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IRS Issues Guidance Interpreting Stock Buyback Excise Tax, with Implications for SPACs

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December 29, 2022 – This past August, as part of the Inflation Reduction Act, Congress enacted a 1% excise tax on stock repurchases by certain publicly traded corporations after December 31, 2022. On December 27, 2022, the Internal Revenue Service (“IRS”) released interim guidance in Notice 2023-2 (the “Notice”) on the application of this new excise tax. The excise tax raised a number of issues for special purpose acquisition companies (“SPACs”), which are required to liquidate if they do not find a suitable acquisition target within a prescribed period and, if they do reach an agreement with a target (commonly referred to as a “De-SPAC transaction”), are required to give their public shareholders the opportunity to have their shares redeemed. This Alert focuses on provisions in the Notice that are particularly relevant to SPACs.

The excise tax applies to any “covered corporation” that “repurchases” its stock. A covered corporation includes any domestic corporation that is traded on an established securities exchange, and would therefore typically include any domestic SPAC. Non-U.S. SPACs are generally not subject to the excise tax unless they domesticate prior to the applicable repurchase.

The term “repurchase” includes both redemptions of stock and transactions that are determined by the Treasury Secretary (typically in the form of regulations) to be economically similar to redemptions, but excludes dividends. In the case of stock redemptions, the Notice imposes a rebuttable presumption against dividend treatment that SPACs are unlikely to be able to overcome. Consequently, SPACs should generally assume that all redemptions of SPAC shares are subject to the excise tax, unless a different exception applies.

Importantly, the Notice clarified that for a widely held company, no redemptions in the taxable year in which the company liquidates and dissolves are treated as repurchases subject to the excise tax. This alleviates a concern that had led many SPACs to liquidate in the last few months of 2022, prior to the government issuing guidance.

In a typical De-SPAC transaction, a SPAC acquires a domestic target through a reverse subsidiary merger, in which the former target’s shareholders receive SPAC shares in a transaction that is intended to be non-taxable, and (possibly)

cash. In the current market, it is now common for the majority of public shareholders to exercise their redemption rights in connection with the acquisition. These redemptions would generally be subject to the excise tax, but the statute and the Notice provide a netting rule. Under this rule, for purposes of calculating the excise tax, the value of redeemed shares is reduced by the value of SPAC shares issued in connection with any private investment in public equity (“PIPE”) and, except in rare cases where the target is itself a publicly traded company, the value of SPAC shares issued to target shareholders. In many De-SPAC transactions, the fair market value of these newly issued shares exceeds the value of the redeemed shares, and as a result no excise tax should be due.

In some De-SPAC transactions, the SPAC may be acquired by a target or by a newly-formed holding company in a “double dummy” transaction. This typically occurs in the context of transactions involving domestic SPACs and foreign target companies. A SPAC redemption is usually required to occur prior to the De-SPAC transaction, while the SPAC is still a covered corporation subject to the excise tax. In these cases, redemptions generally will be subject to the excise tax, as there is usually no new stock issued by the SPAC. The Notice does not include a successor rule that would allow later stock issuances by the new parent (e.g., pursuant to a PIPE) to offset SPAC redemptions.

A SPAC may also offer to redeem shareholders in connection with a shareholder vote to extend the period in which the SPAC can pursue an acquisition. These redemptions would generally be subject to the excise tax. If the redemptions occur in the same taxable year as a De-SPAC transaction, some relief from the excise tax may be available under the netting rule described above. If the SPAC is unable to find a target and instead liquidates, as long as the complete liquidation and dissolution occurs in the same taxable year as the earlier redemptions, those redemptions, though technically not part of the liquidation, can also benefit from the exemption from the excise tax for liquidations described above.

The IRS announced its intent to issue proposed regulations consistent with the Notice applicable to repurchases of stock made after December 31, 2022 and to issuances of stock made during a taxable year ending after December 31, 2022. Taxpayers may rely on the Notice until the publication of proposed regulations.

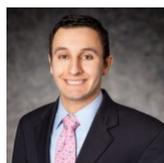
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