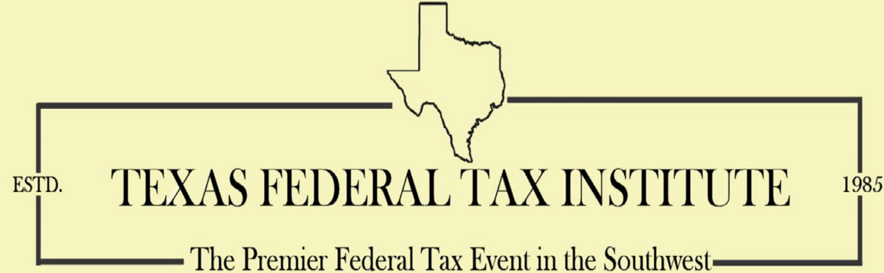

SPACs

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I. Overview of SPACs

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
- 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)

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 instead to exercise their redemption rights

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 to 20% of post-IPO common shares value (the "Sponsor Promote")
  - Largest SPAC ever ($4BN) 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

Capital Structure: Additional funds

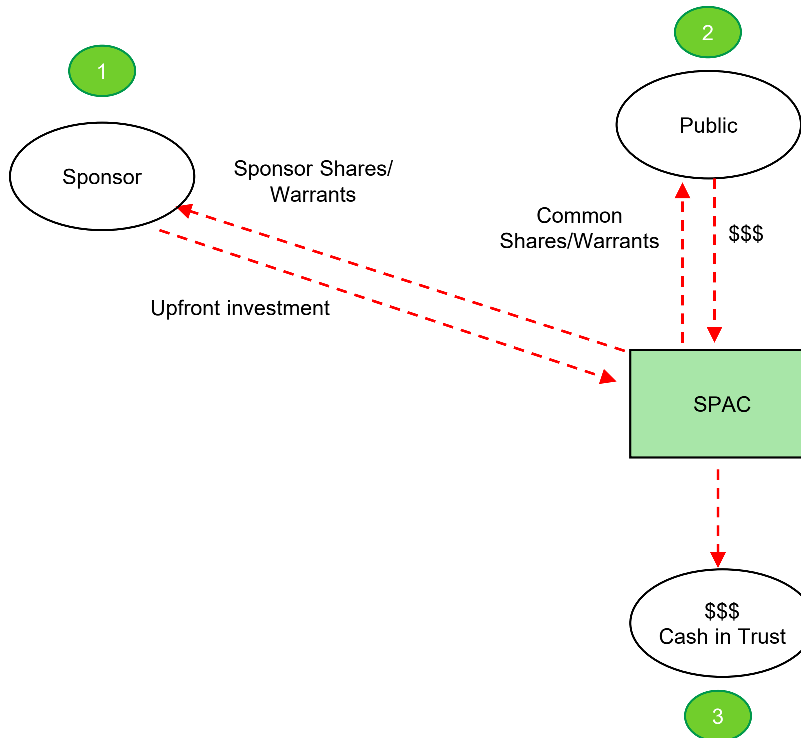
- If additional cash is needed to finance a business combination (i.e., because IPO proceeds won't cover the price of the identified target), a SPAC may raise funds in a private issuance of additional equity
  - Such private issuances often take the form of a "private investment in public equity" (a "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

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

II. Basic SPAC Formation Tax Issues

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)

Type of SPAC	Type of Acquisition Target	General Post-Acquisition Topco Structure
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 ▪ Seller may prefer an Up-C structure
U.S. Corp	**Foreign Corp**	▪ Foreign Corporation ▪ 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) ▪ Seller may want an Up-C structure
Foreign Corp	**Foreign Entity / Business**	▪ Foreign Corporation

