instrument as a modification of the instrument.

[13] Since the definition in §317(b) is ''for purposes of this part,'' technically it applies only Part I of the subchapter i.e. §301–§318 and does not apply to §331.

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caught in the excise tax net. But this would be an exercise of regulatory authority that is likely to take a fairly long time, and should, based on past precedent, be expected to have a prospective effective date.

Perhaps the best argument for a broad interpretation of the term ''repurchase'' is that the statute contains an explicit exception ''to the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 by reason of such reorganization.''[14] This is presumably meant to apply, for example, to a shareholder of a Target corporation that is acquired by Acquiring corporation in an asset reorganization, in which the Target shareholder receives Acquiring stock in exchange for its Target stock. In such a case, the tax-free §354 exchange is technically with Target, i.e., Target is treated as receiving Acquiring stock in exchange for its assets and then distributing the Acquiring stock to Target shareholders in exchange for their Target stock. This exception should not have been necessary, since a transaction under §354 and §361 is definitely not a ''redemption'' as defined in §317(b), and we do not think that term has ever been used to describe what is taking place in such an exchange. Nevertheless, as noted, with no legislative history and only statutory language, this does provide an argument for an aggressive reading of the statute.

Despite the points made above, we recognize that without legislative history or even a Joint Committee Explanation, prudence may demand that SPAC advisers do two things. One, they and relevant industry groups are appropriately communicating to Congressional and Treasury officials the need for clarification on this and other points. Second, a judgment needs to be made on a case by case basis whether liquidation is sufficiently inevitable that it may as well be accelerated into 2022.

In the next section of this article, we discuss legal and practical considerations that a SPAC looking at a potential post-2022 liquidation should confront in the current environment where there is at least some risk that the IRS could assert that the excise tax applies to a SPAC liquidation.

LIQUIDATING THE SPAC — WHAT DO YOU DO WITH THAT ONE PERCENT?

For purposes of this section, we posit that a SPAC going into liquidation during 2023 receives advice that the excise tax likely should not apply to liquidating distributions, there is some degree of uncertainty about this and while counsel is optimistic that Congress or the IRS will ultimately clarify that the tax does not apply in this scenario, there is not complete certainty about the matter. Section 4501(a) imposes the tax on the covered corporation, so if the tax is applicable it would become a liability of the SPAC.

As described above, a SPAC is ordinarily capitalized with a modest amount of working capital and IPO proceeds (and any interest earned thereon) that are placed in trust for limited purposes, mainly to fund de-SPAC transactions, shareholder redemptions and, where necessary, liquidating payout to shareholders. The standard trust document permits payment of taxes incurred by the corporation; in many cases this is limited to income and franchise taxes. Where such limiting language is present, use of trust assets to pay the excise tax under §4501 presumptively may be impermissible.

Putting aside this trust issue, the question of how the SPAC might address the contingency of having to pay one percent of its net assets to the IRS rather than to its shareholders falls largely within the realm of dissolutions under Delaware corporate law.[15] It is worth keeping in mind that while a corporate dissolution will usually occur at the culmination of a liquidation, the latter is an income tax term while the former is a process under state law.

Broadly, it seems that our hypothetical liquidating SPAC may consider the following alternatives:

- Follow the dictates of the trust document and distribute all of its assets to shareholders, subject to payment of income and franchise taxes and other permitted expenses.
- If there is a reasonable concern that the IRS could assert liability against the trust or its trustees for the excise tax, distribute all but the 1%, deferring winding up the dissolution of the corporation and the trust until there is certainty. The trust could potentially be distributed to the shareholders and function as a liquidating trust, but it might be administratively less onerous to retain it as a corporate ''asset.''

A central concern in such a situation is that the corporate directors and shareholders not have exposure to a clawback claim by the IRS. While beyond our expertise, a clawback against shareholders of a public company would seemingly be highly unusual, and even for the directors, the strength of the advice they obtain on the tax and other legal issues involved generally should provide a solid measure of protection. Assuming the scale of the exposure is large enough,

[14] §4501(e)(1).

[15] SPACs are typically incorporated either in Delaware or the Cayman Islands. As noted, the tax is only applicable to domestic corporations, so Delaware is the appropriate jurisdiction to focus on.

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the SPAC may well be able to purchase insurance against these risks.

CONCLUSION

There is little confusion about what sorts of transactions were being targeted by Senators when they conceived using the tax law to impose costs or restrictions on stock buybacks by public companies.[16] What we ended up with was mainly a revenue raising provision with no actual legislative history, and scope language that drafters probably thought was simple and clear. Few public companies find themselves in the position of planning their demise, and SPACs are in this position far more than most. With strong arguments against application of the repurchase excise tax to liquidating distributions by SPACs, and legal responsibility of management not to hold back from shareholders any lawfully available funds, there are good reasons for these companies not to simply hand the money over to the IRS. Disclosing the risk is easy enough; for now, SPACs heading into 2023 embrace the dual hopes that the IRS will provide certainty before post-2022 liquidations begin to occur, and better still, that the market will be friendlier next year to strong de-SPAC transactions.

[16] *See, e.g.,* August 7, 2022, press release by Senate Finance Chair Ron Wyden; comments accompanying September 10, 2021, release of Stock Buyback Accountability Act introduced by Chairman Wyden and Senator Sherrod Brown.

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