Special Purpose Acquisition Companies Offer an Alternative To Traditional IPOs in a Volatile Market

by Anshu Khanna

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While special purpose acquisition companies (SPACs) have been around for two decades, SPAC deals slowed significantly after the global financial crisis of 2008. Since 2015, however, SPAC deals have been gaining momentum, raising billions through public offerings and buying companies across a wide range of industries, including consumer goods, health services, energy, and financial tech. Today, they are experiencing a resurgence amid economic turbulence caused primarily by the pandemic. In short, SPACs are taking the financial world by storm.

The uncertainty in the market has pushed companies to reevaluate their initial public offering approach, and many have moved away from the traditional IPO market and begun to seek alternatives. A few high-profile SPACs have shown investors and companies that there are other — and simpler — ways to go public instead of a traditional IPO, especially during uncertain times like the COVID-19 pandemic. SPACs are increasingly attracting the attention and participation of prominent investors, private equity funds, experienced management teams, reputable underwriters, and other high-profile sponsors.

I. An Introduction to SPACs

A SPAC is a type of shell company or other investment vehicle that is formed to raise money from investors through an IPO and use the funds to acquire a private company. At the time of their IPOs, SPACs have no existing business operations, and they do not even have stated acquisition targets. The company’s purpose is to identify and purchase one or more unspecified businesses that are consistent with the SPAC’s investment objectives.

The money that a SPAC raises from its IPO is placed in an interest-bearing trust account while the SPAC seeks a takeover candidate. These funds cannot be disbursed except to complete an acquisition or return the money to the investors if the SPAC is liquidated. In some cases, some of the interest earned from the trust can be used as the SPAC’s working capital. A SPAC has a specific time frame — usually 18 to 24 months, although it varies by company and industry — during which it must complete a deal. If the period expires without an acquisition, the SPAC must liquidate and return the capital to its investors.

Investors in SPACs range from well-known private equity funds to the general public. Typically, SPACs are formed by experienced business executives (known as sponsors or founders) who have expertise in a particular industry or business sector and intend to pursue deals in that area. They are confident that their reputation and experience will help them identify a profitable company to acquire. Because the SPAC is only a shell company, the sponsors are...
often the selling point when sourcing funds from investors.

The founders provide the starting capital for the company, and they stand to benefit from a sizable stake in the acquired company.

A SPAC may also be used if the capital market is seen as an inefficient mechanism for investing in a particular industry. For instance, a SPAC may be better situated to price a technology target via a negotiated deal rather than targeting the broad shareholder base of an IPO and its ensuing pricing challenge.

II. SPAC vs. Traditional IPO

SPACs are IPOs with flexible benefits. They offer several distinct advantages over traditional IPOs. For example, SPACs can provide companies with access to capital, even when market volatility and other conditions limit liquidity, and they may offer lower transaction fees and expedited timelines. Some companies have recently started considering direct listing or SPACs because of increasing criticism (especially among well-known venture capitalists) regarding some aspects of the traditional IPO process, such as lockup agreements or pricing and allocation.

The table summarizes some of the pros and cons of SPACs compared with IPOs. Clearly, SPACs enjoy various benefits over traditional IPOs, and the advantages often outweigh the challenges.

III. Tax Compliance and Considerations

The formation of a SPAC gives rise to some tax considerations.

The first question to address is whether the SPAC is doing business when it is seeking a deal or operating under an administrative services agreement. A related issue is whether it must register in its tax jurisdiction. This is a highly factsensitive analysis.

A SPAC must follow some tax compliance procedures, such as obtaining a federal ID number and filing its federal and state tax returns regardless of activity.

The U.S. federal corporate income tax rate is 21 percent. Entities formed in some states (for example, Delaware) will need to file a state franchise tax return. Tax is payable annually for the previous calendar year until dissolution. Some adjustments will be necessary based on differences between tax rules and financial reporting rules.

The following subsections examine some key tax issues that the founders or management of a SPAC should consider before formation and throughout the SPAC’s existence.

A. Interest Income

The funds that a SPAC raises are held in a trust or escrow account that will generate interest income. They are used to cover the costs of identifying a deal target and for general administration. The interest will be taxable income. In some cases, state franchise taxes or other expenses may be deductible from the interest income.

B. Start-Up Costs

Start-up costs are capitalized until the SPAC consummates a deal. Thereafter, these can be amortized over a 15-year period. If the SPAC cannot complete a deal and the founders decide to terminate the trust account, the unamortized start-up costs will be deductible in the year of liquidation and dissolution.
Start-up costs typically include the expenses associated with identifying an industry, selecting a business target, and acquisition-related cost, but generally do not include interest, taxes, research and experimentation cost.

