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Continuity of Business Enterprise in SPAC Transactions

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INTRODUCTION

I doubt there is a reader who does not have at least a general familiarity with the publicly-traded special purpose acquisition company, known by its acronym, ''SPAC.'' A blank check company (we will use the terms ''SPAC'' and ''blank check company,'' interchangeably) is a newly-formed corporation, which increasingly is organized by a private equity or hedge fund sponsor, that raises funds in an initial public offering and places the cash proceeds into a trust account for a prescribed time period without any assets or businesses other than a mission to find a suitable acquisition target. In many cases, the sponsor and management have a particular industry focus, and in other cases the scope for potential acquisitions is very open-ended.

The life cycle of a SPAC generally divides into two main phases — the initial public offering of the SPAC, and the business combination transaction (the de-SPAC phase) that occurs after it finds a company, usually private, to acquire. After a brief description of the typical capital structure of the newly public SPAC, this article will focus on the de-SPAC phase, and in particular, the relatively uncommon situations where the SPAC will be a ''target'' corporation in a putative reorganization. In that context, tax advisors have been in the very unusual position of wrestling with whether such a transaction can satisfy the continuity of business enterprise (COBE) requirement under the §368 reorganization rules.[1]

Although there are some differences among these transactions, they bear a strong similarity to one another in the formation stage and we can discuss this on a fairly generic basis. In theory, the subsequent de-SPAC acquisition stage could take as many different forms as there are possible M&A structures (including those that qualify as a tax-free reorganization under §368 and those that qualify as a tax-free exchange under §351), but they have tended to fall broadly into either a purchase of another company with cash being at least a significant part of the consideration or an all-stock merger that is the means for a private company to go public.

In nearly all cases, for just $10 per unit, public investors may purchase an investment consisting of one share of common stock and a fraction (e.g., one-third, but the fractions vary) of a warrant to purchase common stock. Often on the 52nd day following the date of registration, the warrant begins trading separately from the common stock. A whole warrant entitles the holder to one share of common stock upon exercise (generally at an exercise price of $11.50). Although the terms vary, the warrants generally become exercisable after some period (e.g., the later of 30 days after the completion of the business combination and 12 months from the closing of the IPO), at which point the SPAC may decide to redeem outstanding warrants.

Generally, the SPAC commits to complete a business combination (the de-SPAC) within 18 to 24 months of the IPO or return the public investors' money, which it has held in trust (subject to income taxes payable from the trust account). The de-SPAC must be with one or more target businesses with an aggregate fair market value equal to at least 80% of

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated. In the author's experience, whereas COBE has very rarely come up as an issue in reorganization transactions, it has tended to arise more in the context of §382(c), which imposes the draconian result of reducing a loss corporation's annual limitation to zero if the corporation fails to satisfy the §368 COBE test for the two-year period following an ownership change.

the assets held in the trust account at the time of signing of a definitive agreement.[2]

In the case of an outright acquisition, the 80% threshold figures directly into funding the equity portion of the target purchase price. In the more prevalent all-equity de-SPAC transactions, this results in the SPAC's cash being used for working capital and ongoing business purposes for the target business, usually supplemented by a private investment in public company (PIPE) investment in connection with the de-SPAC.

At the time of the de-SPAC, a public stockholder can choose to redeem all or a portion of its shares for an amount equal to its pro rata share of the amount held on deposit in the trust account. It is intended that there will be sufficient cash held to pay $10 per share to investors exercising the redemption right, but the amount available may be reduced under certain limited circumstances in accordance with the terms of the SPAC's trust agreement.

DE-SPAC MERGER WITH SPAC AS "TARGET"

SPACs present a number of interesting issues and challenges, and generally one would not say that subchapter C issues are among these challenges — except the one that is the subject of this article. As stated above, the norm is for the SPAC to acquire the Target in a taxable, tax-free, or combination reorganization transaction, all of which are made freely available by the well-established rules in Chapter C. In at least two types of situations, however, it becomes necessary to use a structure in which the SPAC will be acquired and satisfy the requirements of the reorganization provisions.

