SPAC Tax Issues

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Holland & Knight

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Introduction

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More specifically, Mr. Melton assists clients with investment fund formation, deal acquisition and disposition structuring, financial instruments and derivatives, and audit representation. He is experienced in a broad spectrum of tax issues such as complex partnership allocations, mergers and acquisitions, inbound and outbound cross-border investments, and investments by sovereign wealth funds, tax-exempt entities, international organizations and other institutional investors.

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What is a SPAC?

- A Special Purpose Acquisition Company ("SPAC") or "blank check" company is a shell company with no operations, capitalized through an initial public offering for the purpose of acquiring a yet-to-be-identified target business.

- Proceeds of the IPO are placed into trust or an escrow account to fund the eventual target acquisition (a "Business Combination").

- If no Business Combination is consummated within a specified time frame (usually 18 to 24 months), the trust funds are used to redeem out the IPO shareholders.

- Generally, "units" are sold in the IPO, which consist of one share of SPAC stock and 1 public warrant exchangeable into 1 share or, more commonly, a fractional share.

- Units are generally issued at $10 per share with the public warrant exercise price at $11.50.

- Public warrants are generally redeemable once the share price reaches a certain level, limiting the upside on the public warrants.

Sponsor Economics

- Sponsors will typically take several forms of equity in a SPAC.
  - **Founder Shares**: Sponsors generally get 20% of the outstanding common stock, denominated as class B common. This stock is effectively worthless until a Business Combination occurs, as they are purchased for nominal consideration (e.g., $25,000) and are not entitled to redemption from trust funds in the event no Business Combination occurs.
  - **Private Placement Warrants**: Non-publicly traded warrants are generally issued at around $1 per warrant with a strike price of around $11.50. These warrants are not generally subject to redemption at a specified share price.
  - **Additional Common/Public Warrants**: Some sponsors acquire units *pari passu* with public investors.
- The investment by the sponsor is generally around 7% of the expected IPO capital raise, and these funds are used to pay banking fees and other compliance costs until a Business Combination is consummated.

PIPE Funding

- Once a target is identified, a SPAC will usually engage in a private placement PIPE transaction (Private Investment in Public Equity) to raise additional funds for the acquisition.
- The PIPE is generally around 150% to 200% of the amount raised in the IPO.
- The PIPE investment dilutes both the IPO shareholders and the Founder shares.
- Some SPACs have raised additional funds through equity-linked securities (*e.g.*, forward-purchase contracts) where the security holder agrees to purchase SPAC common shares at some future date when a Business Combination occurs.

Post-Transaction Capital Structure

- This example assumes the following:
  - $80 million raised in IPO
  - $170 million raised in PIPE
  - Target valuation is $1 billion (25% cash/75% equity)

Pre-Business Combination		
	# of Shares (mms)	% Ownership
IPO Shareholders	8,000,000	80.00%
Founders Shares	2,000,000	20.00%
Total Shares at IPO	10,000,000	100.00%

Post- Busines Valuation (pre-warrant exercise)		
	# of Shares (mms)	% Ownership
IPO Shareholders	8,000,000	7.84%
Founders Shares	2,000,000	1.96%
PIPE Investors	17,000,000	16.67%
Target Equity Roll	75,000,000	73.53%
Total Shares at Combination	102,000,000	100.00%

Earnouts

- Earnouts are often used to sweeten the deal for target shareholders.
- They usually take the form of warrants to acquire SPAC stock that are exercisable upon certain valuation thresholds (*e.g.*, $18 per share for 20 days).
- Some earnouts are tranched such that additional warrants become exercisable upon successive hurdles in the stock price.
- These warrants are typically transferred from the pool held by the founders.

