SPACs and De-SPAC Transactions:
Key Tax Issues, Business Challenges and Shareholder Considerations

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September 29, 2021
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I. Overview of SPACs
What is a SPAC?

- A SPAC is a “Special Purpose Acquisition Company” also known as a “blank-check company”. It has no operations, but has been formed for the sole purpose of raising equity capital through an initial public offering (“IPO”) to acquire a not yet identified operating business (a “business combination” or “de-SPAC”)
- Typically formed by well known private equity/hedge fund sponsors, business executives or marque investors relying on their reputation and experience to attract other investors
- IPO proceeds are placed in a trust account and are used to fund expenses and the eventual business combination, including, in some cases, future operations
- 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 (although there is an increasing percentages of SPACs with a shorter time period)
- SPAC IPO volume so far in 2021: ~ $126 bn (441+ IPOs)
- 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” for $10 per unit to public investors in an IPO
  - Each unit generally consists of one common share and warrants
    - The warrants give the holder the right to purchase additional shares of common stock at a specified price ($11.50 per share)
    - The share/warrant ratio varies by SPAC offering (e.g., 1 share + ½ warrant, 1 share + 1/3 warrant, etc.)
    - Common shares and warrants are publicly traded and trade separately (after an underwriter overallotment period)
      - Public warrants are exercisable and callable at a specified premium to issuance price
  - Once the proposed business combination is put to shareholder vote, the shareholders have the right to redeem their shares for their proportionate share of the proceeds in the trust
Capital Structure: Sponsors’ securities

- Sponsors form the SPAC by purchasing common shares for cash up front -- “Sponsor Shares” -- prior to any potential IPO
  - Sponsor Shares have limited liquidity, as insiders typically cannot sell for a lock-up period (1-3 years following the business combination)
  - Generally, Sponsor Shares entitle Sponsors to control the board/elect directors prior to a business combination
  - Sponsors do not have any redemption rights, agree to vote to approve business combination, waive rights to liquidating distributions from trust for failed business combination

- Sponsor Shares represent 20% of post-IPO common shares

- “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

- A SPAC may also raise additional funds in connection with the de-SPAC transaction by issuing common shares to one or more institutional investors via a “PIPE” transaction.

- “PIPE” stands for “private investment in public equity” and the shares issued in the PIPE are identical to the shares already purchased by the public in the IPO. Unlike the public, the PIPE shareholders have no need for, and do not have any, redemption right.

- PIPEs allow SPACs to pursue even larger potential transactions and also demonstrate to the existing public shareholders the confidence other institutional investors have in the announced de-SPAC transaction.

- 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?

- Earn-outs have been used frequently by SPACs in connection with business combinations as part of the negotiation process with the target sellers.
- Earn-outs offered by a SPAC to target sellers may take various forms, including the form of SPAC warrants exercisable upon a specified level of SPAC common share appreciation.
- Earn-outs may also 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). By comparison, Sponsors in the market for foreign targets generally form a foreign SPAC (a “foreign-to-foreign” transaction).
- 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.
- But, the preferred organizational structure for the ultimate target corporation / business will not be known at the time of the SPAC formation and IPO because the de-SPAC target is still TBD.

<table>
<thead>
<tr>
<th>Type of SPAC</th>
<th>Type of Acquisition Target</th>
<th>General Post-Acquisition Topco Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Corp</td>
<td>U.S. Corp</td>
<td>U.S. Corporation</td>
</tr>
<tr>
<td>U.S. Corp</td>
<td>U.S. Partnership</td>
<td>U.S. Corporation, unless business eligible to operate in MLP format. Seller may prefer an Up-C structure.</td>
</tr>
<tr>
<td>U.S. Corp</td>
<td>Foreign Corp</td>
<td>Foreign Corporation, Subject to complying / addressing U.S. anti-inversion rules.</td>
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<td>Foreign Corp</td>
<td>Foreign Entity / Business</td>
<td>Foreign Corporation</td>
</tr>
</tbody>
</table>
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 ability of the parties to achieve the intended and/or preferred tax treatment.