When first setting up a SPAC, a key question is whether it should be domestic or foreign, and this turns largely on whether the sponsor thinks it likely that the eventual Target will be domestic or foreign. When the SPAC is domestic and the eventual business combination is with a foreign corporation, given the alternative of having a U.S. holding company for a foreign operating company, several have chosen instead to take the combined company offshore. Though the foreign Target could acquire the SPAC, it may be more common to have a new foreign parent company acquire the SPAC and the Target through a horizontal double-dummy structure in which one merger subsidiary merges into Target and another merges into the SPAC. The SPAC's shares and warrants are exchanged for shares and warrants in the foreign parent, and the Target shares are exchanged for the mix of foreign parent stock and cash (or all stock) comprising the merger consideration.

The other situation where this structure may be desirable involves a Target that is a partnership. This situation may more likely result in an "Up-C" structure, in which the Target partnership remains in place, the SPAC invests cash for a controlling interest and the Target partners receive the right to exchange their Target interests for SPAC stock; this is typically accompanied by a tax receivable agreement (TRA) issued to the Target partners, providing exchanging partners future cash payments based on the SPAC's tax savings from a basis step-up from these taxable exchanges. However, if, instead, the parties want to arrange for Target partners to receive stock in the public company on a tax-free basis, doing a §351 horizontal double-dummy will likewise make sense.

The domestic SPAC/foreign Target situation certainly presents cross-border tax considerations, primarily, §7874 anti-inversion and §367(a) shareholder-level tax hurdles for the U.S. SPAC shareholders.[3] It is reasonable to expect (certainly for purposes of this article) that both of these can be overcome, and so we arrive at our main destination, subchapter C and the reorganization rules in particular. As noted above, unless the legal structure of the Target needs to be changed to accommodate an acquisition of the SPAC (e.g., the Target is an operating company and a holding company structure is desired), acquisition of the SPAC via one or another §368(a) reorganization makes sense. However, at least in part due to concerns about whether such a transaction can satisfy the COBE reorganization requirement, it has been customary to structure such transactions in a horizontal double dummy §351 format. A new foreign holding company (Holdco) acquires the stock of Target and the stock of the SPAC in reverse subsidiary mergers. SPAC shareholders and warrant holders receive Holdco stock and warrants, and Target shareholders

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[2] This is often due to rules imposed by the exchange. For example, Nasdaq IM-5101-2(b) requires that a SPAC must complete one or more business combinations having an aggregate fair market value of at least 80% of the value of the SPAC trust account within 36 months of the offering or such shorter time period as specified by the SPAC.

[3] Under §7874 generally, adverse consequences would result if the SPAC shareholders owned 60% or more of the post-merger foreign parent, with the more severe consequence of treating the foreign parent as a domestic corporation occurring if the 80% threshold were hit. There are many complexities in the determination, including factoring out new cash investments coming in from PIPE (private investment in public equity) investors in connection with the De-SPAC transaction. Nevertheless, in a transaction in which the private Target shareholders receive a sizable portion of the post-merger company, these rules can be successfully navigated. With respect to §367, under Reg. §1.367(a)-3(c), U.S. SPAC shareholders must receive 50% or less of the vote and value of the foreign parent, and the foreign Target must satisfy active business and "substantiality" requirements.

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receive whatever mix of Holdco stock and cash has been negotiated. The mergers of transitory merger subsidiaries are ignored, and the transaction is treated as a transfer by the Target and SPAC shareholders of their stock to Holdco in exchange for the stock of Holdco, qualifying under §351.[4]

The result is fine, except with respect to the SPAC warrants. Nonrecognition treatment is not provided under §351 for warrant exchanges, while such an exchange is tax-free in a reorganization under the §354 regulations.[5] Tax disclosures differ, but public disclosures may state that nonrecognition for SPAC shareholders under §351 is clear, note that the merger on the SPAC side may alternatively qualify as a reorganization, but due to uncertainty about the COBE issue, there is corresponding uncertainty as to whether warrant holders qualify for nonrecognition treatment.

