Financing Developments and Tax Considerations: IPOs, SPACs and UP-Cs

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Agenda

Traditional IPOs vs. Special-Purpose Acquisition Companies (SPACs)

Background

SPACs are acquisition vehicles that allow an investor to co-invest "publicly" side-by-side with the SPAC sponsor and provide the "de-SPAC target" an alternative to a traditional IPO.

- **Sponsor raises capital by selling units (i.e., stock and warrants) to public investors**
- **Sponsor receives a share "promote" and also buys warrants to cover the IPO placement costs**
- **The capital is held in trust, to be used in connection with a business combination**
- **The sponsor typically has two years to complete a business combination with a "de-SPAC target"**

Traditional IPO Compared to SPAC Merger

Traditional IPO

- Shorter marketing window
- Limited interactions with new investors
- Marketing based on historical financials
- Limited structural flexibility
- Underwriting fees, but no warrants or sponsor promote
- Execution uncertainty?

SPAC Merger

- **Longer marketing window, including access to "PIPE" (private investment in public equity) market**
- **Multiple interactions with investors**
- **Ability to disclose financial projections**
- **Ability to address complete capital structure, including committed debt**
- **Involves warrants and sponsor promote (subject to negotiation)**

Source: UBS Securities LLC

Traditional IPO Compared to SPAC Merger — Statistics

SPAC Merger — 2021 Statistics to Date

Source: SPAC Analytics

Reverse Merger vs. de-SPACs

Reverse Merger

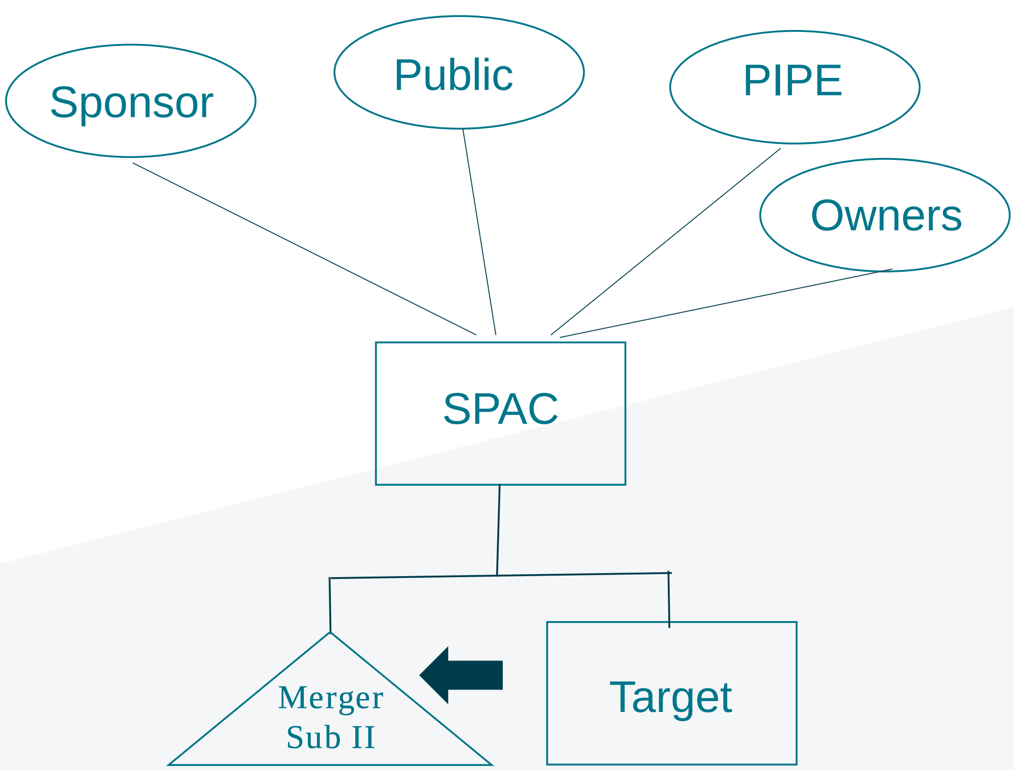
- Public company “acquires” private company, and former stockholders of private company acquire control of the public company
- No redemption rights
- Public company is often

