SPECIAL REPORT

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Selected Tax Issues Involving Blank Check Companies

by Victor Hollender

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In this report, Hollender explains why and how special purpose acquisition corporations are used as vehicles for initial public offerings, and he analyzes potential tax issues raised by those IPOs.

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We tax lawyers delight in using terminology that makes the abstract tangible and breathes life into the structures and entities that we create and control. Corporations can be "old and cold," "dormant," "newly created," or sometimes (but hopefully not) "born to die." We anthropomorphize and impute purpose to unnatural persons, preoccupy ourselves with financial "products," and provide advice that is at times "strong" and at times "weak." Every once in a while a new financial phenomenon comes along that tests our abstractions and forces us to stretch our terminology to address new and unusual situations.

Such is the case with a once again popular public offering vehicle known as a special purpose acquisition corporation (SPAC). A SPAC is the quintessential "cash box," owning only cash or Treasury securities at its inception. Often referred to as a blank check company, a SPAC embodies a host of dualities. It is a public vehicle yet often sponsored by private equity players. It is a purely passive vehicle yet with a specific objective of acquiring an active operating business. SPACs issue a variety of securities with vastly different return profiles, including stock that can lose its entire value in some circumstances (such as a liquidation), stock with redemption rights for cash, and warrants with strike prices at premiums that can significantly dilute the equity.

I. Why Use a SPAC?

The popularity of SPACs has come and gone and come again. Although SPACs have been around for more than 25 years, their use peaked in

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2007 when a record of approximately $12 billion of capital was raised in a single year.[1] In 2007 there were 47 SPAC initial public offerings (IPOs), which accounted for 34 percent of all IPOs and 37 percent of the aggregate IPO proceeds for that year.[2] The use of SPACs is now emerging as a reinvention of the IPO.[3] After going largely out of fashion in 2008 and having only one SPAC IPO in 2009, SPACs began a resurgence a few years later and are now taking the financial world by storm. In 2017 alone there were 38 SPAC IPOs, with an aggregate registration size of more than $11 billion, and three additional SPACs filed IPO registration statements in December 2017.[4] SPACs started out strong in 2018 with four SPACs filing IPO registration statements in January.[5] In addition to becoming more frequent, SPAC IPOs are also increasing in size and are likely to surpass those levels in the near future.[6] Increasingly, well-known private equity firms are sponsoring SPACs.[7]

A. Backdoor IPO

A SPAC business combination typically involves an acquisition (or other combination transaction) of a private company. The sponsor seeks out a worthwhile target acquisition — perhaps seeing it as undervalued. The target sees significant value in the SPAC as a public company with a listing on a nationally recognized stock exchange. Through a business combination, the target effectively becomes a publicly traded company without having to go through a formal IPO process on its own.[8]

B. Inefficiencies of Capital Markets

In some cases a SPAC is used because the sponsor sees the capital markets as inefficient in a particular industry. For example, Social Capital Hedosophia Holdings Corp., a recent SPAC with a focus on the technology sector, attracted investors by arguing that the capital markets are inefficient and ineffective for companies in the technology industry. A SPAC acquirer would be better situated to price a technology target in a negotiated deal as opposed to the price obtained in an IPO, in which there is often high shareholder turnover and significant run-up in the price in the first few days. Moreover, the significant time and effort required by an IPO process is likely distracting to target management. In most private companies, management is preoccupied with running the day-to-day operations of the business and does not have the substantial amount of time required to prepare for and complete an IPO.

C. Bringing Private Equity to the Public Markets

A further business rationale underlying the use of a SPAC is the ability to bring a private equity-type structure to the public capital markets. Several private equity firms, such as Carlyle, Fortress, Gores, and TPG, have sponsored SPACs recently. They view a SPAC as a way to increase their access to equity capital outside the typical private equity model.[9] The private equity firm sponsors a SPAC and subscribes for founder shares that are in some ways similar to a carried interest issued by a private equity fund. Unlike a carry, however, the founder shares dilute public shareholders' interests immediately upon an initial business combination and do not depend on future profits realized beyond the initial investment. As a check

[1] Bloomberg LP, "Dealogic LLC" (2017); and "SPAC Analytics" (2017); and James Mackintosh, "The Modern IPO Is Useless. Let's Reinvent It," *The Wall Street Journal*, Sept. 25, 2017.

[2] Bloomberg, *supra* note 1.

[3] Mackintosh, *supra* note 1. Social Capital Hedosophia Holdings Corp. closed what it deemed "IPO 2.0" after raising $690 million in September 2017. The sponsor chose the ticker symbol IPOA for what it plans to be the first of many SPACs it will sponsor — eventually sponsoring SPACs through IPOZ.

[4] Intelligize, "Registered Offerings" (2017).

[5] Bloomberg, *supra* note 1.

[6] Tom Zanki, "SPACs Grabbing Bigger Share of IPO Market," Law360, Nov. 22, 2017. Two different SPACs completed $690 million offerings in 2017: Social Capital Hedosophia Holdings Corp. and TPG Pace Energy Holdings Corp. Silver Run Acquisition Corp. II raised $900 million in a March 2017 offering.

[7] Michael J. Mies and Gregg A. Noel, "The Resurgence of SPACs in a Quiet IPO Market," Skadden, Arps, Slate, Meagher & Flom LLP (Apr. 26, 2016).

[8] A recent example of a target using the SPAC as a backdoor way to go public is the business combination involving GP Investments Acquisition Corp. and Rimini Street Inc. Rimini Street had tried unsuccessfully to go public on its own on two separate occasions. After a business combination with GP Investments Acquisition Corp., in which the surviving public entity took the name Rimini Street, it finally obtained a listing as a public company on the NASDAQ.

[9] Mies and Noel, *supra* note 7.

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on the immediate dilution, public shareholders can exercise redemption rights in connection with the business combination and receive back their initial investment in cash if they are not satisfied that the business combination will create sufficient value. This gives the public investor a "second look" at the time of a business combination. Many SPACs have had numerous investors exercise their redemption rights, requiring sponsors to either obtain other sources of capital (such as through private investments in public equity) or transfer or forfeit a portion of their founder shares or private placement warrants to induce investors not to redeem.

II. Basic Description of Securities

Although the terms of each SPAC may differ, SPACs commonly issue the following types of securities.

A. Founder Shares

Founder shares are issued shortly after a SPAC is formed (or in connection with the formation of the SPAC) and before the filing of the registration statement with the SEC. The sponsor purchases the shares for a de minimis price (for example, $0.002 per share), generally an amount sufficient to fund a portion of the organizational costs of the entity. Founder shares usually have the same rights as the shares owned by the public. However, holders of founder shares generally agree to vote their founder shares in favor of any initial business combination subject to a shareholder vote.

Founder shares automatically convert into public shares at the completion of an initial business combination. The conversion ratio results in the founder shares equaling, in the aggregate, on an as-converted basis, 20 percent of the outstanding shares in existence after the close of the IPO. As a result, the founder shares automatically dilute the public shareholders after the business combination is completed. Before the completion of the business combination, founder shares constitute junior equity and are typically subordinate to the public shares in that they are not entitled to any of the cash in the trust account that holds the proceeds from the IPO. Further, founder shares have no redemption rights, either in connection with a business combination or liquidation. Founder shares are subject to transfer restrictions, usually for one year after the completion of a business combination.

B. Units

A typical SPAC-offering security consists of a unit. Generally, each unit has an offering price of $10 and is made up of one common share and half or one-third of one warrant. Each whole warrant generally entitles the holder to purchase one common share at an exercise price of $11.50 per share. The shares and warrants comprising each unit begin trading separately shortly after the offering, and holders can separate their units into the underlying components at that time.

1. Public shares.

Public shareholders generally have the right to redeem all or a portion of their shares in connection with the completion of an initial business combination for a redemption price equal to the aggregate amount then on deposit in the SPAC's trust account divided by the number of then-outstanding public shares. A SPAC has a pre-defined life span of usually two years. If the SPAC is unable to complete an initial business combination within that time, the SPAC will either liquidate or request an extension of time from its shareholders to continue its efforts to complete a business combination. Public shareholders are given redemption rights similar to those described above in connection with an extension request.

2. Warrants.

As described above, each unit contains a portion of a warrant. Each whole warrant entitles the holder to purchase one share at a stated price per share. The warrants may be exercised at any time following the later of one year following the closing of the offering or 30 days after the completion of an initial business combination. The warrants expire five years after the completion of an initial business combination, or earlier in the event of a redemption or liquidation.

The sponsor usually agrees to purchase a set amount of warrants (or, in some cases, units) in a private placement occurring simultaneously with the closing of the IPO, typically referred to as the sponsor's "at-risk amount" (generally constituting around 3 to 4 percent of the SPAC's

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capital). The proceeds of that placement are generally used to fund the expenses of the SPAC.

C. Trust Account

The proceeds of an IPO, plus a portion of the sponsor's at-risk amount, are deposited by the SPAC in a trust account. Generally, the funds in the trust account may not be released (except for permitted withdrawal of interest as required to pay any income or franchise taxes or other specified expenses) until the earlier of the completion of an initial business combination or the redemptions of any shareholders properly exercising their redemption rights in connection with an initial business combination (or extension request).

