A SPAC is Born: SPAC Formation

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The SPAC Market

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 (an "initial business combination" or "de-SPAC")

Typically formed by well known private equity/hedge fund sponsors, business executives or marquee investors (the "Sponsor") 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

- Sponsor contributes "at risk" capital, typically in an amount sufficient to cover IPO fees and expenses

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 in 2021: ~ $157 bn (568 IPOs > $100 mm) (through December 31)

By comparison, SPAC IPO volume in recent years:

- 2020: ~ $82 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 plus warrants
  - The warrants give the holder the right to purchase additional shares of common stock at a specified price ($11.50 per share) for 5 years following the de-SPAC
  - 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 a short underwriter overallotment period)
  - Public warrants are exercisable after the de-SPAC and may be called at a specified premium to issuance price (typically $18.00)
- 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
  - If the transaction closes, investors may retain the warrants regardless of whether they redeem the common stock

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 until after a lock-up period (1-3 years following the de-SPAC, as specified in the Business Combination Agreement ("BCA"))
- 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, and waive rights to liquidating distributions from trust for a failed business combination

Sponsor Shares represent 20% of post-IPO common shares

- Some sponsors have utilized a "sliding scale" designed to align the promote with stock price performance

"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 alongside the Sponsor Shares

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 historically have been identical to the shares already purchased by the public in the IPO (i.e., common stock at $10.00 per share). The PIPE funds at closing, therefore PIPE investors do not have a redemption right

- The PIPE shares are subsequently registered under an S-1, usually 30-45 days after closing
- Recent trends in the PIPE market have resulted in more "structure" (i.e., convertible preferred or other forms of price protection), sometimes in combination with common stock

PIPEs allow SPACs to pursue larger potential transactions and also demonstrate to the existing public shareholders a validation by other institutional investors of the terms announced de-SPAC transaction

A number of SPACs have raised additional funds by issuing equity-linked securities (such as forward purchase agreeemnts) 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

The SPAC market has become . . . difficult

1

The SPAC M&A market continues to be very active, with over 500 SPACs currently searching for targets

However, many potential targets that can go public in a traditional IPO have begun to view SPACs as a "Plan B" in light of challenges in the SPAC/PIPE market

2

A number of recent deals have traded up post-closing, but most of the SPAC transactions which are announced but not yet closed are trading ~$10.00

This dynamic generally reflects technical market conditions, not underlying fundamental value

3

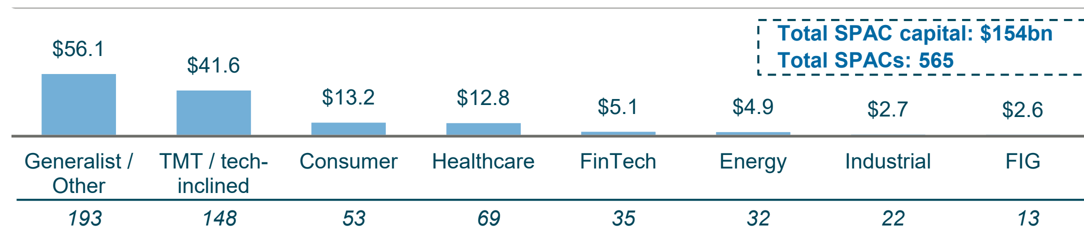
Redemption levels have significantly increased, and it is increasingly common to see redemptions in the 70-80%+ range

This emphasizes the importance of committed capital in the PIPE and through forward purchase agreements, backstops, and non-redemption agreements

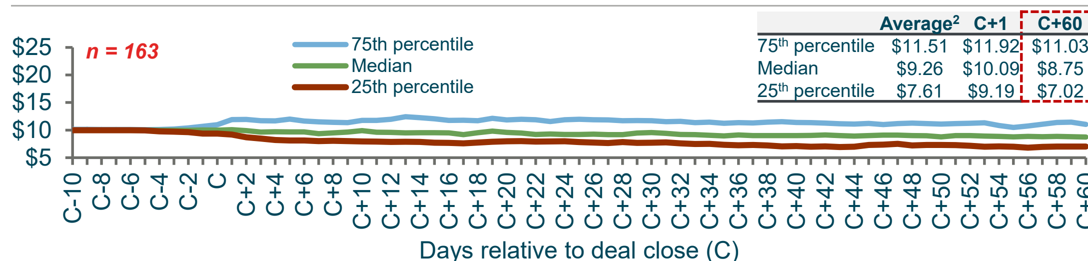
4

The PIPE market remains the key bottleneck, PIPE investors have become extremely selective or are not committing to new SPAC deals

PIPE size has decreased since the beginning of the year, as "momentum" players (i.e., hedge funds) have essentially left the market

