A SPAC Merger Primer for Holders of Qualified Small Business Stock

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The number of private companies electing to go public through a transaction (referred to in this article as a "SPAC Merger") with a special purpose acquisition company (SPAC) has dramatically increased over the past couple of years as an alternative to either a traditional initial public offering (IPO) or engaging in a sale process. The internet is flooded with articles about SPACs, but little has been written about how a SPAC Merger works for private company stockholders holding Section 1202 qualified small business stock (QSBS). This article leaves to others the task of addressing how SPAC Mergers stack up against a traditional IPOs and M&A transactions.[i] After introducing the concept of a SPAC Merger, this article focuses on issues that should be considered by private company stockholders holding QSBS.

This is one in a series of articles and blogs addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code.[ii] During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the corporate rate from 35% to 21%, but founders and investors have also focused on structuring investments to qualify for Section 1202's generous gain exclusion. Future potential increases in capital gains rates may have the effect of making QSBS eligible investments even more attractive.[iii]

A guide to SPACs and SPAC Mergers.

A SPAC is a corporation that has raised a pool of cash in an initial public offering (IPO). The SPAC is required to complete a business combination, referred to as a "de-SPAC" transaction (here a "SPAC Merger"), within a couple of years following the IPO. The market for attractive private companies has become increasingly competitive, with a multitude of SPACs joining the M&A fray along with private equity sponsors, family offices and other financial and strategic

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buyers. In a SPAC Merger, the SPAC acquires a private company, generally via a merger transaction. After completion of the SPAC Merger, the public company's stock is held by a combination of the former private company stockholders, the SPAC's sponsors and investors (public stockholders), and purchasers of the corporation's PIPE (private investment in public equity) agreements.

A critical difference for holders of QSBS when comparing a SPAC Merger, a traditional IPO and a sale to a financial buyer with a rollover equity component, is that the public company stock received in the SPAC Merger almost never qualifies as QSBS for Section 1202 purposes.[iv] This fact is an important aspect of participating in a SPAC Merger. If the private company elects to go the traditional IPO route, the stock held by founders and investors would typically retain its QSBS status, which allows stockholders to claim Section 1202's gain exclusion against post-IPO appreciation in the stock's value (subject to Section 1202's gain exclusion cap). On the other hand, QSBS rolled over into buyer equity in an M&A transaction with a financial buyer can be structured to maintain QSBS status, but it isn't unusual for the buyer to fail Section 1202's $50 million test, particularly when the value of the private company is included in the buyer's "aggregate gross assets."

The typical SPAC Merger involves the private company stockholders rolling most if not all of their QSBS over into public company stock, with the private company surviving as a subsidiary of the public company. Post-closing, the private company's management team generally remains in place, with some of the sponsor's representatives continuing to serve on the public company's board. In some cases, the consideration paid to the private company's stockholders includes both public company stock and cash. Although the SPAC Merger is typically structured as a tax-free reverse triangular merger, there is quite a bit of structuring flexibility. Basically, any way that an acquisition can be structured has been used to accomplish a SPAC Merger (e.g., asset acquisition, stock purchase, merger and up-C structure).[v] The agreement combining the SPAC and the private company often provides for purchase consideration holdbacks, an earn-out, and representation and warranty insurance.

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Target stockholders are typically subject to a lock-up period with respect to the sale of their public company stock for a period of up to one-year after the closing of the SPAC Merger. An important deal point for private company stockholders should be the requirement that they receive registered shares in the SPAC Merger, or at least broad registration rights. The SPAC's founders and PIPE investors will be granted broad registration rights with respect to their public company stock and equity rights.

An outline of the typical SPAC Merger process from the private company's perspective.

The typical SPAC acquisition target is a high-growth private company seeking a means of providing some liquidity for stockholders and an additional source of capital to fund growth. The private company's board will have considered the company's options and made the decision not to sell the company or to undertake a traditional IPO route (often based on the perception that SPAC Mergers are a quicker and less costly alternative). The private company is often represented by financial advisors experienced in negotiating SPAC Mergers. The board determines whether the goal is to maintain control of the combined company post-SPAC Merger (through the receipt of mostly equity, coupled with a corresponding level of board representation), or whether the SPAC Merger is primarily a means for engineering a liquidity event for stockholders (through the receipt of mostly cash, coupled with less control of the post-SPAC Merger public company). Generally, the private company and SPAC will sign a letter of intent and the parties will then commence due diligence and negotiation of the definitive agreement. On a parallel track, the SPAC usually engages in the process of securing additional financing through PIPEs or other debt sources.

