**International Tax Institute**

# SPAC: Cross-Border Issues that Matter

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# SPACs – Taxation

- **SPACs – a/k/a “special purpose acquisition companies” – have emerged as powerful competitors for private companies considering a sale or going public transaction**
  - SPAC IPO volume so far in 2021: $78.7 bn (251 IPOs), with $7.3 bn in the last seven days (both stats of 03/12/2012) (Dealogic)
  - By comparison, SPAC IPO volume in recent years:
    - 2020: ~ $79 bn (240+ IPOs)
    - 2019: ~ $13.6 bn (59 IPOs)
    - 2018: ~ $10.7 bn (46 IPOs)
    - 2011: ~ $1.5 bn (10 IPOs)

See Spacinsider.com for prior year statistics: https://urldefense.com/v3/__https://spacinsider.com/stats/__;!!Jkho33Y!05NYy-q1k8rv0ijWXYl6bV2uwy7CSG8lLrlSZ5OX-zjgZIXA7i0T_yOjsQnZFC8$

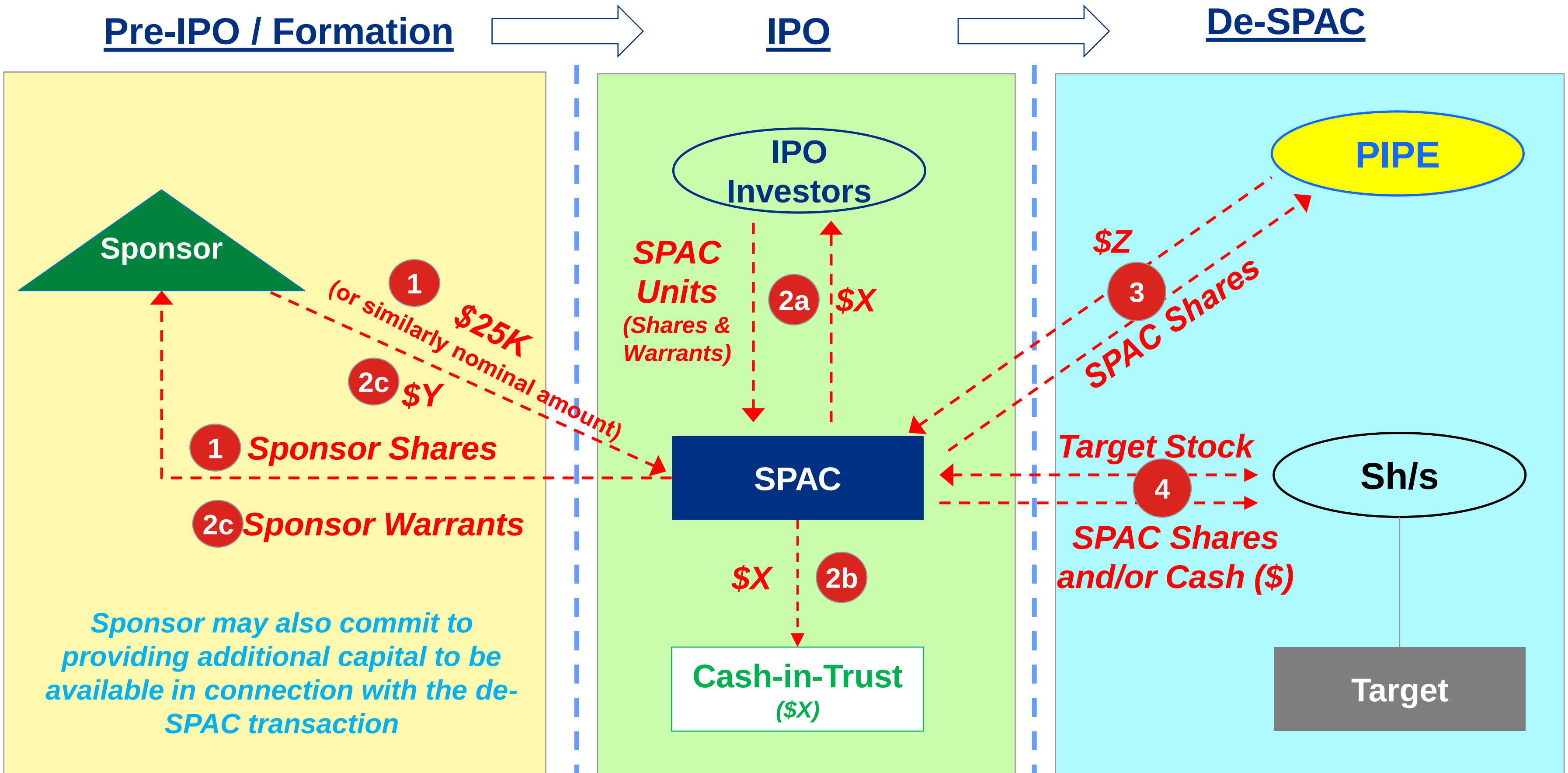
- **Tax represents one of several important considerations pertaining to SPACs and SPAC-related transactions**
  - Only natural given that:
    - M&A – or the de-SPAC transaction – is a central component of any viable SPAC
    - SPACs have significant individual shareholders (i.e., the Sponsor), and
    - Often presents choices between U.S. versus non-U.S. legal organization
- **Today we will discuss certain key U.S. tax aspects and considerations relevant to SPACs in the cross-border context**
  - Basics of the SPAC typical structure
  - Common Cross-Border De-PAC Situations
    - U.S. SPAC / Foreign Target
    - Foreign SPAC / U.S. Target
  - Going public observations

# SPAC – Non-Tax Overview

- **SPACs are Formed to Do a Deal**: Sole purpose of a SPAC is to effect an acquisition / combination with an operating company within a prescribed period of time (normally, 18-24 months). The market refers to this acquisition as the **"de-SPAC" transaction**
- **SPACs Raise Equity from Several Sources**: SPACs are formed by a Sponsor and then go public by issuing "investment units" to public investors
  - Each investment unit consists of (i) one (1) share of Class A common stock and (ii) a fraction of a warrant to purchase additional shares of Class A common stock
    - Units typically price at $10 per unit; Warrant strike (exercise) price typically $11.50
    - Class A common and Warrants trade separately starting soon after the IPO (usually 52 days post-IPO)
    - Warrants generally become exercisable 1-year post-IPO or, if earlier, after the de-SPAC has occurred
  - Sponsors normally buy Founder Shares at the time of formation, which typically represent 20% of the SPAC's common stock on a post-IPO basis
    - Sponsors will also typically purchase Founder Warrants at the time of the IPO
  - All of the IPO proceeds are held in a trust account and may only be used for the acquisition / business combination
  - The target business must be at least 80% of the size of the SPAC's cash in trust
  - In many cases, once it has a deal lined up, a SPAC will raise additional equity via a **"PIPE"** ("private investment in public equity) by selling Class A common shares to several institutional investors
- **Founders Have All the Voting Power Until the De-SPAC Vote**: The Founder Shares possess all the SPACs voting rights until the de-SPAC transaction when the Class A shareholders may vote
- **Public Investor Has a Redemption Right**: Once the de-SPAC deal is out to a shareholder vote, every public Class A shareholder has the right to vote "no" and redeem their shares for its proportionate share of the proceeds held in trust
- **SPAC Will be Liquidated and Cash Returned if no Deal**: SPAC is liquidated and the proceeds in trust will be returned to the Class A shareholders if the de-SPAC is not completed within the prescribed time period
- **The above represents terms commonly found in SPACs, but note the market continues to evolve at a rapid rate**

# Life Cycle of SPAC – Key Tax Issues

# SPAC – Life Cycle – Typical Tax Issues




**Pre-IPO / Formation**

- “Cheap Stock”
- Disguised comp
- § 1061

**IPO**

- § 1032
- Purchase Price Allocation

**De-SPAC**

- § 1032
- §§ 1001, 351, 368
- §§ 367, 7874, 897 *(int’l)*

# SPAC – U.S. or Foreign?

# Legal Identity of SPAC and Target Drives Optimal De-SPAC

- **SPACs are traditionally organized as either a U.S. or foreign corporation, although a SPAC could also be organized as a partnership (we'll touch more on that later)**
- **Choice of jurisdiction for SPAC and the legal identity of the Target are highly relevant to the tax efficiency of the company post-de-SPAC**
- **Preferred ownership structure for the ultimate target corporation / business will not be known at the time of the IPO because the de-SPAC target is TBD**

| Type of SPAC | Type of Acquisition Target | Optimal Post-Acquisition Structure for Tax Purposes (Generally) |
|---|---|---|
| **U.S. Corp** | **U.S. Corp** | ▪ U.S. Corporation |
| **U.S. Corp** | **U.S. Partnership** (or other flow-thru equivalent) | ▪ U.S. Corporation, unless business eligible to operate in MLP format<br>▪ Seller may prefer an Up-C structure |
| ✓ **U.S. Corp** | **Foreign Corp** | ▪ Foreign Corporation<br>▪ Subject to complying / addressing U.S. anti-inversion rules |
| ✓ **Foreign Corp** | **U.S. Corp** | ▪ U.S. Corporation |
| **Foreign Corp** | **U.S. Partnership** | ▪ U.S. Corporation (unless possibly PTP eligible)<br>▪ Seller may want an Up-C structure |
| **Foreign Corp** | **Foreign Entity / Business** | ▪ Foreign Corporation |