D. Who Invests in a SPAC?

There are two broad categories of typical SPAC investor: (1) investors who have faith in the sponsor's ability to create value, and (2) arbitrage investors. In the first category, investors decide to invest because they are attracted to a particular manager based on reputation or past performance. For example, William P. Foley,[10] chair of the board of Fidelity National Financial Inc., Chinh Chu,[11] a former Blackstone dealmaker, and David Maura,[12] chair of Spectrum Brands, have recently sponsored SPACs. In the second category, arbitrage investors usually buy SPAC units with no intention of participating in the initial business combination as shareholders. Arbitrage investors may believe the warrants are underpriced before a successful business combination takes place. They may engage in one of several different strategies that ultimately result in selling some or all of their shares while retaining the warrants. Both categories of investors have an incentive to vote in favor of an initial business combination so that their warrants do not expire worthless.

[10]Reuters, "Blackstone Vet to Launch Largest 'Blank Check' IPO Since Financial Crisis," *Fortune*, Mar. 24, 2016.

[11]*Id.*

[12]Bill Meagher, "Fortress Enters SPAC World While Awaiting SoftBank Closure," *The Deal*, Sept. 28, 2017.

III. Founder Shares: Cheap Stock and Transfer Issues

A. Cheap Stock

Founder shares are issued to the sponsor of a SPAC, in connection with or shortly after its formation, for a negligible price. Quite often a sponsor contributes as little as $25,000 to the SPAC in exchange for a fixed number of founder shares. Once the SPAC is formed, the sponsor has two monumental tasks ahead. First, the SPAC must successfully complete an IPO. Second, the SPAC must complete a successful business combination. Sponsors typically have significant financial and deal-sourcing experience in a particular industry or market. The sponsor generally has no employment or management contract with the SPAC and does not receive any type of compensation or fee for his services.

Because the founder shares are purchased for such a small sum and could, in the event of a subsequent business combination, become worth tens (and in some cases, hundreds) of millions of dollars, there is a question whether the sponsor should be treated as receiving disguised compensation for services because of the acquisition of the founder shares at a bargain price. This is sometimes referred to as the "cheap stock" issue. Tax practitioners typically advise that founder shares be issued to the sponsor as soon as practicable after the formation of the SPAC — certainly before any registration statement is initially filed with the SEC. At that time, not only is an initial business combination completely speculative, but there is also a real possibility that the IPO itself will not successfully be completed. As more fully discussed below, as a result of these significant contingencies (among other reasons), there are strong arguments that the founder shares have no real ascertainable value when issued and purchased by the sponsor and there is therefore no bargain purchase or disguised compensation in connection with their issuance.

1. Two extremes and a SPAC in between.

To better understand the cheap stock issue, it is helpful to consider two situations involving the issuance of founder shares existing at opposite ends of a spectrum where the tax treatments are relatively clear.

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a. Situation 1: Contemporaneous issuance and business combination.

Assume the SPAC issues founder shares to the sponsor for only $0.002 per share at the consummation of the business combination when the SPAC shares are trading at $10 per share (with the public shareholders having paid $10 for each unit in the IPO). A bargain purchase is fairly clear in this example. The excess of the fair market value of the founder shares over the $0.002 price per share would probably be treated as compensation for services.[13] The result would likely be ordinary income to the sponsor in the amount of that excess. A key factor is that the property being issued to the sponsor has a clear FMV. The business combination has been completed, and the sponsor is assured the founder shares will not expire worthless. The sponsor in this case is entitled to this bargain price only because of services provided.

b. Situation 2: Early-stage entrepreneur.

Situation 2 is the case of an entrepreneur in the early stages of a start-up. At the outset, determining whether the business will succeed is completely speculative and extremely difficult to predict. Although an entrepreneur could be the next Steve Jobs, it is also quite possible that the start-up will go bankrupt.

Similar to a SPAC sponsor, our entrepreneur is likely to form an entity to pursue his idea and take back equity, usually in exchange for providing a small amount of cash to fund initial organizational expenses. At the time of formation, the entity has no real and discernible value, and neither does the equity. The founder rightly has no compensation event upon receiving the equity of his business. Because of the speculative nature of the start-up business, there is clearly no compensation event as a result of the founder taking back equity in his own entity at inception. It may very well be the case that as the start-up becomes more and more successful over time as a result of the services performed by the entrepreneur, the stock significantly increases in value. But importantly, there is no realization event and no compensation event for that increase in value. Taxing the entrepreneur at any point before the sale of the equity is inconsistent with the realization principles of our income tax system (as discussed below).

c. The SPAC in between.

The SPAC sits somewhere between the two extremes. Although the IPO and a subsequent business combination are clearly part of an intended plan, they are completely speculative and uncertain when the sponsor receives founder shares. IPOs are costly and time consuming and depend on several factors beyond the sponsor's control, such as obtaining sufficient public interest and establishing an appropriate price. Even after a successful IPO, there is no guarantee the SPAC will be able to complete a subsequent business combination. SPACs generally have only two years in which to complete an initial business combination — a short time to find a target, negotiate a deal, and obtain all required approvals. Any deal remains subject to the approval of public shareholders (as well as any required regulatory or other approvals) — factors that are out of the control of the sponsor. If the SPAC is unable to complete an initial business combination in time, it will liquidate, and the founder shares will be completely worthless. In short, while the success of a SPAC is more likely than that of an entrepreneur forming a business in his garage, the ultimate success of a SPAC is still speculative and highly contingent when the sponsor purchases the shares.

2. Basic principles of federal income tax law.

Basic principles of federal income tax law, such as the realization requirement, the taxation of human capital, and the taxation of self-imputed income, provide a useful framework to analyze issues arising in the typical case of founder shares issued by a SPAC.

a. Realization requirement.

The realization requirement is a fundamental principle underlying our tax system for several reasons, including liquidity and valuation considerations.[14] Absent a realization event, a

[13] *See, e.g.*, *Beckert v. Commissioner*, T.C. Memo. 1978-903.

[14] *See, e.g.*, Deborah A. Schenk, "A Positive Account of the Realization Rule," 57 *Tax L. Rev.* 355 (2004); and Ilan Benshalom and Kendra Stead, "Realization and Progressivity," 3 *Colum. J. Tax. L.* 43, 54 (2011).

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taxpayer may not have the liquid assets necessary to pay taxes. The realization requirement provides a liquidity event that will presumably give the taxpayer the liquidity necessary to pay taxes. The realization requirement also avoids valuation questions by not imposing tax until there is a market event that establishes a reliable indicator of the value of property or services to be taxed.

When the founder shares are issued, it is extremely difficult to conclude that there is any sort of realization event. The sponsor would have no liquidity to pay taxes on any compensation income when the founder shares are purchased or even later in the process, after the SPAC completes its IPO or, as a result of lock-up restrictions generally applicable to the founder shares, even upon the completion of a subsequent business combination. Also, because of the contingencies related to the founder shares ever having significant value, it is difficult to value them. Under the realization requirement, the sponsor should have no taxation event until he sells the founder shares in a market transaction.

b. Human capital.

Another long-standing principle of federal income tax law is that human capital is treated differently from other forms of capital.[15] For example, one is generally able to deduct or capitalize an investment in physical capital used in a trade or business.[16] However, one is generally unable to deduct or capitalize an investment in one's human capital (for example, advanced degrees and other forms of educational training).[17] Increases in value generated by human capital are generally not taxed until there is a clear realization event — for example, until wages are earned or the definitive result of human effort (such as stock or a patent or other form of intellectual property) is sold to a third party. Treating human capital differently is justified for several reasons.

Valuing human capital is difficult. What is the proper time to value one's human capital, and how do you determine tax basis in human capital? It is nearly impossible to value human capital when that valuation is based on services to be provided in the future because of outside contingencies beyond the control of the taxpayer. Liquidity is also a consideration. One is generally unable to borrow against human capital, and forcing a taxpayer to sell other assets or earn wages with which to pay taxes is market distortive. By not taxing human capital until realization through market earnings, the federal income tax system avoids these concerns.

For a SPAC, the contribution of the sponsor is in the form of human capital. The sponsor brings his reputation, relationships, management, and deal-sourcing abilities to the SPAC in hopes of carrying out a successful IPO and consummating a business combination. Any increase in the value of the founder shares results from those efforts. Attempting to value the founder shares before an actual liquidity event would be extremely difficult, and imposing a tax on the sponsor would present liquidity problems because the sponsor would have no earnings with which to pay the tax. Thus, the principles concerning the special treatment of the taxation of human capital (or lack thereof) under the federal income tax system provide further support for not taxing the sponsor on the receipt of founder shares.

c. Imputed income.

Not taxing so-called imputed income is another long-standing principle of the federal income tax system. Imputed income may be considered the fruits of one's own human capital. Not taxing human capital absent a market realization event supports not taxing imputed income. For example, a builder could buy a lot, build a house, and live in the house for years and never have tax consequences unless and until he sells the house. The imputed income from the

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[15] *See, e.g.*, John A. Litwinski, "Human Capital Economics and Income," 21 *Va. Tax. Rev.* 183 (2001); Philip F. Postlewaite, "Fifteen and Thirty-Five: Class Warfare in Subchapter K of the Internal Revenue Code: The Taxation of Human Capital Upon the Receipt of a Proprietary Interest in a Business Enterprise," 28 *Va. Tax Rev.* 817 (2008); David S. Davenport, "The 'Proper' Taxation of Human Capital," *Tax Notes*, Sept. 16, 1991, p. 1401; Brian E. Lebowitz, "On the Mistaxation of Investment in Human Capital," *Tax Notes*, Aug. 12, 1991, p. 825; and Mark P. Gergen, "Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital," 44 *Tax L. Rev.* 519 (1988).