SPAC Mergers are often structured as a tax-free mergers, with the consideration being all public company stock or a mix of public company stock and cash.[vi] Many SPAC Mergers include earn-outs paid in additional shares of public company stock. Definitive merger agreements generally include representations, warranties and covenants similar to those found in traditional M&A merger

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agreements, excluding the obligation of the private company stockholders to indemnify the "purchaser" (the merged public company) for breaches of representations and warranties or pre-closing known or unknown liabilities. With respect to the absence of post-closing indemnification obligations, a SPAC Merger is structured in a manner similar to an M&A transaction with a public company target. In lieu of indemnification escrows and other holdbacks of purchase consideration, the SPAC often obtains representation and warranty insurance coverage. In contrast to M&A transactions where the private company stockholders might have recourse against a merger partner for misrepresentations, the definitive agreement in a SPAC Merger generally provides limited or no recourse for the private company or its stockholders against the public company.

A bucket list for private company stockholders.

Often found at the top of the bucket list for holders of QSBS who have satisfied their five-year holding period requirement is a stock sale, triggering the right to claim Section 1202's generous gain exclusion.[vii] On the other hand, a stockholder holding more than $10 million worth of QSBS might focus on pursuing a tax-free reorganization, which would allow for the exchange of private company QSBS for public company stock and some cash, allowing the stockholder to both exclude $10 million via Section 1202's gain exclusion, while deferring the balance of the gain until the balance of the public company stock is sold. In order to qualify to claim Section 1202's gain exclusion, the transaction must be structured so that the cash "boot" is be treated as consideration for the sale of stock rather than a dividend.[viii]

Private company stockholders who haven't satisfied Section 1202's five-year holding period requirement should definitely focus on structuring a transaction to qualify as a tax-free exchange of private company stock for public company stock under Section 368, giving those stockholders the opportunity to satisfy the five-year holding period requirement through the holding of the public company stock.[ix]

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As discussed below, the private company stockholders' pre-transaction planning should include state income tax planning and potentially wealth transfer planning that includes gifting QSBS and trust planning.[x]

Not all of the private company stockholders will have the same tax planning goals.

One thing to keep in mind when considering the consequences of a SPAC Merger is that the private company stockholders' interests will not necessarily be fully aligned. Some stockholders may hold QSBS and other stockholders may be corporations ineligible to benefit from Section 1202's gain exclusion. Some stockholders may have satisfied Section 1202's five-year holding period requirement and other stockholders may have shorter holding periods. The good news is that a SPAC Merger, where stockholders have the option of exchanging their stock (including QSBS) for public company stock or a mixture of public company stock and cash, should satisfy most tax planning needs. A downside could be that, at least for some period of time, the private company stockholders are required to accept the investment risks associated with holding public company stock.

A SPAC Merger cheat-sheet for the private company stockholders.

The typical tax consequences.

In a typical SPAC Merger, private company stockholders exchange their private company stock (QSBS) for non-QSBS public company stock. The exchange of private company QSBS for public company stock is generally structured to qualify as a tax-free reorganization under Section 368, excluding any cash or other "boot" received in the transaction.[xi] No taxable income will be triggered if a stockholder receives all public company stock in the merger. Since the private company's QSBS will be exchanged for non-QSBS public company stock in the SPAC Merger, the amount of gain that may be excluded under Section 1202 by the former private company

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stockholders post de-SPAC when they sell their public company stock shares will be limited to the amount of gain that would have been realized if those stockholders had sold their QSBS in taxable sale at the time of the SPAC Merger.[xii] Stated another way, each private company stockholder will have a per-share Section 1202 "built-in Section 1202 gain" amount in their public company stock received in the SPAC Merger. The per-share built-in Section 1202 gain amount is usually determined by the trading price for the public company's stock immediately post-SPAC Merger. When a stockholder sells shares of public company stock, the stockholder will claim the applicable per-share Section 1202 gain exclusion, subject to the stockholder's overall Section 1202 gain exclusion cap. Any gain triggered by the sale of public company stock in excess of the deferred per-share Section 1202 gain will be taxed at capital gains rates.

The private company's stockholders will be able to claim Section 1202's gain exclusion with respect to any cash or other taxable "boot" received in the SPAC Merger if the cash/boot is treated as consideration paid for the QSBS shares (i.e., if it is not treated as a dividend under Section 302). A stockholder's QSBS holding period is tacked onto the holding period of the public company stock received in the SPAC Merger.

Should the SPAC Merger ever be structured as a taxable sale of QSBS stock?

There are circumstances certain where it might make sense to structure a taxable exchange of private company QSBS for public company stock.[xiii] A taxable exchange generally would make sense if the private company's stockholders have satisfied Section 1202's five-year holding period requirement and are positioned to claim the Section 1202's gain exclusion. In concept, this plan makes sense because there is always the chance that after a nontaxable exchange of private company QSBS for public company stock, Section 1202 could be repealed retroactively to the date of introduction of legislation or a stockholder could transfer public company stock to a family LLC/LP, or find some other way to destroy the ability to claim the Section 1202 gain exclusion. It generally wouldn't make sense to structure a taxable exchange for

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those stockholders who have large stock holdings that would trigger gain well in excess of Section 1202's gain exclusion caps.[xiv] It is possible that stockholders with large QSBS holdings may not have access to sufficient liquidity given lock-up periods to fund payment of taxes on gains exceeding Section 1202's gain exclusion cap. When QSBS is involved, consideration of the various options of structuring taxable or non-taxable exchanges should be part of the planning process.

