Weil

SPACs – Select Tax Aspects

Devon Bodoh

©2021 Weil, Gotshal & Manges LLP. All rights reserved. These materials are the confidential work product of Weil, Gotshal & Manges LLP. Any reproduction or redistribution of these materials is expressly prohibited.

Weil, Gotshal & Manges LLP

March 4, 2021

Agenda

I. Overview of SPACs

II. Basic SPAC Formation Tax Issues

III. De-SPACing Tax Structuring

A. De-SPACing Overview

B. De-SPACing Domestic SPACs with Foreign Targets

C. De-SPACing Foreign SPACs with Domestic Targets

D. De-SPACing Domestic SPACs with a Flow Through Target

E. De-SPACing Foreign SPACs with a Flow Through Target

Weil

I. Overview of SPACs

Weil

What is a SPAC?

- A Special Purpose Acquisition Company ("SPAC") is a blank-check company with no operations, formed for the sole purpose of raising equity capital through an initial public offering ("IPO") to acquire an operating business (a "business combination")
- Typically formed by well known private equity/hedge fund sponsors relying on their reputation and experience to attract investors
- Significant portion of IPO proceeds are placed in a trust account and are used to fund expenses and the eventual business combination
  - Trust account may be interest bearing in certain circumstances
- Specified time period (typically 18-24 months) to complete the business combination following the IPO, otherwise the SPAC is liquidated and cash (plus interest, if any) is returned to shareholders

Weil

Market overview*

- SPACs generally date back to 1993 with the Securities and Exchange Commission's adoption of Rule 419 for blank-check company offerings
  - Evolved from the "blank-check" companies popular in the public markets during 1980s
  - David Nussbaum, Chairman of EarlyBirdCapital (successor of GKN Securities) is widely credited with the advent of "SPACs" and helped launch 13 offerings between 1993 and 1994**
- Over 250 SPACs have completed IPOs since 2000
- Popularity and size of offerings growing

* SEC Company Filings; http://www.spacdata.com/; Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?*, 85 Wash. U. L. Rev. 931 (2007), available at: http://openscholarship.wustl.edu/law_lawreview/vol85/iss4/5.

Weil

Capital Structure: Publicly-held securities

- SPACs typically raise capital by issuing “units” to public investors in an IPO
  - Each unit generally consists of one common share and warrants
    - The economics with respect to the warrants issued vary among SPAC offerings. In certain offerings, a unit consists of a half-warrant or a third-warrant instead of a full warrant.
    - Common shares and warrants trade separately (after an underwriter overallotment period)
    - Public warrants are exercisable and callable at a specified premium to issuance price
  - In connection with the business combination, common shares are redeemable at the holders’ option for their proportionate share of the funds in trust
  - Often, business combinations must receive majority shareholder approval and cannot be consummated if more than 30% of the public shareholders vote against the business combination and elect to exercise their redemption rights instead

Weil

Capital Structure: Sponsors' securities

- Sponsors invest nominal capital up front for "Sponsor Shares" prior to the SPAC's IPO
  - Sponsor Shares have limited liquidity, as insiders typically cannot sell for a lock-up period (1-3 years following the business combination)
  - In certain deals, Sponsor Shares entitle Sponsors to control the board/elect directors prior to a business combination
  - Sponsors waive redemption rights afforded to public shareholders, agree to vote to approve business combination, waive rights to liquidating distributions from trust for failed business combination
- Sponsor Shares generally entitle holders to SPAC equity equal in value to 20% of post-IPO common shares (the "Sponsor Promote")
  - Largest SPAC ever did not issue any Sponsor Promote
  - Sponsor Promote may be economically "better" than typical private equity carried interest as it sometimes covers contributed capital and future appreciation
- "Sponsor warrants" are typically issued in a private placement concurrently with the IPO and are substantially similar to the public warrants
  - Unlike the public warrants, Sponsor warrants are typically not callable while still held by the initial holders
  - May be subject to a lock-up period

Weil

Capital Structure: Additional funds

- If additional cash is needed to finance a business combination (i.e., because IPO proceeds won’t cover the price of the identified target), a SPAC may raise funds in a private issuance of additional equity
  - Such private issuances often take the form of a “private investment in public equity” (a “PIPE”)
- A number of SPACs have raised additional funds by issuing equity-linked securities (such as forward-purchase contracts) whereby, in connection with a SPAC’s IPO, investors agree to purchase SPAC common shares and warrants at the time of the SPAC’s business combination

Weil

Capital Structure: Earn-out?

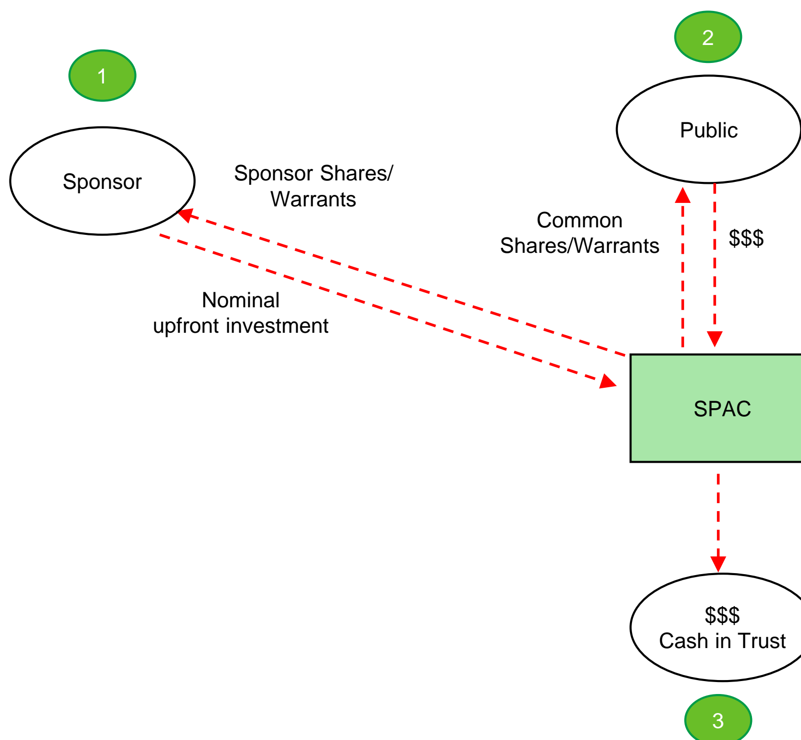
- Earnouts have been used by SPACs in connection with business combinations in order to entice target sellers
- Earnouts offered by a SPAC to target sellers may take the form of SPAC warrants exercisable upon a specified level of SPAC common share appreciation
  - At least one deal involved a dual earnout whereby (i) Sponsors waived a portion of their Sponsor Promote in exchange for warrants and (ii) target sellers received warrants in addition to the deal consideration
- Earnouts assist target rollover sellers (i.e. sellers receiving consideration for their target equity in the form of SPAC shares) in mitigating the dilutive effect of previously issued SPAC warrants