[16] *See, e.g.*, sections 162 and 263.

[17] In some specific cases, an individual may be able to claim a trade or business deduction for expenditures for educational expenses that (1) maintain or improve skills required by the individual in his employment or trade or business, or (2) meet express requirements of the individual's employer or requirements of applicable law or regulations that are a condition to the individual's employment. Importantly, an individual must already be engaged in a trade or business to claim the deduction. *See* sections 162 and 263; and reg. sections 1.162-5 and 1.212-1(f).

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labor used to build the house is deferred and converted into capital gain on any subsequent sale of the house. The same imputed income principle applies to an entrepreneur working on a new business idea. That entrepreneur may toil away for years at building his business but will not be taxed on any imputed income while building the business.

For a SPAC, the sponsor provides services to the SPAC before an IPO when the SPAC is wholly owned by the sponsor. Taxing the sponsor on any income from those services would be inconsistent with the principles of not taxing human capital and imputed income.

3. Relevant case law.

Although there is little law on point regarding the sponsor's purchase of founder shares, several of the cases discussed below illustrate well the fundamental principles regarding imputed income and human capital that are firmly embedded in our tax system. One case in particular bears remarkable similarities to a typical SPAC situation.

***a.* Berckmans.**

In *Berckmans*,[18] the taxpayer subscribed for common stock of a corporation (NewCo) by paying $1 per share, its par value. At the time of the purchase, NewCo (which had no assets at the time) had a plan to acquire the assets of two other corporations, Frankenmuth Brewing Co. and Iroquois Beverage Corp., each actively engaged in the brewery business. Bruce Berckmans had been a well-known executive in the brewery industry with significant experience before becoming the president, general manager, and director of Frankenmuth. He was employed by Frankenmuth under a long-term employment contract. As advised by Berckmans, Frankenmuth began seeking expansion opportunities in 1952 and retained an outside adviser to find potential target businesses. In 1953, under the direction of Frankenmuth, NewCo was formed as a shell corporation. Berckmans believed NewCo would serve as an acquisition vehicle for Frankenmuth's business expansion.

Although the outside adviser had not brought a deal to Frankenmuth, Berckmans began discussions with Iroquois in 1954 regarding a potential asset acquisition. Berckmans hired an investment banking firm, Shields & Co., to advise on financing the acquisition of Iroquois. Berckmans then developed a plan whereby NewCo would issue stock in an IPO and use the cash proceeds to purchase and consolidate both Frankenmuth and Iroquois. Berckmans and Shields would form an underwriting group to carry out the IPO, the public would pay $9.50 per share in the IPO, and Shields would be offered the NewCo stock at a price of $1 per share. The Shields underwriting plan indicated that the closing of the IPO would be simultaneous with a closing of NewCo's acquisition of the Frankenmuth and Iroquois assets. Shields was not obligated to purchase any NewCo stock if Berckmans was not under a long-term employment contract with NewCo at the closing of the IPO.

The key steps in the timeline of the IPO and business acquisitions occurred in quick succession, as follows:

- September 1954: Berckmans discusses a potential acquisition of Iroquois.
- November 1954: Berckmans develops a plan to have NewCo acquire the assets of Frankenmuth and Iroquois and starts planning the IPO. Shields is engaged for financing and underwriting assistance.
- March 1955: The decision to offer NewCo stock to the public for $9.50 per share is made. Berckmans and Shields agree to acquire stock of NewCo for $1 per share.
- April 13 and 15, 1955: Iroquois and Frankenmuth send letters of intent to NewCo regarding a sale of all their assets to NewCo.
- April 15, 1955: Berckmans and Shields purchase the stock of NewCo for $1 per share.
- April-May 1955: Purchase agreements for the NewCo asset acquisitions are executed.
- May 4, 1955: Shields forms an underwriting group for the IPO.
- May 7, 1955: Berckmans enters into a long-term employment contract with NewCo.

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

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- May 12, 1955: The registration statement for NewCo is filed with the SEC.
- May 31, 1955: The SEC declares the NewCo registration statement effective. An underwriting agreement for the IPO is executed.
- June 3, 1955: The IPO is completed at $9.50 per share, and the asset acquisitions close.

As a result of the IPO, 500,000 shares of NewCo stock were sold for $9.50 per share to the public. NewCo had successfully become a publicly traded company conducting the brewery businesses of Frankenmuth and Iroquois. Approximately 45 days before the completion of the IPO and the asset acquisitions, Berckmans and Shields acquired 60,000 shares of NewCo stock for $60,000 ($1 per share). The end result of this rapid series of transactions was Berckmans and Shields owning stock in a public company for which they paid $1 per share shortly before the public paid $9.50 per share for the same company.

The IRS asserted that Berckmans had ordinary income as compensation for services through a bargain purchase in the year of his acquisition of the stock for $1 per share based on the stock having an FMV of $9.50 per share (the public offering price). The Tax Court, however, held that because of all the contingencies, the proper value of the stock remained at $1 per share until the time of the IPO, and thus Berckmans did not have any compensation income from a bargain purchase. The Tax Court noted that: (1) valuation is a question of fact; (2) as of the date Berckmans acquired the NewCo shares, NewCo was an inactive shell corporation; and (3) although there were letters of intent to purchase the assets of Frankenmuth and Iroquois (and there was a well-baked business acquisition plan in place for each of those targets), the business acquisitions were subject to meaningful contingencies.

The Tax Court considered testimony from expert witnesses on the valuation of the NewCo shares. While Berckmans's expert witnesses focused on the contingencies concerning the transactions, the uncertainties of a successful IPO and business combination, and the fact that NewCo stock would be worthless absent an IPO, the IRS's expert witness saw very little probability of any contingency that would not be resolved in favor of NewCo. The Tax Court found that the testimony of the IRS's expert appeared to be "influenced by hindsight knowledge about the successful completion of a complex series of transactions." Declining to take a hindsight approach, the Tax Court determined that the NewCo stock was worth no more than $1 per share when Berckmans purchased it.

Several factors relevant to the founder shares of a SPAC were key to the Tax Court's opinion:

Shell corporation. NewCo was a shell corporation with no business, earnings, or assets other than the $60,000 Berckmans and Shields paid in exchange for its shares. Even though all indications were that NewCo would have an IPO and acquire two businesses, what mattered to the Tax Court was NewCo's profile at the time Berckmans and Shields purchased their shares.

Existence of plan. Berckmans had a plan from the outset that NewCo would issue its stock in an IPO and serve as an acquisition vehicle through which he would capitalize on his reputation, knowledge, and past industry experience to expand Frankenmuth's existing business. Despite the existence of a clear plan for NewCo stock to evolve into a valuable brewery business, the Tax Court concluded that there were significant contingencies to the acquisitions when Berckmans purchased his stock and that the likelihood of successful acquisitions was too uncertain to bear on the value of the stock at the time of the purchase. A significant point emphasized by the Tax Court was that there was no executed underwriting agreement when Berckmans purchased his shares and that the shares had not in fact been registered with the SEC. When Berckmans purchased his NewCo stock, NewCo stock could not have legally been offered to the public, and any number of contingencies outside Berckmans's control could have prevented an IPO.

The typical SPAC structure bears a strong resemblance to the *Berckmans* facts. When the sponsor purchases founder shares, there is no executed underwriting agreement to sell shares. The SPAC will not yet have even filed a registration statement with the SEC, and its shares therefore cannot be legally offered to the public. Although a SPAC is formed solely for the purpose of completing an IPO and engaging in a later business combination, there are significant

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contingencies outside the control of the sponsor that make the IPO and a subsequent business combination contingent.

Berckmans was more susceptible to a compensation argument than a typical sponsor because he was an actual employee of NewCo under a long-term employment contract and had been under a long-term employment contract with Frankenmuth for several years before the series of transactions. Berckmans's employment was so crucial that Shields was not obligated to purchase NewCo stock if Berckmans was not employed by NewCo under a long-term contract at the closing of the IPO. Because Berckmans was already a salaried employee of Frankenmuth and NewCo, the Tax Court could have maintained that Berckmans's purchase of NewCo stock was a bargain purchase resulting in additional compensation income to Berckmans as an employee of NewCo and Frankenmuth. Further, Frankenmuth paid an outside adviser to seek potential acquisition options at the same time Berckmans was actively seeking acquisition options for Frankenmuth. Presumably, the outside adviser recognized compensation income for the fee it received. The Tax Court could have argued that the bargain purchase of NewCo stock was compensation income from either of Frankenmuth or NewCo since it was provided to Shields and Berckmans for services similar to the services rendered by the outside adviser in exchange for a fee.