Market Overview

- SPACs generally date back to 1993 with the SEC's adoption of Rule 419 for blank-check company offerings.
- There are 418 SPACs in existence that are currently seeking a target.*
- SPAC activity spiked significantly in 2020 and 2021 (so far).*

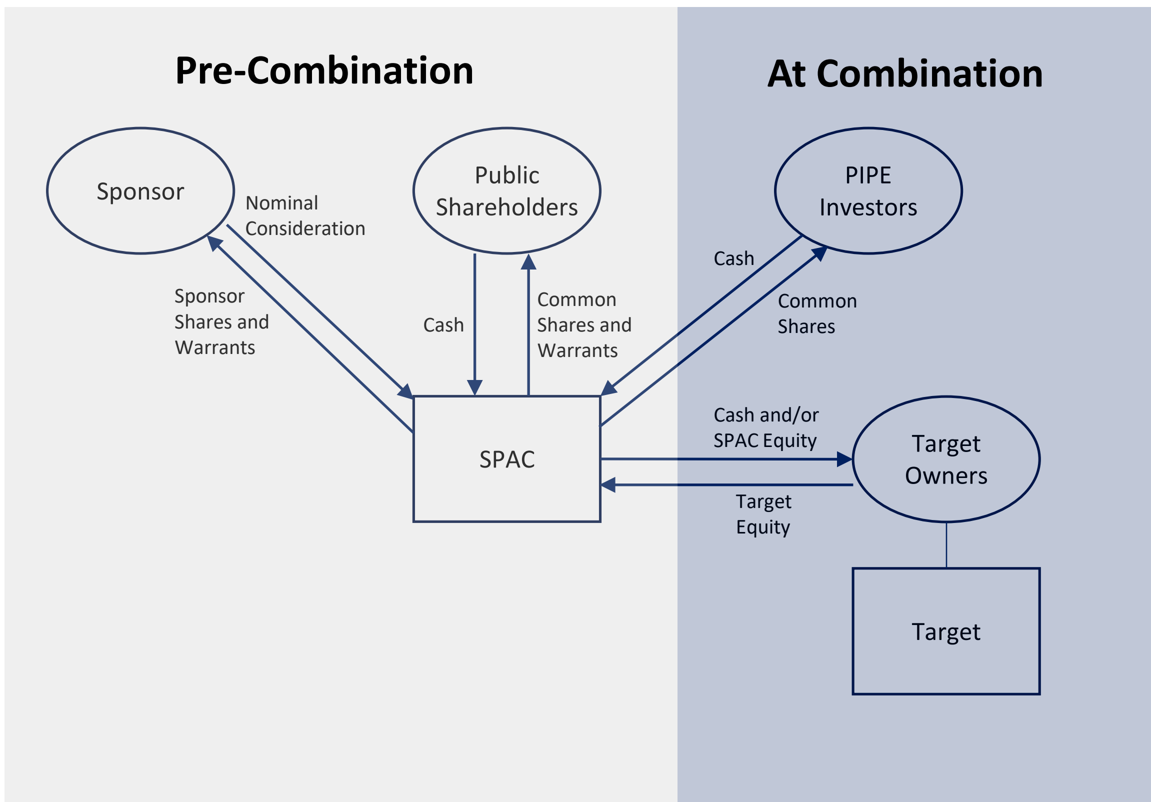
Year	IPO Count	Gross Proceeds (mms)	Average IPO Size (mms)
2021	330	$ 104,988.1	$ 318.1
2020	248	$ 83,354.0	$ 336.1
2019	59	$ 13,600.3	$ 230.5
2018	46	$ 10,751.9	$ 233.7
2017	34	$ 10,048.5	$ 295.5
2016	13	$ 3,499.2	$ 269.2
2015	20	$ 3,902.5	$ 195.1
2014	12	$ 1,749.8	$ 145.8
2013	10	$ 1,455.3	$ 145.5
2012	9	$ 490.5	$ 54.5
2011	15	$ 1,081.5	$ 72.1
2010	7	$ 502.5	$ 71.8
2009	1	$ 36.0	$ 36.0