Cross-border transactions add additional complexity – sometimes, substantial complexity.
III. DE-SPACING TAX STRUCTURING
A. De-SPACing Overview
Typical SPAC acquisition structure

1. Sponsor
   - Sponsor Shares/Warrants
   - Nominal upfront investment

2. Public
   - Common Shares/Warrants
   - $$$

3. $$$ Cash in Trust

4. PIPE Investors
   - Common Shares
   - $$$

5. Target Shareholders
   - Target Equity
   - $$$ and/or SPAC equity

Occurs prior to or as part of the IPO

Occurs at time of business combination
SPAC as a target in the acquisition structure

1. Sponsor
2. Sponsor Shares/Warrants
3. Nominal upfront investment
4. Common Shares
5. SPAC Equity

Occurs prior to or as part of the IPO

Occurs at time of business combination

$SPAC$ as a target in the acquisition structure

Target Shareholders

Target

PIPE Investors

Common Shares

Target equity

SPAC Equity

Sponsor Shares/Warrants
B. DE-SPACING DOMESTIC SPACS WITH DOMESTIC TARGETS
Overview of domestic-to-domestic transactions

- For domestic-to-domestic business combinations (U.S. SPAC / U.S. Target), the issues tend to relate to structuring for a tax-free rollover and issues regarding tax receivable agreements (“TRAs”)
- Target’s entity classification affects structuring choices for receiving a tax-deferred rollover:
  - Corporate target - If consideration is a mix of cash and stock (or all stock), target sellers may expect the business combination to qualify as a tax-free reorganization with “boot” under Section 368(a)
  - Flow-through target
US SPAC / US Target – Reorganizations

**Basic “A” Reorganization**

- **Transaction Structure**
  - Target combines with SPAC by merging into 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
Two Step “A” Reorganization

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

Diagram:
- **Target Owners**
- **Sponsor**
- **Public**
- **SPAC (U.S.)**
- **Merger Sub (U.S.)**
- **New DRE (U.S.)**
- **Target (U.S.)**
- **New DRE (U.S.)**
**SPAC / COBE – Formal Identity of Target – Direction Matters?**

**Target Merges into SPAC**
- **COBE OK**

**SPAC Merges into Target**
- **Consider COBE**

- **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
US SPAC / US Target – Horizontal Double Dummy

### Transaction Structure
- **Step 1**: (A) Target and Merger Sub 1 merge, with Target surviving, and (B) Sellers receive NewCo stock and possibly cash
- **Step 2**: (A) SPAC and Merger Sub 2 merge, with SPAC surviving; (B) SPAC Shareholders receive NewCo stock and (C) SPAC Warrantholders receive NewCo warrants
- Intended to qualify as a Section 351(a) transaction

### Key Tax Considerations
- Because SPAC and Target survive the mergers, the transitory merger subsidiaries are disregarded and the transaction is treated as if the Target and SPAC shareholders transferred their stock to NewCo in exchange for NewCo stock (and other property)
- The SPAC and Target shareholders constitute a “control group” who own 100 percent of the stock of NewCo after the transaction
- No limit on the amount of boot and no COBE requirement
- Can be used with flow-through targets
- Nonrecognition is not available for warrant holders pursuant to Section 351; consider whether Merger #2 qualifies as a reorganization
C. DE-SPACING DOMESTIC SPACS WITH A FLOW THROUGH TARGET
Transaction 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 right to exchange its Target units for SPAC shares.

- **Step 3**: Target may use retained IPO proceeds to pay down existing debt and for other general corporate purposes.

Key Tax Considerations

- Creation of Up-C structure generally tax-free (Section 721).

- If Steps 1 and 2 are combined as a “disguised sale”, which is likely, the transaction will generally result in a stepped up asset basis.

- Exchanges of partnership interests for SPAC common stock in a taxable transaction and results in a stepped up asset basis to partnership (as a result of a Section 754 election).

- 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
Cross-Border SPAC M&A – Common Tax Issues

- There are a handful of general M&A tax issues that are often relevant to planning any de-SPAC transaction, including a cross-border 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
U.S. SPAC / Foreign Target – Big Issues

- COBE concerns + inversion considerations often drive use of §351
- Inversion counting / compliance
- Warrant holders
- Section 367
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
- Several possibilities might be considered. In these materials we will illustrate one of the commonly used structures – a New Foreign HoldCo in a § 351 Transaction (probably the most commonly used structure in the U.S. SPAC / Foreign Target scenario)
U.S. SPAC / Foreign Target – Managing §§ 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 \( \leq 50\% \) of the resulting foreign parent corporation
  - GRA needed for any U.S. SPAC shareholder that receives \( \geq 5\% \) 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)
U.S. SPAC / Foreign Target – Managing §§ 7874 / 367