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***

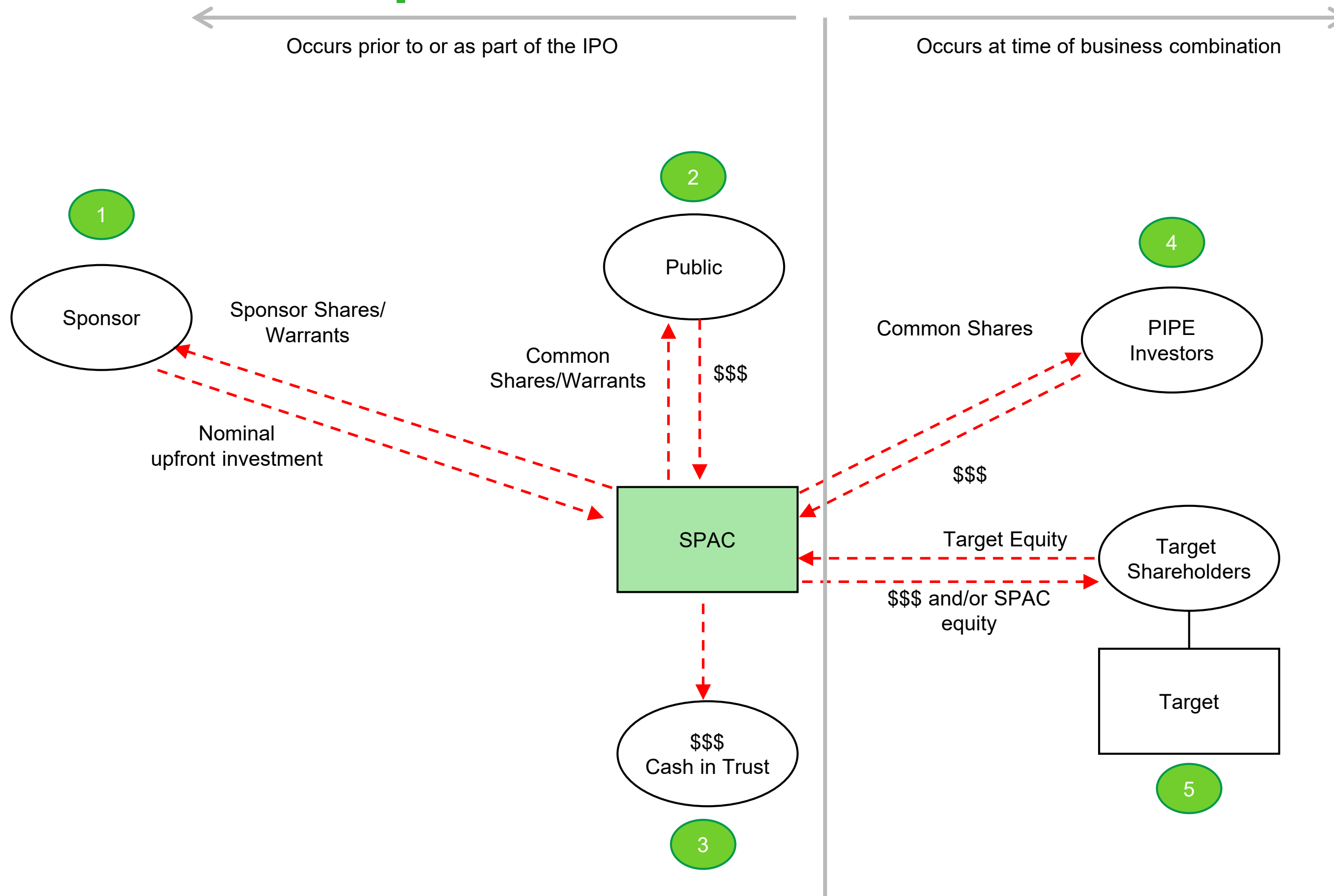
- **SPAC side also prefers non-taxable or tax-free transaction from its perspective – SPAC shareholders and warrant holders do not receive any cash in the de-SPAC transaction (unless they exercise their redemption right)**

