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SPACs in the City

How transactions are structured and the key UK tax considerations


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Analysis

SPACs in the City: the tax take

Speed read

There has been significant interest in whether SPAC listings, popular in the US, could be marketed on European exchanges. Transactions involving UK SPACs, target companies or investors present a multitude of tax issues. Parties need to consider whether the usual mix of shares and warrants that comprise the SPAC's capital structure may lead to UK tax leakage. Once a target is identified, attention must turn to how the business combination can be undertaken in an effective and tax efficient manner, balancing the interests of the sponsors, investors and target shareholders with the overarching need to find a structure that meets the parties' commercial objectives.

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The recent frenzy in special purpose acquisition company (SPAC) listings in the US has prompted speculation on whether European markets, including the UK, could attract similar interest. Changes to the UK listing rules implemented in August were designed to make London a more 'friendly' listing venue for SPACs.

But how friendly is the City's tax environment when it comes to SPACs? After providing a brief background on what SPAC transactions actually involve, we examine the key UK tax considerations that can arise at various stages of the SPAC lifecycle, from incorporation and initial public offering (IPO) to the SPAC's 'business combination' with a target group (the 'de-SPAC'). Most of these considerations apply whether the SPAC or 'de-SPAC' holding vehicle is listed on a UK exchange or elsewhere.

SPACs explained

A SPAC is a 'blank-cheque' or 'cash-box' company with no operations, formed for the sole purpose of acquiring or merging with an operating group. SPACs are not new, but they have experienced a boom in the US in recent years. This is partly due to the perceived speed and efficiency by which they can take a company public compared to the traditional IPO route.

SPACs are typically formed by private equity or hedge fund sponsors ('sponsors') who rely on their reputation and experience to attract investors. A SPAC raises capital to fund its acquisition(s) through an IPO and investors who purchase units in a SPAC are essentially co-investing alongside the sponsors. The capital structure will often consist of a mixture of both shares and warrants. These will usually be held by both the sponsors (who will subscribe for shares and warrants on or shortly after incorporation) and the public (who will purchase listed units in the SPAC, with each unit consisting of one share and one warrant (or a fraction of a warrant) in the SPAC).

A SPAC may identify a specific sector that it will target. Generally, the SPAC will fix a deadline by which an acquisition of a target must be completed (typically 18 to 24 months). During this period, the SPAC's funds will sit in a trust account. If a target is not identified within the specified timeframe, the SPAC must return capital to the investors from the trust account and the SPAC will be liquidated.

When a SPAC identifies a suitable target operating company ('Target'), it will 'de-SPAC' by acquiring or merging with Target. In addition to funds from the sponsors and the public, the SPAC may source additional capital through a private investment in public equity (PIPE), typically private equity or other private investors.

Figure 1: Key stages in the SPAC lifecycle

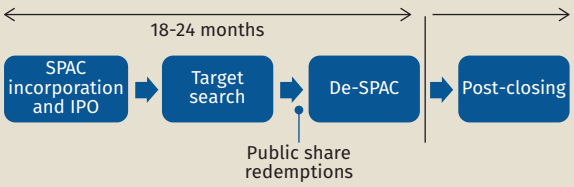
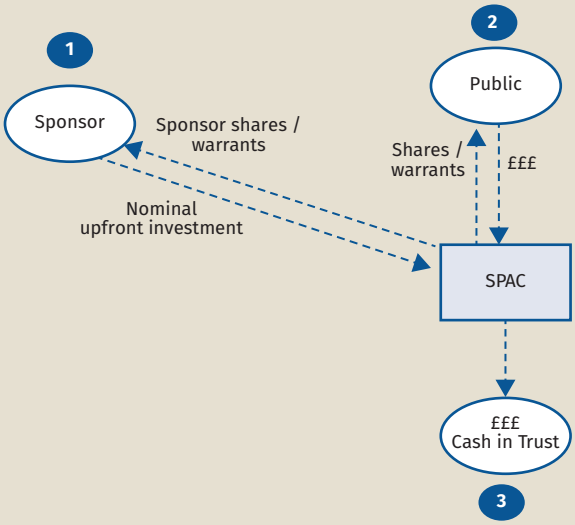