THE COBE ISSUE

As stated in the regulations, continuity of business enterprise requires that the acquiring group either continue a significant historic line of business of the Target corporation (business continuity) or use a significant portion of its historic assets in a business (asset continuity).[6] It seems the concerns about whether acquisition of a SPAC can satisfy COBE are based largely on the fact that, as a recently formed company searching for a business to acquire, it may not have a historic business to continue, or that, if this is a business, it is discontinued once the business combination has been arranged. Whether it has historic business assets is also problematic, since those assets would appear to be limited to the temporary investments held to fund an acquisition and, to the extent necessary, share redemptions. Given what they have to work with, despairing of satisfying the business continuity test, tax planners have taken to advising that the post-merger company retain at least one-third of the SPAC's cash so as to argue that a significant portion of the SPAC's historic assets will be used in the continuing business.[7]

Working solely from the text of the regulations, it is challenging to get comfortable that acquisition of a SPAC can satisfy either the business continuity or asset continuity test. It is the thesis of this article that, nevertheless, there are strong reasons to conclude that COBE is satisfied, based on an understanding of the origins of the COBE requirement, the intended scope of the regulations, the manner in which the rule has been applied by the IRS, and the underlying policies of the reorganization provisions.

A review of the history of the COBE requirement and genesis of the current regulations will be helpful. Prior to 1979, this was a rarely considered and barely defined requirement, which developed largely from liquidation-reincorporation case law seeking to determine whether a corporation that had discontinued its activities and engaged in other steps consistent with a complete liquidation had in fact undergone a reorganization.[8]

The guts of the current regulations were promulgated in 1980 in response to a transaction that became common in the 1970s and eventually became a concern to the IRS. In the transaction, described in Rev. Rul. 79-434, a closely held corporation sells its manufacturing business and, anticipating being acquired by a mutual fund, temporarily holds cash and short-term Treasury notes pending consummation of a purported reorganization with the mutual fund. The ruling struggles to articulate a rationale but does come to the conclusion that the reorganization fails to satisfy the common law COBE requirement, concluding that in substance the transaction ''represents a purchase by [the Target corporation] of the shares of [the Acquiring corporation] prior to [the Target corporation's] liquidation.''[9]

Publication of the ruling was enough to cut off the pipeline of mutual fund transactions, pending promulgation of regulations articulating and codifying what was on the government's mind.[10] The regulations are substantially identical to the current version, except that in 1998 they were enlarged to encompass the concept of the issuing corporation's qualified group and

[4] *See* Rev. Rul. 67-448.

[5] Reg. §1.354-1(e).

[6] Reg. §1.368-1(d).

[7] Reg. §1.368-1(d)(5), *Ex.* 1, signifies that one-third will be considered a significant line of business, and presumably this would apply as well to the quantum of assets. Although, as the text below makes clear, I think that fulfillment of the SPAC's founding purpose through a business combination in which it is not the ''issuing corporation'' should satisfy the business continuity test of the COBE regulations, and even though cash has typically not been seen as a significant operating asset in other contexts — *see, e.g., Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981); Rev. Rul. 57-518 (each denigrating the status of cash as against other intangible assets of a business for purposes of the ''substantially all'' requirement) — I do think it makes sense to highlight the fact that the SPAC's cash will be used to promote growth of the operating business with which it is combining.

[8] *See, e.g., Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965); *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955). See also *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961), finding a valid reorganization and rejecting the IRS's argument that continuity of business enterprise requires more than that the acquiring corporation continue to engage in some business activity.

[9] Rev. Rul. 79-434.

[10] Proposed regulations were published December 28, 1979, along with publication of Rev. Rul. 79-434 and additional administrative actions. Final regulations were issued December 31, 1980, in T.D. 7745, 45 Fed. Reg. 86,437.

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partnerships within the group.[11] In addition to weaving together disparate results from case law, the regulations introduced the concept of the Target corporation's ''historic'' business and required that a significant historic business be continued by the acquiring corporation or that the acquirer continue to use a significant portion of the Target's historic assets in a business. Illustrating how serious this ''historic'' concept is, the regulations include an example where T corporation sells its manufacturing business ''as part of a plan of reorganization,'' invests the cash in a diversified portfolio of stocks and bonds, and a full 3-1/2 years after the sale, undergoes a putative reorganization with a mutual fund. The example concludes that the reorganization fails, because ''T's investment activity is not its historic business, and the stocks and bonds are not T's historic business assets.''[12]

The guiding principle for the COBE regulations is the longstanding statement contained in regulations and reiterated in numerous cases that the ''purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate form.''[13] As discussed further below, there was historically no suggestion in cases or administrative practice that the reorganization provisions were limited to only certain kinds of corporations or activities.