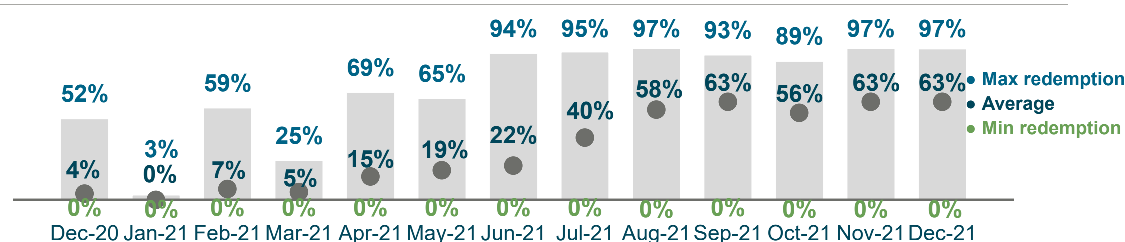


Stock price distribution for SPAC transactions that have closed

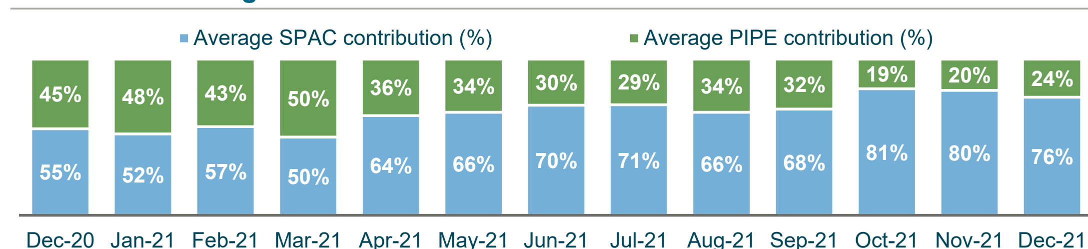


	Average[2]	C+1	C+60
75th percentile	$11.51	$11.92	$11.03
Median	$9.26	$10.09	$8.75
25th percentile	$7.61	$9.19	$7.02

Average redemption rates for closed transactions



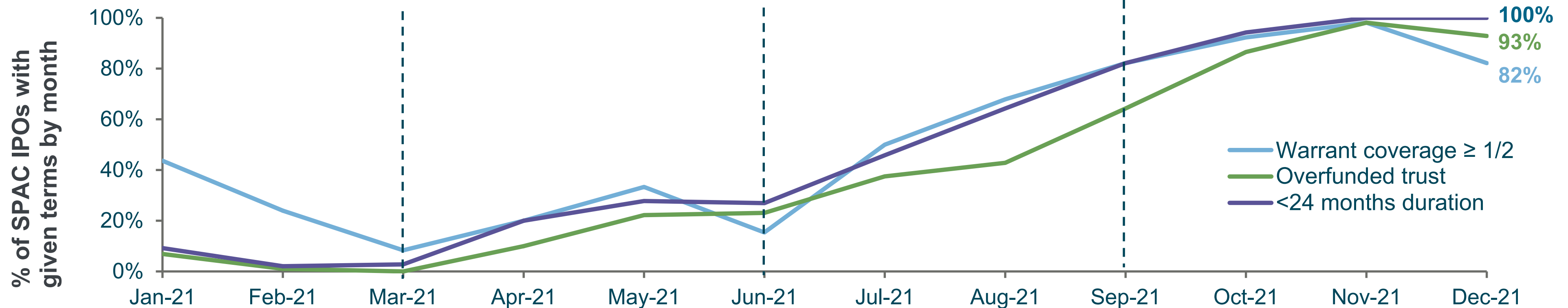
Evolution of average SPAC & PIPE contribution to total consideration[3]



Source: Company filings, Dealogic; J.P. Morgan SPAC database; Data as of 12/31/21
[1] Based on U.S. SPACs that have priced and are currently searching for assets; [2] Average over the period from C to C + 60; [3] Based on annc. date of SPAC mergers

SPAC IPO terms continue to evolve

- Amid strong performance in Q1, SPAC terms tightened meaningfully for issuers, but widened steadily throughout the year in a more challenged market backdrop
- Even for repeat issuers, IPO terms became wider – ½ warrant coverage, overfunded trusts, and shortened durations