For a SPAC, unlike in *Berckmans*, the sponsor is at no point an employee of the SPAC. There is no contract between the sponsor and the SPAC specifically requiring the sponsor to provide employment-type services to the SPAC, and the sponsor is free to abandon the SPAC at any time. Thus, there is no clear employer-employee nexus for a SPAC and a sponsor as there was in *Berckmans* — making the argument stronger that there is no compensation event when the sponsor purchases founder shares.[19]

Also, the plan in *Berckmans* was much more specific and concrete than the typical SPAC structure because the identity of the targets was already known and substantial negotiations with their management had occurred. Moreover, Berckmans acted not only as sponsor but also was part of the management of one of the targets. For a SPAC, although a potential industry for a business combination may be identified at the outset, no specific targets are identified and no discussions with any potential targets have taken place. Any business combination is completely speculative and subject to significant contingencies not only when the founder shares are issued but also even later, when the IPO is completed. *Berckmans* provides quite favorable support for the position that a sponsor does not have a bargain purchase resulting in compensation income by reason of purchasing founder shares at issuance.

b. *Differentiating* Berckmans*:* Husted.

In *Husted*,[20] the Tax Court held that a taxpayer had compensation income as a result of a bargain purchase when the value of the stock purchased was determined to exceed the price paid for that stock. The taxpayer, William Husted, was an expert in the corporate finance and acquisitions sector. He reported his occupation as "business promotion" on his tax returns and claimed business expense deductions for costs incurred in connection with his business acquisition and finance transactions.

Husted purchased stock of two corporations (NewCo and Old PubCo) for $1 and $3 per share,

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[19]Even if there were an employer-employee relationship between a SPAC and a sponsor, that would not be fatal to a compensation analysis. In *Everhart v. Commissioner*, 26 B.T.A. 318 (1932), the taxpayer was engaged in the business of selling syndicate interests as a representative or financial agent of an oil and gas company. The taxpayer received commissions from the company for his sales (and reported those as income). The taxpayer was also allowed to purchase an interest from the company for a price that was two-thirds of the price that investors paid for those interests. The taxpayer's usual commission was equal to the one-third discount. The taxpayer considered the price differential a discount, and the commissioner sought to tax the price differential as compensation income from the employer to the taxpayer as a result of a bargain purchase. The Board of Tax Appeals concluded that the taxpayer purchased the interest as a personal investment and that there was no compensation income resulting from a bargain purchase, even though the taxpayer was an employee.

[20]*Husted v. Commissioner*, 47 T.C. 664 (1967), *acq.*, 1968-2 C.B. 1.

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respectively, as part of a plan to repackage and sell the assets of another corporation (Dorsey-A) in a series of transactions that involved a public stock offering and a business combination with Old PubCo ultimately holding the Dorsey-A assets through NewCo. At the time of those purchases, it was believed that Old PubCo stock would be offered to the public at a much higher price than Husted paid. When Husted purchased his NewCo stock for $1 per share, he entered into an agreement with Old PubCo under which he would exchange his NewCo stock for Old PubCo stock upon NewCo acquiring all the assets of Dorsey-A. The Old PubCo stock, however, was subject to repurchase by Old PubCo if the transactions did not occur.

Old PubCo was an existing holding company in many ways similar to a SPAC. Old PubCo was publicly traded. Old PubCo only held $300,000 cash and government securities at the time of the business acquisition. Old PubCo was actively seeking a profitable operating business to acquire and expended significant effort to ensure the transactions would in fact occur.

Key dates in the timeline of the relevant discussions and transactions are as follows:

- February 1958 to spring and summer 1958: Husted is informed Dorsey might be for sale. Husted conducts diligence on Dorsey-A, discusses a possible acquisition with management, and negotiates the acquisition.
- August 21, 1958: Husted and Dorsey-A management agree to a tentative price for the acquisition.
- November to December 1958: Husted tentatively arranges financing and instructs lawyers to form NewCo to acquire Dorsey-A. Husted approaches an underwriter to arrange the proposed NewCo public offering; subsequently, Old PubCo is considered as the acquisition vehicle.
- December 1958: Husted and Old PubCo management discuss Old PubCo's acquisition of Dorsey-A through NewCo. A tentative letter of intent is sent to Old PubCo under which (1) NewCo would acquire the assets of Dorsey-A; (2) NewCo would issue its stock to Husted for $1 per share, and Husted would purchase Old PubCo stock for $3 per share; (3) Old PubCo would distribute all its assets other than $300,000 in cash and government securities; and (4) Old PubCo would acquire all the stock of NewCo and offer its stock to the public (for at least $10 per share).
- February 27, 1959: Husted executes an asset purchase agreement with Dorsey-A.
- March 12, 1959: NewCo is formed to complete the Dorsey-A purchase.
- March 20, 1959: Old PubCo files a registration statement with the SEC to achieve a public offering of its securities.
- April 8, 1959: Husted purchases Old PubCo stock for $3 per share. Old PubCo stock was trading on the American Stock Exchange for $10.50 at that time.
- April 15, 1959: Husted purchases NewCo stock for $1 per share. Husted assigns the assets purchase agreement to NewCo. Husted enters into an agreement with Old PubCo to exchange his NewCo shares for Old PubCo shares on the closing of the acquisition by NewCo of Dorsey-A.
- April 21, 1959: An underwriting agreement is executed for the Old PubCo stock offering, conditioned on NewCo acquiring Dorsey-A and Old PubCo acquiring NewCo.
- April 23, 1959: Old PubCo's SEC registration statement becomes effective, and stock begins trading at $11 per share.
- April 30, 1959: NewCo acquires Dorsey-A and all the NewCo stock is exchanged for Old PubCo stock.

The Tax Court began its discussion by citing Supreme Court precedent on the tax consequences of a bargain purchase. It cited the principle of *Palmer*[21] that one does not ordinarily realize income as a result of a bargain purchase and that the mere fact that one obtains a good deal does not result in a taxable event. The Tax Court then provided an exception for the principle, made clear by the Supreme Court in *Smith*,[22] that a taxpayer does have taxable income from a bargain purchase when the bargain is intended to

[21] *Palmer v. Commissioner*, 302 U.S. 63 (1937).

[22] *Commissioner v. Smith*, 324 U.S. 177 (1945).

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compensate the purchaser. Finally, the Tax Court cited *LoBue*[23] for the principle that a bargain sale of stock to an employee is a compensatory transaction. Consistent with the Supreme Court precedent cited by the Tax Court, two determinations were necessary: whether Husted had a bargain purchase and, if so, whether the bargain purchase was intended to compensate Husted.

To determine whether there was a bargain purchase, the Tax Court examined the value of the relevant shares. It acknowledged that there were contingencies to the overall series of transactions, but it did not regard them as especially significant. Importantly, unlike the corporation in *Berckmans*, (1) Dorsey-A was an operating entity with existing assets, and (2) Old PubCo was an existing publicly traded company with a share trading price of $10.50 per share when Husted purchased its stock for $3 per share (and when he purchased for $1 per share the NewCo stock that would be exchanged for Old PubCo stock on a share-for-share basis). Further, when Husted purchased the Old PubCo and NewCo stock, there was an executed purchase agreement for Husted to acquire Dorsey-A. On the date Husted purchased NewCo stock, an agreement was executed for Husted's NewCo stock to be exchanged for Old PubCo stock, with Old PubCo acquiring Dorsey-A (by acquiring all the stock of NewCo). Also, unlike in *Berckmans*, Old PubCo filed a registration statement with the SEC regarding its public offering almost three weeks before Husted purchased Old PubCo stock and nearly a month before Husted purchased NewCo stock. The Tax Court found that the overall series of transactions was the "evolution and consummation of the plan that . . . was merely the final step in a plan designed to vest ownership of the [Old PubCo] stock in [Husted] at a cost of only $1 per share," resulting in a bargain purchase.

After concluding that there was a bargain purchase, the Tax Court determined the intent underlying the bargain purchase to ascertain whether Husted was a wise or fortunate investor (resulting in no taxable event under *Palmer*) or if instead the bargain element was intended to compensate him (resulting in compensation under *Smith* and *LoBue*). The Tax Court ultimately found that the bargain purchases were made with a compensatory intent. It looked at what Husted did before acquiring his Old PubCo stock: He "spent substantial time and effort" in arranging Old PubCo's ultimate acquisition of Dorsey-A, including negotiating the transaction agreements, arranging for financing and underwriting, and having assistants prepare plans for the arrangements that would have to be made in connection with the acquisition.[24] Old PubCo was seeking an opportunity to acquire a profitable operating business, and Husted provided that opportunity.

The facts in *Husted* can be distinguished from those in *Berckmans* on several grounds. First, in *Berckmans* NewCo was a shell company with no operating history. In contrast, Husted's purchased stock was either (1) stock in NewCo, which had a right to acquire an existing operating business (Dorsey-A) that would be exchanged for Old PubCo stock (which was publicly traded at the time) upon NewCo's acquisition of Dorsey-A or (2) stock of Old PubCo — an existing publicly traded company whose shares were trading for $10.50 per share at the time.

Second, in *Berckmans* a registration statement with the SEC had not yet been filed when Berckmans purchased his NewCo stock. In contrast, Old PubCo was already listed and trading on a public stock exchange before any of the transactions in question. Further, the registration statement for the Old PubCo public stock offering in connection with the Dorsey-A acquisition was filed with the SEC almost three weeks before Husted purchased Old PubCo stock, and nearly a month before he purchased NewCo stock.