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

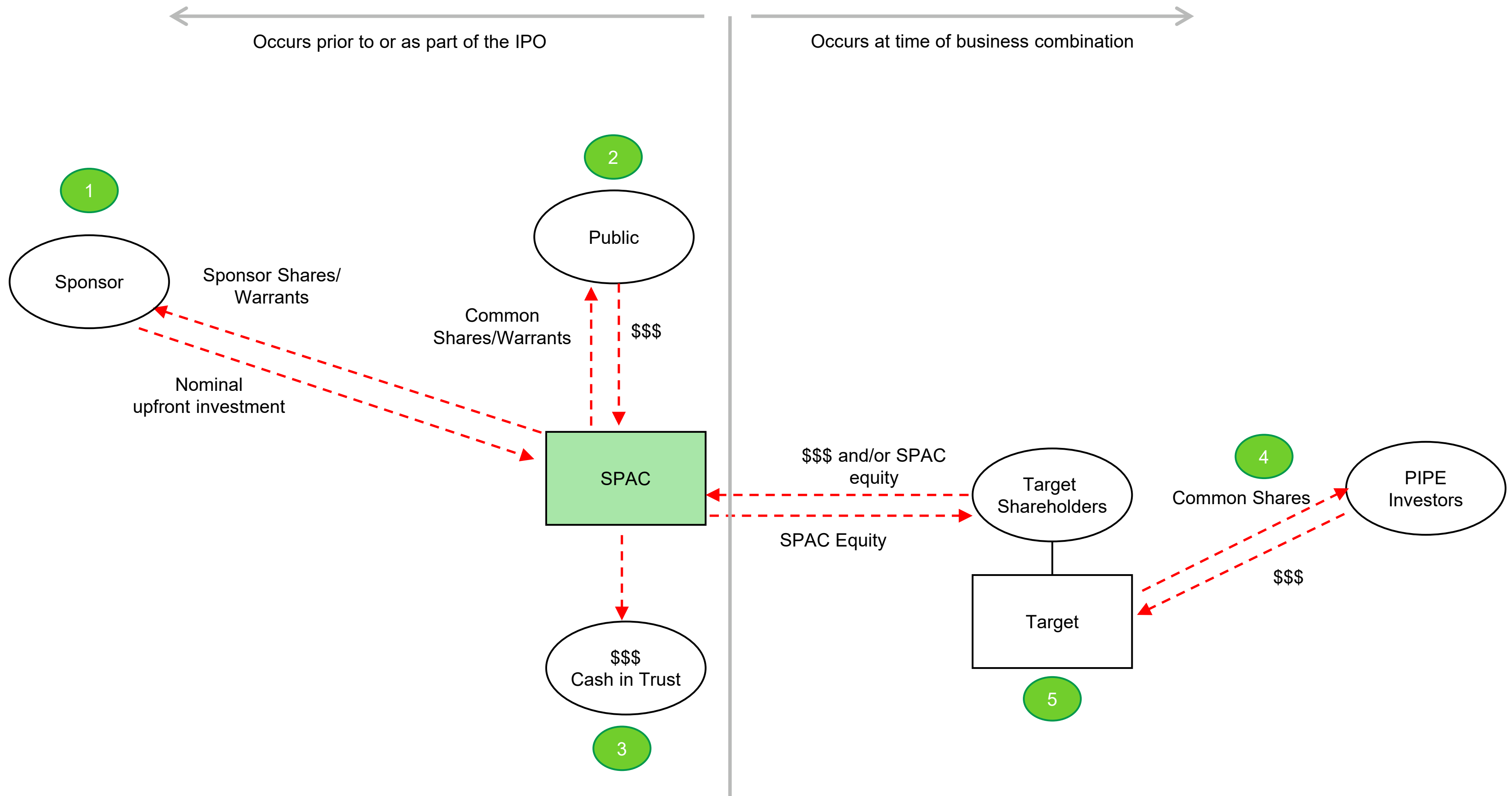
III. DE-SPACING TAX STRUCTURING

A. De-SPACing Overview

Typical SPAC acquisition structure



SPAC as a target in the acquisition structure

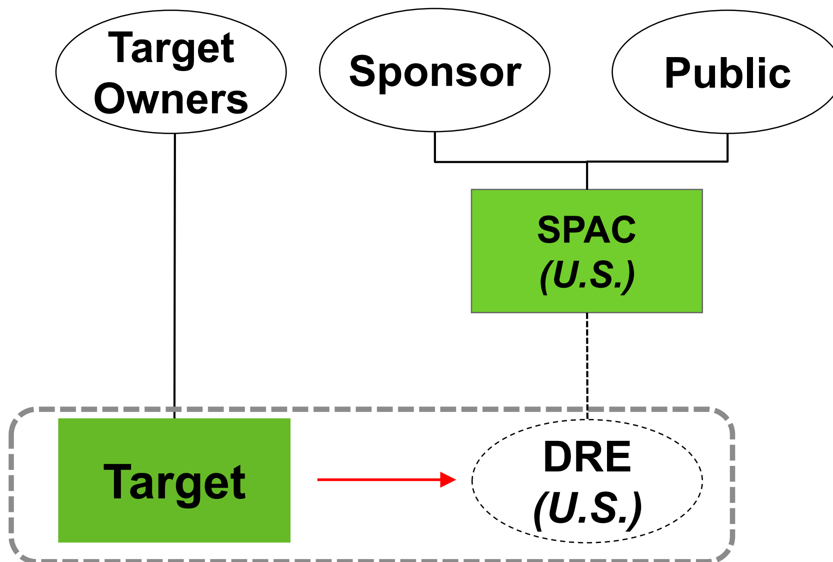


B. DE-SPACING DOMESTIC SPACS WITH DOMESTIC TARGETS

Overview of domestic-to-domestic transactions

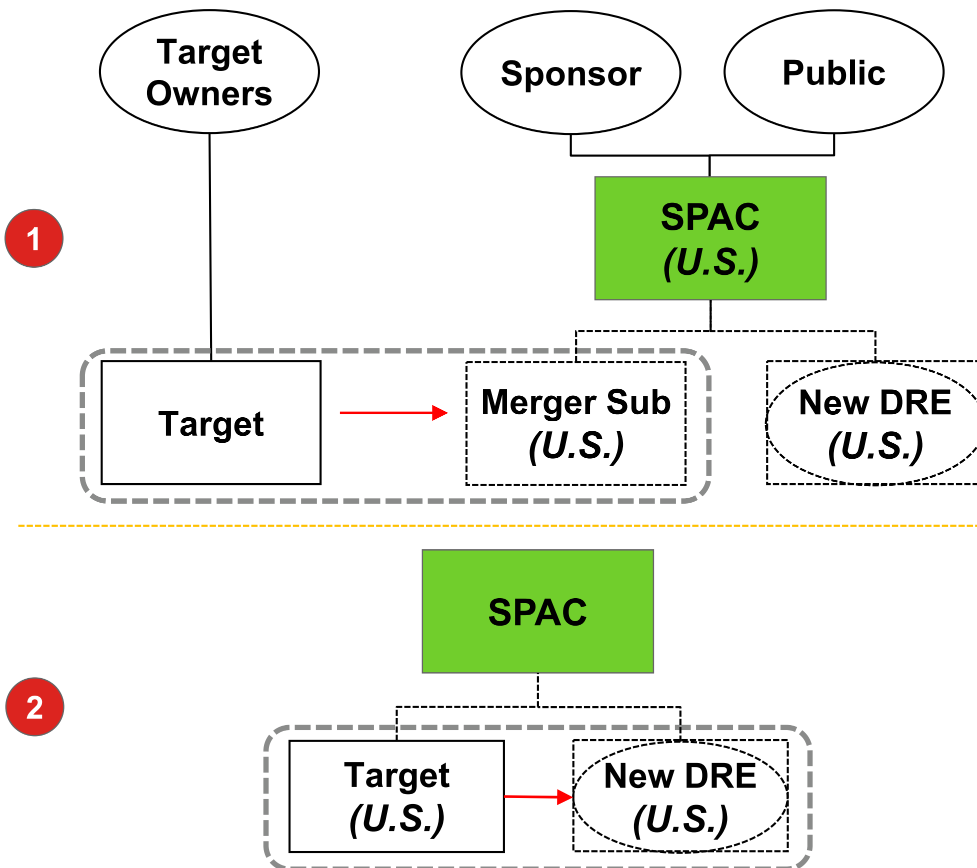
- If reasonably certain that you are pursuing a domestic target, then a domestic SPAC is a great option
- For domestic-to-domestic business combinations, the issues tend to relate to structuring for a tax-free rollover and issues regarding tax receivable agreements ("TRAS")
- Entity classification of the target affects structuring choices for receiving a tax-deferred rollover:
  - Corporate target - If consideration is a mix of cash and stock, target sellers may expect the business combination to qualify as a tax-free reorganization with "boot" under Section 368(a)
  - Flow-through target
- 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