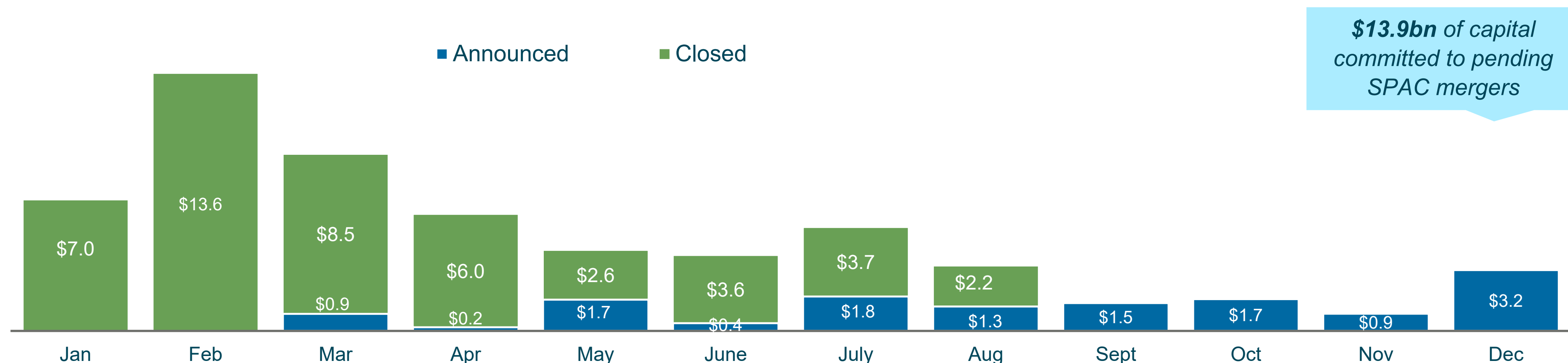


	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21
# SPACs	87	96	108	10	18	26	24	28	28	52	53	38
Avg IPO size	297	372	335	294	219	241	209	183	229	198	218	210
% repeat issuers	24%	41%	48%	50%	33%	42%	42%	36%	21%	17%	19%	18%
Median warrant coverage	1/3	1/3	1/4	0	1/3	1/3	1/2	1/2	1/2	1/2	1/2	1/2
Median cash in trust	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.8%	101.5%	102.0%	102.0%
Median duration[1]	24	24	24	24	24	24	24	18	18	18	15	18

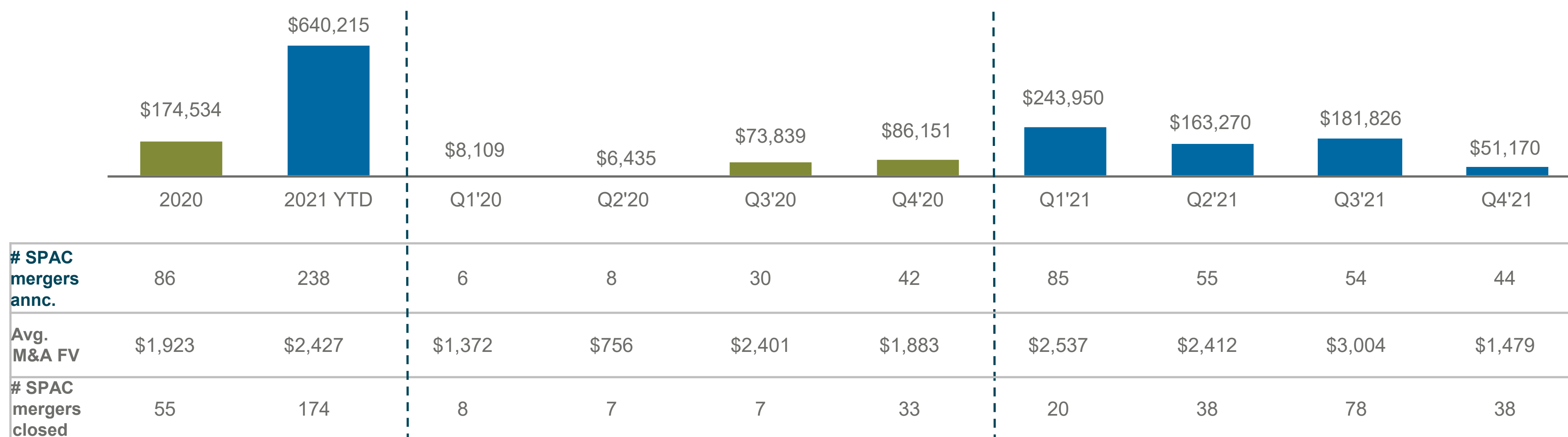
Source: Dealogic, Factset, and company filings as of 12/15/2021
Includes SPAC IPOs ≥$100mm
1Excludes extension provisions

SPAC M&A activity has declined as the PIPE market remains a bottleneck…

Capital committed to SPAC PIPEs ($bn)[1]



Announced U.S. SPAC mergers (total equity value $mm)