Basic de-SPAC Structures

Two-Step/Forward Triangular Merger

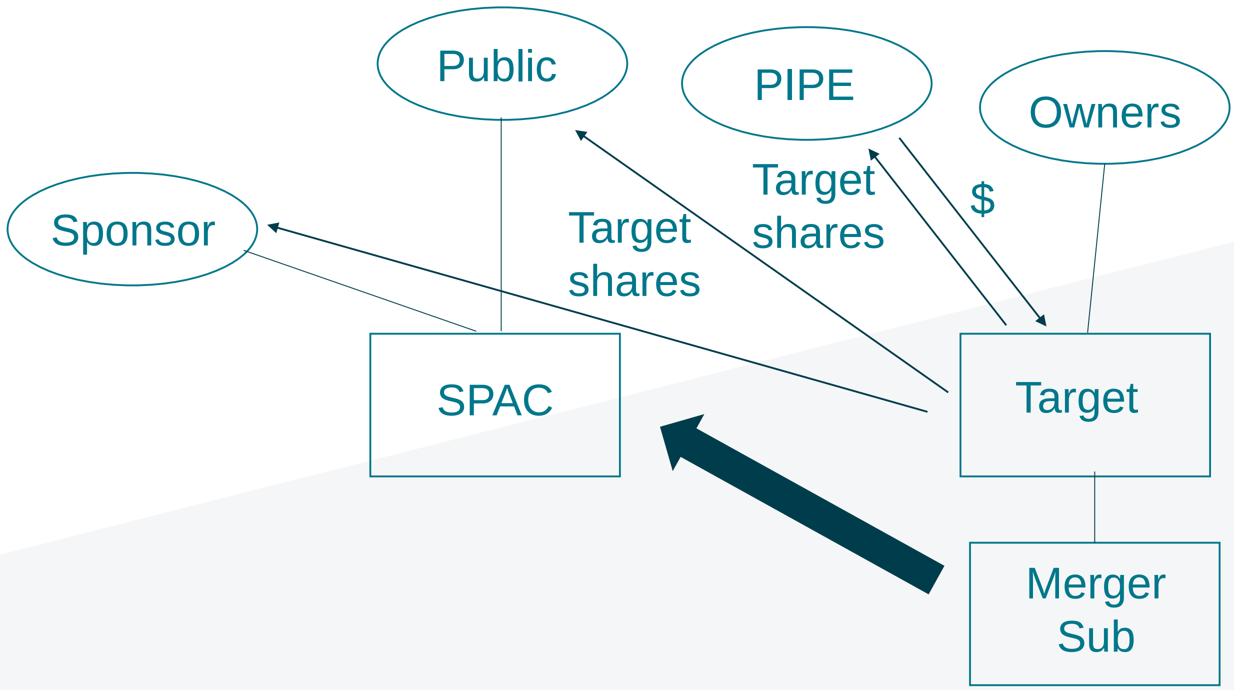
Basic de-SPAC Structures

Two-Step/Forward Triangular Merger: Resulting Structure



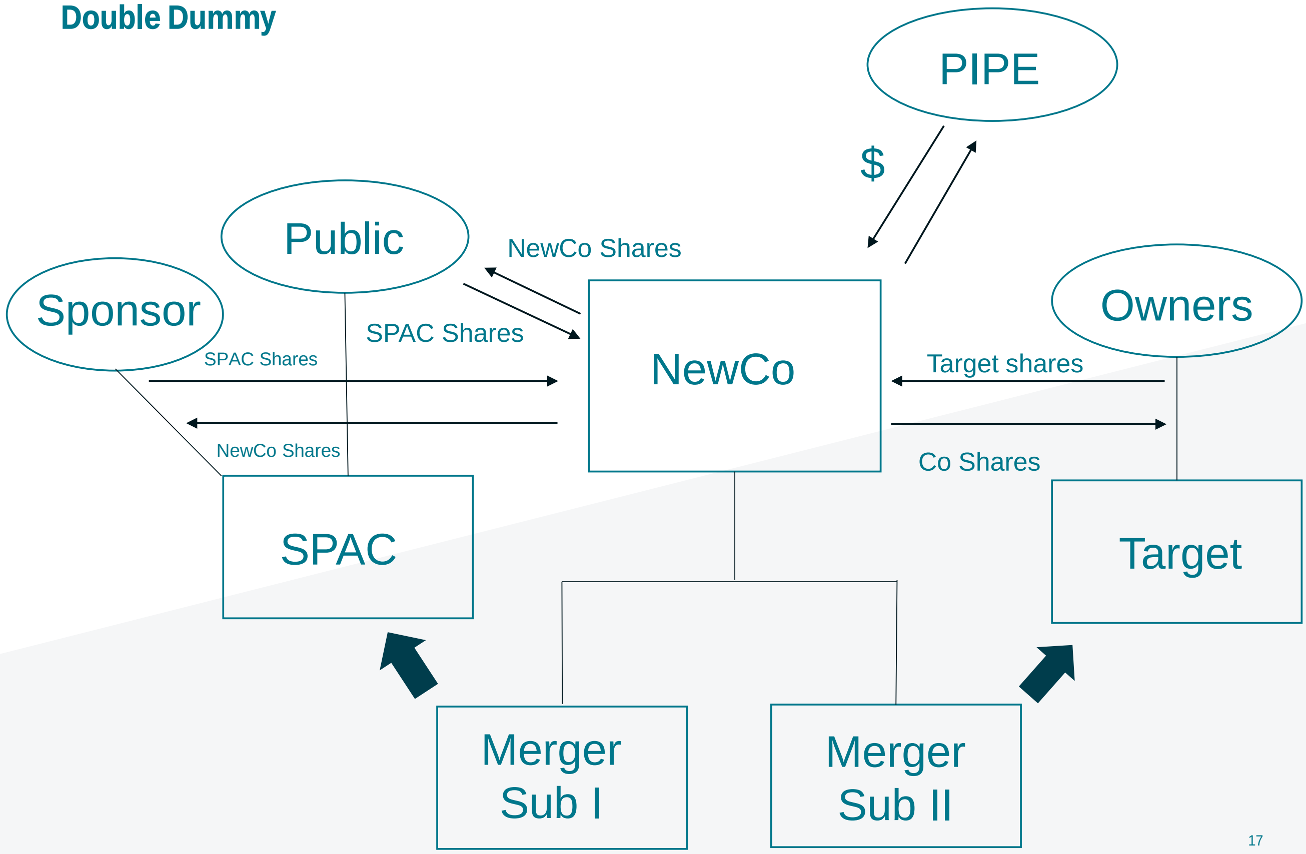
Basic de-SPAC Structures

Target as Acquiror



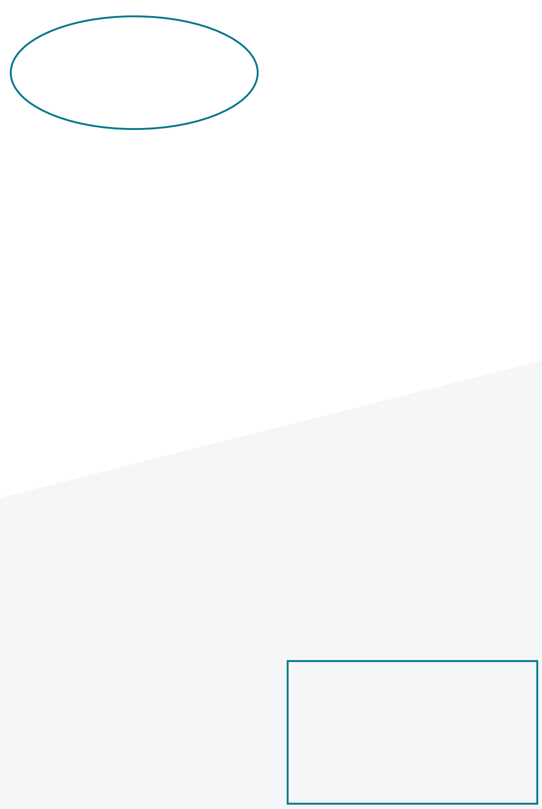
Basic de-SPAC Structures

Double Dummy



Basic de-SPAC Structures

Double Dummy: Resulting Structure



Redemption Rights

- Public investors typically buy units in the SPAC for $10, which consists of one common share plus warrants
    - Warrants typically have an exercise price of $11.50
    - Shares and warrants trade separately
- Once a deal is announced, public investors, but not sponsors, have the right to redeem for a proportionate share of the SPAC's trust account
- Per