Weil

II. Basic SPAC Formation Tax Issues

Weil

Typical SPAC IPO structure



Overview of jurisdictional considerations

- Sponsors in the market for targets based in the United States generally form a domestic SPAC (a "domestic-to-domestic" transaction)
- Sponsors in the market for foreign targets generally form a foreign SPAC (a "foreign-to-foreign" transaction)
- Difficult tax issues can arise if, for whatever reason, a domestic SPAC identifies a foreign target or a foreign SPAC identifies a domestic target

Weil

Non-US SPAC – Overview of PFIC rules

- Subject to the “start-up exception” and PFICs that are also CFCs (discussed later), a foreign corporation will be a PFIC if it “fails”:
  - the “Income Test”: 75% or more of its gross income is passive income; or
    - Note that even $1 of interest income earned on the IPO funds deposited in trust would “fail” the Income Test
  - the “Asset Test”: average value of its passive assets in a taxable year is 50% or more of the value of its total assets
    - Cash may be considered a passive asset under the Asset Test
- Once a foreign corporation has “failed” one of the PFIC tests during a US shareholder’s holding period, the shares retain the PFIC “taint” with respect to such US shareholder, even if the corporation ceases to be a PFIC, unless the US shareholder makes a purging election (“once a PFIC always a PFIC”)
- SPACs own only cash prior to business combination, so foreign SPACs are PFICs unless (i) it doesn’t “fail” the Asset Test or Income Test in the year of its IPO (i.e., the business combination occurs in the year of the IPO) or (ii) the start-up exception applies

Weil

Consequences of PFIC status

- Taxation to US shareholders on “excess distributions” (which include stock dispositions) at ordinary income rates and the imposition of an interest charge based on the shareholders’ “deferred tax liability” (the “default regime”)
- US shareholders may be able to elect out of the harsh default regime by making either a:
  - Section 1293* – Qualified Electing Fund election (“QEF election”); or
  - Section 1296 – Mark-to-market election
- Special rules under Section 367(b) apply to PFICs engaging in tax-free reorganizations under Section 368 (discussed later)
- Section 1291(f), Section 1298(a)(4) and regulations proposed under such Sections may apply to PFICs engaging in tax-free reorganizations (discussed later)

* All “Section” references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations (“Treas. Reg.(s)”) promulgated thereunder.

Weil

Electing out of the default PFIC regime

- QEF election
  - If a US shareholder makes a valid QEF election in the SPAC's first taxable year in which it would otherwise be a PFIC (or a subsequent taxable year if the shareholder makes a QEF election and a purging election), the SPAC will be a "pedigreed" QEF
  - Preserves character of income
    - US shareholder currently includes its pro rata share of the QEF's ordinary earnings as ordinary income and its pro rata share of net capital gain of the QEF as capital gain
    - Requires corresponding adjustments to stock basis
  - No deferred tax interest charge
  - According to proposed regulations, not available for options/warrants
  - Note that a shareholders' ability to make an effective QEF election is contingent upon, among other things, the provision by the PFIC of a "PFIC Information Statement"
  - Mark-to-market election
  - Available if the PFIC stock is "marketable" (i.e. regularly traded on a qualified exchange)
  - The US shareholder will be treated as if it sold its PFIC stock at the end of each year for its fair market value. Any gain realized will be taxable at ordinary income rates. Any loss realized will be deductible only to the extent of any prior year gains recognized by the shareholder under the MTM election regime
  - The deferred tax interest charge is avoided
  - Presumably not available for options/warrants, as regulations have not yet been issued

Weil

Start-up exception to PFIC status

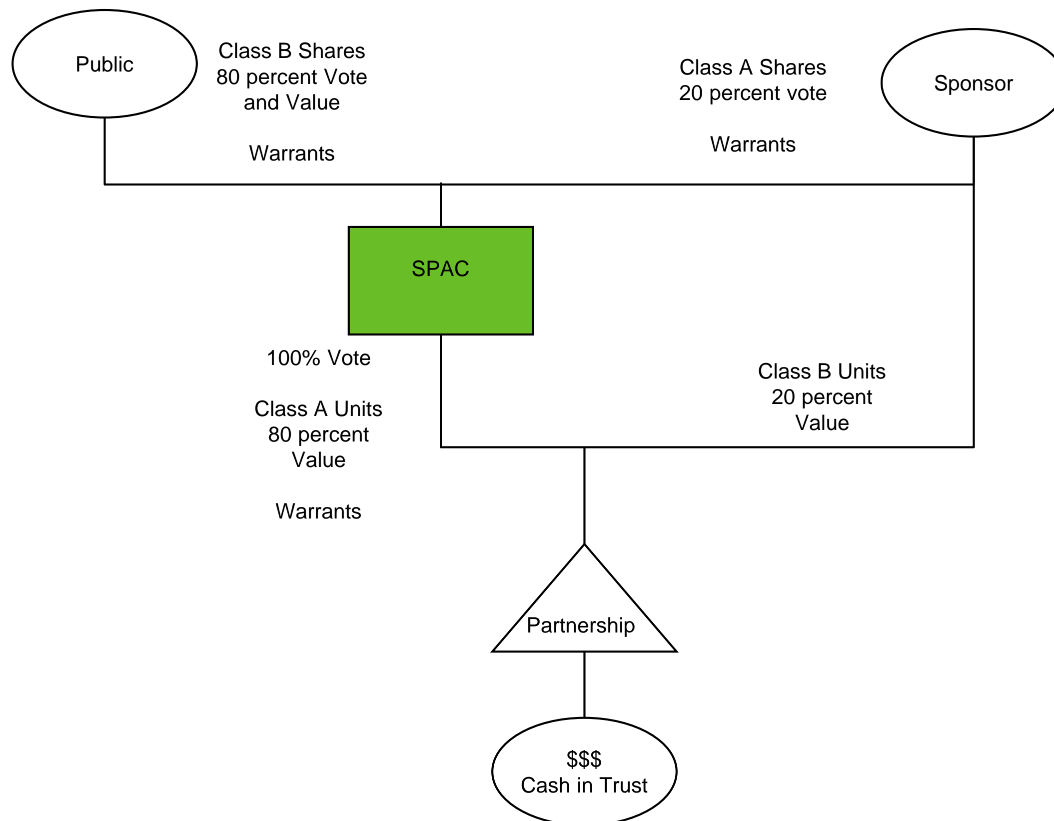
- Under the “start-up exception” in Section 1298(b)(2), a corporation is not a PFIC if:
  - in its “start-up year” (defined as the first taxable year it earns gross income), no predecessor corporation was a PFIC;
  - it establishes, to the satisfaction of the IRS, that it will not be a PFIC in either of the two succeeding years; and
  - it is not in fact a PFIC for either succeeding year
- What result if, in year 1, SPAC earns no income but “fails” the Asset Test?
  - If no income is earned prior to the business combination (i.e., because IPO funds are deposited in a non-interest bearing trust), the start-up exception is available
- What result if, in year 1, SPAC earns income but closes its business combination in the first quarter of year 2?
  - Year 1 will be SPAC’s “start-up year”
  - The PFIC Asset Test tests asset composition on the last day of each quarter
  - Therefore, if the business combination closes before the last day of the second quarter of year 2, the SPAC would “pass” the Asset Test and Income Test in year 2, would not be a PFIC in year 2 and would satisfy the start-up exception (assuming it continues to own an active business and “passes” the PFIC tests in year 3)