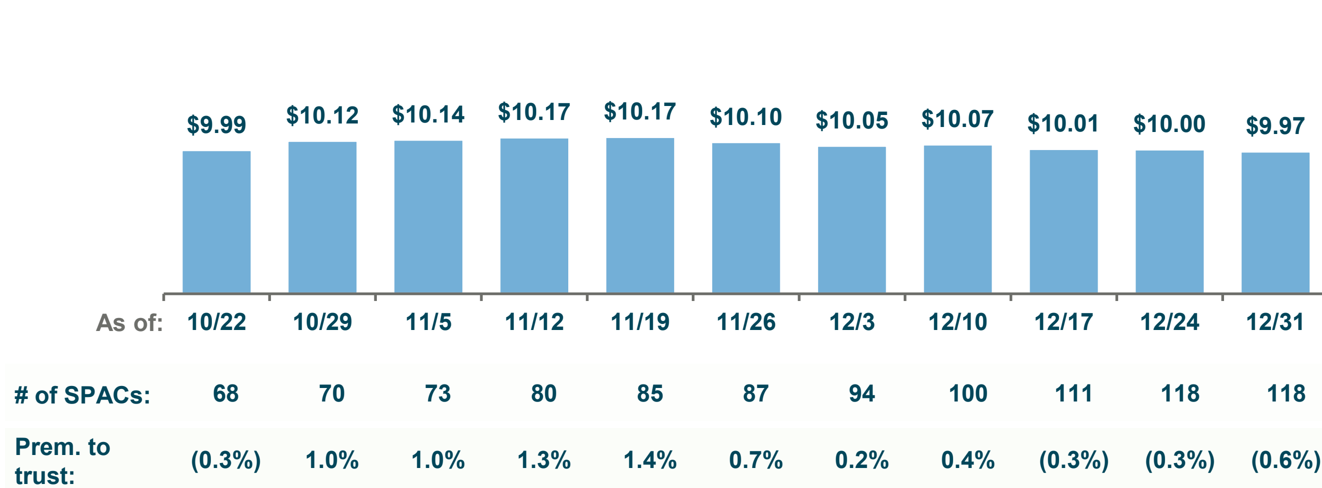


	2020	2021 YTD	Q1'20	Q2'20	Q3'20	Q4'20	Q1'21	Q2'21	Q3'21	Q4'21
# SPAC mergers annc.	86	238	6	8	30	42	85	55	54	44
Avg. M&A FV	$1,923	$2,427	$1,372	$756	$2,401	$1,883	$2,537	$2,412	$3,004	$1,479
# SPAC mergers closed	55	174	8	7	7	33	20	38	78	38

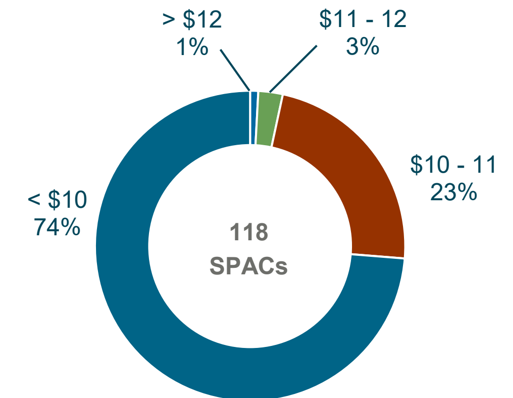
Source: Dealogic as of 12/15/2021
Includes SPAC IPOs ≥$100mm since 2015.
1 PrivateRaise as of 12/31/21, includes SPAC deals >$50mm; excludes deals with no PIPE commitments

…while trading performance remains challenged and high redemptions persist

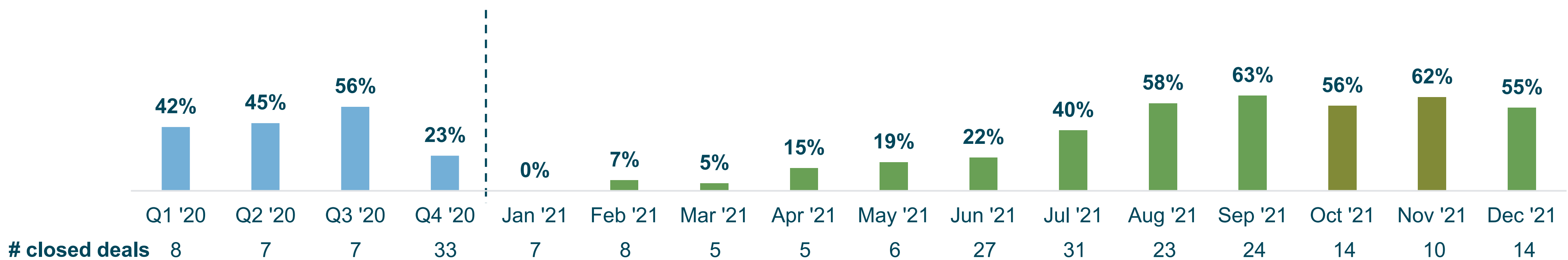
Average share price of pending SPAC mergers[1,2]



As of:	10/22	10/29	11/5	11/12	11/19	11/26	12/3	12/10	12/17	12/24	12/31
# of SPACs:	68	70	73	80	85	87	94	100	111	118	118
Prem. to trust:	(0.3%)	1.0%	1.0%	1.3%	1.4%	0.7%	0.2%	0.4%	(0.3%)	(0.3%)	(0.6%)



SPAC redemptions are averaging >50%, with a wide distribution ranging from ~0% to 85%+