Proposed Excise Tax on Redemptions

- Apply a 2% excise tax to domestic publicly-traded corporations that redeem any securities equal to the value of securities redeemed, reduced by the sum of the value of:
    - Any newly issued securities issued during the year and
    - Any securities issued to employees during the year (including in response to an exercise of an option)
- The excise tax would not apply to:
    - Redemptions that are part of a non-recognition transaction and are not subject to recognition
    - Redeemed securities that are contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan, or an amount equal to the value of the securities are so contributed, or
    - Redeemed securities if the value of the securities does not exceed $1 million

Pershing Square

- Pershing Square Tontine Holdings negotiated to buy 10% of Universal Music Group for a portion of its cash
- The SEC questioned the terms of the deal on regulatory grounds
- PSTH withdrew its offer to UMG
- In August, PSTH was sued by an investor, who asserted that PSTH was really an investment company under the Investment Company Act of 1940
- PSTH also announced plans to liquidate, in exchange for cash and a warrant in "SPARC", a "special purpose acquisition rights company"
    - Key difference: investors in a SPARC receive a unit, which represents the right to invest once the SPARC finds a business opportunity, rather than paying cash upfront and having a redemption right

IPO Readiness

Due diligence matters

- **Sales and use taxes**
- **Withholding taxes**

Internal controls

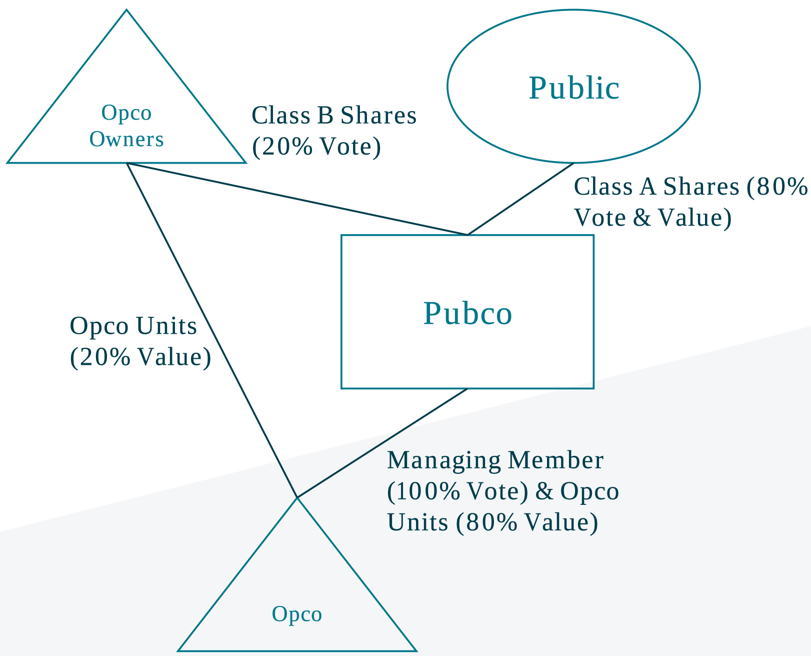
Whose EIN?