The examples in the COBE regulations present companies engaged in what one might refer to as conventional businesses of the period: selling toys, manufacturing resins, operating a department store. But viewed in the context of tax-free corporate reorganizations as they had been historically understood, there is no reason to attribute to the Treasury department, and nothing contained in the preamble to the regulations, suggesting an intent to suddenly limit the availability of the reorganization provisions to corporations exhibiting a given level of activity. The COBE regulations do not require that the Target carry on an active trade or business. They do not require that the Target carry on a trade or business. Do they even require that the Target actually carry on a business, at least in a way that is matched by any known definition of that word? The regulations make it fairly clear that a Target corporation only holding investment assets could be acquired in a COBE-satisfying reorganization, provided that holding those investment assets constituted its historic activity and/or they were its historic business assets.[14]

There is nothing in the regulations and apparently nothing in subsequent administrative or judicial authority denying the ability of an utterly passive corporation to undergo a corporate reorganization. There is no reason to doubt that a corporation only passively holding unproductive land could be acquired in a reorganization consistent with the COBE rules. If corporations were animals, then as far as the reorganization rules are concerned, a sloth would be as welcome to be acquired as a jaguar, provided the sloth had historically been a sloth.

Moving away from unimproved land and tree sloths, there is relevant authority in judicial and administrative rulings involving the acquisition by an operating company of a holding company whose principal asset is stock in the operating company. A downstream merger of a pure holding company into its subsidiary was held to be a valid reorganization in *Gilmore v. Commissioner*.[15] The IRS upheld a downstream reorganization of a holding company owning cash, land and a 5% interest in the acquiring corporation in Rev. Rul. 78-47.[16]

In Rev. Rul. 70-223, X corporation purchased all the stock of Y and, less than two years after the purchase, merged down into Y in what was held to be a valid reorganization. This occurred under the pre-1982 §338 predecessor regime of §334(b)(2). Although the facts do not indicate whether X held any assets other than the recently purchased stock of Y, it seems reasonable to infer that it did not, and private letter rulings have interpreted it in that way.[17] The presumed reason for publishing the ruling was to

[11] T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

[12] Reg. §1.368-1(d)(5), *Ex.* 3.

[13] Reg. §1.368-1(b).

[14] This is the clear implication of Example 3 discussed in the text. See also §368(a)(2)(F), which explicitly envisions a reorganization in which one or both participating corporations are investment companies, and unregulated, undiversified ones at that.

[15] 44 B.T.A. 881 (1941), *aff'd*, 130 F.2d 791 (3d Cir. 1942), *acq.* 1946-2 C.B. 2.

[16] For a short period, the IRS froze issuance of rulings involving downstream reorganizations where the parent owned less than 80% of the subsidiary, based on repeal of *General Utilities* concerns. Rev. Proc. 94-76. The study project and no-rule position were terminated via Notice 96-6. See also PLR 9506036, which generally acknowledged as involving the transaction where a corporation conducting the Petrie Stores retail business sold that business and then engaged in a downstream C reorganization into Toys ''R'' Us, in which it held a highly appreciated minority investment.

[17] *See, e.g.,* PLR 8947057, PLR 8933022, PLR 8304081. Note that despite the fact that the sole ''business'' of Parent is owning the stock of Sub and that its sole asset is the stock of Sub, the private letter rulings contain a standard representation that ''[a]cquiring will continue the historic business of Target or use a significant portion of Target's historic assets in a business.''