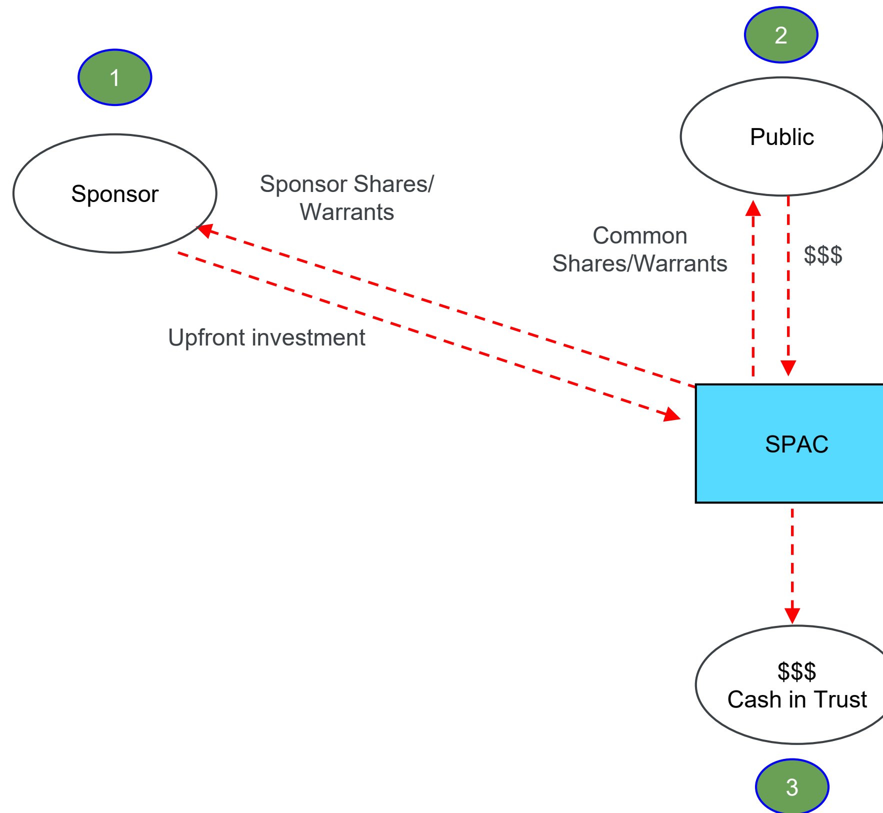


	Q1 '20	Q2 '20	Q3 '20	Q4 '20	Jan '21	Feb '21	Mar '21	Apr '21	May '21	Jun '21	Jul '21	Aug '21	Sep '21	Oct '21	Nov '21	Dec '21
# closed deals	8	7	7	33	7	8	5	5	6	27	31	23	24	14	10	14

Source: Dealogic; Company filings, as of 12/31/2021
Note: Includes deals ≥$100mm IPO size.
[1] Sample set consists of SPAC deals announced 2021 YTD; Average share price of group of SPACs at respective date; [2] Average share price and premium to trust excludes Digital World Acquisition / Trump Media deal trading at $56.02

Basic SPAC Formation Tax Issues

Typical SPAC IPO structure



Threshold Issues with SPACs

Are common shares debt or equity?

- Investors have a right to redeem their shares within a fixed period and initial investments are set aside in a trust account, making the investment debt-like
- If debt, investors could have phantom income accruals for discount during the period prior to de-SPAC transaction and there could be adverse consequences under the PFIC rules (e.g., "qualified electing fund" elections are not available)
- Historically, IRS argues for equity treatment in close cases

Promote shares as compensation

- If promote shares are issued in connection with the performance of services by Sponsor, then Section 83 applies
  - Excess of fair market value over amount paid is income upon issuance or, if subject to vesting and Section 83(b) election is not filed, upon vesting; consequently, Sponsor could have significant compensation income[1]
  - If the promote shares are issued prior to filing of registration statement, they are likely to have a low (or no ascertainable) value; the closer to IPO, the more likely they are to have value
  - Promote shares are also subject to contingencies (e.g., conversion to common occurs only in the de-SPAC transaction), making valuation difficult
    - Do these contingencies also suggest the promote shares are unvested?
- Similarly, if warrants are issued in connection with performance of services by Sponsor, Section 83 applies
  - Since Sponsor pays for the warrants and SPAC uses cash to run operations, arguably warrants should not be treated as issued in connection with the performance of services
  - If they are, however, Sponsor warrants likely do not have a readily ascertainable fair market value under Treas. Reg. 1.83-7(b) and, as such, they would be taxable as compensation upon exercise

Ownership of promote shares should be carefully structured—ownership through a partnership may extend holding period required for capital gain treatment as a result of Section 1061

[1] Berckmans v. Commissioner, T.C. Memo. 1961-100

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

A common challenge is that the de-SPAC target cannot have been identified at the time of the IPO – so, in some cases, a U.S. SPAC will end up pursuing a foreign target or a foreign SPAC will pursue a U.S. target

Foreign targets generally prefer to remain offshore for tax reasons, but also for non-tax reasons (e.g., Foreign Private Issuer status and ability to use IFRS reporting, rather than converting to U.S. GAAP

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 – Deals Follow Many of the Traditional Paths

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 the 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 (and Sponsors) do not receive any cash in the de-SPAC transaction (unless they exercise their redemption rights)

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

Cross-border transactions add additional complexity – sometimes, substantial complexity

PFICs Generally

Forming a Foreign SPAC: The PFIC Problem

Sponsors may prefer to form a SPAC in a foreign jurisdiction to avoid the hurdles for a US SPAC to acquire a foreign business

- SPAC Shareholders and warrant holders will need to navigate the PFIC rules, including in a de-SPAC transaction