✓ ***Situations we will focus on today.***

# SPAC / "de-SPAC" – M&A Overview

- **SPAC or de-SPAC transactions are more traditional that mystical, yet there are some tax-related quirks and peculiarities to SPAC deals that differ from mainstream M&A**

**Comparable to Typical M&A**

- ✓ SPAC transactions involve a U.S. or foreign acquirer, i.e., the SPAC, trying to acquire / combine with a target
- ✓ Target may be a corporation, partnership (or other flow-through), division, basket of assets, etc. – and, if an entity, may be U.S. or foreign
- ✓ Acquisition consideration commonly consists of shares and cash
- ✓ Sponsor typically has an economic stake that greatly exceeds its capital investment at the time of de-SPAC

**Less Common vs. Typical M&A**

- SPAC is merely a box of cash
- And the existing shareholders of the box of cash – can "vote no" on a shareholder-by-shareholder basis and get redeemed at NAV once a deal is put to a vote
- Increasingly, the SPAC acquires substantially less than 50% of the Target
- Warrants represent a key part of the SPAC's capital structure
- New and committed equity capital – via the PIPE investors – frequently represent a key part of the deal financing
- SPACs are initially controlled by individuals who have a very low tax basis in their stock and warrants – and they often have an investment horizon that differs from the SPAC's other investors
- Limited concern that either party is or was a PFIC – typically, there is some concern a foreign SPAC is a PFIC
- High percentage of deals have earn-outs in one form or another
- Sponsors frequently surrender a portion of their economics in the SPAC as part of negotiating the de-SPAC

***Perspectives vary regarding whether a "de-SPAC" transaction normally is better categorized as a going public versus a M&A deal – or some combination of the two***

# SPAC M&A – Think Traditional, Not Mystical

- **Most M&A structures that can be used in a typical M&A transaction can also be used in the context of the “de-SPAC” transaction**

- **Many de-SPAC transactions are designed to qualify for tax-free treatment – exactly what you’d expect since the Target often retains / receives a large equity stake and relatively little or no cash**

- **Three primary ways for the *Target* side to enjoy a non-taxable or tax-free transaction where the Target is a corporation**
  - Target formally acquires SPAC
  - SPAC acquires Target in ***a tax-free reorganization***
  - SPAC and Target combine in a ***Section 351 transaction***

- **SPAC side also prefers non-taxable or tax-free transaction from its perspective – SPAC shareholders and warrant holders do not receive any cash in the de-SPAC transaction (unless they exercise their redemption right)**

- **Numerous aspects of the U.S. tax laws may affect the abilty of the parties to achieve the intended and/or preferred tax treatment**

- **Everything cross-border is more complicated – can’t just assume it will work (of course, you know that already!)**

# Non-Specific Cross-Border Issues Relevant to SPAC M&A

- **There are a handful of general M&A tax issues that are often relevant to planning the de-SPAC transaction**

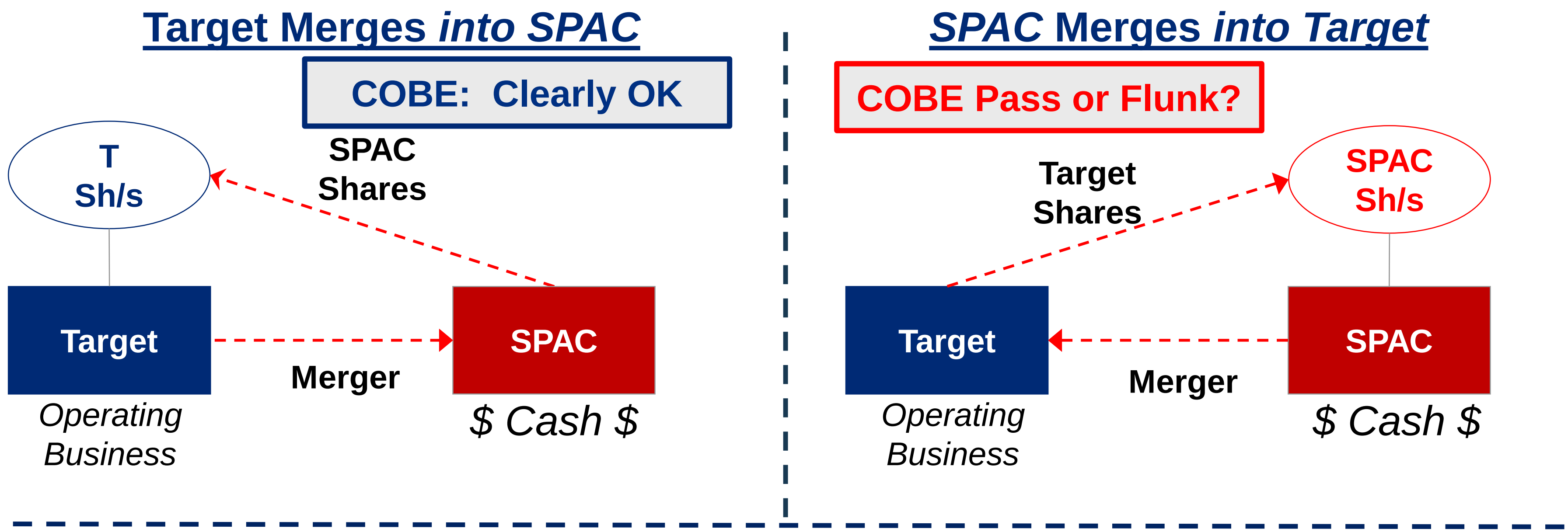
1 **Continuity of Business Enterprise**
  - Significant uncertainty regarding whether a SPAC can satisfy the continuity of business enterprise requirement, a rule that applies to all acquisitive reorganizations
  - Relevance: Strong preference for the SPAC serving as the legal acquirer in a de-SPAC transaction

2 **Section 351 does not protect warrants**
  - Section 351 does not have a COBE requirement, but unlike reorganizations, warrants cannot be received tax-free in a § 351 transaction
  - Still, a §351 transaction is often preferred versus a structure where the Target acquires the SPAC in a purported reorganization

3 **Redemption right shrinks the types of reorganization variants you may want to use**
  - Even if you are confident the COBE requirement would be satisfied where the SPAC is acquired, the redemption rights held by the SPAC's sh/s pose other potential challenges to qualifying as a reorganization
    - Substantially all requirement – may be concerned sub all would be failed if too many shareholders of the SPAC seek redemption
  - Relevance: Leads to a preference for "A" or B reorganization over other reorganization variants

4 **Other redemption rights-related structuring considerations**
  - Use a 2-step LLC "A," rather than a traditional "A," reorganization mechanic
    - Avoids triggering corporate-level taxes if deal flunks reorganization treatment
    - But, consider whether exercise of redemption right might even curtail QSP qualification

# SPAC /COBE – Formal Identity of Target – Direction Matters?




- **Continuity Business Enterprise Requirement applies to all types of acquisitive reorganizations**
  - Acquiring entity must either
    - Continue the target corporation's (T's) **historic business**, OR
    - Use a significant portion of T's **historic business assets** in a business
- **Target merging into SPAC can readily satisfy COBE**
- **But may be hard readily to conclude a merger of SPAC into Target satisfies COBE**
  - Is SPAC in a "business" before the de-SPAC? If so, is such business "historic?" Should that business be treated as continuing in the de-SPAC?
  - Is SPAC's cash a "business" asset?
    - Does it matter how the cash is used (fund acquisition, used in business post-de-SPAC, etc.)?
  - If SPAC will be the target in a purported reorganization, consider using a reverse subsidiary merger or a "two-step LLC A" to avoid risk of triggering corporate-level gain if deal flunks reorganization status (RR 2001-46)
    - Note: FMV of SPAC will often exceed cash-in-trust value at time of de-SPAC

# A Preview of Things to Come

## U.S. SPAC / Foreign Target

- COBE concerns + inversion considerations often drive use of §351
- Inversion counting / compliance
- Warrant holders
- Section 367