Third, Husted considered himself a professional in the business of corporate

[23] *Commissioner v. LoBue*, 351 U.S. 243 (1956).

[24] On the NewCo stock that was exchanged for Old PubCo stock, the Tax Court took a substance-over-form approach and concluded that there was no real business purpose for which Old PubCo would agree to exchange its stock (which was to be publicly offered for at least $10 per share) for an equal number of NewCo shares that Husted had purchased for $1 per share on the same day — especially given that the exchange "had been planned at a time when [NewCo] did not even exist." The Tax Court found that the "only realistic explanation for the agreed-upon exchange ratio is that Husted was being provided with further compensation for his services in arranging the acquisition" of Dorsey-A.

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acquisitions, as evidenced by his tax returns. Husted had no intention of staying with a company post-acquisition and resale. He sought out distressed operating companies only to repackage the businesses and quickly sell them to investors. Berckmans, however, intended to expand operations in the brewery business in a manner he thought was the future of success in the brewing industry. Berckmans had been involved in the brewing business for a significant length of time and planned to remain in that business.

Husted is fundamentally different from *Berckmans*. In the former, an existing operating company hired the equivalent of an investment banker (Husted) to arrange the sale of a company to the public. The nature of the services provided were akin to a fee, and providing compensation for those services through a bargain purchase of publicly traded stock was clearly compensation. On the other hand, the formation of a NewCo to undergo a public offering and ultimately acquire a target company is fundamentally different. For a SPAC, the sponsor performs services on behalf of his own newly formed company, not a preexisting entity that is attempting to sell itself.

***c.* Trust Co. of Georgia.**

Trust Co. of Georgia[25] is another case supporting the position that there is no bargain purchase or compensation issue with respect to the founder shares. There, the taxpayer purchased stock of a new corporation (NewCo) for $5 per share one week before it was offered to the public for $40 per share. In response to the IRS's argument that the taxpayer had income as a result of the bargain purchase of stock, the court held that the taxpayer did not in fact have any income and that any later gain on the stock could not be considered (in whole or in part) compensation income. The court stated that what is meant by the term "compensation for services" is compensation for services "performed for another," when the service provider is paid by that other. The taxpayer had not been hired by anyone to do anything. Rather, the taxpayer merely purchased stock — similar to a sponsor who acquires founder shares and is not performing any services for "another" at the time of the purchase. The court emphasized the valuation of the stock and determined that only the value at the time of purchase was relevant.

***d.* Eaton.**

As illustrated throughout this report, transactions that increase value in shares through services performed by shareholders for their own corporations do not necessarily result in a compensation event. In *Eaton*,[26] for example, the court held that events that substantially increased the value of shares of a corporation shortly after their purchase (even though part of a plan to achieve specific synergies) were not to be considered. The taxpayer and his two brothers formed a corporation (NewCo) on November 28, 1928. The three brothers contributed $300 to NewCo in exchange for all its outstanding common stock. Approximately two weeks later, the brothers paid an additional $15,000 to NewCo in exchange for additional shares of common stock. Separately, the brothers were equal co-partners in a restaurant business and owned all the shares of a corporation (LandCo) that owned the land on which the restaurant operated. The brothers were planning to transfer the restaurant and land to NewCo, retain a significant interest in NewCo, and bring in outside investors to provide working capital for the business. Security brokers were retained to arrange for the issuance of NewCo shares in connection with the contemplated transactions and to sell NewCo shares to outside investors.

On January 2, 1929, the brothers transferred the restaurant to NewCo in exchange for preferred stock, which was sold through the security brokers to outside investors. On January 8, 1929, LandCo transferred the land to NewCo in exchange for preferred stock, which was distributed to the brothers in liquidation. The brothers then sold the NewCo preferred stock to outside investors through the security brokers. In the aggregate, the brothers paid approximately 10 cents per share for their NewCo common stock. The question in the case came down to whether the taxpayer should have included any income

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25 *Trust Co. of Georgia v. Rose*, 25 F.2d 997 (N.D. Ga. 1928), *aff'd*, 28 F.2d 767 (5th Cir. 1928).

26 *Eaton v. White*, 70 F.2d 449 (1st Cir. 1934).

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resulting from his purchase of NewCo common stock for 10 cents per share in December 1928 based on the increased value brought to the shares by the January contributions.

The IRS argued that the series of transactions should be collapsed so that the brothers, in a single transaction, sold the restaurant and land in exchange for NewCo preferred stock (which was converted into cash) and NewCo common stock at FMV (the NewCo common stock purchased by the brothers for 10 cents per share). The court disagreed and emphasized that even though the NewCo common stock appreciated as a result of the restaurant and land contributions, that appreciation was never realized by the brothers. Therefore, the court concluded, the taxpayer did not have income on the NewCo common stock. Even though the brothers contemplated the later transactions, which would enhance the value of NewCo common stock, it was improper to take those transactions into account when the brothers purchased their NewCo common stock.

An economic increase in value in the common stock, even as a result of planned transactions, is not alone a sufficient realization event to justify taxation. Similarly, for a SPAC, the sponsor purchases stock whose value subsequently increases when the public acquires their common shares in the IPO. As with a SPAC, *Eaton* involved the creation of a special purpose company to both raise capital and acquire an active business.

The cases described above embody the fundamental tax law principles discussed earlier. An issuance of stock whose value increases as a result of the subsequent efforts of its shareholders should not be taxed as compensation upon issuance. The value is too speculative, and there is no liquidity with which to pay any tax that would be imposed. Further, although performing services for another results in compensation, building a business and creating and enhancing the value of a capital asset for oneself or one's own corporation clearly does not.

Another important principle that can be gleaned from the cases above is that filing a registration statement with the SEC is an important milestone. As illustrated in *Berckmans*, *Husted*, and *Messing*[27] (discussed below), whether a registration statement has been filed with the SEC appears to be where courts have drawn the line. In *Berckmans* and *Messing*, no registration statement had been filed (although an IPO was contemplated in each case) when the relevant stock was purchased. In *Husted*, however, a registration statement had been filed, and the court considered that in its determination of the value of the relevant stock. Given that one cannot legally offer securities to the public and complete an IPO without having an effective registration statement, the filing of that document is a logical place to draw the line.

4. Principles from other areas.

a. Gift tax context.

In the gift tax context, the Tax Court in *Messing* concluded that later events did not affect prior valuations in a case in which the taxpayer gifted stock of a privately held corporation to his children shortly before the corporation filed a registration statement with the SEC and completed an IPO. The taxpayer asserted that the value of the stock on the date of transfer to his son was $10 per share, based on the price others had paid for the stock in arms-length transactions at or around that time (not in a public offering). The taxpayer had contemplated an IPO of the corporation before making the gifts, had engaged a securities firm to assist with the IPO, and anticipated the stock would be offered to the public. A mere few months after the stock was gifted, public investors paid $36.66 per share. In a question of the valuation of the gifted stock, the Tax Court emphasized that the gifts of stock were made before the IPO, when it was privately traded stock, and that "a publicly traded stock and a privately traded stock are not . . . the same animal. . . . The essential nature of the beast is different."

b. Taxation of profits interests received for services.

Founder shares are in many respects similar to partnership interests in future profits (pure profits interests). In both cases, the holder is not entitled to any proceeds or assets if the entity

[27] *Messing v. Commissioner*, 48 T.C. 502 (1967), *acq.*, 1968-2 C.B. 1.

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liquidates immediately after the interest is transferred. The IRS's current position and the historical treatment of the receipt of pure profits interests provide principles that are helpful, and at least analogous, in analyzing any potential cheap stock issue associated with founder shares.

In Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, the IRS provided a safe harbor for partnership profits interests received in exchange for services. A profits interest is defined as an interest that does not entitle the recipient to any share in the assets of the partnership if the partnership sells all its assets and liquidates, as determined when the recipient receives the profits interest. Specific exceptions apply, however, when the profits interest:

- relates to a substantially certain and predictable stream of income from partnership assets (such as income from high-quality debt securities or a high-quality net lease);
- is disposed of by the partner within two years of receiving the interest; or
- is a limited partnership interest in a publicly traded partnership.

A few important principles can be gleaned from these revenue procedures. First, if the profits interest is substantially certain to lead to a stream of steady income, its value is not speculative, and it should not be given tax-free treatment. Second, if the taxpayer is able to monetize the profits interest shortly (within two years), it is questionable whether the profits interest was really incapable of being valued at the time of transfer. Underlying the treatment of pure profits interests is the concept that future profits are so speculative and contingent that it is only proper and administrable to use a liquidation valuation method to determine their value upon receipt.[28]

Founder shares are quite similar to partnership profits interests. As with partnership profits interests, founder shares are not entitled to any assets of the SPAC before a business combination. If a SPAC liquidates before a business combination, the founder shares become worthless. Even following a business combination, the value of the founder shares is speculative because they will be based on the success of the post-business-combination SPAC. Under a liquidation valuation, therefore, the founder shares have no value when issued to the sponsor. Although the revenue procedures and case law dealt with partnership profits interests, the liquidation valuation method also applies for interests issued by a corporation.