* https://spacinsider.com/stats/

Tax Receivables Agreement

- SPACs will typically, when there is a flow-through target, enter into a Tax Receivables Agreement (“TRA”) with the sellers.
- Under the TRA, the SPAC will pay a portion of the cash tax savings it enjoys on account of the step-up in basis that occurs in the Business Combination.
- Generally, the SPAC will pay 85% of the cash tax savings, as deductions from the step-up are utilized. One recent deal paid 90%.
- The justification is that public entities are generally valued at a multiple of EBITDA. Because the valuation doesn’t account for taxes paid, it doesn’t hurt the stock price for the SPAC to pay taxes to the IRS or TRA payments to the seller (in theory).
- Given that often much of the value is goodwill, the TRA will pay out over a minimum of 15 years. It could be several decades in the case of an UP-SPAC transaction where the target is acquired by the SPAC over several years.
- Private Equity sellers generally have a finite fund life and will need to sell their TRA.
- TRA payments are generally treated as installment notes for tax purposes.

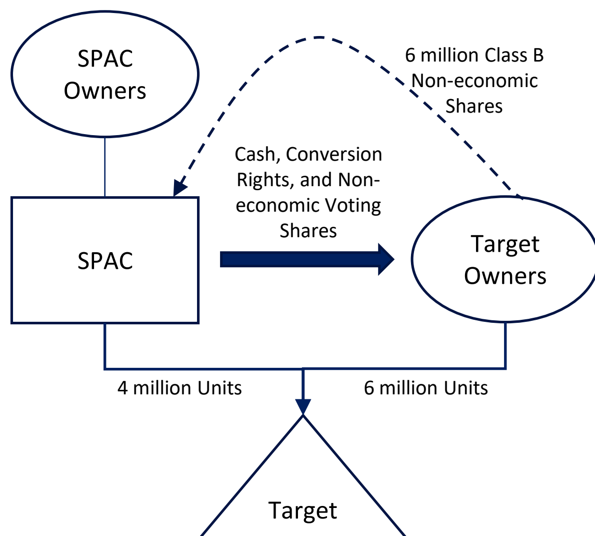
Typical SPAC Acquisition Structure



Considerations

- Section 351 is not likely to apply to SPAC stock paid as consideration unless target owners are in control of the SPAC post-closing.
- Possible triangular merger for tax-free reorganization (with boot).
- Double Dummy structure might be used to achieve 351 transaction if reorg requirements aren't satisfied.
- If target is a partnership, an UP-SPAC structure will likely be used.

UP-SPAC – Basic Structure



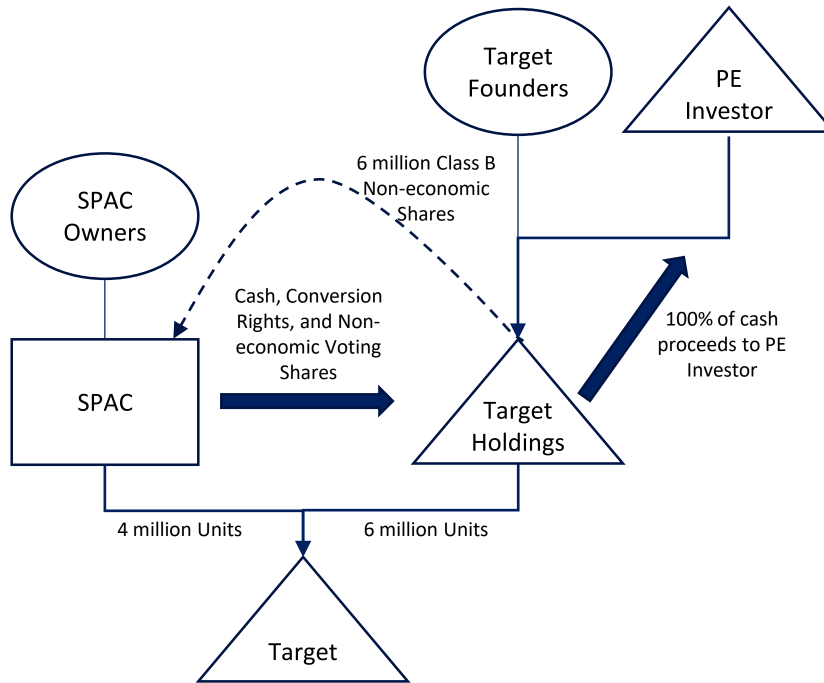
Considerations

- SPAC purchases a partnership interest from Target Owners for cash.
- Target files 754 election for SPAC to obtain basis step-up.
- Target owners retain non-purchased partnership, providing tax deferral.
- Target owners have the right to convert each Target unit into one share of SPAC common stock. The conversion is a taxable event and usually will only occur when the Target Owners are seeking liquidity.
- Target units will be recapitalized so they are uniform and one unit matches the economics of one SPAC share.
- Target Owners will receive voting rights in the SPAC for retained Target Units as if the companies were fully combined.