## Foreign SPAC / U.S. Target

- PFIC issues / considerations galore
- Warrant holders

# U.S. SPAC / Foreign Target

# U.S. SPAC / Foreign Target

- **Sometimes the best target for the U.S. SPAC will turn out to be foreign**
- **In that case, the parties will prefer a foreign parent structure post-de-SPAC**
  - But this requires the U.S. corporation to re-domicile or become a subsidiary of a foreign corporation
- **Must consider the anti-inversion rules – §§ 7874 / 367 – whenever a U.S. SPAC migrates offshore or becomes a subsidiary of a foreign corporation**
- **Possibility #1: Foreign Target acquires U.S. SPAC in a purported reorganization transaction**
  - But may fail reorganization treatment due to COBE risk (and possibly other reorganization qualification issues)
    - The potential upside if reorganization treatment obtained is deal would be tax-free both to SPAC's shareholders and warrant holders assuming compliance with § 367
- **Possibility #2: Use New Foreign HoldCo in a § 351 Transaction (most commonly used structure in the U.S. SPAC / Foreign Target scenario) – we will highlight this one with an example**
  - Ensures tax-free result for SPAC's shareholders
  - But warrants cannot be received tax-free in a § 351 transaction
  - There are complex / non-traditional strategies that may help warrant holders avoid triggering gains, but they tend to be clunky and, as a practical matter, only worth pursuing for the Sponsors
  - Be on the lookout for foreign tax on warrant issuance in certain foreign countries
- **Possibility #3: U.S. SPAC migrates to foreign country ("New F-SPAC") and then acquires Foreign Target (rarely used)**
  - Proponents contend
    - First step corporation migration is a "F" reorganization with no indirect stock transfer or deemed stock issuance for purposes of § 367
    - Section 7874 should be tested on an "end result" basis, i.e., only after New F-SPAC acquires Foreign Target
  - But substantial risk the first step migration flunks §7874 altogether because, standing alone there is no change in ownership at the U.S. SPAC and New F-SPAC will not have "substantial business activities' in the applicable foreign country. In that case, it would simply result in a U.S. corporation acquiring Foreign Target for U.S. tax purposes

# U.S. SPAC / Foreign Target – Managing Sections 7874 / 367

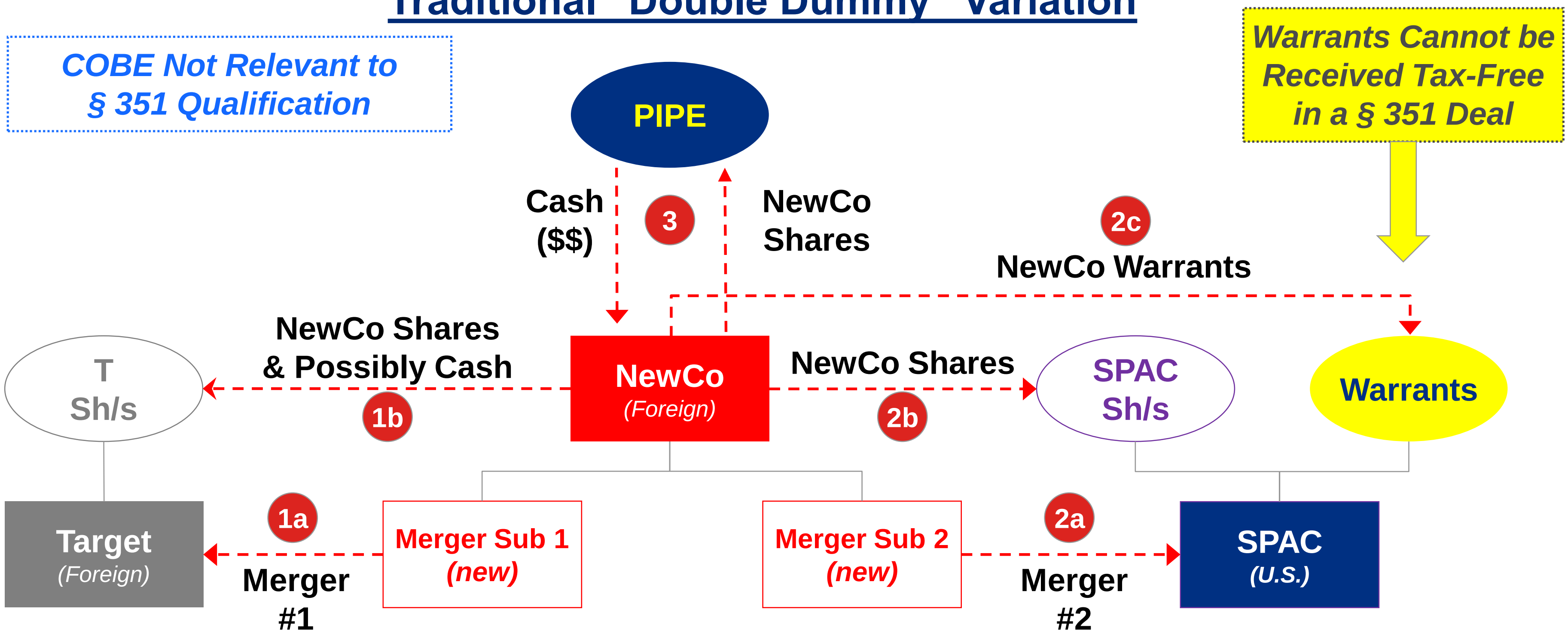
- **Sections 7874 critical to a favorable and commercially logical outcome**
  - Want to ensure the resulting foreign parent corporation is not a U.S. corporation for U.S. tax purposes and, preferably want to avoid "limited inversion" status too

- **Need to comply with § 367 to ensure tax-free treatment under §351 or §368, as applicable, for the SPAC shareholders**
  - Key Rule: Generally, the U.S. SPAC's shareholders must receive ≤50% of the resulting foreign parent corporation
  - GRA needed for any U.S. SPAC shareholder that receives ≥5% of the stock of the resulting foreign parent corporation and is a U.S. person
  - Sleeper issue: Must comply with §367's active trade or business requirement (may be particularly relevant if Foreign Target is a start-up, has a short history and/or no revenues yet)

- **Avoiding / Managing Section 7874**
  - Foreign acquiring corporation will be treated as a U.S. corporation for all U.S. tax purposes if (i) the shareholders of the U.S. SPAC receive ≥80% (by vote or value) of such foreign acquiring corporation by reason of owning U.S. SPAC shares and (ii) the foreign acquiring corporation flunks the "substantial business activities" test
  - Two ways to avoid §7874
    - <u>Substantial Business Activities</u>: ≥ 25% of revenues, tangible assets, and employees (by headcount and total compensation) of the resulting foreign parent corporation's "expanded affiliated group" take place in / are located in such foreign parent's country of incorporation and is a tax resident of such country (unless such foreign country does not impose a corporate income tax)
    - <u>Ownership Test – < 60%</u>: Shareholders of the U.S. SPAC receive <60% (by vote and value) of the resulting foreign parent corporation's stock by reason of owning U.S. SPAC shares
  - Limited Inversion Status: Shareholders of U.S. SPAC receive ≥60%, but <80% (by vote and value), of resulting foreign parent corporation by reason of owning U.S. SPAC shares
    - Numerous adverse post-deal consequences (notably, no COGS deduction for BEAT purpose and no QDI)
  - Complex counting rules take into account / require deemed adjustments for distributions, issuances and redemptions in the 3-year pre-closing period
    - Special rules for Warrants – Generally treats the "in-the-money" value as deemed stock for purposes of the value threshold under §7874's ownership test

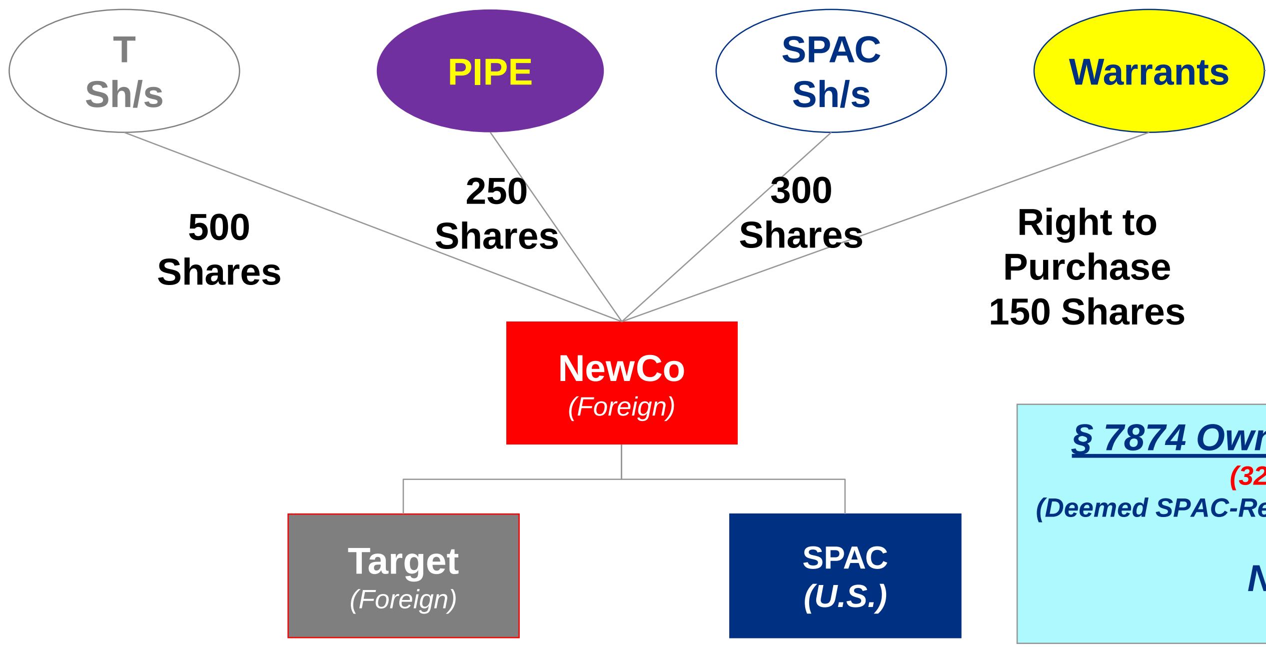
# U.S. SPAC Foreign Target – New Foreign HoldCo (§351)