In *St. John*,[29] the court relied on *Berckmans* (which, as discussed above, involved stock in a corporation) in using a liquidation valuation and concluding that the taxpayer did not have income on the receipt of a pure profits interest. As with a SPAC, the interest in that case was a subordinated interest that was not entitled to receive any assets of the partnership on liquidation until other partners recouped their initial contributions. Also similar to a SPAC, the operations of the partnership had not yet started when the interest was received, and, as emphasized by the court, any success of the business was completely speculative. The court held that the value of the interest received was zero — the liquidation value of the interest. The *St. John* court also relied on additional cases illustrating the use of a liquidation value method for a corporation.[30]

c. Personal goodwill not corporate asset: Martin Ice Cream.

In the typical SPAC, the sponsor uses its goodwill, experience, and relationships to attract public investors and source, negotiate, and complete a subsequent business combination. It could be argued that the founder is contributing those personal intangibles to the SPAC. Under that theory, the founder shares could have significant value, which could in turn result in a bargain purchase by the sponsor. However, case law illustrates that personal goodwill does not

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[28] For a detailed discussion of the history and evolution of the taxation of partnership profits interests, see William S. McKee, William F. Nelson, and Robert L. Whitemire, *Federal Taxation of Partnerships and Partners*, para. 5.02 (4th ed. 2007 and Supp. 2017-4).

[29] *St. John v. United States*, No. 82-1134 (C.D. Ill. 1983).

[30] *See Estate of Garrett v. Commissioner*, No. 35955 (1953) (using the liquidation value method for a corporation that had ceased active operations); and *Learner v. Commissioner*, T.C. Memo. 1983-122 (using the liquidation value method to value the shares of stock of a corporation when there were reasonable prospects that the corporation would be liquidated). In those cases, the courts made no attempt to distinguish the use of a liquidation value method for a corporation from its use for a partnership, suggesting that the liquidation value method is a general valuation principle that applies equally in each case.

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constitute a corporate asset, especially when generated before and independent of the existence of the relevant corporation.

Martin Ice Cream[31] stands for that proposition. A father and son were shareholders of Martin Ice Cream Co. (MIC), an ice cream distributor. MIC's business success was largely attributable to the close personal relationships that the father had developed and maintained for decades with customers. A company initiated negotiations with MIC to acquire rights to distribute MIC products to MIC customers. MIC formed a subsidiary and transferred those rights to the subsidiary in exchange for all the stock of the subsidiary. MIC immediately distributed the stock of the subsidiary to the father in exchange for his stock in MIC. The father then sold the stock of the subsidiary to the company that wished to acquire the rights held by the subsidiary. The distribution was held to be taxable, so one of the issues in the case was whether the benefits of the personal relationships developed by the father were assets of MIC or instead were owned by him. The Tax Court noted that the father had never entered into any agreements with MIC through which his relationships and goodwill became the property of MIC (such as an employment agreement) and that the father's customer relationships and goodwill were thus owned by him.

Under the *Martin Ice Cream* analysis, the sponsor — not the SPAC — would be treated as the owner of the sponsor's goodwill, experience, and relationships, and the value of the SPAC would not reflect the sponsor's goodwill, experience, or relationships. Under the *Martin Ice Cream* reasoning, however, it is important that there be no agreement between the sponsor and the SPAC concerning those intangibles (such as an employment agreement) that could create a valuable asset in the SPAC.

d. Business opportunity not property.

An argument could be made that the founder shares have significant value on the theory that the SPAC possesses a valuable business opportunity. Those opportunities, however, are generally not viewed as property for tax purposes. For example, in *Crowley*,[32] the Tax Court held that a taxpayer was not taxable on income earned by a partnership as a result of the taxpayer directing business opportunities to the partnership or generating business for the partnership. This was true even though all the business directed or generated could have been performed by the taxpayer rather than the partnership. In *Hogle*,[33] the Tax Court concluded that income realized by trusts as a result of gains and profits on securities trading conducted by the grantor of the trusts did not constitute a taxable gift. The corpus of the trusts consisted of trading accounts directed by the grantor. Although the trusts would benefit from the trading direction of the grantor, that trading was not a transfer of property constituting a gift from the grantor to the trusts.

5. Are the founder shares really options?

Arguably, founder shares are effectively options to acquire SPAC public shares that can only be exercised upon the completion of a business combination. After all, founder shares are not entitled to any distributions, nor are they entitled to any liquidation proceeds. Only upon the completion of a business combination do the founder shares automatically convert into public shares. If the founder shares are treated as options, they could give rise to ordinary income.

Case law and a revenue ruling support respecting the founder shares as stock.[34] In *Carlberg*,[35] shareholders of target corporations received common stock of an acquirer and a nonvoting "certificate of contingent interest" for additional acquirer stock. The shares underlying the certificates were authorized and specifically set aside as a way for the acquirer to reserve for contingent liabilities of one of the targets. The shares underlying the certificates were reduced as they were used to satisfy the liabilities. The holder of a certificate was entitled to receive its allocable

[31] *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).

[32] *Crowley v. Commissioner*, 34 T.C. 333 (1960), *acq.*, 1961-2 C.B. 3.

[33] *Hogle v. Commissioner*, 7 T.C. 986 (1946), *aff'd*, 165 F.2d 352 (10th Cir. 1947).

[34] *See also* Robert Willens, "What Restrictions on Voting Rights Will Affect Voting Stock Status?" 75 *J. Tax'n* 208 (1991).

[35] *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960).

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portion of the underlying shares after six years for no additional payment. The government argued that the certificates were not stock (and constituted boot in the reorganization). The court disagreed. Important to the court's conclusion was that the certificates could become only stock and no other form of property. Further, the certificates automatically entitled the holder to stock based on a determined time and for no additional consideration. The only logical conclusion, therefore, was that the certificates were stock or "nothing," and the court determined the certificates were stock.

Similarly, in *Hamrick*,[36] two inventors formed a new corporation and transferred patent rights to it in exchange for stock and rights to receive additional stock contingent on the earnings of the corporation (subject to a cap) for the seven years following the formation of the corporation. The government argued that the contingent rights were not stock but instead other property that would be taxable boot to the inventors. The Tax Court disagreed and held that the rights to receive additional stock were not boot because the holder of those rights could only ever receive stock for them.

In Rev. Rul. 66-112, 1966-1 C.B. 68, the IRS addressed a similar issue when determining whether an interest constituted stock or other property. In that ruling, X Corp. and Y Corp. equally owned stock in M Corp., and Y sought to acquire X's M stock. Because M was closely held, it was difficult to value the M stock. In consideration for X's M stock, Y exchanged 40,000 shares of its own voting stock and entered into an agreement under which X had a right to receive additional Y voting stock in each of the four years following the transaction in which M met specified income thresholds. The additional stock right was not assignable and could only ever give rise to additional Y voting stock. The IRS concluded that because the right was not assignable and could only ever give rise to Y voting stock, this additional stock right did not constitute other property.

Although founder shares do not participate in distributions or liquidation proceeds before a business combination, founder shares, as with the rights at issue in *Carlberg*, *Hamrick*, and Rev. Rul. 66-112, can only ever give rise to stock. Immediately upon a business combination, founder shares convert automatically into public shares for no additional consideration. Moreover, founder shares have other significant indicia of equity, possessing voting and governance rights, including rights to elect directors to the board. If the founder shares were determined to be options, the SPAC would be left without any real stock outstanding (at least until an IPO).

B. Transfers of Founder Shares

The sponsor may use founder shares as consideration to enable the SPAC to complete a business combination. The sponsor may transfer or forfeit founder shares to induce public investors to vote in favor of a business combination and not exercise redemption rights. The sponsor may also transfer or forfeit founder shares to target shareholders in a subsequent business combination to help bridge a value gap. The question arises whether any of these transactions results in a taxable disposition.

1. Contribution of founder shares to capital: *Fink*.

There is Supreme Court authority supporting the position that a forfeiture of stock is a nontaxable contribution to capital. In *Fink*,[37] the taxpayers (controlling shareholders of a closely held corporation) voluntarily surrendered some of their shares to the corporation, reducing their combined percentage ownership from 72.5 percent to 68.5 percent. The shares were surrendered to increase the attractiveness of the corporation to outside investors. The taxpayers received no consideration for their surrendered stock. At issue was whether the taxpayers were entitled to a loss deduction for the shares surrendered. The IRS denied the loss, concluding that the share surrender was a contribution to the capital of the corporation. The Tax Court sustained the commissioner's position but was

[36] *Hamrick v. Commissioner*, 43 T.C. 21 (1964), *acq.*, 1966-2 C.B. 3.

[37] *Commissioner v. Fink*, 483 U.S. 89 (1987), *rev'g* 789 F.2d 427 (6th Cir. 1986), *rev'g* T.C. Memo. 1984-418. *See also Schleppy v. Commissioner*, 601 F.2d. 196 (5th Cir. 1979) (holding that a non-pro-rata stock surrender by majority shareholders to improve the financial condition of the corporation was a contribution to the capital of the corporation).

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reversed by the Sixth Circuit. The Supreme Court reversed and held that the shareholders were not allowed an ordinary loss because a voluntary surrender of shares to the corporation closely resembles an investment or contribution to capital of the corporation.