Directionally, Treas. Reg. §1.1502-75(d)(3) indicates that EIN of SPAC should be used, even though the consolidated group of target is treated as continuing:

"...then any group of which the first corporation was the common parent immediately before the acquisition shall cease to exist as of the date of acquisition, and any group of which the second corporation was the common parent immediately before the acquisition shall be treated as remaining in existence (**with the first corporation becoming the common parent of the group**)" (emphasis added)

EIN block on the first page of the consolidated tax return should be filled in with SPAC's EIN, presenting name of taxpayer as:

Traditional UP-C



Traditional SPAC vs. UP-SPAC

UP-SPAC	Traditional SPAC
Sponsors remain in pass-through structure unless they want to unwind at de-SPAC	Less impediments/costs to CIC transaction
Future sell downs by sponsors generate tax basis step up for Pubco; TRA potential	No tax basis step up related to Sponsor/Founder shares; no TRA potential
More complexity (usually) (financial reporting, tax reporting, structuring)	Less complexity (usually)
More flexibility in structuring	

PTP Concerns for Opco

If OpCo were treated as a PTP and

Current Developments: Dual Class Stock

Dual Class Voting Stock

Why is dual class voting stock issued?

Company founders and leadership team can focus on long-term strategy without getting distracted by activist shareholders looking for short-term stock performance

More internal stability and harmony, which may be reassuring to customers and partners

Founders have more control takeover activity and other key strategic decisions

Implementation

Typically issued in a recapitalization in which existing regular vote stock is exchanged for new high or low vote stock

Increasingly common for only certain pre-IPO owners, such as founders and key executives, to receive high vote stock

In certain cases, all pre-IPO owners receive high vote stock, whereas new investors in IPO receive low vote stock

Dual Class Voting Stock

Tax Consequences

Dual Class Voting Stock

Tax Consequences

Treas. Reg. §§ 20.2031-1(b) (estate taxes) and 25.2512-1 (gift taxes) define FMV as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Should hypothetical "willing buyer" be treated as purchasing the low vote stock, since the high vote stock will convert to low vote stock upon transfer?

- "The willing buyer is a purely hypothetical figure and valuation does not take into account the personal characteristics of the actual recipients of the stock. The hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage. This advantage must be achieved in the context of market conditions, the constraints of the economy, and the financial and business experience of the corporation existing at the valuation date. Moreover, in valuing stock, the rights, restrictions, and limitations of the various classes of stock must be

Dual Class Voting Stock

Tax Consequences

Or is the relevant FMV the value of the stock in founder's hands, apart from its value upon sale?

- Accession to wealth? *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)
- Founder wants voting control, and normally giving founder things that nobody else has in order to keep founder happy is compensatory
- What if founder's voting control enables her to increase the value of the shares? Or cause the board to pay her more compens0.8(o)-2cs.3(m)1.fLTo3(0.8(o)-22Vh)3.1(in)-3(g)-2.

Dual Class Voting Stock

Tax Consequences

Rev. Rul. 59-60

- Outlines approach, methods and factors to be considered in valuing shares of capital stock of closely held corporations for estate tax and gift tax purposes
- Methods also apply to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value
- Heavy emphasis on economic factors, but

Dual Class Voting Stock

Tax Consequences

Relevance of Control Premium Cases—Which way do they cut?

Dicta includes concept that control is valuable, but analysis and holdings are focused on what a buyer would pay for the stock

- *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990) "Control means that, because of the interest owned, the shareholder can unilaterally direct corporate action, select management, decide the amount of distribution, rearrange the corporation's capital structure, and decide whether to liquidate, merge, or sell assets"
- *Dahlgren v. United States*, 553 F.2d 434 (5th Cir. 1977) , reh'g denied, 557 F.2d 456 (1977) (control premium taken into account for purposes of Section 1239, citing to dicta in *United States v. Parker*, 376 F2d 402 (5th Cir. 1967) "Even absent any contemplated change in management, control increases the value of an investment by protecting it.

SPAC Structuring: Control

- To qualify as a tax-free reorganization under Section 368(a)(2)(E) (a "reverse triangular merger"), the buyer must acquire "control" in exchange for voting stock
  - Also applies to "B reorganizations"
  - Section 368(c): ownership of stock possessing at least 80 percent of the total combined vote and 80% of the total number of shares of all other stock of the company.
    - The IRS has ruled that 80% of each class of nonvoting stock must be exchanged for voting stock.
- Voting power: generally means the right to elect directors

SPAC Structuring: Control

- Examples:
  - Corporation T has two classes of stock, Class A (voting) and Class B (non-voting). Each class has 100 shares outstanding. In a reverse triangular merger, Acquiror P exchanges each Class A share of T for 1 share of P voting stock and each Class B share for .5 shares of P voting stock and $1. The merger does not qualify as a tax-free reorganization.
  - Same facts, except Corporation T has 90 shares of Class A stock and 10 shares of Class B stock outstanding. P acquires each Class A and Class B share for 1 share of P voting stock. Stockholder Y, who owns 3 shares of Class B stock, dissents and receives $3 cash. The merger does not qualify as a tax-free reorganization, even though the overall consideration is 97% stock.