- 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
  - **Substantial Business Activities:** ≥ 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)
  - **Ownership Test – < 60%:** 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% (by vote or value), but <80% (by vote and value), of resulting foreign parent corporation by reason of owning U.S. SPAC shares
    - Numerous adverse post-deal consequences
  - 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
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)
U.S. SPAC / Foreign Target – Inversion Counting Example

<table>
<thead>
<tr>
<th>Shareholder / Investor</th>
<th>Include for §7874 Ownership Test?</th>
<th>Actual Shares Owned</th>
<th>Deemed Shares For §7874 Ownership Test</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPAC Sh/s</td>
<td>Yes</td>
<td>300</td>
<td>300</td>
</tr>
<tr>
<td>Target Sh/s</td>
<td>Yes</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>PIPE</td>
<td>No</td>
<td>250</td>
<td>0</td>
</tr>
<tr>
<td>Warrants</td>
<td>Yes (in-the-money value)</td>
<td>0</td>
<td>22.22 ($300 in-the-money value / $13.50 per share)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>1050</td>
<td><strong>822.22</strong></td>
</tr>
</tbody>
</table>

**PIPE Buys Invest at NewCo-level, not SPAC-level**

Assume at Closing:
- NewCo’s FMV: $13.50 / share

**§7874 Ownership Fraction = 39.2%**
(322.22 / 822.22 = 39.2%)

(Deemed SPAC-Related Shares / Total Deemed Shares)

**NO INVERSION**
D. DE-SPACING FOREIGN SPACS WITH DOMESTIC TARGETS
Foreign SPAC / U.S. Target – Big Issues

- PFIC issues / considerations galore
- Warrant holders
Domestication

SPAC Domesticates To U.S

1. SPAC "Domesticates" Converts from Foreign to U.S. Corp Status (e.g., DGCL § 388)

SPAC (Foreign)

SPAC (U.S.)

Receive Shares & Warrants in U.S. SPAC Upon Domestication

SPAC Investors

SPAC Acquires Target for Stock

SPAC (U.S.)

Target (U.S.)

Merger Sub (new)

Merger

PIPE

$\$ 2

SPAC Shares

T Sh/s

SPAC Shares

1. 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)

2. Acquisition / Combination:
   - SPAC’s acquisition of Target stock generally intended to qualify as a tax-free reorganization
Foreign SPAC with domestic target, generally

- The domestication of a foreign SPAC is intended to qualify as an inbound reorganization prior to the business combination (a “domestication”)
  - The foreign SPAC is 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) applies to the domestication but generally has little practical effect / impact

- PFIC rules, including regulations proposed under Section 1291(f), may also 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 its 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:
  - If the foreign SPAC were a CFC, the Sponsors would have already 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
  - Possible application of the CFC/PFIC overlap rules to warrants is unclear

- In all cases, the SPAC’s All E&P Amount should be relatively nominal because it has not operations and merely earns interest on the IPO trust fund proceeds until the de-SPAC transaction
Consequences of Section 367(b) and PFIC rules to shareholders in a domestication (Cont’d)

- More complicated if SPAC is a PFIC
  - 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
Consequences of PFIC rules to warrant holders in the domestication where SPAC is a PFIC

- Section 367(b) should not apply to warrants
  - Warrant holders remain eligible for 354 tax-free treatment on the exchange of SPAC warrants in the domestication

- But the QEF Election is not 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
United States – PFIC Test Generally

Because its starts life as a simple box of cash, there typically some concern that conventional a Foreign SPAC may 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 or Asset Test

- Gross Income Test: ≥ 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, i.e., passive income
- Asset Test: ≥ 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 bona fide 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)
Foreign SPAC – PFIC Test Generally (Cont’d)

- **Start-Up Exception:** A foreign corporation will not be treated as a PFIC for the first tax year it has gross income – 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?

- IRS takes the position that cash is always a passive asset for purposes of PFIC classification (Notice 88-22 – all cash even in an operating business treated as bad), but Code does not prescribe “all cash is bad”
- Cash is always bad construct may not really 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 the opposite aim and that is precisely why investors are attracted to them
- Notwithstanding these seemingly logical arguments and circumstances, the proposed regulations issued in Dec 2020 continue to take the positon cash is bad with extremely limited and narrow exceptions