Example

- Target Valuation is $100 million, and SPAC will initially purchase 40% of Target.
- SPAC shares are valued at $10 per share.

UP-SPAC – Structural Issues



Considerations

- Uniformity of Target units may not be possible based on distribution preferences and preferred returns among Target Owners.
- Consider forming holding partnership to act as seller to SPAC.

Example

- PE Investor has invested $30 million on 1/1/16 and accrues a preferred return of 15% each year. Current accrued preferred return is $34.7 million (5.5 year holding period assuming 6/30/21 De-SPAC date).
- Waterfall is as follows:
  - 100% to PE Investor until IRR of 15%, then
  - 50%/50% among Target Founders and PE Investor.
- 100% of cash proceeds on sale of 40% of the business would go to PE Investor under the waterfall and preferred return continues to accrue.

UP-SPAC – Structural Issues

Valuation (at De-SPAC)	$ 100,000,000			
	Tier 1	Tier 2	Total Equity Value	% Ownership
SPAC			$ 40,000,000	40.00%
PE Investor	$ 24,700,000	$ 17,650,000	$ 42,350,000	42.35%
Target Founders		$ 17,650,000	$ 17,650,000	17.65%
	$ 24,700,000	$ 35,300,000	$ 100,000,000	100.00%

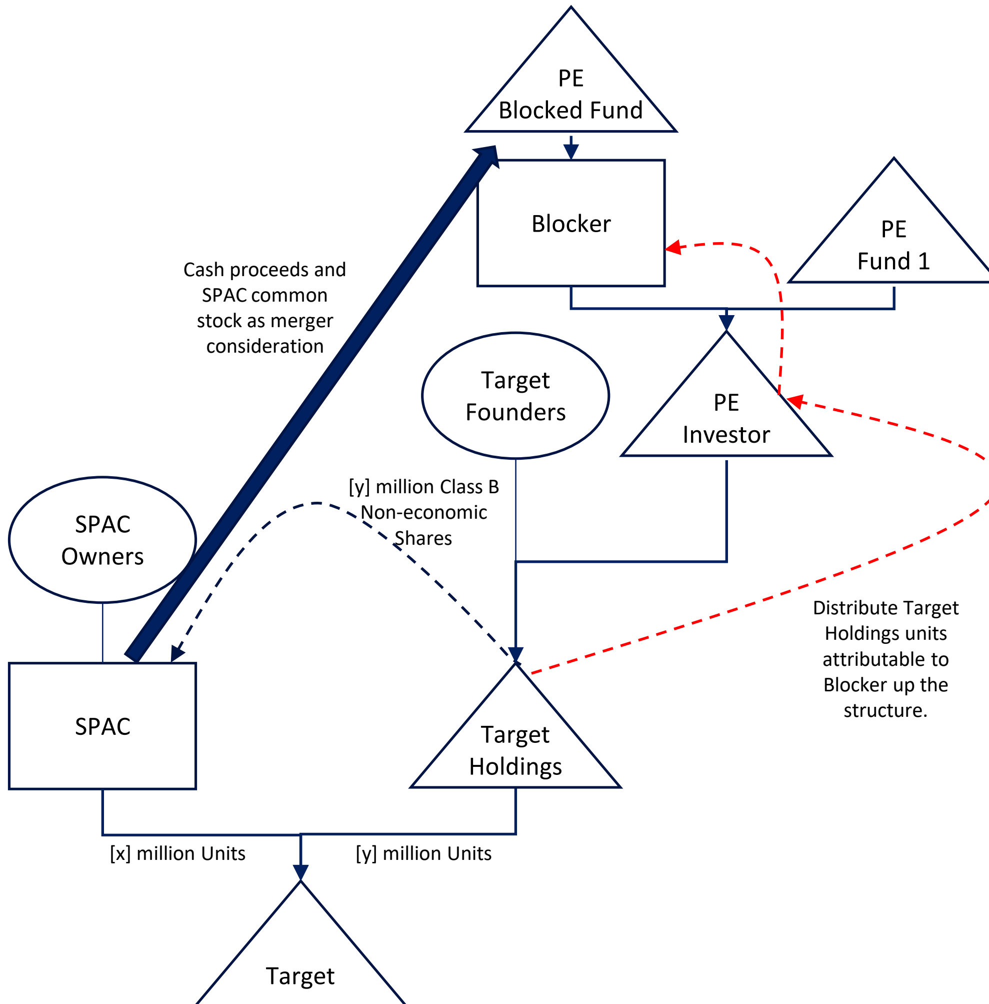
Valuation (1 year later)	$ 200,000,000			
	Tier 1	Tier 2	Total Equity Value	% Ownership
SPAC			$ 80,000,000	40.00%
PE Investor	$ 28,410,000	$ 45,795,000	$ 74,205,000	37.10%
Target Founders		$ 45,795,000	$ 45,795,000	22.90%
	$ 28,410,000	$ 91,590,000	$ 200,000,000	100.00%