Weil

SPACs that are CFCs

- A CFC is a foreign corporation in which “U.S. Shareholders” own more than 50% of the corporation’s stock (measured by vote or value)
  - A “U.S. Shareholder” is a US person who owns 10% or more of the total value of shares of all classes of stock or of 10% or more of the CFC’s total combined voting power
  - Voting power is measured by whether a class of stock possesses the power to elect the board of directors
  - New look-through rule for GILTI / Sub-part F
- When a CFC earns “subpart F income” (certain passive/mobile income), the United States generally taxes the CFC’s U.S. Shareholders currently on their pro rata share of such income
- Under a special rule in Section 1297(d), a corporation that is treated as a CFC with respect to a U.S. Shareholder is not treated as a PFIC for that U.S. Shareholder
  - In order to avoid the PFIC regime, US-based Sponsors of foreign SPACs will often take steps to cause the SPAC to qualify as a CFC prior to a business combination
  - The foreign SPAC will be a CFC if U.S. Shareholders own more than 50% of its stock by vote or by value
  - Sponsor Shares typically entitle Sponsors to more than 50% of a foreign SPAC’s stock by vote until after the business combination
- Typically, Sponsor Shares lose their special voting rights in connection with the business combination, such that the SPAC is no longer a CFC from and after the business combination

Up-SPAC Structure Post-IPO



Weil

Taxation of Founders Shares

- If transferred in connection with the performance of services Section 83 applies
  - Excess of fair market value over amount paid is income upon transfer, or, if subject to vesting and 83(b) election not filed, upon vesting
    - Fair market value “willing buyer-willing seller”
- Time-Valuation Continuum
  - Formation--IPO--Business Combination
  - Issuance of Founders Shares between formation and IPO
    - Contingencies

Taxation of Founders Shares continued

- Up-SPAC
  - Founders shares granted as profits interests under Rev. Proc. 93-27
  - Liquidation value of $0
  - Book up to achieve parity
    - At business combination
  - Holding period implications
    - Section 1061
    - Rev Proc 93-27
      - 2 year disposition rule