The “passive foreign investment company” or “PFIC” regime is intended to eliminate the ability to use a foreign corporation to accumulate and defer tax on passive income and convert that income into long-term capital gain

A foreign corporation is a PFIC if, in any tax year, (i) at least 75% of its income is passive or (ii) at least 50% of its assets are held for the production of (or produce) passive income

- Passive income includes dividends, interest, rents and royalties and gains from the disposition of passive assets
- Asset test is calculated based on the average of the FMV of the corporation’s passive assets determined on a quarterly basis, divided by the average total assets

Shareholders of PFICs are subject to a variety of adverse consequences, with gains taxed at ordinary income rates and subject to an interest charge

- Shareholders are also not eligible for reduced tax rates on dividends

Under the “once a PFIC always a PFIC” rule, a corporation that is a PFIC with respect to a shareholder in any tax year will be a PFIC as to that shareholder for all future years

- This is the case even if the corporation otherwise does not meet the PFIC income or asset tests in those later years
- A shareholder may cleanse this PFIC “taint” by making a “deemed sale” election or, if the PFIC is a CFC, “deemed dividend” purging election[1]

[1] Section 1298(b)(1); Treas. Reg. 1.1298-3

Is the SPAC a PFIC?

A foreign SPAC may be a PFIC prior to a de-SPAC transaction because it holds only cash or cash equivalents

- Cash is generally a passive asset
  - This treatment applies to cash held as working capital in an operating business, Notice 88-22, 1988-1, C.B. 489
  - While this may seem overly broad and arguably ought not apply to cash held by SPACs, proposed regulations continue to treat cash as passive and only provide a limited exception that is unlikely to apply to a SPAC[1]
- Since the asset test is based on the weighted average on a quarterly basis, the SPAC may not be a PFIC if an acquisition occurs in the SPAC's first year
  - Will depend on when the SPAC was formed, its taxable year, the relative sizes of target and SPAC and the timing of the de-SPAC
- While there are policy arguments that a SPAC should not be a PFIC as its purpose is not to facilitate tax-deferral, there is a serious risk that a SPAC may be a PFIC

Under the "start-up" exception, a corporation generally will not be a PFIC for the first taxable year it has gross income if it establishes that it will not be a PFIC for the following two taxable years and, in fact, is not a PFIC for those years

- A corporation is eligible for this exception only if it has some income during the year, FSA 2002 WL 1315676
  - Accordingly, a SPAC that earned no income would be a PFIC due to its passive assets
  - However, the SPAC may qualify for the "start-up" exception in a subsequent year; this would benefit only those shareholders that acquired shares in the subsequent year
- Whether the exception is available is unlikely to be known until after SPAC completes a de-SPAC transaction

[1] Prop. Treas. Reg. 1.1297-1(d)(2)

Is the SPAC a PFIC? (cont'd)

A SPAC acquiring a foreign target may be able to avail itself of this exception so long as it completes a de-SPAC transaction early enough in its second taxable year (depending on size of target)

- It often takes SPACs more than a full year to complete a de-SPAC transaction, such that SPACs formed later in the year are likely to cross taxable years
- A SPAC may try to extend the timeframe to complete a de-SPAC transaction and qualify for the start-up exception by adopting a non-calendar year that begins at (or shortly before) SPAC's formation
  - SPACs that are CFCs may be limited in their ability to adopt a non-calendar year under Section 898(c)
- As discussed on slide 35, a SPAC acquiring a US target will be limited in its ability to rely on this exception

Consequences if SPAC is a PFIC

As a result of the "once a PFIC always a PFIC" rule, if a SPAC is a PFIC as to a shareholder prior to the de-SPAC transaction, it will remain a PFIC as to that shareholder after the de-SPAC transaction, unless PFIC tax is triggered in the de-SPAC transaction

PFIC tax may be triggered in certain de-SPAC transactions

- Section 1291(f) provides that non-recognition provisions do not apply to transfers of PFIC stock "to the extent provided in regulations"
- Regulations proposed in 1992 would require gain to be recognized on all reorganizations unless certain (limited) exceptions apply; if finalized, those regulations would apply with retroactive effect[1]

SPAC shareholders can mitigate these adverse consequences by making a "qualified electing fund" or "QEF" election

- In general, a shareholder that has a QEF election in place for the entire period it owns SPAC stock can avoid these rules
- The shareholder must include its allocable share of the SPAC's earnings in income every year in which the SPAC is a PFIC, regardless of whether those earnings are distributed
  - SPACs must make available certain information about their earnings to permit shareholders to make QEF elections
- Since a SPAC's net income is generally limited to interest on deposits and is offset by its expenses, this inclusion is often small (or zero)
- A "mark-to-market" election is also available to avoid adverse PFIC consequences, but this requires a shareholder to recognize gain annually (taxed at ordinary rates) based on appreciation in the PFIC's stock price

Because of the uncertain availability of the start-up exception and the minimal cost, advisors generally recommend that SPAC shareholders make QEF elections