Comparison at New Valuation		
Liquidate	Wait for Cash	Variance
$ 80,000,000	$ 80,000,000	$ -
$ 84,700,000	$ 74,205,000	$ (10,495,000)
$ 35,300,000	$ 45,795,000	$ 10,495,000
$ 200,000,000	$ 200,000,000	

Example (cont.)

- Two paths: (1) liquidate Target Holdco and distribute Target Units in-kind at current valuation; or (2) leave Target Holdco in place until cash hits the pref hurdle.
- PE sponsors will prefer the latter as the former leaves them at risk of losing cash if the SPAC stock value goes down, but this may also be beneficial for the Target Founders if the valuation increases substantially.
- In Path 1, Target Holdco would distribute all cash to PE Investor and then split up the remaining units under the waterfall at the $100 million valuation. In Path 2, Target waits for one year to convert/sell additional units. If Target Holdco sells $28,410,000 worth of units, it will bust through the hurdle. But at a $200 million valuation that takes half as many units. So there are more units remaining, of which the Founders will get 50%.

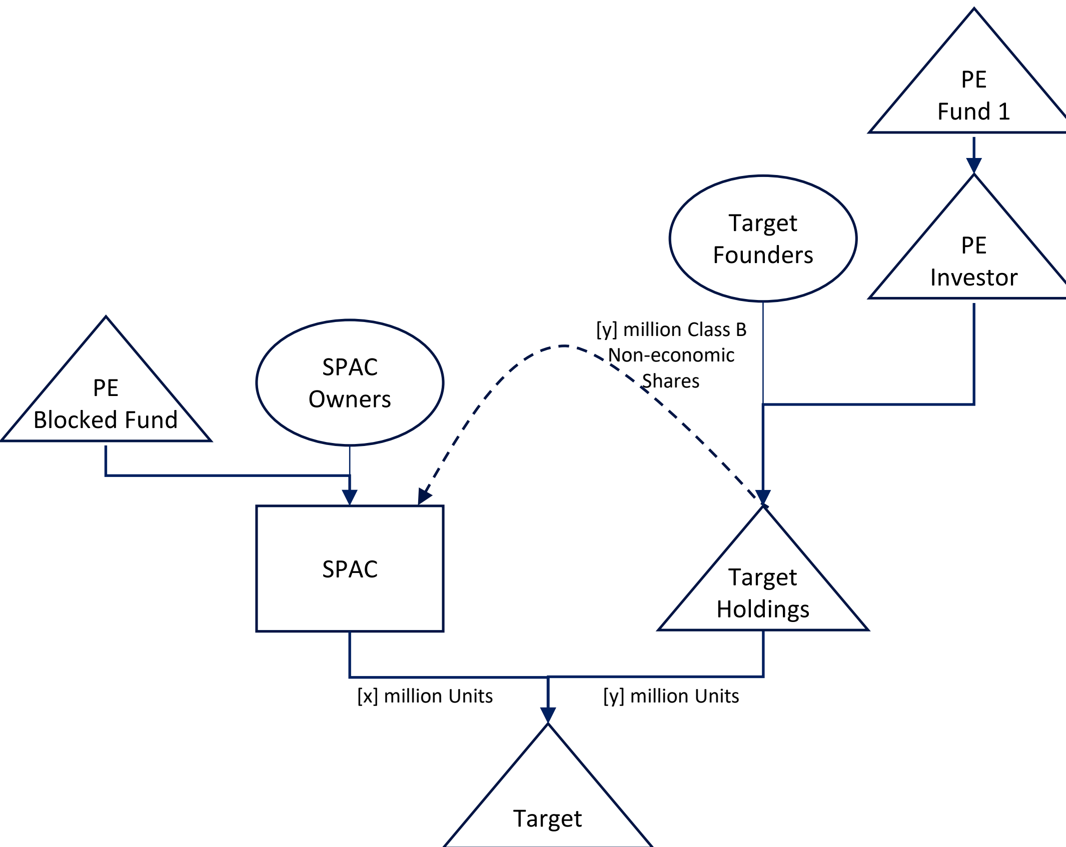
UP-SPAC – Blockers



Considerations

- It is inefficient for blockers to continue to own an interest in Target, as the SPAC itself can act as an ECI/UBTI blocker.
- Eventual sale of the SPAC stock on exit should result in no taxable income to tax-exempt or foreign investors; whereas, a conversion of Target units into SPAC stock will result in gain to the blocker that reduces available cash to investors.