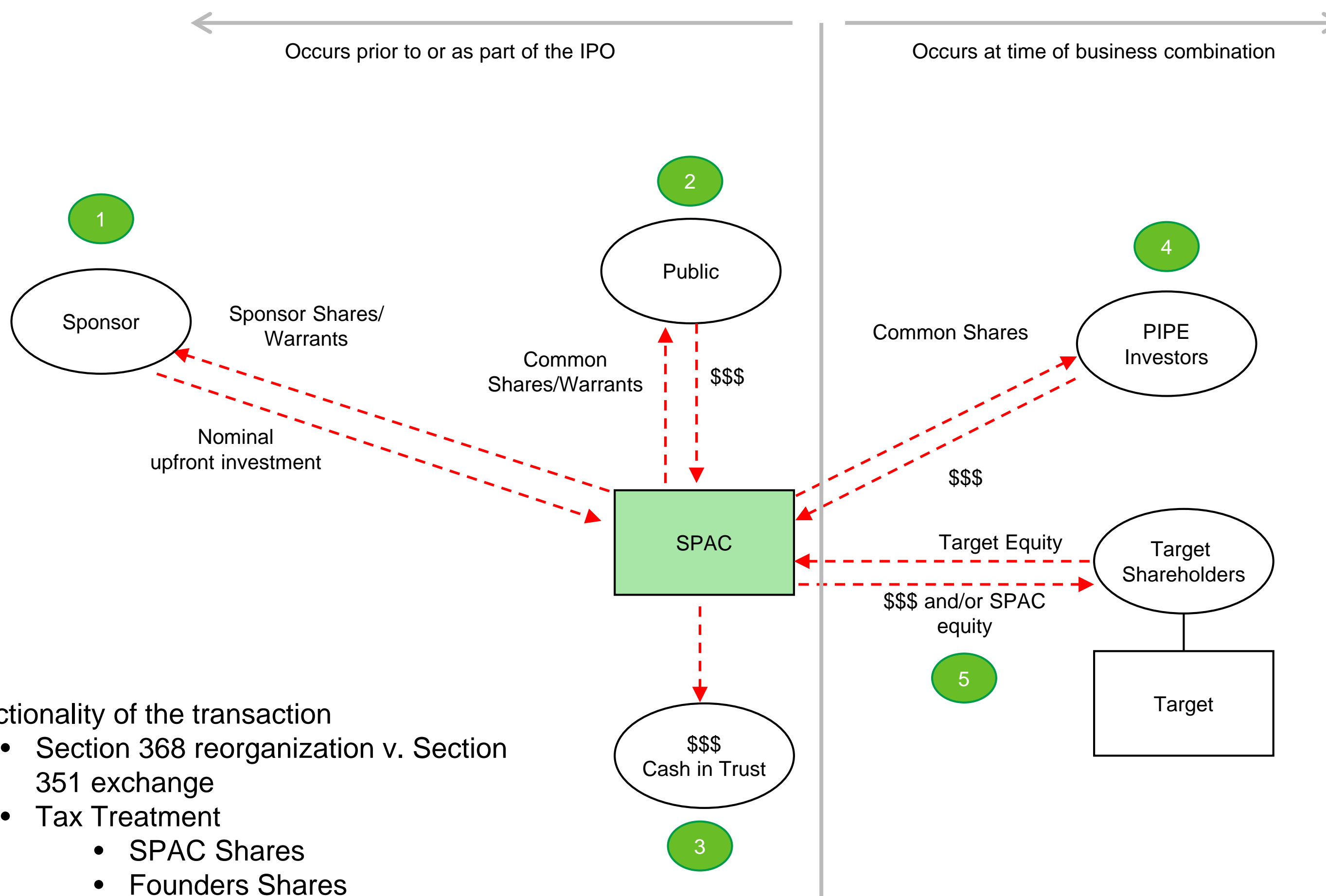
Weil

III. De-SPACing Tax Structuring

Weil

A. De-SPACing Overview

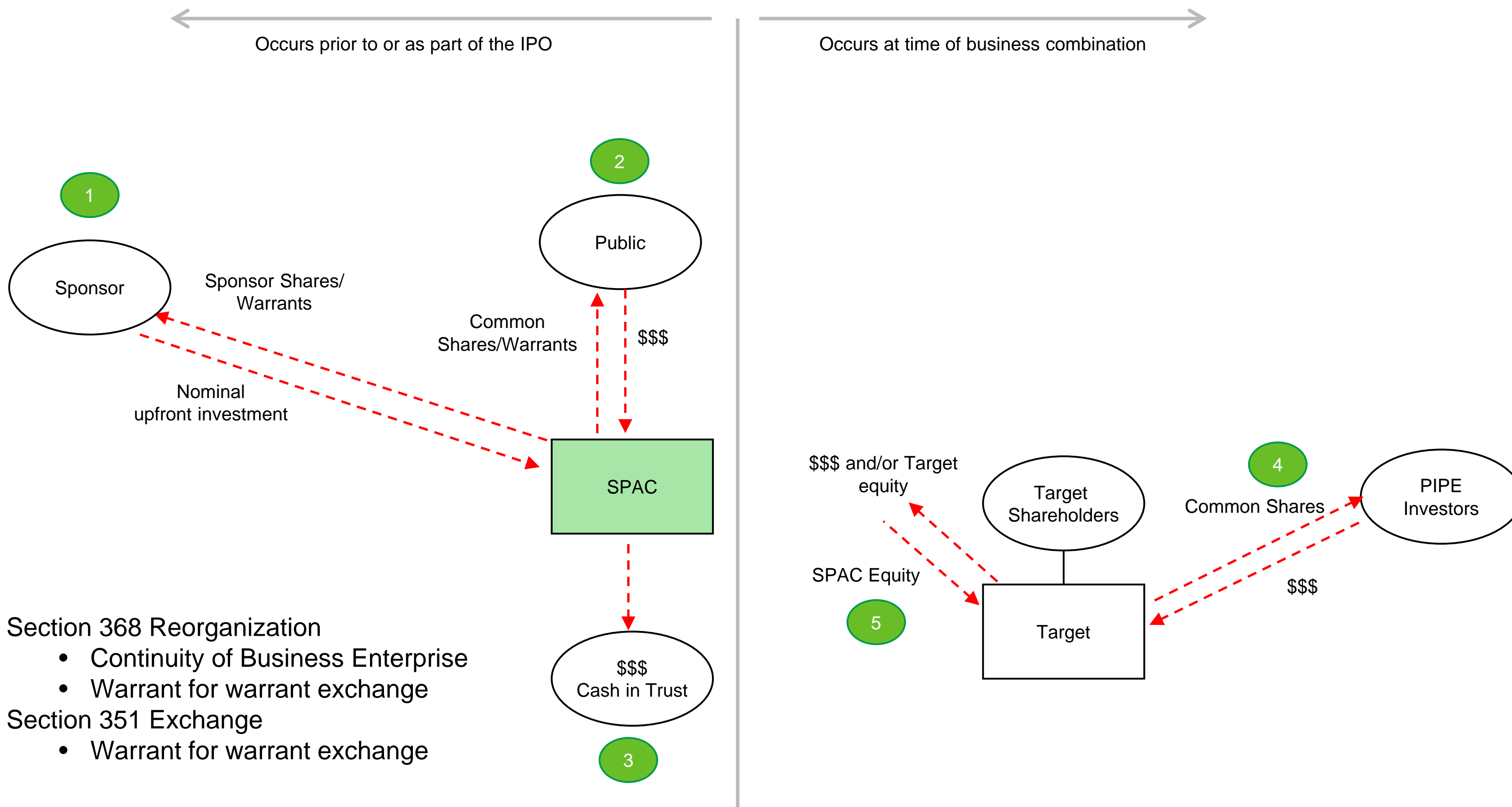
Typical SPAC acquisition structure



- Directionality of the transaction
  - Section 368 reorganization v. Section 351 exchange
  - Tax Treatment
    - SPAC Shares
    - Founders Shares
    - Warrants
    - Target Shares
  - Practical Solutions

SPAC as a target in the acquisition structure

Weil



- Section 368 Reorganization
  - Continuity of Business Enterprise
  - Warrant for warrant exchange
- Section 351 Exchange
  - Warrant for warrant exchange

Overview of domestic-to-domestic transactions

Weil

- Tax considerations depend on whether a SPAC is acquiring a target for 100% cash, 100% SPAC equity or a mix of cash and SPAC equity
- A 100% cash purchase is a taxable acquisition
- If consideration is a mix of cash and stock, target sellers may expect the business combination to qualify as a tax-free reorganization under Section 368(a)
- Target sellers can achieve tax deferral in certain circumstances where target is a flow-through entity

Overview of foreign-to-foreign transactions

Weil

- Since most SPACs have US persons as shareholders, there are many US tax considerations
- A foreign SPAC will likely manage "passive foreign investment company" ("PFIC") status by satisfying certain exceptions
- Foreign SPACs are typically incorporated in the Cayman Islands or the British Virgin Islands. Immediately prior to a business combination, a foreign SPAC will typically migrate to the jurisdiction of its identified target
  - Migration transactions typically take the form of an F reorganization
  - Implicates the foreign-to-foreign reorganization rules in Section 367(b)
- If the foreign target has US sellers, they may desire to structure the business combination as a tax-free reorganization transaction
  - Implicates the potential gain recognition rules in Section 367(a)

Foreign-to-foreign SPAC migration as tax-free F reorganization

Weil

- Foreign SPACs typically migrate via an F reorganization to the appropriate foreign jurisdiction prior to a business combination
  - Under Section 368(a)(1)(F), a “F reorganization” is a "mere change in identity, form, or place of organization of one corporation, however effected.” There is no “continuity of business enterprise” requirement.
  - If a SPAC changes its jurisdiction of incorporation, it is treated as a transfer by the migrating SPAC (“Old SPAC”) of all of its assets to a newly-formed SPAC (“New SPAC”) in exchange for New SPAC stock which Old SPAC distributes to its shareholders in complete liquidation. Old SPAC holders are treated as exchanging their Old SPAC equity for New SPAC equity. (see Treas. Reg. 1.367(b)-2(f)).
- Section 354 generally provides exchanging holders (including warrant holders) in a Section 368 reorganization with non-recognition treatment upon the exchange of stock/securities in one corporation for stock/securities in another corporation party to the reorganization
- Section 367(b) and accompanying regulations may cause US shareholders (but not warrant holders) to recognize income in a reorganization
  - In a foreign-to-foreign F reorganization, Section 367(b) generally would cause US shareholders to recognize income only where a U.S. Shareholder (under the CFC rules) of Old SPAC is not a U.S. Shareholder of New SPAC as a result of the reorganization
  - Because Sponsor Shares do not lose their special voting rights until the business combination, Sponsors that were U.S. Shareholders in Old SPAC would generally remain U.S. Shareholders in New SPAC
  - Note, that even if Sponsors did become non-U.S. Shareholders in the foreign-to-foreign F reorganization, because all of Old SPAC’s earnings would have been subpart F income, Sponsors would already be required to include their share of such income currently and therefore Section 367(b) would have no incremental tax impact
- Regulations proposed under Section 1291(f) do not apply to F reorganizations of one PFIC into another PFIC