- Foreign SPACs generally agree to endeavor to furnish the information necessary to make a QEF election
- Furnishing such information may be difficult (and the inclusions may be substantial) if the SPAC continues to be a PFIC following the de-SPAC transaction

[1] Prop. Treas. Reg. 1.1291-6

CFC Issues for Sponsor and Large US Shareholders

Foreign SPACs that are controlled foreign corporations or "CFCs" present a different set of technical issues

- Consequences are likely to be minimal, and it may help alleviate some of the PFIC issues

A Foreign SPAC held by a US Sponsor may be a CFC prior to de-SPAC transaction

- Pre-IPO: A foreign SPAC held by a domestic partnership or by a US Sponsor through a foreign partnership will be a CFC
- Post-IPO: A foreign SPAC may still be a CFC because US Sponsors retain all of the voting rights for the SPAC's directors
- Post-de-SPAC Transaction: The SPAC is unlikely to be a CFC as the US Sponsors will lose their special voting rights as part of the de-SPAC transaction

Sponsors and other shareholders who own 10% (by vote or value) of the CFC, or "US Shareholders", are taxed currently on their share of most of the CFC's income under the Subpart F / GILTI rules

- As mentioned previously, SPACs do not generate significant income
- In addition, shareholders would have to include any income if they made a QEF election to manage the PFIC consequences

Under the "CFC / PFIC overlap rule" in Section 1297(d), PFIC treatment does not apply to stock held by US Shareholders of a CFC

- The PFIC rules will still apply to any warrants held by a US Shareholder
  - The overlap rule applies to options held by a US Shareholder of a CFC only in very limited circumstances not relevant here, namely if the shares underlying the options are owned by another US Shareholder who is not exempt from tax[1]

US Sponsors and other 10% US Shareholders must consider impact of the SPAC losing its CFC status in any de-SPAC transaction

- As discussed on later slides, these shareholders may incur tax in connection with any such transaction

[1] Section 1297(d)(4)

The Special Case of Warrants

Proposed regulations generally treat warrants to acquire stock in a PFIC as stock of the PFIC

- Section 1298(a)(4) provides that options in PFICs are treated as stock of the PFIC "to the extent provided for in regulations"
- Regulations were proposed in 1992 with a retroactive effective date but have not been finalized[1]
- Warrants held by a US Shareholder of a SPAC that is a CFC are not eligible for the CFC / PFIC overlap rule (see prior slide)

The proposed regulations provide that "PFIC taint" carries over to shares received upon exercise, but do not permit a QEF election (or mark-to-market election) to be made for a warrant

- PFIC taint carries over even if the holder makes a QEF election with respect to their stock
- Some practitioners suggest making a protective QEF election on the warrants themselves (even though an election does not appear to be permitted)

[1] Prop. Treas. Reg. 1.1291-1(d)

The Special Case of Warrants (cont'd)

It is possible to address this issue by making an election to purge the PFIC taint upon exercise of the warrant

- "Deemed sale" purging election requires shareholder to pay PFIC tax on any gain that would arise upon a sale of the stock at that time[1]
  - Depending on how much stock has appreciated above the strike price, election may be expensive for SPAC warrant holders
- An alternative "deemed divided" election permitting a holder to include undistributed E&P may be available if the corporation is a CFC at the time of exercise[2]
  - Unlikely to apply since SPAC is unlikely to remain CFC post de-SPAC when warrants are exercised

Similar to PFIC stock, under proposed regulations PFIC tax may be triggered on warrants in certain non-recognition transactions[3]

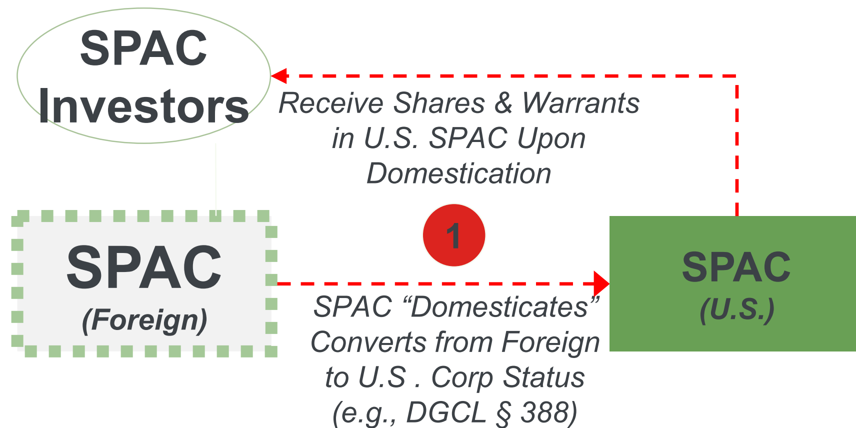
- Because no QEF election may be made for warrants, exchanges of warrants are not eligible for QEF exception