- Blockers will generally merge into the SPAC. The Blocker's share of Target Holdings Units must be distributed up the chain so the Blocker holds them directly prior to the merger of the Blocker into the SPAC.

UP-SPAC – Blockers



Considerations

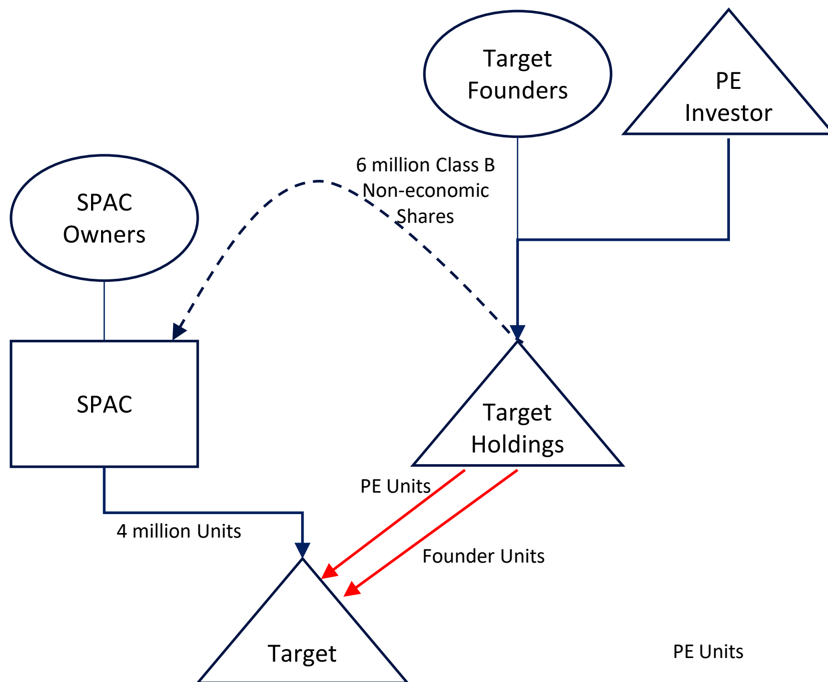
- Adjustments must be made to the Target Holdings operating agreement to account for the following:
  - Any carry due to the Target Founders must account for distributions in Target Holdings waterfall AND cash flow to the Blocked Fund as if it went through the waterfall;
  - It is generally advisable to provide for the dissolution of the Target Holdings after the final hurdle is achieved to facilitate ease of exercising conversion rights.
- It is difficult to determine how many units should be distributed to the Blocker if the De-SPAC transaction doesn't generate enough cash to bust through the pref hurdle.
- This is one justification for liquidating Target Holdings at the De-SPAC date and value in-kind distributions as of that date, effectively removing the pref hurdle concept.
- Otherwise a true-up mechanism must be developed to account for changes in valuation at cash-out events that resulted in too much or too little being distributed to the Blocker.