Figure 2: Typical SPAC IPO structure



SPAC IPO

Jurisdiction of residence and incorporation

One of the first questions for sponsors is where to establish the SPAC. This will be influenced by their overall commercial objectives, the location(s) of management and the potential targets and investor base, their preferred market for listing, and corporate law, tax and regulatory considerations.

From a tax residence perspective, the usual considerations in forming a holding company that is publicly listed will be relevant. The benefits of UK corporate tax residence will be well known to readers, including the dividend exemption, the substantial shareholding exemption, an extensive double

tax treaty network and, despite anticipated increases, a comparatively low rate of corporation tax. Sponsors will also want a structure that works for their home tax jurisdiction. Sponsors will often include US tax residents, so US tax advice may have a significant impact on the overall SPAC structuring.

As regards the jurisdiction of incorporation of the SPAC, it is, of course, possible to have a UK resident company which is incorporated outside the UK by virtue of its central management and control being exercised in the UK. Non-tax issues such as corporate law flexibility, familiarity to investors and, for a UK listed SPAC, the ability to trade through CREST and the application of the Takeover Code will all be relevant factors. While the Cayman Islands, Bermuda and Delaware are most familiar in US markets, UK markets may (in addition to the UK) be more familiar with Jersey, Guernsey or BVI companies. If the corporate UK re-domiciliation regime, announced in the Autumn Budget 2021, is enacted to enable non-UK incorporated companies to 'reincorporate' in the UK, this may provide SPACs with additional flexibility, provided that such a re-domiciliation is permitted under the laws of the SPAC's jurisdiction of incorporation. From a tax perspective, a UK incorporated SPAC means that UK stamp duty and UK stamp duty reserve tax will also need to be considered (see further below).

Whatever jurisdiction(s) are chosen, it will be important for the parties to understand what is required in terms of establishing and maintaining 'substance' in that jurisdiction, being mindful of potential changes to governance following the 'de-SPAC'. This is important not only to establish tax residence in the desired jurisdiction from a tax perspective, but also to comply with 'economic substance' legislation which has been introduced by many of the jurisdictions of incorporation mentioned above, and also to the extent there is an intention to rely on a double tax treaty to extract dividends from the underlying target group.

Stamp taxes: shares

Where the SPAC is UK incorporated and is listed on a US exchange, the statutory 1.5% stamp duty or SDRT charge on entry to a clearance service (such as the Depository Trust Company (DTC)) or depositary receipt form (such as American depositary receipts (ADRs)) needs to be considered. The charge on shares has not been collected by HMRC following the CJEU decision in *HSBC Holdings Plc and Vidacos Nominees Ltd v HMRC* (Case C-569/07); and the First-tier Tribunal decision in *HSBC Holdings Plc and The Bank of New York Mellon Corporation v HMRC* [2012] UKFTT 163 because it was found to be contrary to EU law. There was some doubt on the status of these decisions post-Brexit. However, HMRC have since confirmed that, based on the Withdrawal Agreement, this practice still applies following the end of the Brexit transition period, and will continue to do so 'unless stamp taxes on shares legislation is amended' (see HMRC's *Stamp Taxes on Shares Manual* at STSM014020). Once within the depositary or clearance service, shares can be traded without incurring UK stamp taxes.

Outside the context of clearance services or depositary receipt system, stamp duty and SDRT will apply to issuances and transfers of shares in a UK incorporated SPAC in the usual way. Listing on a 'recognised growth market' such as AIM may be beneficial here as stamp duty and SDRT were abolished on transfers on those markets.