## Traditional "Double Dummy" Variation




- **Transaction is intended to qualify as a valid § 351 transaction**
  - Section 351: Transfer of property to a corporation (here, NewCo) where the transferors, *in the aggregate*, receive stock representing (i) ≥ 80% of the voting stock and (ii) ≥ 80% of any class of nonvoting stock – clearly met here ("§368(c) Control")
  - No COBE issue; similarly, other reorganization requirements are not applicable
  - Ensures transaction will be tax-free to SPAC shareholders (subject to §367)
- **But, unlike in a reorganization, the receipt of warrants is not tax-free in a § 351**
  - Relevant here because in the traditional double dummy, all of the depicted stakeholders are transferring property to NewCo, including SPAC's warrant holders – warrant treatment can be especially important for Sponsor
- **Section 351 qualification does not preclude taxpayer from making the argument that the SPAC merger (Merger #2) is a valid reorganization (if and when you conclude you will satisfy COBE and any other applicable requirements)**

# U.S. SPAC / Foreign Target – Inversion Counting Example




*Each Warrant give right to purchase ½ common share at $11.50 / share*

***<u>Assume at Closing:</u>***
***NewCo's FMV:***
***$13.50 / share***

***<u>§ 7874 Ownership Fraction = 39.2%</u>***
***(322.22 / 822.22 = 39.2%)***
***(Deemed SPAC-Related Shares / Total Deemed Shares)***

***NO INVERSION***

| Shareholder / Investor | Include for § 7874 Ownership Test? | Actual Shares Owned | Deemed Shares For §7874 Ownership Test |
|---|---|---|---|
| **SPAC Sh/s** | Yes | 300 | 300 |
| **Target Sh/s** | Yes | 500 | 500 |
| **PIPE** | No | 250 | 0 |
| **Warrants** | Yes (in-the-money value) | 0 | 22.22 *($300 in-the-money value / $13.50 per share)* |
| **Total** | | **1050** | **822.22** |

# U.S. SPAC / Foreign Target – Additional Counting Questions

- **What should you do to take into account that the "in-the-money" vale of the Warrants will not be known until the closing of the de-SPAC transaction?**
  - The ownership fraction depends on the in-the-money" value of the Warrants, which can be known with certainty only at the time of the de-SPAC transaction (closing)
  - Does this mean you may need to build in a little "cushion" up-front?
  - Or can the parties build-in a contractual mechanism to ensure the ownership fraction will stay below the 60% threshold for limited inversion status or will such mechanism be disregarded under the inversion rules for non-ordinary course distributions?

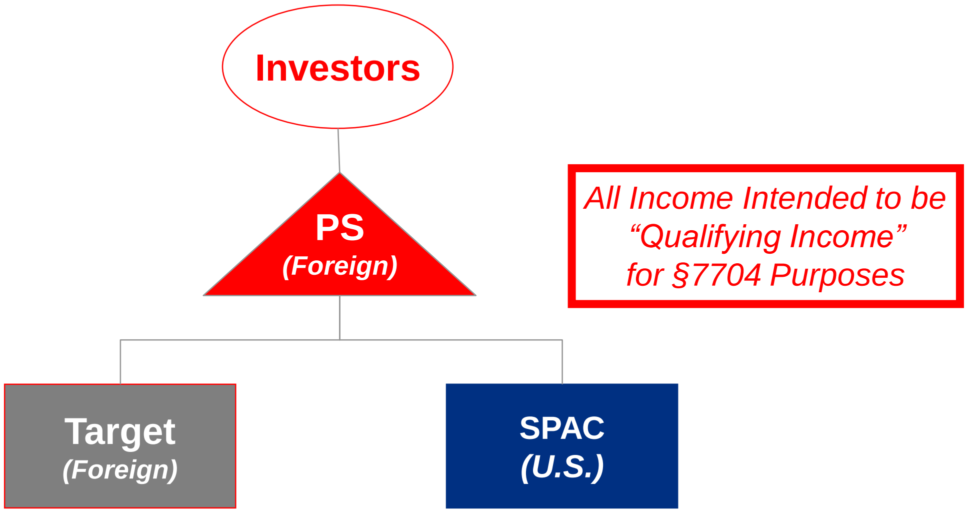
- **What should we do when some SPAC sh/s exercise their redemption rights?**
  - Ignore any redemption and treat the otherwise redeemed shares as outstanding and having received the applicable deal consideration for purposes of §7874 ownership test counting (§7874(c)(4))
  - Has the effect of increasing the §7874 ownership fraction

- **What if there are forward purchase agreement shares?**
  - In many cases, before any potential target has been identified, the Sponsor enters into a forward purchase agreement (FPA) under which it agrees to purchase additional shares / warrants in connection with an actual, future de-SPAC transaction
  - FPA is typically drafted so that the agreement is an obligation to purchase additional shares of the U.S. SPAC
    - Accordingly, in such a situation, the shares acquired per the FPA should be treated as outstanding shares of the U.S. SPAC that must be taken into consideration for purposes of the §7874 ownership fraction – this has the effect of increasing the §7874 ownership fraction
  - Is there a practical way possibly to draft the FPA so it would not be necessary to treat the shares acquired per that agreement as shares of the U.S. SPAC shares ("bad shares") for purposes of § 7874 ownership testing?

# U.S. SPAC / Foreign Target – Final § 7874-Related Notes

- **Foreign NewCo will generally be located in the same country as Foreign Target due to the "third country" rule of §7874**
  - The "third country" rule in the §7874 regulations essentially prohibit Foreign NewCo from being organized in country other than the country in which Foreign Target legally organized before the transaction with the U.S. SPAC, with limited exceptions (Reg. §1.7874-9)
    - Exception #1: Generally ok to move from one tax haven to another tax haven
    - Exception #2: Generally ok to move to a foreign country in which the Foreign NewCo is a tax resident and in which its has substantial business activities (ignoring the effect of the combination with the U.S. SPAC)
- **Future strategic activity may be affected by the "serial inverter rule" in the §7874 regulations**
  - Foreign NewCo may not be able to its equity consideration to effect future, unrelated acquisitions of other U.S. corporations that are signed up in the 3-year post-de-SPAC period due to the anti-Serial Inverter Rule in the §7874 regulations
    - The "Serial Inverter Rule" is a bright-line rule that modifies the computation of the ownership fraction in cases where the foreign acquiring corporation has made prior, albeit unrelated, acquisitions of other domestic entities (<u>e.g.</u>, Foreign NewCo has acquired U.S. SPAC)
    - Under the Serial Inverter Rule, the foreign acquiring corporation shares issued in connection with any prior acquisition of a <u>domestic</u> entity in the 3-year period prior to the <u>signing date</u> for the acquisition being tested must be excluded from the denominator when calculating the ownership fraction

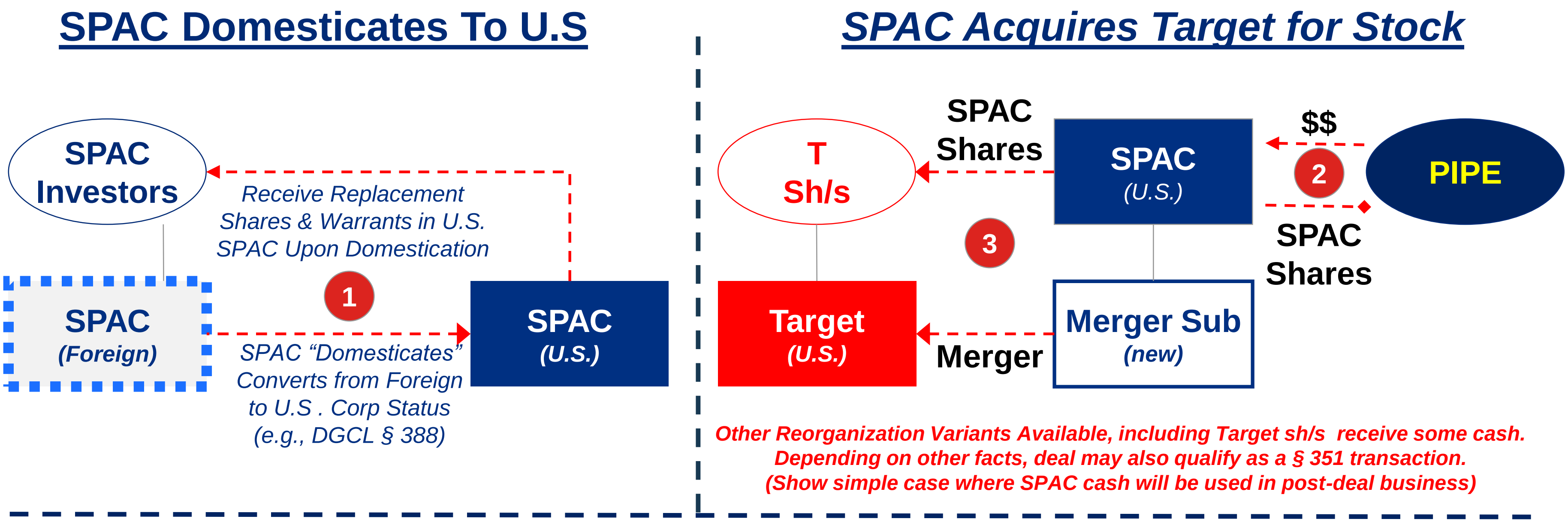
# U.S. SPAC / Foreign Target – One Last Idea