UP-SPAC – Conversion Rights

Considerations

- Target Owners may, and usually do, want to convert Target Units and liquidate their positions at different times.
- If there are pari passu distributions in the waterfall and one partner wishes to convert while the other partner does not, a pro rata amount of Target units will be distributed in kind to the non-converting partner.
- The partners could have the right to direct Target Holdings to convert units, liquidate the shares and distribute the proceeds to the electing partner. This raises some concerns regarding allocating the resulting gain solely to the electing partner.
- The partners could also have the right to demand an in-kind distribution of Target Units, which the electing partner could then convert and liquidate outside of the partnership. This, however, raises possible 704(c)(1)(B) issues.

UP-SPAC – 704(c)(1)(B)



PE Units

Considerations

- The formation of Target Holdings may implicate Section 704(c)(1)(B), which accelerates the 704(c) gain when property contributed by one partner is distributed to another partner within 7 years.
- There is some risk the IRS could take the position that because Target units are fungible, a distribution of units to an electing partner wanting to convert might be a pro rata distribution of units contributed by a non-electing partner; thus, triggering gain to the non-electing partner.
- Section 704(c)(1)(B) doesn't apply if a contributing partner is merely receiving a distribution of its own built-in gain property.
- Consider issuing separate classes of Target equity (with all of the same rights) to Target Holdings; one representing the specific units contributed by PE Investor and another class representing the specific units contributed by Target Founders.
- Distributions of Target units requested by each party would be the specific units that party contributed.
- Note this is difficult if the De-SPAC transaction doesn't produce enough cash to bust through the pref hurdles for the reasons noted on slide 13.

SPAC Jurisdictional Issues

- SPACs intending to identify domestic targets are generally formed as domestic entities.
- SPACs intending to identify foreign targets are generally formed in a foreign jurisdiction (e.g., Cayman Islands, BVI, etc.).

Foreign SPAC – PFIC Issues

- Subject to the "start-up exception" and the CFC exception, a foreign corporation is a PFIC if:
  - at least 75% of its gross income for its tax year is passive, or
  - at least 50% of the assets it held during the year produce passive income or are held for the production of passive income.
- The passive assets test is generally applied based on the fair market value ("FMV") of the corporation's assets.
- During the search phase, a foreign SPAC will primarily only hold cash, which is treated as an asset held to produce passive income (whether it is invested in interest-bearing accounts or not).

Foreign SPAC – PFIC Issues

Consequences of being a PFIC

- Distributions from a PFIC must first be bifurcated into non-excess distributions and excess distributions.
  - An excess distribution is the amount a distribution that exceeds 125 percent of the average distributions for the immediately preceding three years (or shorter period if the shareholder has held the stock for less than three years). There is no excess distribution in the first year.
- Non-excess distributions are recognized in the year paid as ordinary dividend income (*i.e.*, not qualified dividends taxed at capital gains rates). Excess distributions are then allocated to each day of the shareholder's holding period.

Foreign SPAC – PFIC Issues

Consequences of being a PFIC

- The portion of the excess distribution allocable to the current taxable year is recognized as ordinary income similar to other forms of current income.
- The portion allocable to prior years is taxed at the highest marginal tax rate for such year. In addition, excess distributions allocable to a prior year are also subject to an interest charge, calculated in the same way as though the tax for those prior years was due at that time and paid late.
- Gains on the disposition of PFIC stock are treated 100 percent as excess distributions. Losses on PFIC stock may not be netted against gains on PFIC stock, and are instead treated as capital losses subject to capital loss limitations.