Foreign-to-foreign business combination as tax-free reorganization

Weil

- US sellers of a foreign target may wish to structure the SPAC acquisition of target as a tax-free reorganization
- In addition to satisfying the requirements under Section 368, Section 367(a) must be analyzed
- Generally, a transfer of stock/securities by a US holder to a foreign corporation in a Section 354 exchange is subject to Section 367(a)(1) and a US holder must recognize gain unless an exception under the Section 367(a) regulations is satisfied
  - Under Treas. Reg. 1.367(a)-3(b)(1), US sellers would not be required to recognize gain if (i) they own less than 5% of target or (ii) they enter into a 5 year gain recognition agreement
  - If the foreign-to-foreign reorganization is structured as an asset reorganization, the transaction will generally be excepted from the requirements of Section 367(a) (see Treas. Reg. 1.367(a)-3(a)(2)(ii)).
- Even if the foreign-to-foreign reorganization is an asset reorganization excepted from 367(a), Section 367(b) and accompanying regulations may still cause US shareholders to recognize income where a U.S. Shareholder (under the CFC rules) of the target is not a U.S. Shareholder of the SPAC immediately following the reorganization

Weil

B. De-SPACing Domestic SPACs with Foreign Targets

Weil

Domestic SPAC with a foreign target

- As discussed above, Sponsors seeking foreign targets typically set up foreign SPACs
- If a domestic SPAC happens to identify a foreign target, it would typically attempt to expatriate to the jurisdiction of the foreign target prior to the business combination
  - Note that simply maintaining a domestic SPAC operating the target as a foreign business would be tax-inefficient, as the foreign business would be a CFC (if organized as a corporation) or the SPAC would be subject to taxation in the foreign jurisdiction
- An expatriation transaction would typically be structured as a domestic-to-foreign F reorganization
  - The domestic SPAC is treated as transferring all of its assets to a newly-formed foreign SPAC in exchange for foreign SPAC stock which domestic SPAC distributes to its shareholders in complete liquidation. Domestic SPAC holders are treated as exchanging their domestic SPAC equity for foreign SPAC equity.
- In addition to Section 367(a), expatriations in this context implicate the anti-inversion rules contained in Section 7874 and accompanying regulations. These provisions in many circumstances prevent transactions proceeding in this manner

Weil

Anti-inversion rules

- Under Section 7874, an "inversion" occurs where a foreign corporation acquires substantially all of a domestic business whose former owners own 60% or more (by vote or value) of the foreign acquiring corporation after the transaction by reason of their ownership in the domestic business
- If former owners of the domestic business own 80% or more (by vote or value) of the foreign acquiring corporation, then the foreign corporation is treated as domestic for all US tax purposes
  - 60% and 80% tests are referred to herein as the "Ownership Tests"
  - Must follow special anti-inversion rules when calculating Ownership Tests, which can result in "tax" ownership that differs from actual ownership
- Because the SPAC's ownership profile will be the same before and after the expatriation F reorganization, the SPAC will "fail" the 80% Ownership Test and will continue to be treated as a US corporation for US tax purposes
- "Substantial business activities" exception may apply to except SPAC expatriation from Section 7874

Weil

C. De-SPACing Foreign SPACs with Domestic Targets

Foreign SPAC with domestic target, generally

Weil

- Sponsors seeking domestic targets typically set up domestic SPACs
- If a foreign SPAC happens to identify a domestic target, it would typically attempt to migrate from the foreign jurisdiction to the United States in an inbound F reorganization prior to the business combination (a "domestication")
  - The foreign SPAC would be treated as transferring all of its assets to a newly-formed domestic SPAC in exchange for domestic SPAC stock which foreign SPAC distributes to its shareholders in complete liquidation. Foreign SPAC holders would be treated as exchanging their foreign SPAC equity for domestic SPAC equity.
- Section 367(b) may apply upon a domestication
- PFIC rules, including regulations proposed under Section 1291(f), may apply upon a domestication

Weil

PFIC Start-up exception revisited

- Because a SPAC owns only cash and stands to earn only interest income prior to a business combination, unless a foreign SPAC can avail itself of the start-up exception, it will be treated as a PFIC
- How can the SPAC satisfy the start-up exception?
  - If the SPAC invests its IPO proceeds in an non-interest bearing trust account, it will not earn gross-income until the business combination, and should be able to avail itself of the start-up exception
  - If the SPAC earns interest income on its IPO proceeds in its first year, but it domesticates prior to the end of its first year, the SPAC should meet the start-up exception
    - Under Treas. Reg. 1.367(b)-2(f)(4), an inbound F reorganization will cause the SPAC's taxable year to close
    - The SPAC's first taxable year, which ends at the close of the day of the F reorganization, will constitute its "start-up year"
    - Presumably, the SPAC will not be a PFIC for its second taxable year (the short year beginning the day after the F reorganization and ending on the last calendar day of the calendar year of its formation) as it will not be a foreign corporation
    - Presumably, the SPAC will not be a PFIC for its third taxable year as it will not be a foreign corporation
  - If the SPAC earns interest income in its first year, completes the business combination in its second year and domesticates on the last day of its second year, it should meet the start-up exception

Consequences of Section 367(b) and PFIC rules to shareholders in a domestication

Weil

- Under Section 367(b):
  - a US shareholder who, at the time of the domestication owns 10% or more of the voting power of the SPAC must include in income as a dividend the "all earnings and profits amount" ("All E&P Amount")
  - A US shareholder who, at the time of the domestication, owns less than 10% of the voting power of the SPAC must either recognize gain with respect to the disposition of is shares or elect to recognize its All E&P Amount
  - A US shareholder's All E&P Amount is the net positive E&P of the SPAC (as determined under Treas. Reg. 1.367(b)-2(d)(2)) attributable to the SPAC shares
- Consequences to Sponsors:
  - No PFIC/CFC overlap
  - Because the foreign SPAC may be a CFC, the Sponsors would have been required to currently include the SPAC's earnings as subpart F income and there will be no incremental tax consequence of the All E&P Amount inclusion
- Consequences to Public:
  - If the SPAC is not a PFIC, public holders of common shares must include their appropriate share of SPAC's All E&P Amount
  - If the SPAC is a PFIC, unless a shareholder makes a QEF election for the SPAC's first taxable year, it must include in income either (i) its appropriate share of the All E&P Amount under Section 367(b) or (ii) if regulations proposed under Section 1291(f) are followed, the gain realized on the exchange as an "excess distribution" under Section 1291 (including the punitive deferred interest charge)
  - Can avoid uncertainty of applicability of the proposed regulations by timely making a QEF election for the SPAC's first taxable year and including appropriate share of SPAC's earnings in income currently
- In all cases, the interest earned on the IPO trust funds will be relatively nominal, and thus the All E&P Amount will be relatively nominal