- **Would it ever be easier / acceptable simply to structure the combination of a U.S. SPAC / Foreign Target under a newly created foreign partnership structure?**
  - Intended U.S. Tax Highlights:
    - PS treated as a partnership for U.S. tax purposes
    - Tax-free to all SPAC shareholders and unitholders
    - Newly created foreign partnership respected as a partnership for U.S. tax purposes per the exceptions in the publicly traded partnership rules
    - Avoid §7874 and §367
  - But must deal with:
    - Unusual legal structure
    - K-1 reporting
    - Significant ongoing financial and operational complexity, including future M&A
  - **Probably not worth it for a deal that already avoids §7874. But what if your deal would be a limited inversion (or worse)?**

# Foreign SPAC / U.S. Target

# Foreign SPAC / U.S. Target – Domesticate then Combine




- **<u>Domestication</u>**: SPAC converts from being a foreign corporation (<u>e.g.</u>, Cayman Islands) to a U.S. corporation (<u>e.g.</u>, Delaware)
  - Domestication is a simple and routine paperwork process – readily handled by counsel (DGCL § 388)
  - Domestication qualifies as a "F" reorganization – SPAC's shares and warrants simply transform into shares and warrants in the now domesticated U.S. SPAC – no change in economic or other terms
  - Practically speaking, domestication is *tax-free to shareholders* since shareholders only need to include his/her share of SPAC's "all earnings and profits amount," which should be $0 (or virtually $0) since SPAC will have had no income or (virtually no) income as of the time of domestication (Reg. §1.367(b)-3(c)(2))
    - ≤10% Shareholder need to make election to include All E&P amount; otherwise must recognize lesser of gain realized or All E&P amount
  - Typically shareholders should make a QEF election to protect themselves in the event the SPAC is classified as a PFIC – avoids having to pick up any extra income on domestication beyond the All E&P amount
  - Taxation of SPAC warrants far from clear under the PFIC rules
- **<u>Acquisition / Combination</u>**:
  - SPAC's acquisition of Target stock generally intended to qualify as a tax-free reorganization

# Foreign SPAC / US Target – § 367(b) Applies

- The domestication of the Foreign SPAC will qualify as a "F" reorganization (§ 368(a)(1)(F))
- Section 367(b) applies to inbound "F" reorganizations but has little economic effect as a practical matter for the shareholders of the Foreign SPAC, provided they have made a QEF election
  - ≥10% U.S. shareholders (measured by voting power): Include their share of the Foreign SPAC's "all earnings and profits" ("All E&P") amount, which will be $0 or virtually $0
  - <10% U.S. shareholders: Recognize gain unless they elect to include their share of the Foreign SPAC's All E&P amount
    - Need Foreign SPAC to agree to provide necessary information all E&P election, but foreign SPACs routinely agree to do so
  - [Should we point out the shareholders owning <20% and <$50,000 worth of Foreign SPAC stock avoid §367(b) gain / All E&P pick-up altogether?]
  - Sponsors pick up their share of the Foreign SPAC's All E&P amount per the subpart F rules if Foreign SPAC is CFC and the Sponsor is a U.S. shareholder
    - As noted above, typically, the SPAC will not have any income at the time it domesticates
- The proper treatment of the warrant holders is less clear due principally to three issues:
  - #1: Whether the Foreign SPAC should be classified as a PFIC,
  - #2: Whether Warrants to acquire PFIC stock should be treated as PFIC stock and subject to PFIC tax on disposition, and
  - #3: Per the PFIC regulations, including the recently finalized regulations, a QEF election cannot be made for a warrant

# Foreign SPAC / US Target – Use a Foreign Parent?

- **Inversion rules of §7874 generally prevent the acquisition of the U.S. Target under a foreign corporate parent**
  - Normally, there are several reasons the parties would want to effect the de-SPAC between a U.S. Target under a U.S. holding company structure
- **The §7874 inversion rules and regulations generally would stunt or at least severely curb the abilty to effect the de-SPAC of a U.S. Target under a foreign parented structure**
  - The inversion rules generally disregard shares of a foreign acquiring corporation solid in a public offering related to "the acquisition" of a U.S. corporation for purposes of computing the inversion ownership fraction (§7874(c)(2)(B))
    - Some may argue that the public offering is not related to "the acquisition" since the acquisition U.S. Target will not have been established at the time of Foreign SPAC's IPO.
    - But consider how the redemption right should factor into the analysis
    - In addition, it would seem clear that any shares issued in the PIPE segment of the transaction would be ignored for purpose of computing the inversion ownership fraction
  - In addition special inversion counting rules pertaining to shares issued in a public offering, a Foreign SPAC acquiring a U.S. Target under a foreign parented-structure would need to consider the inversion regulations concerning foreign acquiring corporation's with a substantial percentage passive assets (Reg. §1.7874-7)
- **Even if §7874 were not an obstacle, Section 367 would still likely preclude the use of a foreign parent structure in most cases because U.S. Target shareholders typically expect tax-deferral for the stock portion of the deal consideration received in the de-SPAC**
  - For example, among other requirements, to qualify as tax-free under §367, the foreign acquiring corporation must satisfy an active trade or business requirement
    - Generally requires the foreign acquiring corporation to have been engaged in an <u>active trade or business outside the U.S</u>. continuously for <u>36 months pre-closing</u> – a Foreign SPAC is unlikely to satisfy this standard

# Foreign SPAC – PFIC Issues

# Foreign SPAC – PFIC Overview – PFIC Shares

- There is typically a concern regarding whether a foreign SPAC would be classified as a PFIC given that it starts life as a mere cash box
- PFIC Taxation – Very High Level
  - When applicable, a U.S. investor who sells or disposes of PFIC stock at a gain (or receives an "excess distribution") generally will be taxed at ordinary income tax rates plus a possible interest charge on any deferred taxes, unless certain elections are made (e.g., a QEF election, market-to-market election, or a "purging" election)
  - The overarching concern behind the PFIC rules is to eliminate the abilty to use a foreign corporation to accumulate tax-deferred income from passive assets and then convert such income into long-term capital gains at preferred tax rates
- By making a QEF election, the electing shareholder agrees to include its share of the PFIC's ordinary earnings and net capital gains for the year in its taxable income for such year
  - To make the QEF election, the electing shareholder must have access to the necessary information about the company
  - Fortunately, all publicly traded foreign SPACs agree to furnish the information necessary to make a QEF election
- It almost always make sense for a shareholder of a Foreign SPAC to make a QEF election in light of the simple fact that the SPAC will have virtually no earnings up to the time of, and rarely will be classified as a PFIC after, the de-SPAC transaction

# Foreign SPAC – PFIC Overview – Warrants and Sponsor

- By comparison to PFIC shares, the applicable law and path for the Warrants is less clear
  - As discussed in more detail below, the path is more complicated because:
    - Treasury regulations do not permit a taxpayer from making a QEF (or market-to-market) election for a warrant to purchase PFIC stock
    - Depending on the applicability of proposed regulations issued in 1992, a warrant holder may be taxed on a deemed disposition of a Warrant even if such disposition occurs as part of an otherwise tax-free transaction, <u>e.g.</u>, a "F" reorganization

- Common Situations Where this Matters to Warrant Holders
  - <u>When the Foreign SPAC Domesticates</u>: A Foreign SPAC will often domesticate in a "F" reorganization immediately before effecting its acquisition of a U.S. target
  - <u>When the Foreign SPAC Acquires / Combines with a Foreign Target</u>: Once the SPAC qualifies as a PFIC during the applicable U.S. shareholder's or warrant holder's holding period, then all shares, including shares acquired by exercising Warrants, are PFIC shares (unless the shareholder makes a costly "purging" election) due to the "once a PFIC always a PFIC" taint