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make clear that if Parent corporation made a qualified stock purchase of a Sub corporation and wished to eliminate the two-tier structure within two years of the purchase, it could avoid the consequences of liquidating Sub into Parent under then-current §334(b)(2) by merging downstream into Sub in a valid reorganization. In such cases, it would be typical for Parent itself to have been formed solely for the purpose of engaging in the purchase of Sub.[18]

One can also infer from the §338 regulations that a purchasing corporation created to make a qualified stock purchase can merge downstream in a qualified reorganization. Reg. §1.338-3(b)(1) states that an individual cannot make a qualified stock purchase, but a new P formed by an individual can make a qualified stock purchase ''if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.'' Although raising a cautionary flag about whether new P's existence may be so transitory as to be ignored for tax purposes, the regulation may be read also, in conjunction with Rev. Rul. 70-223, as otherwise considering P's historic business of buying T to qualify for COBE purposes.

So what are we to make of the SPAC, a corporation lacking much history altogether, created and capitalized for one purpose — to search for and consummate a business combination with an operating company, ordinarily in certain targeted industries with which the founding investors have some experience and ability to add value? With which company and exactly in what form the business combination will occur are not initially known, but such a combination, followed by the work to help the Target company pursue its business strategies, is the SPAC's lodestar, and it seems sensible to regard this as the historic business of the SPAC. Engaging in the business combination, even if the SPAC ends up being acquired in a putative reorganization, is, rather than a liquidating event in the life of the company, the fulfillment of its very raison d'être.

Separate from the concern that acquisition of the SPAC may not technically meet the requirements of the COBE regulations, there may also be some concern that there is something intolerably transitory about the SPAC's existence. I view this concern as ultimately misplaced. First, no SPAC is formed intending specifically to be the Target rather than the acquiring entity in a prospective business combination, though it may recognize this as a possibility. Second, assuming the acquisition of the SPAC takes the form of a reverse subsidiary merger, the SPAC remains as a surviving corporation whose existence continues after the merger. In such cases, there is no basis at all for viewing the SPAC as having a transitory existence, legally or for tax purposes.

What of the unlikely situation where it is necessary that the SPAC be merged out of existence in the reorganization with the ''Target'' company?[19] The right answer is mostly provided by the reliable citation to *Moline Properties*[20] and the pervasive proposition that a corporation's existence is not ignored except under exceptional circumstances. In the subchapter C area, those circumstances are laid out in published rulings and while the application of these rulings is common, their parameters are well known and well established.[21] In no instance has the IRS or a court ignored the existence of a corporation that was formed and capitalized, issued stock in the public markets and embarked on a commercial course, where eventually being dissolved was never more than a possibility. Indeed, the notion of ignoring the existence of such a corporation for tax purposes, across multiple tax years, is unprecedented and appropriately conjures the word ''unthinkable.''

CONCLUSION

The vast majority of de-SPAC transactions will undoubtedly continue to involve the SPAC as the ''issuing corporation'' (to use the term in the COBE regulations), but there will continue to be transactions where it is necessary for the SPAC to be acquired in a transaction that will qualify as a tax-free reorganization provided the COBE test is met. Tax advisors will wrestle with this issue, come to varying levels of comfort in advising their clients, and due to the uncertainty, guidance to public investors will be largely absent. As discussed above, there are strong reasons in existing tax law and policy supporting a favorable conclusion, and no apparent policy reasons indicating

[18] This fact pattern is explicitly indicated in PLR 8204183. That ruling on a merger of Parent into Company, which was requested by the taxpayer in a ruling request dated November 7, 1980, states, ''Parent is a State A corporation which was incorporated in 1979 in order to purchase 100 percent of the stock of Company from its previous shareholder. . . . Parent's only activities are that of owning all of the stock of Company and paying off the purchase price of Company stock to Company's original shareholder.''

[19] It is most unlikely because the SPAC investors ordinarily do not receive consideration other than a rollover of their securities, and therefore, at least from the standpoint of tax planning, no reason to go to a forward merger, all the less likely since it would put corporate level tax on the table in the event that the reorganization failed.

[20] 319 U.S. 436 (1943).

[21] *See, e.g.,* Rev. Rul. 78-250, Rev. Rul. 73-427, Rev. Rul. 67-448.

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otherwise. This is an ideal set of circumstances for the IRS to issue a revenue ruling providing clear guidance, and thereby, certainty to the matter.

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