Stamp taxes: warrants

As noted above, warrants are a common feature of many SPAC transactions and present a couple of specific stamp tax questions.

The first is, in a US listed context, whether the HMRC practice described above applies to issuances of warrants, as well as shares. It is unfortunate that, given the charge remains on the UK statute books, the HMRC guidance refers only to the disapplication of the 1.5% charge for 'shares', but it seems reasonably clear that warrants would usually be part of a raising of new capital and therefore the 1.5% charge will be disapplied in line with the principles in the EU case law referred to above.

Another question, which applies to UK incorporated SPACs listed in the US or elsewhere, is whether the grant of the warrants is itself a conveyance of an interest in a marketable security (being the underlying SPAC shares, even though they are yet to be issued), potentially chargeable to UK stamp duty based on the principles in *George Wimpey & Co Ltd v IRC* [1975] 2 All ER 45 as described by HMRC at STSM113010. This will depend on the terms of the warrants and the underlying shares. Where the charge applies, depending on the context, it may not be necessary for the warrants to be stamped (and stamp duty paid) for any registration purposes in the UK. Nevertheless, the broader implications of choosing not to stamp the warrants should be considered; instruments which are not duly stamped are inadmissible in evidence in civil proceedings.

Corporation tax: warrants

If the SPAC is a UK resident company, then the grant of the warrants may also present corporation tax complexities. As options over shares, the grant of the warrants may, depending on the arrangements, fall within the derivative contracts rules in CTA 2009 Part 7 (where, broadly, the tax position follows the accounting treatment) or the chargeable gains rules.

The starting point for the analysis is the accounting treatment but, even where the warrants are accounted for as derivatives, the conditions mentioned in CTA 2009 s 589(5) may well apply to exclude the warrants from the derivative contract regime.

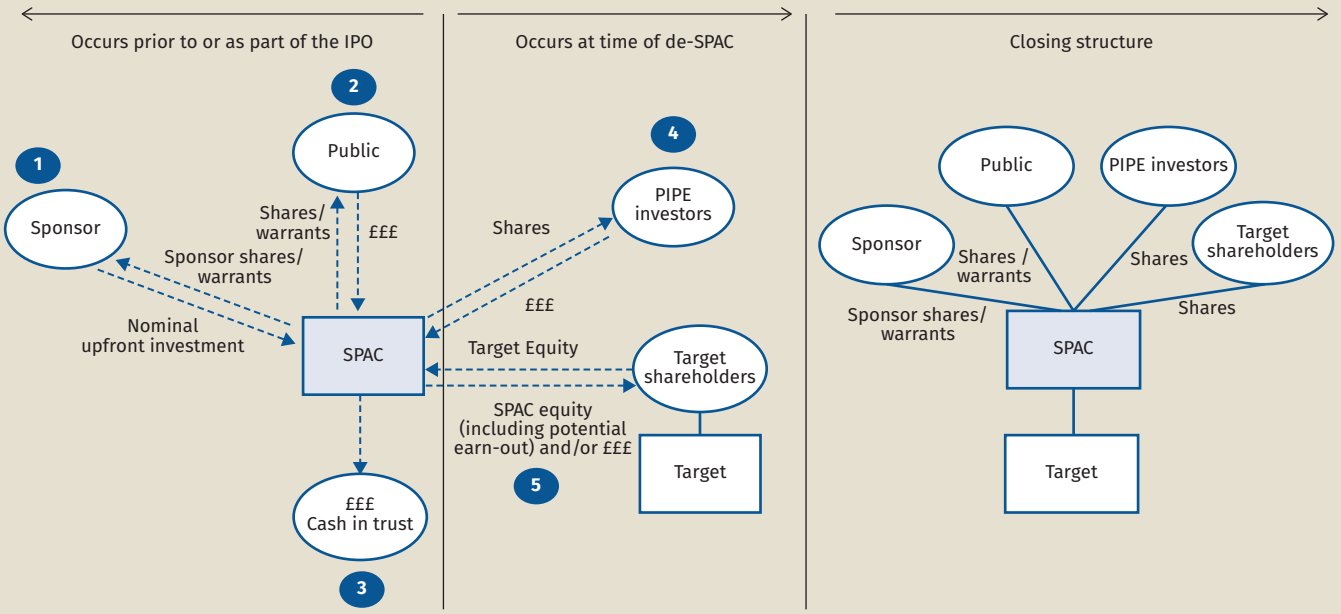
Where the chargeable gains regime applies, subject to any exclusions, TCGA 1992 s 144, will treat the grant of the warrants as the disposal of an asset (being the warrants themselves), with the consideration being the amount paid for the grant or, if TCGA 1992 s 17 applies, the market value. To the extent that the warrants are exercised, the grant and exercise will be treated as a single transaction, being the issuance of shares (TCGA 1992 s 144(2)). Any chargeable gains arising on the grant of the warrants will therefore effectively be eliminated and, although the procedure for reclaiming any tax paid is not clear, HMRC's guidance confirms that any tax charged on the grant needs to be set-off or repaid (at CG12317).