C. Transaction Costs

There are various types of transaction costs (also called deal costs), and the tax rules governing their treatment are complex. The rules are also uncertain, and their application controversial. An extensive and fact-based analysis must be performed to meet the subjective technical requirements and extensive documentation rules.

In general, taxpayers must capitalize costs that facilitate a transaction. The term “transaction” is defined broadly and includes acquisitions of the stock or assets of a trade or business, reorganizations or restructurings, borrowings, stock issuances, and changes to a company’s capital structure. Facilitative costs are the costs incurred when investigating or pursuing a transaction. Special rules and exceptions apply to some transaction costs that are deemed inherently facilitative (capitalizable) or non-facilitative (potentially deductible), such as integration expenses, employee compensation, and amounts eligible under the bright-line date rule. The bright-line date is the earlier of (1) the date the representatives of the acquirer and the target execute a letter of intent, exclusivity agreement, or similar written communication; or (2) the date the corporation’s board of directors authorizes or approves of the transaction. Thus, costs may be considered:

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### SPACs vs. IPOs

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<th>Benefits</th>
<th>Challenges</th>
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<td>Faster and more efficient process: SPACs have a clean slate, which makes the SPAC IPO process faster and simpler than the traditional IPO. Both the SEC registration and the disclosure requirements for SPACs are very limited. Typically, SPACs use Form S-1.</td>
<td>Tightened listing requirements: The Nasdaq Stock Market, the most popular exchange for SPACs, revised its listing requirements. The new rules are sometimes tricky and may give rise to last-minute issues that need to be resolved. Typically, an issuer’s underwriter syndicate will take care of listing issues at the IPO stage, but the company must be prepared to prove its compliance when the SPAC merges with the target (de-SPACing).</td>
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<td>Lower cost structure: Underwriting and marketing costs are significantly lower for a SPAC than a traditional IPO. SPAC entity sponsors typically pay a 2 percent underwriting fee at time of the SPAC IPO, with the combined company paying an additional 3.5 percent underwriting fee at the completion of merger. For a traditional IPO, fees are typically 7 percent and all of that expense is borne by the company.</td>
<td>Very short post-deal window: The merger of a SPAC and a target company involves an accelerated public company readiness timeline, complicated accounting rules, complex financial reporting, and special registration requirements. If the target company’s accounting and reporting processes and internal controls are not up to par, meeting the regulatory filing deadlines and satisfying the reporting requirements can be challenging.</td>
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<td>Generally, a SPAC faces fewer roadblocks to going public than an IPO. Retail investors gain access to private equity-like transactions, especially leveraged buy-out transactions. Selling to a SPAC is an attractive exit option for private equity funds that want to have a liquidity event in their portfolio. SPACs benefit from the reputation and past successes of their fund managers, which mitigates the risk involved.</td>
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<td>Price: SPACs have already raised capital, which provides greater price certainty for a private company that is contemplating an IPO. The traditional IPO process involves significant uncertainty around the ability to raise capital, especially during times of market volatility and economic downturns.</td>
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Facilitative: Aside from costs that are inherently facilitative, costs are facilitative if they are incurred in the course of investigating or pursuing an acquisitive transaction and are incurred on or after the bright-line date. Generally, facilitative costs are capitalized into the basis of acquired stock or assets acquired.

Inherently facilitative costs: These include the costs of some types of activities or services performed when investigating or otherwise pursuing the transaction. Examples include costs associated with appraisals, preparing or reviewing deal documents, negotiating the structure of the transaction, obtaining regulatory approval, and obtaining shareholder approval. Inherently facilitative costs must be capitalized into the basis of acquired stock or assets regardless of when the services are performed.

Non-facilitative: Costs are non-facilitative if they are incurred in the course of investigating or pursuing an acquisitive transaction and are incurred before the bright-line date. They are deductible as incurred, unless the company is in the start-up phase.

D. Failed Deal Costs

Failed deal costs (or failed transaction costs) are the costs related to pursuits or opportunities that did not materialize. They generally generate a tax deduction in the current year.

E. Success-Based Fee

A success-based fee is a fee that is contingent on the successful closing of a transaction. Success-based fees are generally considered facilitative.

The safe harbor in Rev. Proc. 2011-29, 2011-18 IRB 746, permits an electing taxpayer to treat 70 percent of a success-based fee as an amount that does not facilitate the transaction. The facts and circumstances of each case need to be analyzed to determine if safe harbor rules are beneficial.