Consequences of PFIC rules to warrantholders in the domestication where SPAC is a PFIC

Weil

- Section 367(b) should not apply to warrants
  - Warrantholders remain eligible for 354 tax-free treatment on the exchange of SPAC warrants in the domestication
- No CFC/PFIC overlap on warrants
- No QEF Election available for warrants
- Regulations proposed under Section 1291(f) would cause the exchange of warrants in the foreign-to-domestic F reorganization to be taxable
- If the regulations proposed under Section 1291(f) do not apply, the warrant exchanges would remain eligible for tax-free treatment under Section 354
- Section 1291(f) requires that "to the extent provided in regulations" a US person that disposes of stock of a PFIC must recognize gain notwithstanding any other provision of the Code
  - Section 1298(a)(4) provides that, "to the extent provided in regulations" an option for PFIC stock is treated as PFIC stock
- No final Treasury regulations are currently in effect under Section 1291(f) or Section 1298(a)(4). Proposed regulations were promulgated in 1992, with a retroactive effective date if finalized.
  - The proposed regulations would require gain recognition by a US holder with respect to its exchange of foreign SPAC securities for domestic SPAC securities in the domestication
  - Such gain would be treated as an "excess distribution" made in the year of the domestication and subject to the special tax and interest charge rules discussed earlier
  - The proposed regulations include coordinating rules with Section 367(b), whereby the gain realized on the transfer is taxable as an excess distribution under Section 1291

Weil

D. De-SPACing Domestic SPACs with a Flow Through Target

Weil

Domestic SPACs

- If reasonably certain that you are pursuing a domestic target, then a domestic SPAC is a great option
- For domestic-to-domestic business combinations, the issues tend to relate to structuring for a tax-free rollover and whether there will be a TRA and the terms of the TRA
  - Entity classification of the target affects structuring choices for receiving a tax-deferred rollover:
    - Flow-through target
    - Corporate target

Weil

Domestic SPACs: Flow-through targets

- There are only two ways to structure a tax-deferred rollover for target shareholders of a flow-through entity:

	Up-C	Double Dummy

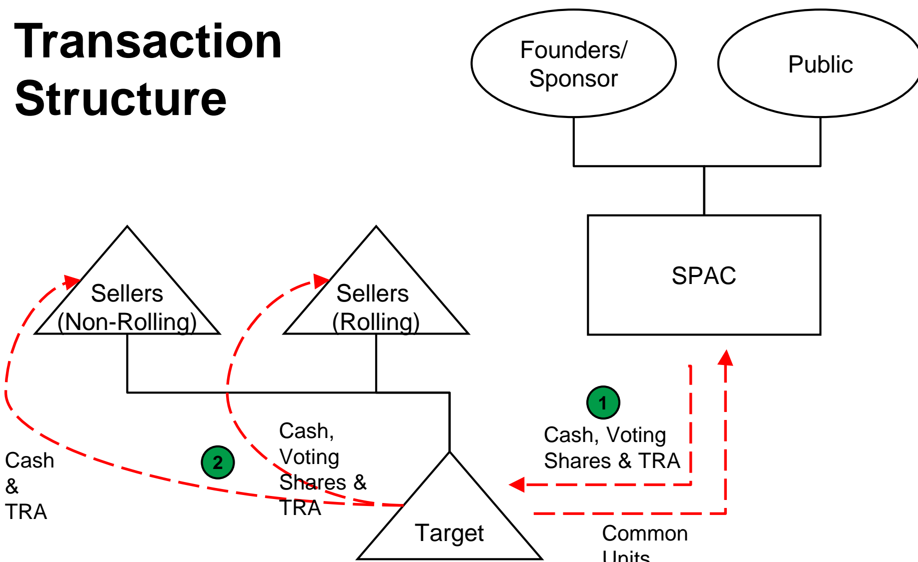
Benefits	• Access to tax shield from step-up on future dispositions by Seller (Rolling)
	• Maintains flexibility of partnership structure, which may provide for:
	  • Greater ability to provide tax-deferred rollover to sellers on future acquisitions
	  • Flexibility in economic sharing with Seller (Rolling)
	• Seller (Rolling) builds basis from allocations of income, which may provide for additional tax shield on future dispositions
	• Target shareholders can realize the benefit from any losses generated
		• Still aligns gain recognition with cash receipt (and provides tax-deferred rollover)
		• Simplified operating structure

Detriments	• Added complexity in negotiations and structure maintenance and compliance • Higher tax rate on operating income for individuals and potential additional tax-related cash outlay depending on negotiated tax distributions	• Lack of tax shield from step-up on future dispositions by Seller (Rolling) • The assumptions of debt by NewCo (without any repayment) may trigger gain to Seller (Rolling) on the transaction (see Section 357) • Lack of flexibility of partnership structure (see Benefits of Up-C) • Unable to achieve tax-free treatment under Section 351 for the exchange of warrants for warrants