2. Surrender of shares as taxable: Rev. Rul. 73-233.

In contrast to the Supreme Court's conclusion in *Fink*, an earlier revenue ruling concludes that a surrender of shares to induce other shareholders to approve a merger is a taxable transaction. In Rev. Rul. 73-233, 1973-1 C.B. 179, Y Corp. wished to acquire X Corp. in a merger in exchange for 100 shares of Y stock. The stock of X was owned by three individuals, A (60 percent), B (20 percent), and C (20 percent). Under applicable corporate law, a two-thirds vote of the X shareholders was required to approve the merger. B and C refused to vote in favor of the merger unless they would each receive 25 shares of Y stock. In consideration for B and C voting in favor of the merger, A agreed to permit B and C each to receive 25 shares of Y stock instead of the 20 shares of Y stock to which they would have been entitled based on their ownership percentages. Under that agreement, A contributed one-third of his X stock to the capital of X (reducing A's stock interest in X to 50 percent and increasing each of B's and C's stock interests in X to 25 percent). The merger was unanimously approved and thereafter completed. A, B, and C received, respectively, 50, 25, and 25 shares of Y stock in exchange for their X stock.

The IRS determined that the overall transaction was properly viewed as (1) a merger of X into Y, with a distribution of 60, 20, and 20 shares of Y stock to A, B, and C, respectively, in exchange for their X stock, with no gain or loss being recognized to A, B, or C on this exchange under section 354; and (2) a transfer by A of five shares of Y stock to B and five shares of Y stock to C in consideration for their voting in favor of the merger. The transfer of shares from A to B and C was analyzed as a taxable exchange, whereby A recognized gain or loss on the shares deemed transferred and B and C recognized income under section 61.[38]

3. Reconciling *Fink* with Rev. Rul. 73-233.

It is not uncommon for a sponsor to agree to transfer or surrender founder shares to facilitate the completion of a subsequent business combination.[39] While an outright transfer is likely a taxable disposition, the treatment of a forfeiture or surrender of shares is less clear. Although *Fink* may support a tax-free contribution, Rev. Rul. 73-233 raises at least a question regarding taxable exchange treatment to the sponsor as well as potential income realization to the economic recipient of the surrendered shares. It is difficult to reconcile the holding of *Fink* with Rev. Rul. 73-233. *Fink* was decided by the Supreme Court nearly 15 years after the revenue ruling was issued, which could suggest that Rev. Rul. 73-233 is limited to its specific facts. A more detailed consideration and analysis of the facts of *Fink* and Rev. Rul. 73-233 provides additional guidance.

Peter and Karla Fink had been dominant owners of their corporation, Travco Corp., for more than 10 years and had invested a significant amount of their own capital in Travco. Travco's financial condition weakened, and, as a result, its existing lender placed significant pressure on it to make a payment on its outstanding loan. Travco was unable to make the payment and had three options: liquidate, find a new lender, or obtain new capital. Mr. Fink unsuccessfully sought additional capital from multiple sources and began negotiating with a new lender to replace its existing lender. The replacement lender conditioned its extension of credit on Travco raising $700,000 of new equity capital. Travco then engaged an investment adviser to attract outside investors to raise the required $700,000 equity capital. To improve Travco's financial

[38] *See also* Rev. Rul. 79-10, 1979-1 C.B. 140, in which the IRS ruled that a non-pro-rata liquidation was properly viewed as a pro rata distribution with all shareholders considered to have received their pro rata share of the distribution, and any excess over a shareholder's pro rata share received was considered as payment in a separate transaction.

[39] One way or another, the sponsor will reduce his holdings of founder shares (either by forfeiting the requisite number of founder shares, which the SPAC will then reissue to an investor, or by directly transferring founder shares to an investor).

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position in order to attract outside investors and ultimately preserve the business, the Finks surrendered some of their Travco stock. The Tax Court noted that the couple "did not surrender stock as a part of any indirect transfer to a third party." Importantly, there was no specific outside investor identified at the time of the surrender. The Supreme Court emphasized that the Finks surrendered their shares only to protect or increase the value of their investment by obtaining additional capital needed for Travco to continue operating. The Supreme Court was careful in limiting its holding, stating "We conclude only that a controlling shareholder's voluntary surrender of shares, like contribution of other forms of property to the corporation, is not an appropriate occasion for the recognition of gain or loss."

The sparse facts of Rev. Rul. 73-233 can be differentiated from *Fink*. In the ruling, A was not acting to protect its investment. Rather, A agreed to surrender shares to which it was entitled upon a merger in order to induce others (B and C) to vote in favor of a merger, which they otherwise refused to do. Unlike the Finks, A apparently had an explicit agreement with third parties (B and C) to surrender the relevant amount of its shares to X to accomplish the merger.

How do *Fink* and Rev. Rul. 73-233 apply to founder shares? If a sponsor directly transfers founder shares as part of a negotiated agreement to a third-party transferee immediately before or in connection with a business combination for the purpose of obtaining the vote or capital of the transferee, it is difficult to see the transfer as anything other than a taxable disposition. Even if there is no actual transfer but a surrender and targeted reissuance to the third party, the transaction is likely treated as a direct transfer to the third party. In contrast, if a sponsor surrenders founder shares to the capital of the SPAC to enhance its financial profile and there is no particular third-party investor that will receive the founder shares, the surrender is close to the facts of *Fink*. Even when the sponsor surrenders some of his shares to induce the public shareholders as a group not to exercise redemption rights, the sponsor is arguably protecting his investment in his founder shares and not providing consideration to any specific investor(s).

A more difficult case is when a sponsor agrees to surrender founder shares to the capital of the SPAC immediately before or in connection with a business combination and then, as part of a subsequent separately negotiated agreement with an investor, issues some or all of those surrendered shares to the investor in exchange for voting in favor of the business combination or providing needed capital. This fact pattern has similarities to both Rev. Rul. 73-233 and *Fink*. Similar to the scenario in Rev. Rul. 73-233, the sponsor wants the business combination to occur and knows that a vote or capital is needed from the third-party investor for the business combination to be completed. However, similar to *Fink*, the sponsor surrenders his shares to protect his investment, knowing there will likely be no business combination absent the investor's vote or capital, and the sponsor's interest would become worthless if the SPAC is unable to complete a business combination and liquidates. The surrender and reissuance in that case is crucial to the viability of the SPAC. Ultimately, the proper analysis of a surrender of founder shares depends on the particular facts and circumstances.

IV. Forming a SPAC: Choice of Jurisdiction

A fundamental question at the outset of forming a SPAC is whether it will be incorporated in the United States or offshore (typically the Cayman Islands or British Virgin Islands). That decision will largely depend on the jurisdiction of an intended target. If the target is a U.S. company, it may be inefficient to have it held by a foreign SPAC, subjecting payments by the U.S. target to its foreign parent to U.S. withholding tax at rates as high as 30 percent. If the target is a foreign company, it may be inefficient to have a U.S. SPAC owning a foreign subsidiary and subjecting its earnings to an additional layer of U.S. tax. If a sponsor is certain of the target's jurisdiction, it may be efficient to form the SPAC in that jurisdiction. If the target is a U.S. company, forming the SPAC in the United States is likely the best choice. Similarly, if the target is foreign, a foreign SPAC is likely the best choice.

If the target is not in a jurisdiction originally considered, the consequences of changing the

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jurisdiction of the SPAC will need to be considered. For example, if a SPAC is originally formed in the United States and seeks to acquire a foreign target, it may be difficult to redomicile offshore because of the section 7874 anti-inversion rules that could continue to treat the SPAC as a U.S. corporation.[40] Similarly, if a foreign SPAC were to seek to acquire a U.S. target, it could domesticate before the business combination. The domestication would typically qualify as a tax-free F reorganization. However, as discussed below, the domestication may raise some significant passive foreign investment company issues, especially regarding the warrants.

A. PFIC Rules

The PFIC rules present a gating issue for a foreign SPAC. A SPAC will be considered a PFIC for a given tax year if at least 75 percent of its gross income in that tax year is passive income (the income test) or if at least 50 percent of its assets in that tax year, determined based on FMV and averaged quarterly over the year, are assets held for the production of passive income (the asset test).[41] Passive income generally includes cash, dividends, interest, some rents and royalties, and gains from the disposition of passive assets.[42] Because a SPAC is a blank check company with no operations or assets other than cash proceeds raised in the IPO (passive asset), and no income other than possibly interest earned in the trust account (passive income), it is quite likely treated as a PFIC at the outset unless it can satisfy the start-up exception, as discussed below.

1. Consequences to shareholders.

A U.S. shareholder in a PFIC must recognize gain upon specific distributions referred to as "excess distributions" and upon a sale or other (taxable) disposition of PFIC shares. That gain is subject to tax at the highest rate applicable to ordinary income in each specified year, and an interest charge would be imposed on the tax liability for each specified year.[43] The PFIC rules are particularly harsh for founder shares because the sponsor has minimal basis. Also, section 1298(a)(4) provides that to the extent provided in Treasury regulations, any person that has an option to acquire stock of a PFIC will be treated as owning that stock. Prop. reg. section 1.1291-3 (the option regulations) provides that options on stock of a PFIC are themselves treated as stock of a PFIC. Holders of SPAC warrants, therefore, may also be subject to the PFIC rules.