# Foreign SPAC – PFIC Overview – Warrants and Sponsor

- PFIC Classification Generally Less Important for Sponsors
  - In many cases, Sponsors structure their holdings in Foreign SPAC in a manner that qualifies for the CFC / PFIC overlap rule, where CFC trumps – this means Sponsor merely picks up Subpart F income during the pre-de-SPAC period, again an amount which will be $0 or virtually $0 (see Slide 29 for an example)
    - But there is a difference of opinion regarding whether the CFC / PFIC overlap rule protects the Sponsor with respect to its Warrants (see Slides 30-31)
    - There are complex / non-traditional strategies that may allow Sponsors to avoid triggering gains on their warrants, but they tend to be complex and clunky and not truly applicable to public warrant holders)
- **But all of this presumes the Foreign SPAC is a PFIC in the first place .. Let's consider that in more detail**

# Foreign SPAC – PFIC Test Generally

- **Because its starts life as a simple box of cash, conventional thinking is a Foreign SPAC will be, or there is a serious risk it will be treated as, a PFIC unless:**
  - De-SPAC or Domestication occurs before the end of the 1st year, or
  - Start-Up Exception applies
- **A foreign corporation will be a PFIC for a tax year if it meets either an Income Test <u>or</u> Asset Test**
  - <u>Gross Income Test</u>: ≥ 75% of the SPAC's gross income for the tax year is passive income
    - Passive income generally means **interest**, dividends, gain from sale of passive asset and rents and royalties (unless derived in the conduct of an active trade or business)
    - **Before effecting the de-SPAC, a SPAC's only potential income is interest income, <u>i.e.</u>, passive income**
  - <u>Asset Test</u>: ≥ 50% of the SPAC's assets are passive assets
    - For publicly traded corporations, asset test is based on the weighted average of the FMV of the corporation's assets determined on a quarterly basis for the applicable tax year – and the FMV of such assets is normally based on the foreign corporation's trading value
    - Government considers cash a passive asset – even cash being held as <u>bona</u> <u>fide</u> working capital or cash held by a SPAC that can only be used to pursue and finance an acquisition or used in the active business after the de-SPAC (yes, this rule is as crazy as it sounds)
  - <u>Start-Up Exception</u>: A foreign corporation will not be treated as a PFIC for the <u>first tax year it has gross income</u> – the "Start-Up Year" – if:
    - No predecessor of such foreign corporation was a PFIC
    - The foreign corporation establishes to the satisfaction of the Treasury secretary that it will not be a PFIC for either of the first two years following its Start-up Year, and
    - The foreign corporation is not in fact a PFIC for either of the first two years following the start-up year
    - Note, IRS takes the position the Start-Up Exception does not apply if the foreign corporation flunks the Asset Test in a year before the Start-Up Year even if it had no gross income in such earlier year (FSA 2002 WL 1315676 (2002))

# Foreign SPAC – Is it Really a PFIC?

- **Is it actually so clear that a Foreign SPAC should be classified as a PFIC?**
  - IRS position that cash is always a passive asset for purposes of PFIC classification is questionable (Notice 88-22)
    - Code does not prescribe "all cash is bad"
  - Cash is always bad does not fit the facts and circumstances of a SPAC
    - SPAC "can never do the deed" the PFIC regime was designed to address – i.e., defer passive income
    - A SPAC's cash can be employed solely to purchase an active business (and pay associated expenses)
    - Put most simply:
      - The cash is not being held for the production of passive income but instead to fund the purchase of an operating business
      - The cash will not generate any interest or other passive income if it is held in a non-interest bearing account
      - Even if interest were earned on the cash, it would be a very low amount
      - A SPAC is expected to have no or, at most a de minimis amount of, income during the entire period before the de-SPAC transaction
      - The time period for any deferral of income is very short and finite – no more than two years, which marks the time the PFIC will liquidate if it fails to complete a de-SPAC transaction
      - SPACs are not formed to serve as investment vehicles for passive assets – in fact, they have he opposite aim and that is precisely why investors are attracted to them
  - Nevertheless, we must acknowledge the proposed regulations issued in Dec 2020 continue to take the positon cash is bad with extremely limited and narrow exceptions

***Note the oddity of attempting to apply the PFIC rules, an anti-abuse regime designed to prevent the deferral of tax on passive income, in the context where there is no, and contractually cannot be, any such income***

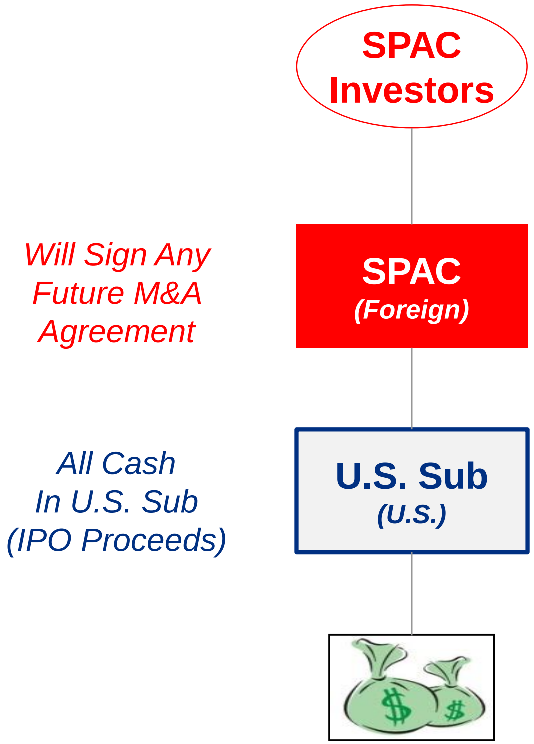
# Foreign SPAC – Is it Really a PFIC? – Start-Up Exception

- **Start-Up Exception – No Gross Income in Year 1**
  - Start-Up Year is defined as the "first taxable year [the PFIC] has gross income" (§1298(b)(2))
  - The definition creates a highly technical concern that a Foreign SPAC could be a PFIC in the year of its IPO even if it places all the proceeds in a non-interest bearing account due to failing the Asset Test
    - As noted above, the IRS has taken this position in a FSA
  - Does this mean a Foreign SPAC intending to avail itself of the Start-Up Exception should place the IPO proceeds in an interest bearing account?

- **Start-Up Exception – Foreign Target**
  - It would appear that Foreign SPAC should be able to satisfy the Start-Up Exception if its completes the de-SPAC with a foreign target before the end of Q2 of Year 2 (tax year after the IPO) or in some cases later if the U.S. Target is sufficiently large
    - Asset Test is applied on a quarterly basis (last day of each quarter in the tax year of the foreign corporation being tested) and the de-SPAC target will be an active operating company

- **But Start-Up Exception doesn't really help the foreign SPAC converting to U.S. corporations status**
  - The Start-Up Exception does not help a foreign SPAC that converts (domesticates) to U.S. corporation status in its second year – even if it completes the de-SPAC transaction by the end of Q2 of its second year – because the conversion / domestication would occur immediately before the consummation of the de-SPAC
  - This means the <u>Foreign SPAC's second tax year ends before it ever acquires</u> the active target company
  - Thus, the Foreign SPAC never gets the chance to prove it was not a PFIC in each of the two years after its Start-Up Year as required under the conditions for the Start-Up Exception
  - Harshest potential effect on warrant holders

# Foreign SPAC – Another Way to Manage PFIC Concern?



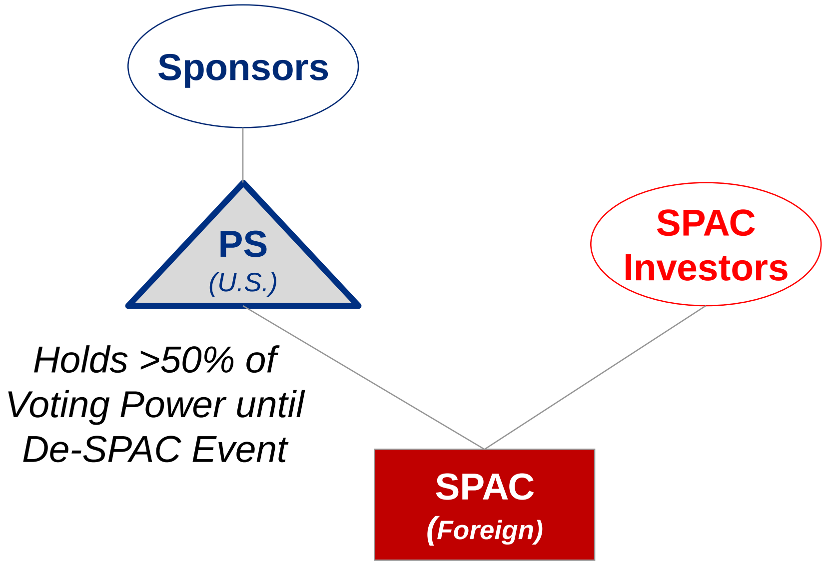

***Is there any downside to adopting this approach?***

- SPAC places all its cash in a wholly owned U.S. corporate subsidiary ("U.S. Sub")
- PFIC regulations provide that stock in a 25%-owned domestic corporation generally is treated as an asset that does not produce passive income (Code §1298(b)(7), Reg. §1.1298-4(b))
  - Consider anti-abuse rule that provides that the normal rule for 25%-owned domestic subsidiaries does not apply "if a principal purpose for the formation, acquisition, or holding of the stock of the 25%-owned domestic corporation … is to hold passive assets [through such corporation] to avoid classification of the tested foreign corporation as a PFIC." (Reg. § 1.1291-1(e)(1).
- Can we point out there is no abuse through a combination of:
  - Any income earned on such cash would be subject to U.S. tax on a current basis without regard to the PFIC rules
  - There is no certainty SPAC will make any acquisition whether U.S. or foreign
  - The SPAC's economic group will either succeed in making the acquisition of an active operating company in a fairly short period of time or cease to exist altogether
- Any concern if U.S. Sub pays expenses for SPAC?
  - Deemed withholding tax
  - *Alter ego*, etc.