US SPAC / US Target – Reorganizations



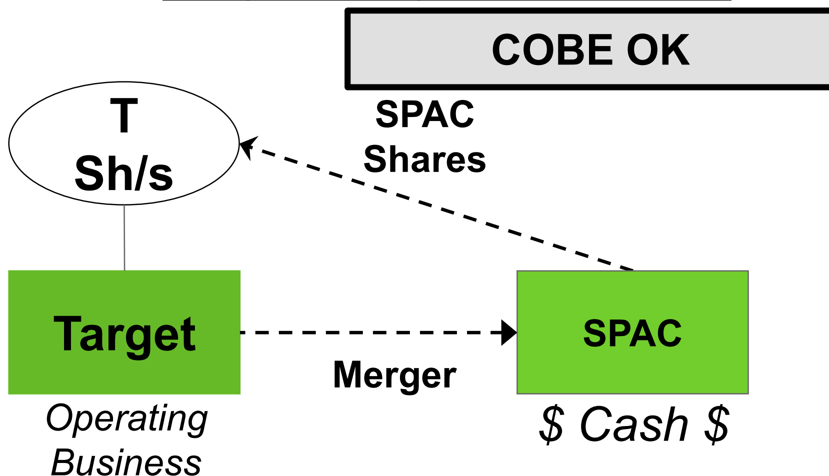
- **Transaction Structure**
  - Target merges into SPAC to an entity disregarded as separate from SPAC for US federal tax purposes
  - Intended to qualify as a reorganization under Section 368(a)(1)(A)
- **Key Tax Considerations**
  - Up to 60% "boot" permissible
  - No "substantially all" requirement
  - Must meet "continuity of business enterprise" requirement

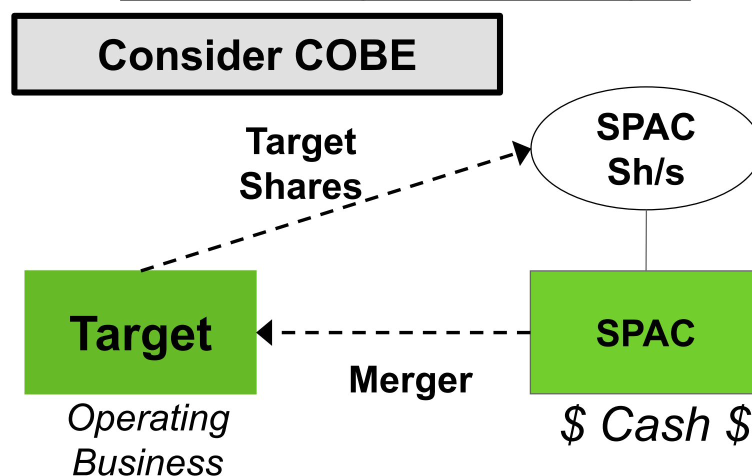
US SPAC / US Target – Reorganizations (cont'd)