Employment taxes

The employment tax position of both UK and non-UK based officers and employees of the SPAC will need to be considered, together with any related UK payroll obligations. Non-UK individuals performing duties in the UK, such as meeting with potential targets or attending board meetings, may be subject to UK tax on income attributable to those duties. Double tax treaties (and social security agreements), and HMRC's 'short-term business visitors arrangement', may assist in respect of employment related income, although treaties do not generally protect directors' fees from being taxed in the UK.

Founders and individuals affiliated with the sponsor may also acquire shares and warrants in the SPAC or in a feeder vehicle. For UK based individuals, the employment related securities regime in ITEPA 2003 Part 7, will need to be considered, with the potential for income tax and national insurance contributions to arise where full value is not paid for the securities. HMRC's well-known view is that founders who are to be directors of the company are within the scope of

Figure 3: SPAC acquires Target directly



the rules (see HMRC's *Employment Related Securities Manual* ERSM20240). SPACs may consider obtaining valuations to support payroll positions being taken.

Further complexities can arise where the individuals acquiring securities are non-UK tax residents, where the internationally-mobile employee (IME) rules, which were revised in 2015, will also need to be considered. Again, double tax treaties may assist with any double tax charges or mismatches between the UK system and the home jurisdiction of the individual.

PIPE and public investors

Of course, the sponsor will want to ensure that the SPAC is attractive to the PIPE and the target public investors (and, in the context of the latter, may make disclosures about the anticipated tax treatment in the public prospectus). As noted above, no UK withholding tax on dividends should arise on payments from a UK resident SPAC. Particular thought will need to be given as to any disclosures in respect of warrants and redemptions, which are less common features of UK public companies.

De-SPAC

When the SPAC has identified its target, the 'business combination' or 'de-SPAC' will then occur. As with any corporate acquisition, the structure will depend on many factors, including the identity of the shareholders, the nature and location(s) of the target group and the funding of the target group.

Figures 3 and 4 illustrate two potential acquisition structures for the de-SPAC. For simplicity, we have assumed that Target is a UK incorporated and tax resident company, and that Target shareholders include UK tax resident individuals. The acquisition might be effected through a private offer (with uncooperative shareholders being 'dragged' along) or through a scheme of arrangement.

SPAC acquires Target directly

Figure 3 depicts a de-SPAC where the SPAC acquires Target directly in exchange for equity in the SPAC (including a possible 'earn-out' or deferred component) and/or cash consideration. Additional capital may be sourced by way of PIPE investors purchasing shares in the SPAC prior to the de-SPAC. Following the acquisition, the SPAC becomes the new publicly listed holding company of the target group.