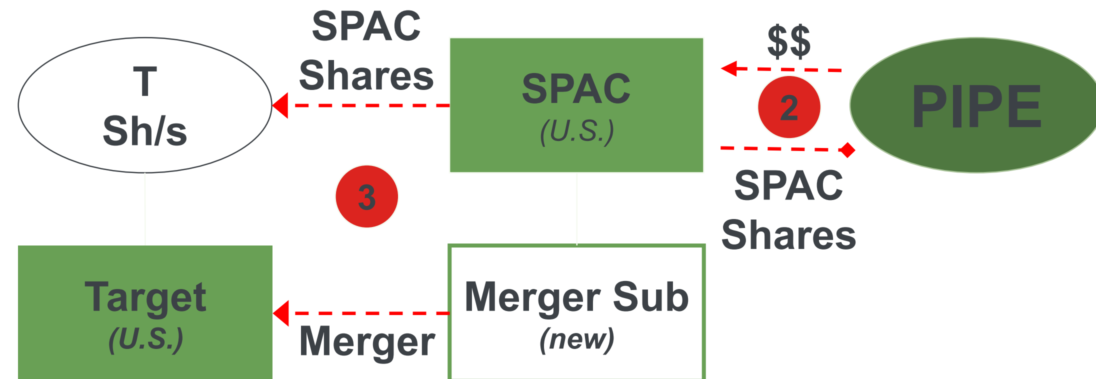
There are arguments that the proposed regulations do not apply and that the rule that turns off non-recognition and the option rule are not self-executing and require regulatory authority

[1] Section 1291(d)(2)(A); Treas. Reg. 1.1291-10
[2] Section 1291(d)(2)(B); Treas. Reg. 1.1291-9
[3] Prop. Treas. Reg. 1.1291-6

PFIC Details

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

Foreign SPAC with domestic target, generally

The domestication of a foreign SPAC is intended to qualify as an inbound F 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 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:

- 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 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
- 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

Other choice of jurisdiction implications

Other lurking issues in choice of jurisdiction

Prevalence of "double-dummy" transactions

- "Double-dummy" structures may be employed for tax, corporate law, financial reporting, or audit reasons and are fairly common in SPAC transactions
  - In particular, a double-dummy can – in certain circumstances – convert a three-year audit requirement into a two-year audit requirement, which may be beneficial to early-stage companies
- Can arise in all permutations – US/US, US/Foreign, Foreign/US, and Foreign/Foreign
- Implicates COBE, Substantially All and deemed liquidation issues that will be discussed in M&A panels

The special case of warrants

- Additionally, US SPAC warrant holders generally would not be entitled to tax-free treatment in a "double-dummy", as warrants are treated as "boot" under Section 351
  - Warrant holders may be entitled to tax-free treatment if the transaction also qualifies as a reorganization
- Also, as noted previously, warrants can interact unfavorably with the PFIC rules in the case of a foreign SPAC

Section 7874

- More often than not, U.S. targets will remain onshore and foreign targets will remain offshore, mitigating potential 7874 risks
- However, corner cases can arise (e.g., multiple targets, large U.S. SPAC / small foreign target, disregard of PIPE raise) and cross-border deals should remain aware of potential section 7874 issues

Proposed excise tax on stock buybacks

- While "Build Back Better" has stalled for the moment, the proposed 1% tax on stock buybacks seemed to have gained traction last year, and scores as a significant revenue raiser
- Though final legislation may fix various unintended consequences, SPAC redemptions could conceivably be captured by the buyback tax, increasing friction for domestic SPACs, especially in an environment of high redemptions

Section 7874 Considerations

Section 7874 can cause an acquiring foreign corporation to be treated as a US corporation for US tax purposes if the ownership percentage is ≥80%

- Additionally, if Foreign Newco is not tax resident in the same country as Foreign Target, the "third country rule" may cause Foreign Newco to be treated as a domestic corporation if the ownership percentage is ≥60%

Redemptions of US SPAC shareholders and PIPE investments may skew ownership percentages and make inversion more likely

- Section 7874(c)(4) would disregard redemptions of US SPAC shareholders, increasing (or, more accurately, not decreasing) the size of US SPAC
- In addition, PIPE investments into the Foreign Target may be disregarded under the public offerings rule of Section 7874(c)(2)(B), decreasing size of Foreign Target
- At the same time, PIPE investments into US SPAC may be taken into account in determining the size of US SPAC

Future M&A activity may be restricted under the serial acquiror rule

- If Foreign Newco uses stock to acquire additional US companies, the serial acquisition rules of Treas. Reg. 1.7874-8 would increase likelihood of an inversion in a future acquisition

Section 7874 can also result in adverse tax consequences if the ownership percentage is ≥60%

- Remaining US shareholders may lose their eligibility for favorable "qualified dividend income" rates
- Payments by related US entities made for "costs of goods sold" to the foreign corporation constitute "base erosion payments" for purposes of the "base erosion anti-abuse tax" or "BEAT"
- US SPAC must recognize "inversion gain", which includes gain on the transfer of US SPAC assets under Section 367, notwithstanding any available NOLs
  - This gain may be small and US SPAC likely will not have NOLs to offset the gain, in any event

The Biden administration has proposed strengthening these rules

- Administration has proposed a 50% ownership-threshold and "place of management and control" test for inversions