- **Transaction Structure**
  - Step 1. Newly-formed merger subsidiary merges with and into Target
  - Step 2. Target merges into SPAC to an entity disregarded as separate from SPAC for US federal tax purposes
  - Intended to qualify as a reorganization under Section 368(a)(1)(A)
- **Key Tax Considerations**
  - If transaction fails to qualify as an "A" reorganization:
    - Step 1 is intended to be treated as a taxable acquisition of Target stock
    - Step 2 is intended to be treated as a tax-free liquidation of Target into SPAC

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**

C. DE-SPACING DOMESTIC SPACS WITH A FLOW THROUGH TARGET

Domestic SPACs: Flow-through targets

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

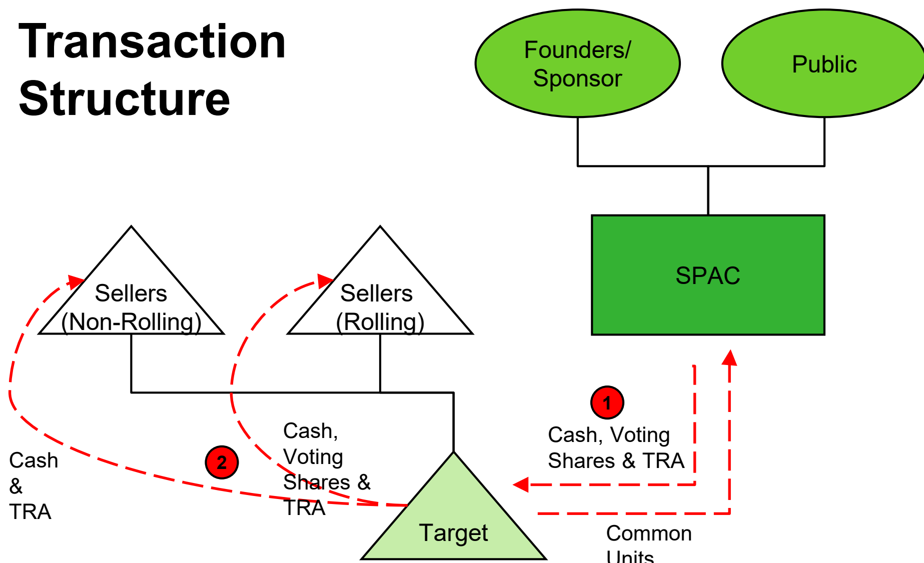
	Up-C	Double Dummy

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 losses generated
		• Still aligns gain recognition with cash receipt (and provides tax-deferred rollover)
		• Simplified operating structure

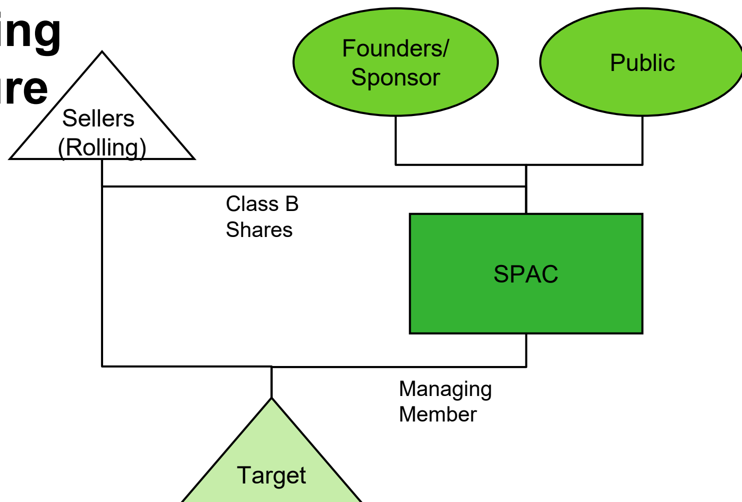
Detriments	• Added complexity in negotiations, structure maintenance and compliance • Higher tax rate on operating income for individuals and potential additional tax-related cash outlay depending on negotiated tax distributions	• Lack of tax shield from step-up on future dispositions by Seller • The assumptions of debt by NewCo (without any repayment) may trigger gain to Seller 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