The SPAC could remain tax resident in its original jurisdiction. However, as the combined group is likely to include different management (e.g. from Target), it may be the case that the SPAC would 'migrate' its tax residence upon or shortly after the de-SPAC to another jurisdiction to reflect how it will be managed thereafter.

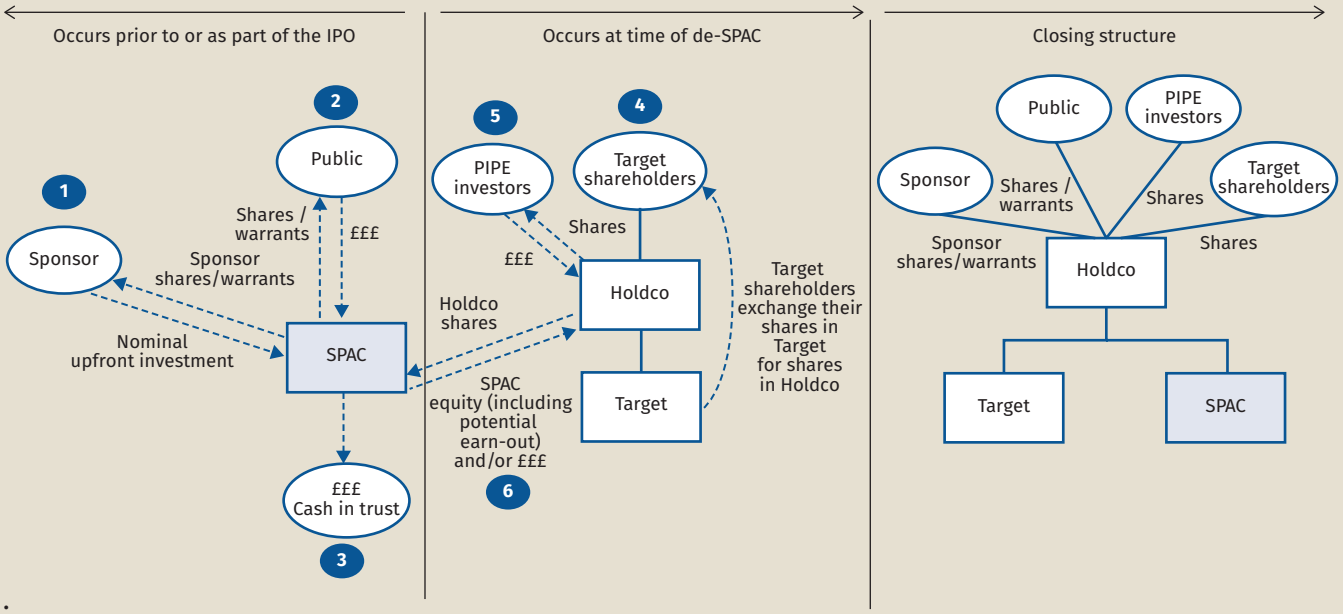
Stamp taxes: Where Target is a UK incorporated company, the starting point is that stamp duty will apply at the rate of 0.5% of the value or consideration given for the transfer of shares in Target. Any deferred element of consideration given for the Target shares may also be chargeable to stamp duty under the contingency principle (see STSM021120). Stamp duty acquisition relief under FA 1986 s 77 should be considered, although this will be challenging to obtain, particularly where there is a cash and/or a future share 'earn-out' element.

UK individual shareholders and employees: UK individuals will likely look for capital gains tax rollover relief in respect of the shares that the Target shareholders acquire in the SPAC in exchange for their Target shares (TCGA 1992 s 135) and may expect HMRC clearance under TCGA 1992 s 138 (as well as under the 'transactions in securities' legislation) to be obtained. Again, the impact of any earn-out or deferred consideration will need to be taken into account.