# Foreign SPAC – Self-Help PFIC Strategies

| Other Possible Self-Help Strategies on PFIC | |
|---|---|
| ***SPAC places cash in a non-interest bearing account*** | ○ Avoids failing Income Test and may buttress argument SPAC"s ash is not a passive asset<br>○ Possibly boosts a "clean hands" type of argument you satisfy the Start Up Exception if it turns out de-SPAC does not occur until Year 2<br>○ Cash possibly placed in interest bearing account in Year 2? |
| ***Domesticate early in those situations where the foreign SPAC signs up deal for a U.S. Target before end of Year 1, even if there is a risk the deal won't eventually close*** | ○ When facts allow, domesticate upon signing deal for U.S. target and eliminate concern about PFIC classification<br>○ But, domestication is permanent, could have tax consequences (especially for warrant holders) and could be a disadvantage for a later deal if the first fails to close for whatever reason |
| ***Sponsor invests in SPAC via U.S. partnership (applies to Sponsor only)*** | ○ Sponsors routinely do this already<br>○ SPAC is a CFC with respect to Sponsor so PFIC rules not relevant<br>○ But, as noted, this only aids the Sponsor not the other SPAC shareholders and warrant holders |
| ***Place cash in a U.S. subsidiary*** | ○ SPAC argues U.S. subsidiary is not a passive asset and U.S. fisc can be sure to collect tax currently on any passive income, the exact concern that motivated the PFIC regime<br>○ Possible application of anti-abuse rule? (Reg. § 1.1298-4) |
| ***SPAC adopts non-calendar tax year*** | ○ PFIC rules are mechanical – Start-Up Year covers the applicable tax year – whether long or short<br>○ Provides (limited) additional breathing room to identify and close de-SPAC, but limits on the difference that a CFC can have versus its U.S. shareholder minimizes the possible benefit |

# Foreign SPAC – PFIC Self-Help for Sponsors – CFC Rules!




***But is it clear the CFC / Overlap Rule also extends to Warrants owned by the Sponsor? (see following pages)***

- **Sponsor should be able to benefit from the CFC / PFIC overlap rule**
- **By investing via a U.S. partnership, Sponsor should be able to avoid PFIC concerns due to the CFC / PFIC overlap rule where CFC status trumps PFIC**
- **SPAC should be a CFC w/r/t PS**
  - PS is a U.S. shareholder of the SPAC, a foreign corporation for CFC testing purposes
  - PS holds >50% of the voting power until the de-SPAC
- **Relevance**
  - Sponsor avoids PFIC rules
  - Sponsor must pick up any Subpart F income, but that should be nominal
  - Equally helpful regardless whether target turns out to be a U.S. vs. foreign
- **Possible Change in Rules in the Future**
  - Proposed regulations would relieve small partners in PS from including subpart F items – if so, this may also alter the application of the CFC/PFIC overlap rule

# Foreign SPAC – Does CFC / Overlap Rule Apply to Warrants?

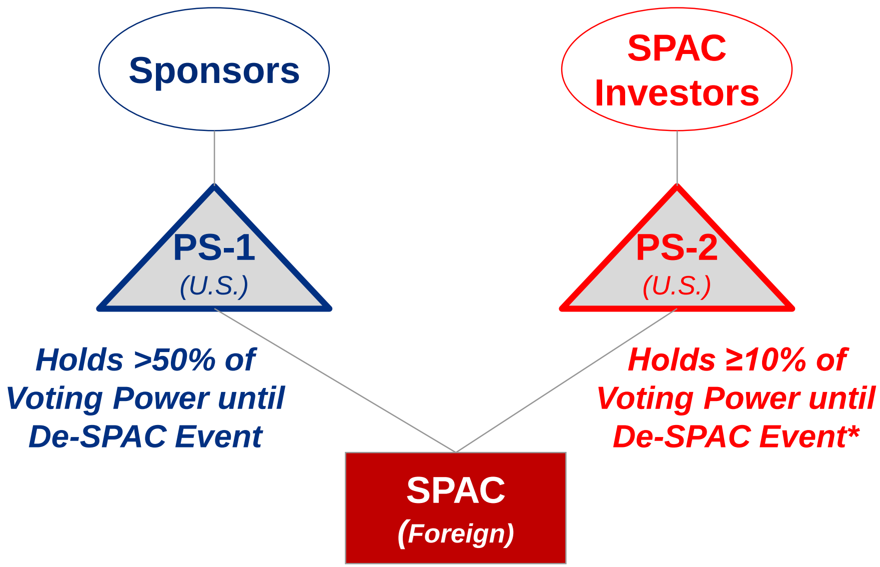
- The typical Sponsor of a Foreign SPAC owns both shares and warrants via a U.S. partnership, and the Foreign SPAC qualifies as a CFC at all times prior to the de-SPAC transaction
- The CFC / PFIC overlap rule generally provides that a foreign corporation will not be treated as a PFIC with respect to a particular shareholder during the period such foreign corporation was a CFC and such shareholder was a U.S. shareholder (with the meaning of §951(b) thereof
  - In other words, the CFC regime and not the PFIC regime generally applies to the applicable shareholder in those cases where a foreign corporation could be both a PFIC and a CFC
- The normal operation of the CFC / PFIC overlap rule would appear to subject the Sponsor fully to the CFC regime, but turn off the PFIC regime at least until after any de-SPAC transaction
- A question arises, however, whether the CFC / Overlap Rule applies not only to the shares, but also the warrants, owned by a Sponsor of a Foreign SPAC
- Pertinent Code sections include:
  - Section 1297(d)(1) provides: "… a corporation shall not be treated with respect to a shareholder of a PFIC during … such shareholder's holding period with respect to stock in such corporation."
  - Section 1297(d)(4) says that Section 1297(d)(1) "shall not apply to stock treated as owned by a person" under the option attribution rule of Section 1298(a)(4) unless such person establishes that such stock is owned by a U.S. shareholder (for §951(b) purpose) who is not exempt from tax under this chapter
  - Section 1298(a)(4) states that "[t]o the extent provided in regulations, if any person has an option to acquire stock, such stock shall be considered as owned by such person."
    - The applicable proposed regulations were issued in 1992 but are not yet effective. However, as drafted, such regulations would be retroactive if finalized

# Foreign SPAC – Does CFC / Overlap Rule Apply to Warrants?

- **CFC / PFIC Overlap Rule *Should Apply* to SPAC Shares and Warrants Owned by the Sponsor**
  - There is no doubt that the SPAC is a CFC and the Sponsor is a U.S. shareholder of such CFC
    - And the SPAC is a CFC and the Sponsor a U.S. shareholder thereof without resorting to any attribution rule for options (i.e., the SPAC is not a CFC solely by virtue of an attribution rule)
  - The Sponsor is subject to the CFC rules
  - CFC / PFIC overlap rule is based on the belief that a taxpayer should only be subject to one set of inclusion rules, and the overlap rule further implies that the CFC regime) by requiring a sufficient inclusion of Subpart F income) shields the fisc against the potential abuse that motivated the need for the PFIC regime
    - If the CFC rules wanted a special inclusion rule for warrants it would have so provided
  - The SPAC shares subject to the Sponsor Warrants are not outstanding. Thus, all of the SPAC's income is subject to U.S. tax currently --- whether under the CFC or PFIC regime, as appropriate. But see §1297(d)(4) and below
  - A separate analysis would need to be considered, and possibly a different result would be appropriate, if the applicable U.S. person only held warrants and not both shares and warrant
  - It would seem very strange to treat a person as a shareholder of a CFC for only a portion, rather than, all of its equity-like interest in the applicable foreign corporation

- **CFC / PFIC Overlap Rule *Should Not Apply* to SPAC Warrants Owned by the Sponsor**
  - The IRS contends the CFC / PFIC overlap rule does not apply to option holders (Instructions to IRS Form 8621 citing §1297(d))
  - The language of §1297(a)(1) refers only to "stock" and "shareholder"
  - As an exception to an anti-abuse rule, the CFC / PFIC overlap rule should be construed narrowly
  - Section 1297(d)(4) provides that the CFC/PFIC overlap rule only applies to stock treated as owned by a person by virtue of their holding an option if the stock is owned by a United States shareholder who is not tax exempt (i.e., the stock is outstanding and held by someone subject to the subpart F rules)

# Foreign SPAC – PFIC Self-Help for Public Too?




- **Should the public invest in SPAC via a partnership too?**
  - If so, should it really be a U.S. partnership?
- **SPAC should be a CFC w/r/t PS-2**
  - PS-1 and PS-2 are U.S. shareholders of SPAC, a foreign corporation
  - PS-1 and PS-2 together hold >50% of the voting power until the de-SPAC
- **Relevance for Public**
  - Public side avoids PFIC rules by being treated as investing in a CFC
  - Investors end up picking up their shares of Subpart F income, but that should be nominal
  - May be helpful if target turns out to be a U.S. corporation
  - Possible inversion complications if target is foreign?
  - Legal durability of structure if IRS converges Subpart F and GILTI rules for small partners of a U.S. partnership?