Although some elections may be able to mitigate the adverse PFIC tax consequences upon a disposition of shares, such as a qualified electing fund (QEF) election described below, no such elections are available for warrants.[44] Any holder of warrants could therefore be required to recognize gain as ordinary income and subject to an interest charge under the rules described above. Further, because the shareholder's holding period in the stock received upon exercise of the warrants includes the holding period in the warrants, a QEF election made on the stock would not rid the stock of its PFIC taint absent the shareholder recognizing gain or including a deemed dividend amount in a purging election.[45]

2. QEF election.

A U.S. shareholder may make a QEF election to mitigate adverse PFIC tax consequences regarding its shares.[46] The U.S. shareholder is then required to include in income its allocable pro rata share of the SPAC's net capital gains and other earnings and profits annually, regardless of whether those amounts are actually distributed. A SPAC is unlikely to have any capital gains or E&P before a business combination. If there is any interest income earned in the trust account, that income is probably offset significantly, if not entirely, by deductions for expenses. The allocable amount a shareholder would have to include before a business combination because of a QEF

[40] For an all-cash deal, a foreign SPAC may successfully avoid the anti-inversion rules. A recent example of this is CF Corp.'s acquisition of Fidelity & Guaranty Life, which closed November 30, 2017.

[41] Section 1297.

[42] Notice 88-22, 1988-1 C.B. 489.

[43] Section 1291.

[44] Reg. section 1.1295-1(b)(2)(iii).

[45] *See* sections 1291 and 1298; and reg. sections 1.1291-9, 1.1291-10, 1.1297-3, and 1.1298-3.

[46] Section 1295. A mark-to-market election under section 1296 may also be available to mitigate adverse PFIC tax consequences.

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election would therefore probably be negligible, if not zero. After the business combination, the SPAC would likely no longer be a PFIC, and the shareholder would then not be required to include any QEF inclusions.[47] The QEF election prevents the shareholder from having to recognize ordinary income and an interest charge on a disposition of its shares.

Under the option regulations and the disposition regulations (described below), the potential PFIC consequences to U.S. holders of warrants are especially harsh when a foreign SPAC domesticates in connection with an acquisition of a U.S. target. Because a QEF election may not be made for PFIC warrants,[48] a U.S. holder of PFIC warrants could be required to recognize ordinary income subject to an interest charge on its warrants at the time the SPAC domesticates, resulting in a "disposition" of the warrants by the U.S. holder. The result can be especially harsh because in some dispositions, such as tax-free reorganizations, the warrant holder would have no cash to pay the tax.

Section 1291(f) provides that "to the extent provided in regulations," gain will be recognized "notwithstanding any provision of law." Prop. reg. section 1.1291-6 (the disposition regulations) provides that despite any other code provisions (including nonrecognition provisions), a PFIC shareholder is required to recognize gain (as ordinary income and subject to the PFIC interest charge) on any direct or indirect disposition of PFIC stock, which, under the option regulations, would include a warrant. The disposition regulations could apply to tax a warrant-for-warrant exchange under a tax-free F reorganization, such as the domestication of a foreign SPAC.

Both the option regulations and the disposition regulations were proposed in 1992 and have not been finalized. If those regulations were finalized, their effective dates would be retroactive to April 1992. Given that the option regulations and the disposition regulations are only proposed and have been proposed for more than 25 years, a reasonable position could be taken that under current law they do not apply.[49]

Warrants may still result in adverse PFIC consequences even without a domestication. When a foreign SPAC acquires a foreign target, the holding period for stock received upon exercise of the warrants would include the holding period for those warrants.[50] Under a "once a PFIC, always a PFIC" rule provided in section 1298(b)(1), the stock received on exercise would retain a PFIC taint despite being exercised after a business combination when the SPAC would likely no longer be a PFIC.[51]

B. Start-Up Exception

Under a start-up exception,[52] a foreign corporation will not be treated as a PFIC for the first tax year it has gross income (its start-up year) if: (1) no predecessor of that corporation was a PFIC; (2) the corporation establishes to the satisfaction of the Treasury secretary that it will not be a PFIC for either of the first two tax years following its start-up year; and (3) the corporation is not in fact a PFIC for either of the first two tax years following its start-up year. Although the start-up exception is intended to allow a new business to start up without being treated as a PFIC, the start-up exception has been criticized as extremely narrow.[53] As a policy matter, a SPAC should be entitled to qualify for the start-up exception since its entire purpose is to acquire an active business within a relatively short time frame, and there is no meaningful concern regarding deferral because any passive income earned by the SPAC on its cash or Treasury securities in the trust account is negligible.

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[47] Reg. section 1.1295-1(c)(2)(ii).

[48] Reg. section 1.1295-1(b)(2)(iii).

[49] The IRS has not issued specific guidance on whether section 1291(f) and the disposition regulations or section 1298(a)(4) and the option regulations are self-effectuating, and the preamble to those regulations does not provide significant guidance.

[50] Prop. reg. section 1.1291-3.

[51] *See* T.D. 8750.

[52] Section 1298(b)(2).

[53] Kimberly S. Blanchard, *PFICs*, Tax Mgmt. Port. (2012); New York City Bar Committee on Taxation of Business Entities, "Report Offering Proposed Guidance Regarding the Passive Foreign Investment Company Rules" (Sept. 21, 2009).

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However, given the narrow wording of the start-up exception, it may be difficult for a SPAC to qualify for several reasons.

The start-up year is the first year in which the corporation has gross income — regardless of how long the corporation has been in existence. If the corporation was formed before the first year in which it has gross income, it might already be treated as a PFIC under the asset test, because the PFIC determination is based on having either income or passive assets. In that case, the once-a-PFIC, always-a-PFIC rule could taint the stock of any U.S. shareholders holding stock before the start-up year. The IRS has in fact issued field service advice that treated a corporation as a PFIC in a year before its start-up year based on the assets of the corporation in that prior year, regardless of whether the corporation later qualified for the start-up exception.[54]

Upon formation of a SPAC, the sponsor purchases founder shares for cash. The SPAC uses all that cash fairly quickly for operating expenses. Cash is a passive asset for purposes of the PFIC tests and is the only asset of the SPAC at that time.[55] Proceeds of an IPO constitute additional passive assets regardless of whether any interest income is earned on the proceeds. Owning solely passive assets would cause the SPAC to be treated as a PFIC under the asset test. Under a literal application of the statute and the above-mentioned field service advice, the SPAC would be subject to the PFIC taint regardless of whether it qualified for the start-up exception in a later year. This result is highly technical and inconsistent with the policy of shielding corporations from PFIC status during their start-up phase.

Despite the lack of clarity around the start-up exception, a SPAC may still take some measures to increase its chances of satisfying the exception. For example, a SPAC may hold off putting its cash into an interest-bearing account, at least for its initial year of existence. The proceeds in the non-interest-bearing account would then generate no interest income, and the SPAC would have no gross income. When the proceeds are moved to an interest-bearing account, the SPAC will have gross income, and that tax year will constitute the start-up year of the SPAC — starting the clock on the start-up exception period.[56] Sponsors may also give themselves the right to domesticate a SPAC unilaterally before year-end, so that the SPAC's existence as a foreign corporation does not extend beyond the intended start-up year.

V. Conclusion

SPACs are becoming increasingly popular in the capital markets. They have been heralded as a new path to bring "unicorns" to the public market, replacing the traditional IPO.[57] Prominent private equity firms are taking note and are increasingly looking at SPACs as a viable structure. SPACs are also attractive to public investors since they are relatively safe investments that provide a cash exit in connection with a subsequent business combination. Finally, SPACs have proven attractive for private companies that can obtain a public company listing without the costs and inefficiencies of the traditional IPO process. ■

[54] *See* IRS Field Service Advice — PFIC Issues, 2002 WL 1315676 (2002).

[55] The asset test looks at the nature and value of a corporation's assets at the end of each calendar quarter. When the sponsor purchases founder shares during a particular calendar quarter and the SPAC uses all that cash before the end of that quarter and before the completion of an IPO, there is a strong argument that the SPAC would not be a PFIC under the asset test because the SPAC would have no passive assets (*i.e.*, no cash) as of the relevant valuation dates.

[56] In addition to the uncertainty of the interaction of the asset test and the start-up exception, additional complexities arise regarding the SPAC's tax years following the start-up year. As noted above, to qualify for the start-up exception, the SPAC must not be a PFIC in either of its two tax years following its start-up year. Presumably, the SPAC will acquire an active business in its initial business combination and not be a PFIC following the business combination. A SPAC's tax year, however, will generally end upon a domestication. Therefore, the SPAC (assuming it meets the PFIC income or asset tests in the relevant year) would not qualify for the start-up exception if it domesticates in a tax year following its start-up year because the SPAC will have been a PFIC for one of its tax years following its start-up year — *i.e.*, the short year ending with the domestication. This result makes the start-up exception quite narrow. Unless the SPAC domesticates before the close of its start-up year, it would not likely qualify for the start-up exception.

[57] Nicole Bullock and Tom Braithwaite, "Social Capital Heralds New Model for Unicorn IPOs," *Financial Times*, Sept. 14, 2017.

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