Often SPAC targets are early stage companies and the shareholders may have qualified for relief under the enterprise investment scheme (EIS). Where the acquisition occurs within three years of the date of investment (or three years from the date that the qualifying trade commenced, if later), then EIS income tax relief may be withdrawn (ITA 2007 s 201), unless the conditions in ITA 2007 s 247 are met. As with stamp duty acquisition relief, these conditions may be difficult to meet where there is anything other than 'straight' share consideration.

The Target may also have a number of employee shareholders and optionholders (which could include 'unapproved' options). Parties will need to assess how any exercise mechanics operate, what taxes may arise and whether

Figure 4: SPAC as a target in the acquisition structure



the holders should enter into ITEPA 2003 s 431 elections.

Impact on tax assets: The acquisition may constitute a change in ownership for UK tax purposes. To the extent the Target group has tax losses or other tax assets, the impact on those should be considered, particularly if the way in which the business operates is likely to change or if new capital will be raised.

SPAC as a target in the acquisition structure

Figure 4 depicts an acquisition structure where, immediately prior to the de-SPAC, a new holding company (Holdco) is inserted above Target. Target shareholders exchange their shares in Target for shares in Holdco. Holdco will become the new publicly listed parent company of the Target group. Holdco then acquires the SPAC.

Holdco could be tax resident and incorporated in the same, or a different, jurisdiction to Target or the SPAC.

Many of the same tax issues outlined above in relation to the figure 3 acquisition structure will also arise on this structure. In addition, under this structure, the shares and securities in the SPAC will need to be exchanged for shares in the new Holdco, presenting the following questions:

- When Holdco assumes the obligations under the warrants issued by the SPAC, what is the corporation tax position for the SPAC and Holdco? Will that constitute the grant of an option by Holdco so that TCGA 1992 s 144 will be in point? Or could the derivative contracts rules apply?
- What is the tax treatment of the exchange for the SPAC shareholders and warrantholders (including employees)?
- If the SPAC is UK incorporated, will UK stamp duty be payable on the acquisition of the SPAC (as well as on Target)?
- If Holdco is UK incorporated, similar stamp tax issues as discussed in the 'SPAC IPO' section above will again need to be considered.

Accessing cash

On either structure, there will be a need to extract cash from the SPAC to fund cash consideration to the Target shareholders (where applicable), inject cash into the business and to return to investors. This is likely to be more straightforward under figure 3 than figure 4, where there will need to be an upstreaming of funds (through dividends, upstream loans or returns of capital).

Practical points

The enthusiasm for SPACs in the US has somewhat waned in recent months and the European market, particularly the UK, has been slower to embrace the use of SPACs than many had predicted. That said, there is still considerable interest from sponsors looking for ways to invest their pools of cash. For those who pursue the idea, the following tax points should be borne in mind:

- There is likely to be a desire to replicate familiar structures from the US context, including the use of warrants, redemptions and earn-outs triggered by share price. Such features are often less common in the UK (from a tax or company law perspective), so the analysis in each relevant jurisdiction should be considered and explained to parties at the outset.
- Similarly, US sponsors investing in Europe may wish to replicate the transaction documentation they are familiar with in a US context (such as a 'business combination' or 'merger' agreement). Those may include provisions allocating tax costs and risks and may need to be adapted for a UK context (for example, provisions regarding stamp taxes and VAT).
- Often a significant number of the potential directors of the SPAC (or the Holdco) may be based in the US. In such cases, as the US (currently) applies an incorporation test for tax residence, it is usually straightforward to ensure that a UK incorporated company is tax resident in the UK for UK tax purposes. It is, however, more difficult to ensure that a company incorporated in (say) Jersey or Cayman is UK tax resident, particularly where there are travel restrictions in place.
- As it is critical that the ultimate structure will work, the potential 'de-SPAC' mechanics, future governance and extraction of cash should be stress-tested at the SPAC incorporation and IPO stage.
- Finally, US tax considerations, including the CFC rules, PFIC regime, and anti-inversion rules, will likely be a key driver and should be vetted at an early stage. ■