SPAC Structuring: Warrants

- General rule under Section 354:
  - No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.
  -

SPAC Structuring: Continuity of Business Enterprise Requirement

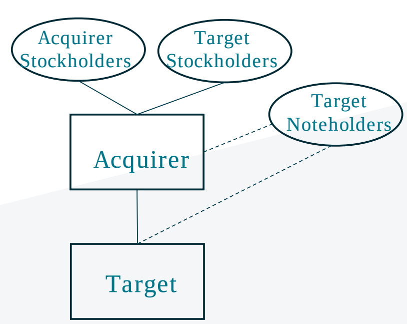
- Section 368 requires issuing corporation (P) to continue target's historic business or use a significant portion of target's historic business assets in its business
  - If T is in multiple lines of business, P must continue a "significant" line of business
  - Business assets may include stock, securities and intangibles
- What is the SPAC's historic business?
- Note that Section 351 does not have a COBE requirement

What Happens to Outstanding Convertible Debt?

TAX CONSEQUENCES:

- Change in delivery obligation from Target stock to Acquirer stock is by operation of the terms of the debt, so under general rule, not a modification requiring testing for deemed exchange treatment under Cottage Savings regs.
- Addition of Acquirer as co-obligor does not change in payment expectations from speculative to adequate or vice versa. §§1.1001-3(e)(4)(iii) and (vi).

AFTER



TAX CONSEQUENCES:

- When holders convert, is conversion tax-free?
- Rev. Rul. 72-265 provides that no gain is realized upon the surrender of debenture pursuant to its terms for stock of the issuer.
- In contrast, exercise of an exchange feature is taxable. Rev. Rul. 69-135.
- Cottage Savings regs state that an alteration that results in a property right that is not debt for US federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the

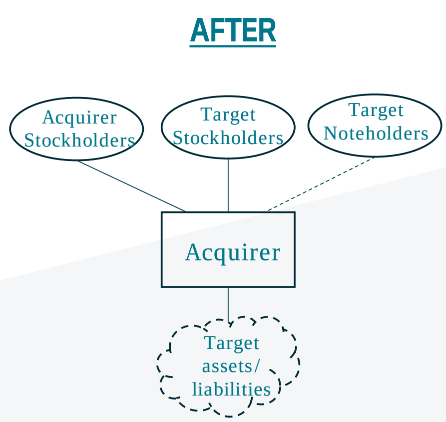
EXAMPLE 2 FACTS:

- Same facts as Example 1, except that the tax-free reorganization is structured as

What Happens to Outstanding Convertible Debt?

LAW:

- General rule is that substitution of a new obligor on recourse debt is a significant modification/deemed exchange. §1.1001-3(e)(4)(i)(A).
- Exception if change in obligor is pursuant to Section 381(a) transaction or acquisition of substantially all Target's assets, no change in payment expectations and no significant alteration of the debt. §§1.1001-3(e)(4)(i)(B) and (C).
- Significant alteration is an alteration that would be a significant modification but for the fact that it occurs by operation of the terms of the debt. §1.1001-3(e)(4)(i)(E).
- Is convertibility into stock of a different issuer per se significant, even though the conversion rate is adjusted in accordance with the deal terms in order to preserve the economics?
- If so, isn't that also true in Example 1?
- What if Acquirer is a SPAC? Is SPAC stock really any different than Target stock?