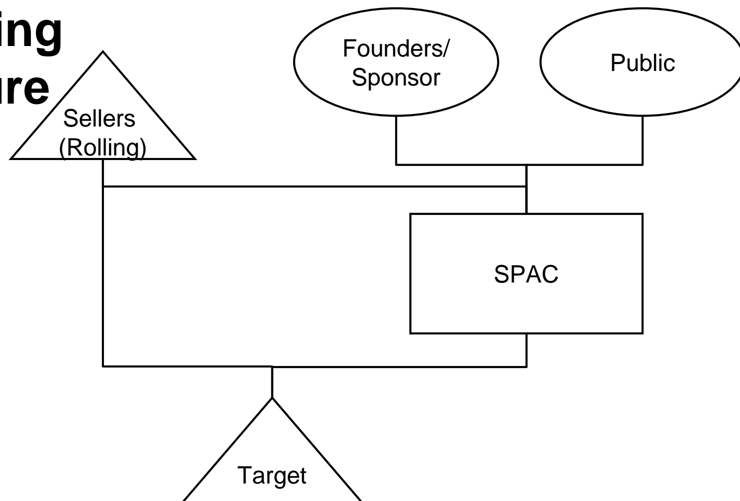
Flow-Through Target: Up-C

Weil

Transaction Structure



Operating Structure



Transaction Steps

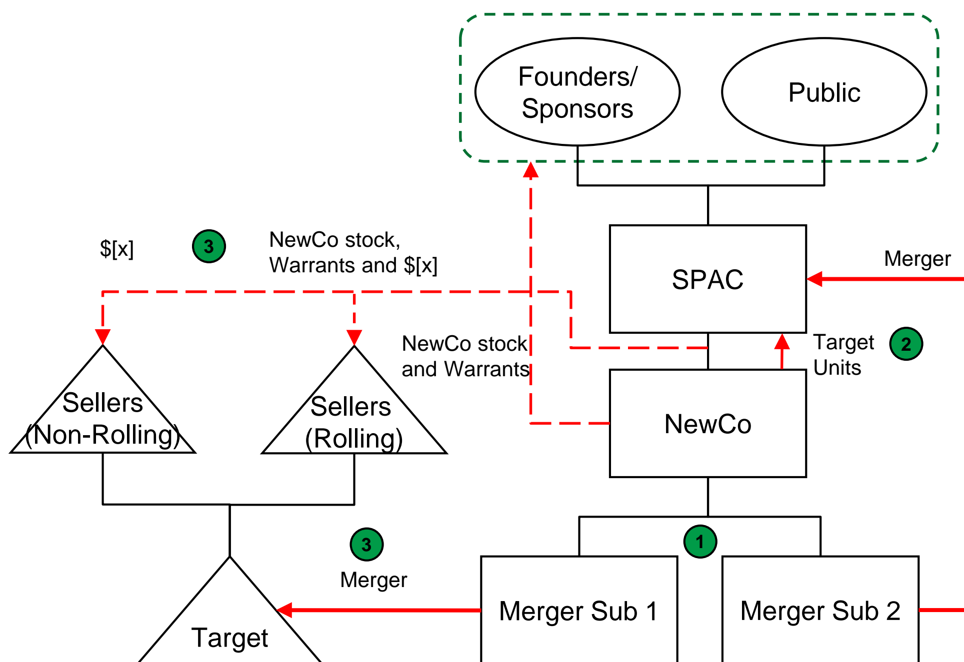
- Step 1: SPAC contributes the IPO proceeds to Target, as well as voting shares and TRA rights, and receives [x] common units of Target in return. SPAC becomes the managing member of Target
- Step 2: Target distributes $[x] of cash received from SPAC to the Sellers (Rolling) and Sellers (Non-Rolling). Seller (Rolling) and Sellers (Non-Rolling) also receive TRA rights. In addition, Seller (Rolling) receives voting shares of the SPAC
  - When viewed in connection with Step 1, the distribution will be treated as a disguised sale of Target units to SPAC, which may result in a step-up in tax basis in assets solely for the benefit of SPAC if Target has a Section 754 election in place
- Step 3: Target may use retained IPO proceeds to pay down existing debt and for other general corporate purposes

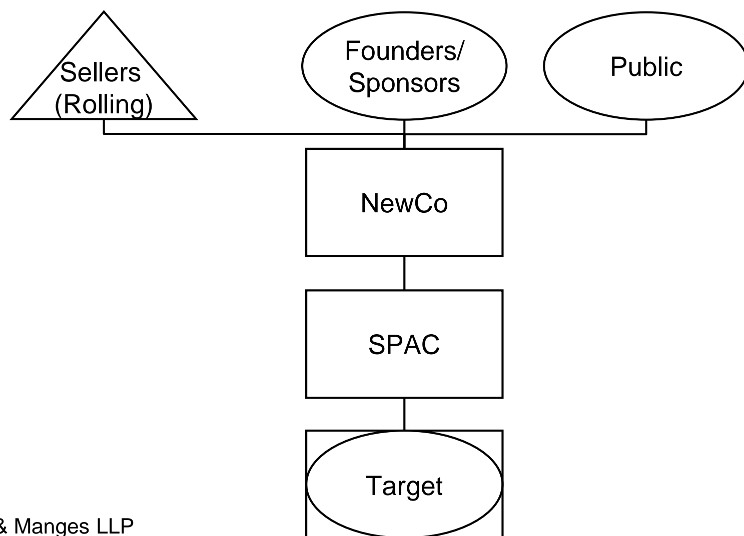
Considerations

- SPAC is the managing member of Target and thus controls the operations. This control provision allows SPAC to consolidate the operations of Target for financial statement purposes and avoid '40 Act issues
- Sellers (Rolling) hold SPAC class B voting shares commensurate with their economic interest in Target, and thus voting power is in line with their reduced economic interest in Target
- Sellers (Rolling) will have an exchange right and may put its Target units to the partnership, which has the option to satisfy this put with cash or SPAC shares
- Target may issue profits interests to Sellers (Rolling) and/or SPAC to align the parties equivalently with the upside of the Founders' preferred shares

Flow-Through Target: Double Dummy

Weil





Transaction Steps

- Step 1: SPAC forms NewCo, Merger Sub 1, and Merger Sub 2
- Step 2: SPAC and Merger Sub 2 merge, with SPAC surviving the merger, and Founders and Public receive NewCo stock
- Step 3: Target and Merger Sub 1 merge, with Target surviving the merger, and Seller (Rolling) receives NewCo stock and $[x] cash. Seller (Non-Rolling) receives $[x] cash only
- Step 4: NewCo may contribute Target units to SPAC

Considerations

- Steps 2 and 3 are intended to be treated as a tax-deferred Section 351 transaction. Any cash received as consideration is expected to be taxable to the Sellers and generates a tax basis step-up for NewCo.
- Question over how to structure an exchange of the warrants in a tax-free manner.
- Target is deemed to liquidate in accordance with the principles of Rev. Rul. 99-6

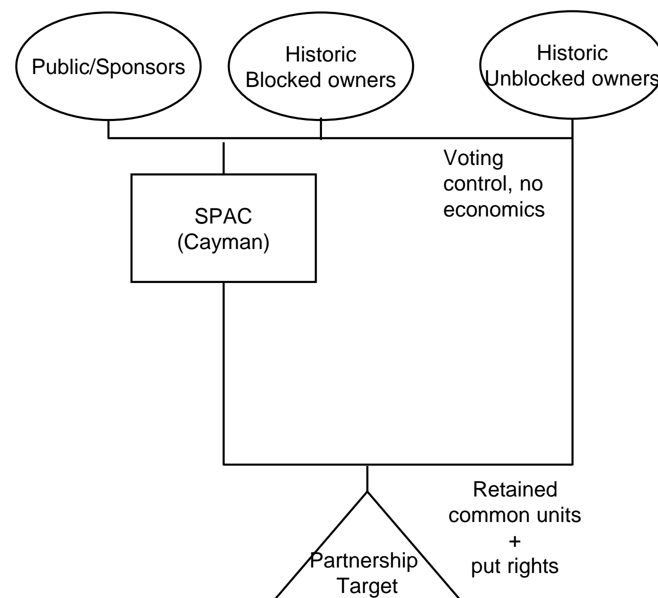
Weil

E. De-SPACing Foreign SPACs with a Flow Through Target

Weil

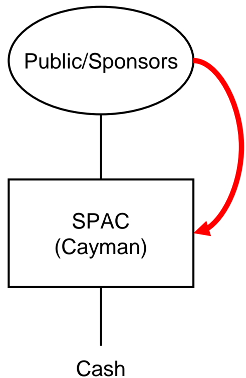
What is an Up-C?