* Would require a modification to the terms of the Class A shares versus current standard practice to allow for voting rights before a de-SPAC transaction..

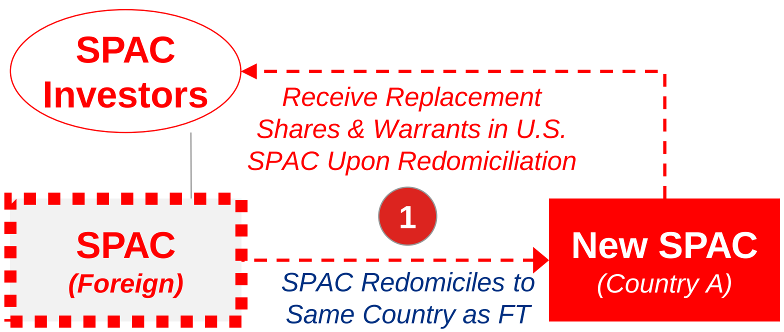
# Foreign SPAC – PFIC Rules for Warrants

- As already noted, if a Foreign SPAC is properly classified a PFIC, the inability to make a QEF election could prove (quite) costly to a warrant holder, but this presumes that the proposed regulations concerning PFIC dispositions and options are actually applicable
- The Code does not automatically alter the treatment of options in an otherwise tax-free M&A transaction merely because such option gives the holder the right to acquire stock in a PFIC
- **Instead, the Code provides regulatory authority to find a deemed disposition of PFIC stock and to tax such disposition "notwithstanding any [other] provision of law"**
  - More fully, §1291(f) provides: *"To the extent provided in regulations, in the case of any transfer of stock in a PFIC where (but for this subsection) there is not full recognition of gain, the excess (if any) of (1) the FMV of such sock over (2) its adjusted basis, shall be treated as gain from the sale or exchange of such stock and shall be recognized notwithstanding any provision of law…."*
- In April 1992, the IRS issued proposed regulations that, if finalized, requires a shareholder in a PFIC to recognize gain under the excess distribution regime of §1291 (ordinary income treatment plus interest) in connection with any direct or indirect disposition of PFIC stock (Prop. Reg. § 1.1291-6)
  - Under the option regulations, a direct or indirect disposition here includes a disposition of a warrant to purchase PFIC stock
  - Consequently, the domestication of a Foreign SPAC – even in connection with a "F" reorganization – would result in a deemed disposition of Warrants that would require the holder to recognize phantom gain at ordinary income tax rates (plus interest) under the harsh excess distribution regime per §1291
- As drafted, the proposed regulations on dispositions and options, if and when finalized, would be effective as of April 1992, yet nearly 29 years later they have never been finalized
- **Could a taxpayer reasonably argue that the proposed regulations simply do not apply currently?**
- **Could a taxpayer somehow make a protective QEF election even though the regulations literally forbid it?**
- **Any concern the proposed regulations are self-executing? (see Michael J. Miller, "Is Code Section 12927(f) Self-Executing?," Int'l Tax Journal (Jan-Feb 2021)).**

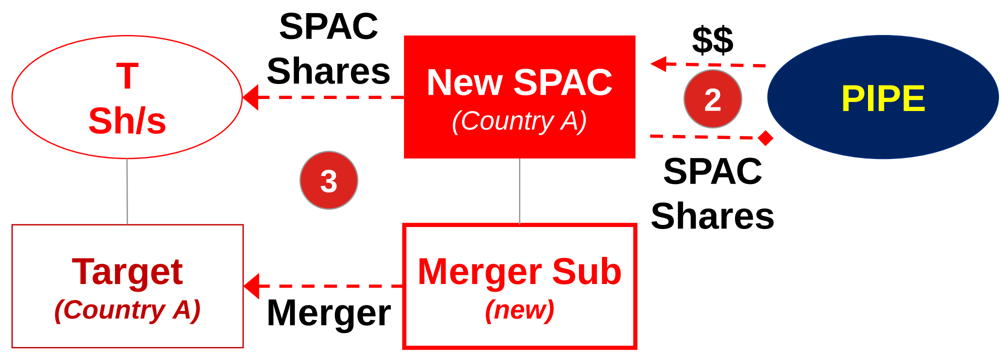
# Foreign SPAC / Foreign Target

# Foreign SPAC / Foreign Target

## SPAC Redomiciles to FT's Country




## *SPAC Acquires Foreign Target for Stock*




***Other Reorganization Variants Available, including Target sh/s receive some cash. Depending on other facts, deal may also qualify as a § 351 transaction. (Show simple case where SPAC cash will be used in post-deal business)***

- **Redomiciliation**: Foreign SPAC will often re-domicile to the country ("New F-SPAC") in which the Foreign Target is organized in advance of the de-SPAC which will typically be structured as New F-SPAC acquiring Foreign Target
  - No changes in the economic terms of the shares or warrants
  - Re-domiciliation qualifies as a "F" reorganization – tax-free to both shareholders and warrant holders, even if Foreign SPAC is a PFIC
  - Re-domiciliation: Section 367(b) applies to the foreign-to-foreign "F" reorganization but has little economic effect as a practical matter because there is no change in proportionate ownership so no 10% shareholder would ever lose its 10% shareholder status
- **De-SPAC**: Generally, tax-tree per §§368/351 and 367, provided ≥5% shareholders must enter into GRA
  - If an asset transfer, then gain recognized by any 10% U.S. shareholder of SPAC that does not maintain 10% shareholder status (unusual transaction)

# SPAC – Non-Traditional Going Public Structures

# Alternative Legal Structure SPAC at the time of the IPO

- **Given the inherent uncertainty at the time of the IPO concerning the SPAC's ultimate acquisition target, some sponsors may want to consider taking its SPAC public as a *foreign partnership***
  - Would enhance the SPAC's flexibility to have the optimal tax profile post-acquisition
  - The foreign partnership does not have to be maintained forever – in fact, the foreign partnership typically could be readily converted to whatever structure was best for the particular target corporation / business acquired without triggering any tax cost
    - Any concern that a "born-to-die" partnership should not be treated as a partnership for tax purposes?
  - The affairs of the foreign partnership used in the SPAC's IPO could be set up so that it would not have to deliver a K-1 to the investors
    - Important because capital market pros have historically identified K-1 reporting as an important marketing disadvantage versus the normal corporation structure where investors receive a 1099
    - The obligation to deliver a K-1 to investors can be avoided simply by making sure the foreign partnership does not earn any U.S.-source income before completing its acquisition
      - Typically, the SPAC's only possible income in the pre-acquisition period is interest earned on the IPO proceeds being held for deployment in the M&A deal
      - Thus, it is easy to avoid earning any U.S.-source income in the pre-acquisition period if the SPAC deposits the IPO proceeds in a foreign, rather than U.S., bank account thereby earning foreign-source, rather than U.S.-source, income

# Alternative Legal Structure SPAC at the time of the IPO

| SPAC IPO Structures – High-Level Pros / Cons | | |
|---|---|---|
| **U.S. Corporation** | **Foreign Corporation** | **Foreign Partnership** |
| ▲ Traditional<br>▲ Well-established and understood by investors<br>▲ Generally works out, especially if target is a U.S. corporation or business that should be so operated post-acquisition | ▲ Traditional (has become common)<br>▲ Better if target is a foreign corporation | ▲ Maximum flexibility to end up with optimal post-acquisition tax profile<br>▲ No K-1 needed (so long as proper planning adopted and maintained)<br>▲ Can earn interest on cash w/o PFIC risk<br>▲ No §7874 / §367 |
| ▼ Numerous PFIC issues, risks and potential complications | ▼ Numerous PFIC issues, risks and potential complications | ▼ Novel – no precedents<br>▼ General bias against partnerships in public context<br>▼ Too much additional work / complication if Sponsor practically knows it will be acquiring a U.S. corporation / business |

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