Transaction Structure



Operating Structure



Transaction

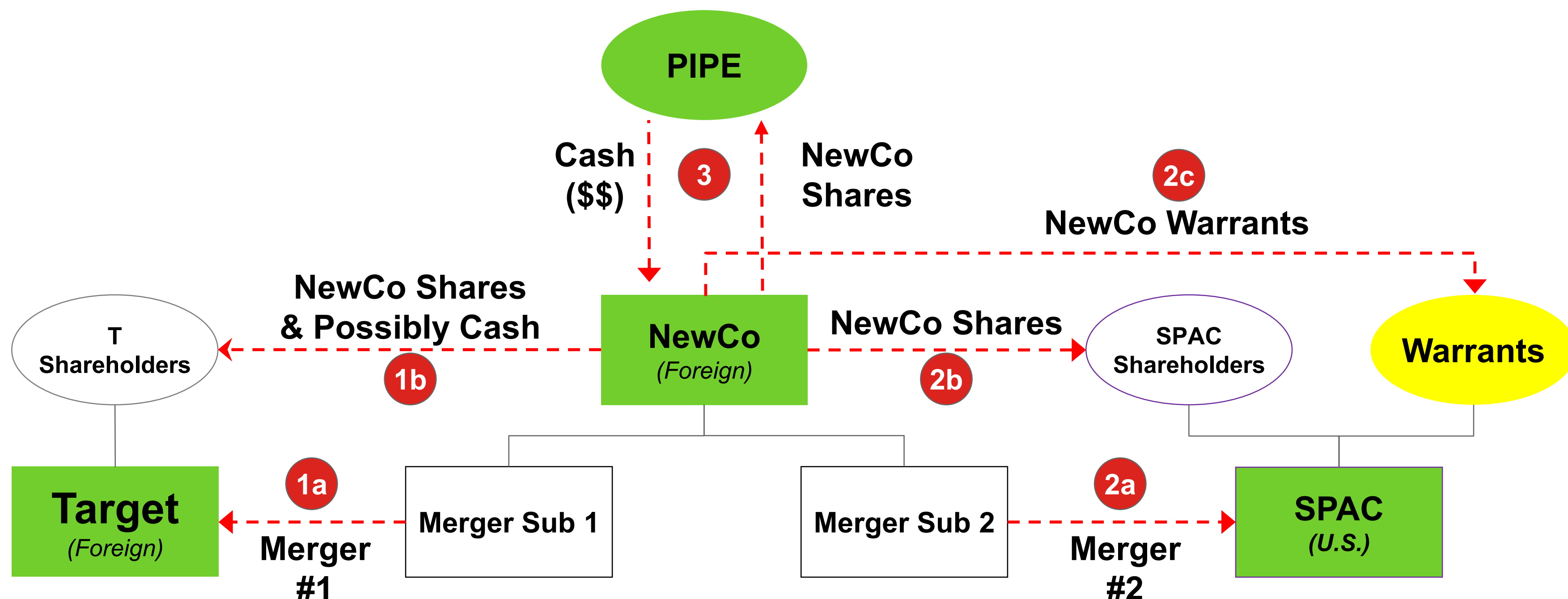
- Step 1: SPAC contributes the IPO proceeds to Target, as well as voting shares and TRA rights, and receives [x] common units of Target in return. SPAC becomes the managing member of Target
- Step 2: Target distributes $[x] of cash received from SPAC to the Sellers (Rolling) and Sellers (Non-Rolling). Seller (Rolling) and Sellers (Non-Rolling) also receive TRA rights. In addition, Seller (Rolling) receives voting shares of the SPAC and exchange rights structure
- Step 3: Target may use retained IPO proceeds to pay down existing debt and for other general corporate purposes