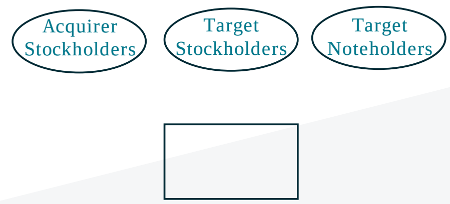
TAX CONSEQUENCES:

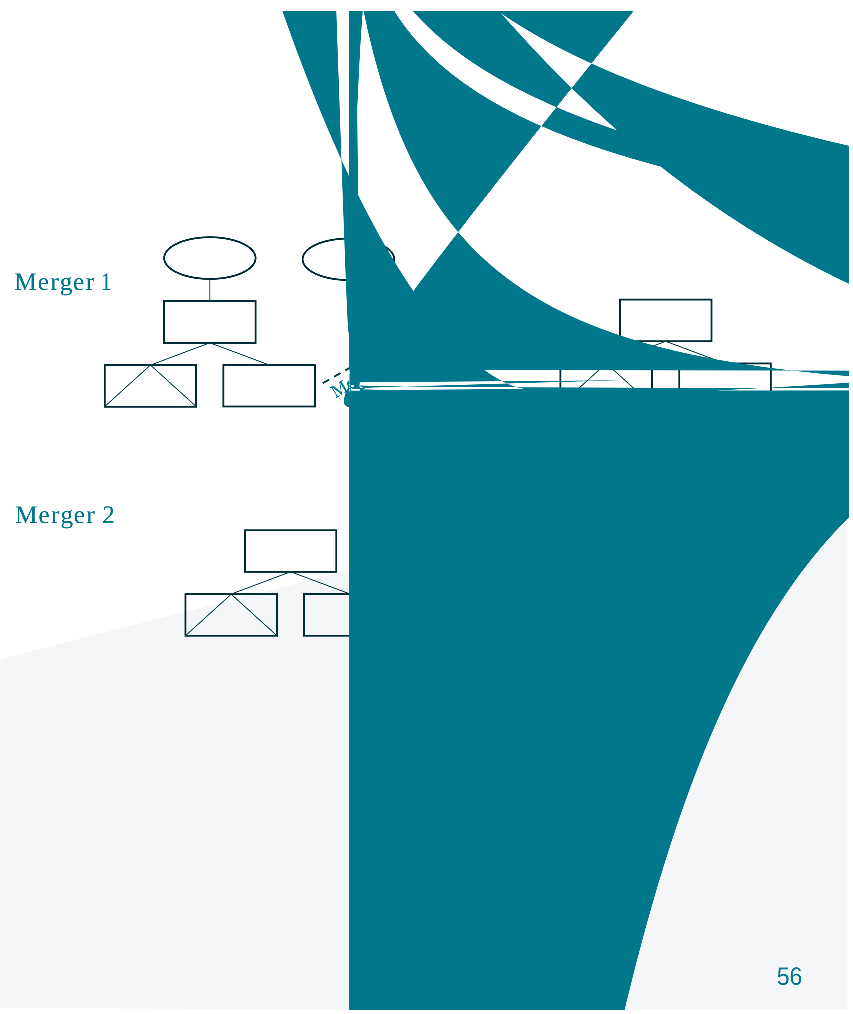
- If convertibility into stock of a different issuer is not per se significant, then under §1.1001-3(e)(4)(i)(B), no deemed exchange of the debt and no tax consequences for noteholders.
- Under Section 357, absent a tax avoidance purpose, Acquirer's assumption of Target's liabilities is not treated as boot and does not prevent the exchange of Target's property for Acquirer's stock and securities in the reorganization from being tax-free to Target under Section 361.

EXAMPLE 2.1:

- Same facts as Example 2. Assume Target's debt has increased in value because the conversion feature is in-the-money. Aggregate principal amount is $150 million and FMV is $200 million.
- Assume that convertibility into stock of a different issuer is per se significant, so that there would be a deemed exchange of Target's debt and issuance of Acquirer's debt. §1.1001-3(e)(4)(i)(B),
- Face amount stays the same, but Target debt is treated as retired in exchange for issue price of Acquirer debt, based on sales prices or firm or indicative quotes. Section 1273(b)(3), §1.1273-2(b), (c) and (f).
- Premium of $50 million is non-deductible under Section 249 to extent attributable to conversion feature.
- If stock price subsequently falls and debt is retired for its face amount (or converted into stock worth less than adjusted issue price of Acquirer debt), should Acquirer be required to recognize COD income, even though it got no tax benefit from the premium?