Foreign SPAC – PFIC Issues

Start-UP Exception

- A foreign corporation otherwise failing the PFIC income and asset tests will not be a PFIC if in its "start-up year," which is defined as the first taxable year in which the foreign corporation has gross income, if:
  - No predecessor corporation was a PFIC;
  - It establishes to the satisfaction of the IRS that it will not be a PFIC for either of the two years following the start-up year; and
  - It is, in fact, not a PFIC for those two years.

- Year 1, SPAC has no gross income but fails asset test
  - The start up exception is available.

- Year 1, SPAC earns interest on trust account but closes combination by Q2 of year 2.
  - The start up exception will apply assuming combination results in passing the asset test because testing is done quarterly. This also assumes it continues to operate such a business in year 3.

Foreign SPAC – PFIC Issues

Electing Out

- QEF Election: A shareholder subject to the PFIC regime may file a Qualified Electing Fund election "QEF election." Such a shareholder will be required to recognize currently its pro rata share of the foreign corporation's income, but will not be subject to the other punitive impacts of the PFIC regime. Once the foreign corporation is no longer a PFIC, no phantom income inclusions will be required (*i.e.*, once a Business Combination is completed).
    - If a shareholder fails to make a QEF election for the first year it holds stock, it may make a late election, but there will be a deemed sale of the stock as of the first day of that later year. Any gain will be subject to the PFIC rules.
- Shareholders of a PFIC may also elect to mark-to-market, where this option is available.
- Shareholders may also make a purging election once the foreign corporation no longer fails the income or asset tests. This is also treated a deemed sale, gain or loss from which is subject to the PFIC rules.
- Note that if nothing is done to cleanse the taint of PFIC status, the foreign corporation will continue to be a PFIC even if it no longer fails the income and asset tests. This is known as the once a PFIC, always a PFIC rule.

Taxation of Founder Shares

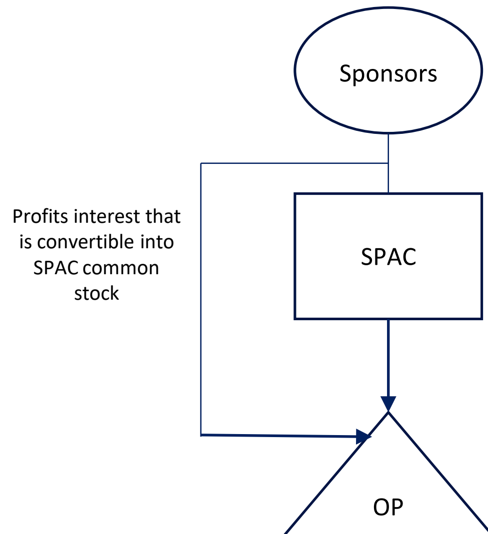
- Founder shares are issued for nominal consideration. If the shares are found to have more than nominal value at the date of grant, the value above the bargain purchase could be viewed as compensatory.

- Most founders shares are issued in advance of the IPO, at a time when there is no assurance of approval for the IPO and well in advance of knowing whether a deal will ultimately be consummated.

- The primary view is that the issuance of the founder shares are not taxable, as they merely represent early investment into a highly speculative business. However, no direct guidance is available.

- Founder warrants are generally treated for tax purposes the same as non-qualified stock options. They are not taxable at the grant date, but rather are taxable on the exercise date.

Taxation of Founders Shares



Profits Interests

- Instead of holding Founders shares, founders could instead hold a profits interest in a subsidiary operating partnership ("OP") that is convertible into shares of the SPAC.
- Upon conversion, post-combination, the gain would trigger a stepped up basis to the SPAC, producing additional tax deductions to the SPAC.
- The tax deductions could also be partially harvested through a tax receivables agreement.

Questions?