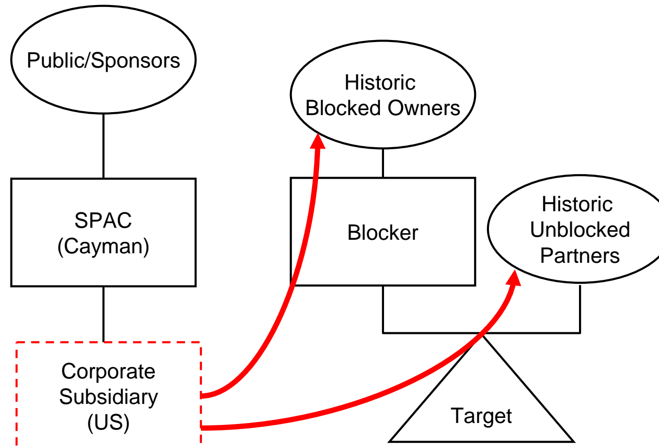
- **In a typical Up-C IPO, historic owners of a business operating in flow-through form ("Partnership Target") sell some Partnership Target interests to a (typically newly-formed) public company in exchange for cash (which cash the public company typically raises via an IPO) and admit it as the managing member/GP of the Partnership Target. In connection with the deal, the public company may issue special non-economic majority voting rights to the historic Partnership Target owners.**
- **The historic owners are granted rights to exchange their retained Partnership Target interests for cash or public company common shares in the future ("put rights"). They also often enter into a tax receivable agreement with the public company to effectively capture the majority of the value associated with the public company's tax basis step-up in Partnership Target's assets that is expected to result from these exchanges.**
- **If some of the Partnership Target's historic owners are "blocker corporations," then typically those blocker corporations do not retain Partnership Target interests, but instead the blockers merge with the public company, with their owners receiving cash and public company stock**

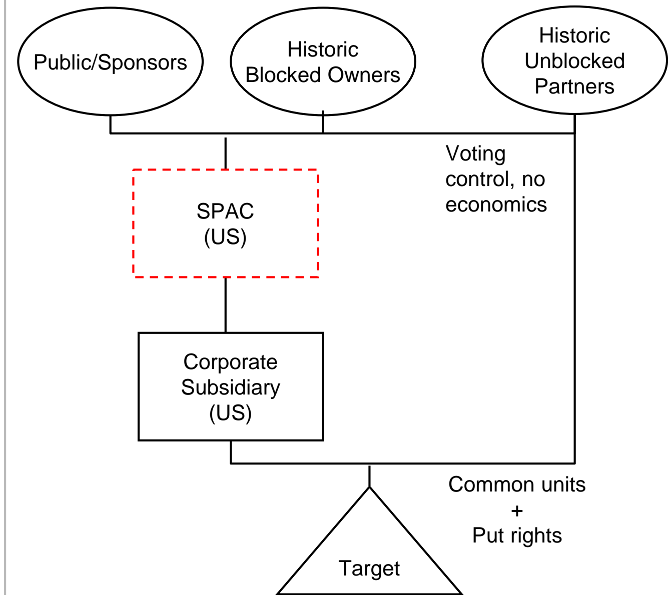


Can Up-C SPAC avoid PFIC status and navigate anti-inversion rules?

Weil







1. In year 1, Sponsors form SPAC and SPAC closes its IPO and issues stock/warrants to the public in exchange for cash, which it places in an interest-bearing trust. Trust earns income in year 1.

2. In year 2, SPAC forms a domestic corporate subsidiary and acquires a minority interest in Target in the first quarter of year 2 via an Up-C structure. In connection therewith, (i) historic unblocked partners receive put rights for their retained partnership interests and voting control of the SPAC and (ii) historic blocked owners receive cash and SPAC stock.

3. Simultaneous with close of year 2, SPAC domesticates via an inbound F reorganization. Because the SPAC's taxable year would not close until the end of year 2 during which it would have active assets and income, the SPAC likely would not be a PFIC for its second taxable year and could utilize the start-up exception.

Impact of anti-inversion rules

- Must analyze impact of anti-inversion rules, as the SPAC (a foreign corporation) is acquiring a domestic target whose historic owners are receiving SPAC shares (for the historic blocked owners) and interests exchangeable into SPAC shares (for the historic unblocked owners via the put rights)
- Impact on historic blocked owners:
  - Section 7874(c)(2)(B) provides that stock sold by foreign acquiring corporation in a public offering related to the business combination is not included when calculating the anti-inversion Ownership Percentages
    - Because the SPAC common shares held by the public were issued in an IPO and are treated as nonexistent, historic blocked owners would be treated as owning 100% of SPAC (exceeding the 80% Ownership Percentage) and SPAC would be treated as domestic corporation
    - Treas. Reg. 1.7874-2(j) provides that the deemed “domestication” resulting from a failed inversion under Section 7874 occurs via an inbound F reorganization, resulting in the close of the SPAC’s taxable year at the time of the business combination
    - One potential solution is that the historic blocked owners could instead (i) retain the non-cashed out portion of their blocker corporation shares, (ii) co-own the blocker corporations with the SPAC for a period of time and (iii) receive a put right for SPAC shares exercisable at some future date
      - Historic blocked owners would then be analyzed in the same way as historic unblocked owners for purposes of the anti-inversion rules

Weil

Impact of anti-inversion rules continued

- Impact on historic unblocked owners:
  - Treas. Reg. 1.7874-2(h)(1) provides that options for stock in the foreign acquirer are treated as stock therein for purposes of calculating the Ownership Percentage
    - Put rights likely trip up this rule
    - Query whether locking up put rights until after the domestication solves the problem
  - Treas. Reg. 1.7874-2(i) provides that an interest will be treated as stock in the foreign corporation if it provides the holder distribution rights that are substantially similar in all material respects to the distribution rights provided by stock therein
    - Example 18 involves facts similar to our Case Study, where partnership ("PS") is owned by historic partners and a foreign corporation. The historic partners are entitled to distribution rights from PS approximately equal to any dividend distributions made by foreign acquirer with respect to its publicly traded stock. Historic partners also have a put right against PS for cash equal to the value of foreign acquirer stock.
    - Query whether the fact that historic partners do not bear corporate-level tax makes their distribution rights substantially different
    - Query whether historic partners' voting control interest in SPAC causes voting Ownership Percentage problem