AFTER

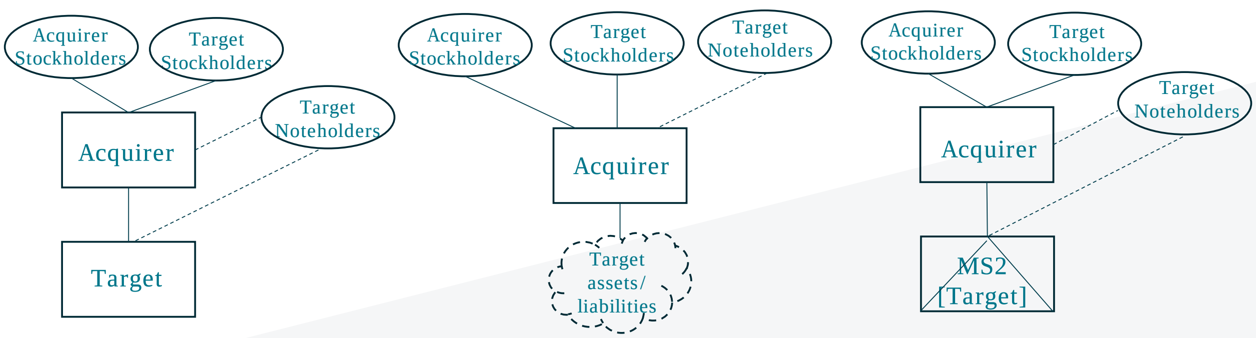




What Happens to Outstanding Convertible Debt?

Is end state of Example 3 more like Example 1 or Example 2?

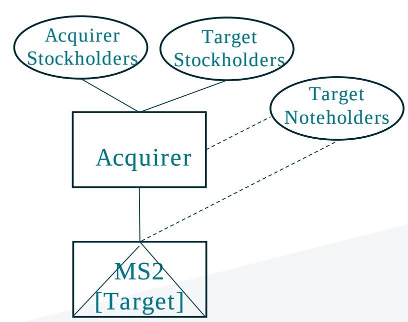
EXAMPLE 1 EXAMPLE 2 EXAMPLE 3



What Happens to Outstanding Convertible Debt?

- Is Example 3 the addition of a co-obligor or a change in obligor for purposes of Section 1001?
- Should MS2 [Target] be treated as the same obligor as Target, given that it holds all of (and only) Target's assets and liabilities? Should MS2 [Target] be treated as the same obligor as Acquirer, given that it is a disregarded entity?
- PLRs 201010015, 200630002, 2003315001; AM 2011-003.; Cf. PLR 202050014.

EXAMPLE 3

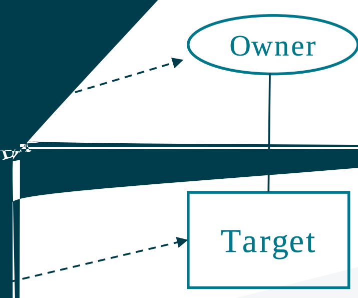


Cross Border Tax Considerations: Foreign SPAC

Pros for Foreign Target	Cons for US Target
Domestication into target's jurisdiction usually does not raise U.S. tax issues (e.g., inversion rules)	Domestication to the U.S. usually required; may have tax issues
Typically able to structure for tax-free rollover under foreign law	SPAC likely a PFIC prior to acquisition so PFIC rules l

Cross Border Tax Considerations: US SPAC

Cons for Foreign Target	Pros for U.S. Target
Target income subject to U.S. tax (GILTI, 245A)	Allows for tax-free reorg with U.S. target
Foreign withholding on distributions from target to SPAC	No intercompany U.S. withholding issues
U.S. withholding on distributions from SPAC to foreign shareholders	
Domestication of SPAC into target's foreign jurisdiction (or if SPAC is target) raises inversion issues (367 and 7874)	



SPAC NOL Issues –

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