F. Stock Issuance Costs

Stock issuance costs are the expenses a corporation incurs when it issues securities to the market. The costs associated with issuing stock typically include fees for attorneys, accountants, and underwriters. Stock issuance costs should be subtracted from the related proceeds and the net amount listed as the proceeds from the offering.

G. Net Operating Loss Carryforwards

If deductible expenses are in excess of taxable income, a company generates a net loss in a period, and it can carry the loss back two years (assuming it was profitable in the last two years), or it can carry the losses forward for 20 years to offset future taxable income, thus creating net operating loss carryforwards.

Under IRC section 382, if a change in ownership occurs, the use of NOLs will be subject to annual limitations that may significantly reduce the value of the NOLs. A change in ownership occurs when one or more 5 percent shareholders increase their ownership share in the company by more than 50 percentage points during a three-year period. For instance, if a 10 percent shareholder increased his position in the company to 70 percent (a 60 percent point increase), then a change in ownership has occurred and the use of NOLs would be subject to annual limitations.

Simply put, once the SPAC enters into a transaction and undergoes an ownership change, the future use of these NOLs may be limited, and the impact of this rule must be analyzed in detail.

H. Deferred Taxes

The SPAC will need to record deferred taxes based on any book-vs.-tax-basis differences and tax attributes as part of the process of preparing for the financial statement audit. Deferred tax assets will largely include temporary differences related to capitalized start-up costs and NOL carryovers.

I. State Nexus and Registration

States are becoming increasingly aggressive in collecting taxes based on nexus. Therefore, it is important to consider whether the SPAC should be registered in the state of its address, the state where it operates, the state in which it is looking for the deals, or the state where its assets are located. If there is no nexus, then there is no state registration or related income tax filing requirement.
Whether a SPAC’s activities create a nexus with a particular state must be evaluated case-by-case considering the various methods that jurisdictions use to compute an entity’s tax base. This evaluation should include the activities that the SPAC engages in as well as those performed by management, key personnel, or contractors acting on the SPAC’s behalf. Management of the SPAC must also be aware of contact with states that have a tax on capital.

These are highly fact-sensitive issues, and they require a critical evaluation of the business and the points where nexus can be created.

J. Offshore Structures

While most SPACs are formed as Delaware corporations, several have been formed in foreign jurisdictions, including the British Virgin Islands, Cayman Islands, and Marshall Islands. If the SPAC is pursuing a target outside the United States, a foreign SPAC may be useful because it may allow for a more efficient structure after de-SPACing (that is, after merging with the target) if foreign assets are acquired, and the SPAC can redomicile into the United States if domestic assets are purchased instead.

If the founders are considering a foreign SPAC, the corporate law of the foreign jurisdiction must be evaluated, and they may find that it is poorly developed. Also, offshore structures may pose additional tax issues such as the treatment of passive foreign investment income. Controlled foreign corporation and passive foreign investment company rules should be carefully evaluated to determine if, for example, the SPAC generates effectively connected income.

Emerging market-focused SPACs, particularly those seeking targets in China, have been incorporating a timeline of 30 to 36 months to account for the added time that it has taken other entities to complete their business combinations.

SPAC rules are becoming increasingly common throughout the world. Malaysia has a specific regulatory framework for SPACs. In 2014 the Toronto Stock Exchange adopted a “Guide to Special Purpose Acquisition Corporations” to provide investors with guidelines for SPACs in Canada. The Korea Exchange provides a definition for SPACs in the Enforcement Decree of the Financial Investment Services and Capital Markets Act. South Korea’s definition is similar to that used in the United States, and SPACs are listed as public companies under the KOSPI or the KOSDAQ markets. The London Stock Exchange has seen some recent examples of companies like Metro Bank and Pennpetro Energy pursuing a direct route to listing. (In London, a direct listing is referred to as an introduction.)

Cayman Islands exempted companies are one of most popular vehicle choices for SPACs due to their simpler and efficient merger regime and familiarity with international investors and stock exchanges.

V. Key Takeaways

These are exciting times for SPACs. The SPAC market has never been hotter. For private equity firms and other sellers, selling to a SPAC can offer a quick, well-priced transaction. That said, SPAC deals are not simple. They are closely regulated by the SEC. The process remains similar to that for an IPO, but with tighter deadlines.

Besides a experienced management team, it is critical for a successful deal that both the SPAC and the target understand multiple tax and other requirements and be well prepared to effectuate a deal in a tight time frame. Two years fly by quickly.

Also, offshore structures may be viable and need to be carefully assessed; if a foreign structure is used, a strong understanding of local laws is imperative.