Key Tax Considerations

- Exchanges of partnership interests for SPAC common stock results in a stepped up assets basis to partnership (as a result of a Section 754 election)
- If Steps 1 and 2 are combined as a “disguised sale”, the transaction may also result in a stepped up asset basis
- Under the terms of a TRA, partners (or members) are compensated for the value of the stepped-up basis

C. DE-SPACING DOMESTIC SPACS WITH FOREIGN TARGETS

Horizontal Double Dummy



- **Transaction is intended to qualify as a valid Section 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)**

Domestic SPAC with a foreign target

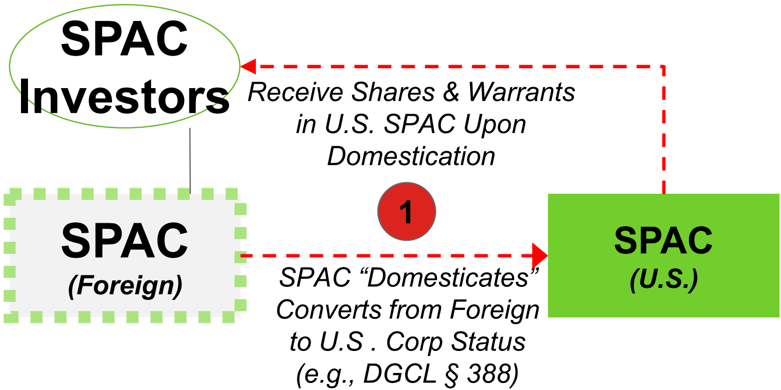
- As discussed above, Sponsors seeking foreign targets typically set up foreign SPACs
- If a domestic SPAC happens to identify a foreign target, it would typically attempt to expatriate to the jurisdiction of the foreign target prior to the business combination
  - Note that simply maintaining a domestic 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 Horizontal Double Dummy transaction (a section 351)
- 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

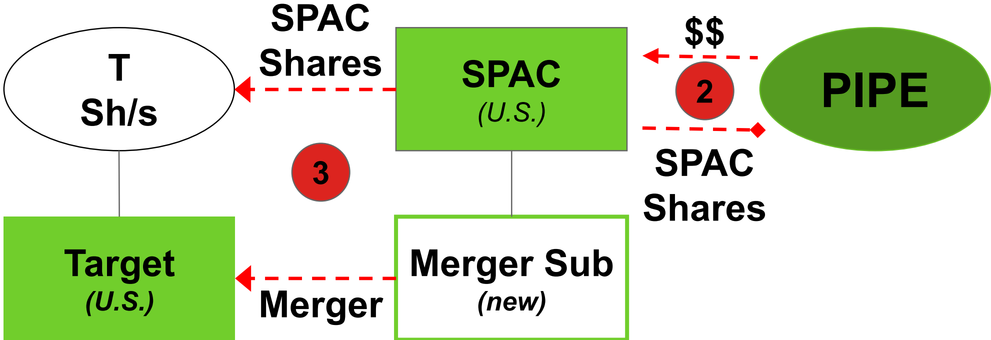
Anti-inversion rules

- 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
- “Substantial business activities” exception may apply to except SPAC expatriation from Section 7874

D. DE-SPACING FOREIGN SPACS WITH DOMESTIC TARGETS

Domestication





- **Domestication**: SPAC converts from being a foreign corporation (e.g., Cayman Islands) to a U.S. corporation (e.g., 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 "passive foreign investment company" ("PFIC") – avoids having to pick up any extra income on domestication beyond the All E&P amount
  - Taxation of SPAC warrants not clear under the PFIC rules (if they apply)
- **Acquisition / Combination**:
  - SPAC's acquisition of Target stock generally intended to qualify as a tax-free reorganization

Overview of foreign-to-foreign transactions

- Since most SPACs have US persons as shareholders, there are many US tax considerations
- A foreign SPAC will likely manage 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 holders, 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 SPAC with domestic target, generally

- 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

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

- 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 shareholder’s 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

- 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