Tax consequences of the receipt of all cash.

The receipt of all cash in the SPAC Merger will be treated as the sale of the private company stockholder's stock. The stockholder will be in a position to claim Section 1202's gain exclusion if all eligibility requirements are satisfied. Stockholders can roll some or all of the proceeds over under Section 1045 into replacement QSBS, although this generally only makes sense if the five-year holding period requirement hasn't been satisfied and perhaps if the target stockholder bumps up against Section 1202's gain exclusion cap.

Tax consequences of the receipt of public company stock and cash (or other "boot").

If the SPAC Merger involves the receipt of "boot" (cash or other taxable property), then the private company stockholders will be able to claim Section 1202's gain exclusion only if the boot is treated as payment for stock. Under Section 356(a)(1) and (2), the boot could be treated as payment for stock or as a dividend. The SPAC Merger will be viewed as if the private company stockholder received all stock and then a portion of the stock was redeemed, triggering application of Section 302's rules regarding whether the deemed stock redemption is a treated as a purchase of stock or a dividend for tax purposes.[xv] In a SPAC Merger, it is unlikely that the boot will be treated as a dividend since there should be a meaningful percentage reduction in each stockholder's percentage interest in the corporation (the public company) surviving the merger.

Tax consequences of the receipt of contingent stock or earn-out boot.

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Courts have ruled that the receipt of contingent stock in a tax-free reorganization does not constitute boot.[xvi] While this is good news for private company stockholders, there isn't any tax authority addressing how Section 1202 "built-in gain" should be divided among shares when public company shares are issued at closing and the acquisition agreement provides that additional shares will be issued to the private company stockholders if certain contingencies are satisfied. We assume that courts would look to the principles that that apply to contingent payment sales for determining how to determine the per-share Section 1202 "built-in gain" amount against when there is contingent stock in an installment sale.

Schedule D includes instructions for claiming Section 1202's gain exclusion when installment payments governed by Section 453 apply. It might make sense to elect out of the Section 453 installment sale rules if a stockholder's aggregate gain on the sale of private company stock will fall below the usual $10 million gain exclusion cap. The reason for this is the uncertainty of how any legislative changes to Section 1202's rules would apply to installment sales payments.

What if the private company stockholders haven't achieved a five-year holding period for their QSBS?

If stockholders haven't achieved the required five-year holding period necessary for claiming Section 1202's gain exclusion, they can satisfy the holding period requirement by combining their private company QSBS holding period with their replacement public company stock holding period to achieve a combined five-year holding period, so long as the exchange of private company QSBS for public company stock is accomplished through a Section 368 tax-free reorganization. If the exchange of private company QSBS for public company stock is a taxable exchange, then the private company stockholders should consider rolling the sales proceeds over into replacement QSBS under Section 1045.[xvii]

If the transaction involves installment payments governed by Section 453 such as an earn-out, the calculation of the amount of sales proceeds will still need to be made at closing because Section

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1045 requires that proceeds are rolled over into replacement QSBS within 60 days of the date of sale, not the date of payment. In calculating the amount of proceeds under the Section 453 installment sale rules, if there isn't the equivalent of a "stated maximum selling price," it would make sense to determine the per-share Section 1202 "built-in gain" amount based on the shares of public company stock received by the private company stockholders at closing. Consideration should also be given to electing out of the installment sales rules.

Pre- SPAC Merger planning for the private company stockholders.

Estate planning; multiplying the QSBS gain exclusion cap.

The private company stockholders should consider estate planning that includes gifting QSBS before the stock value increases dramatically when the SPAC Merger looms. Stockholders who expect to hold public company stock with an aggregate value exceeding $10 million (i.e., an amount exceeding Section 1202's typical gain exclusion cap), should consider gifting shares of QSBS to a separate taxpayer for federal income tax purposes (i.e., one that has its own Section 1202 gain exclusion cap), including potentially gifting QSBS to non-grantor trusts (often Delaware or Nevada asset protection trusts). Stockholders should work with their estate planning attorneys, financial planners, accountants, and tax advisors experienced in dealing with Section 1202. A stockholder's pre-SPAC Merger planning can involve a combination of addressing the stockholder's cash requirements, income tax planning, estate planning, investment and financial planning, and charitable giving goals.

Pre-SPAC Merger exercise of options.

It isn't unusual for private company employees to be holding nonqualified stock options. During the pre-SPAC Merger stage and in particular, before the private company commences exploring its sale/SPAC/IPO opportunities, it is often possible to exercise options

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based on the most recent Section 409A valuation or other determination of enterprise value, that will prove to be far below the value placed on private company stock in a SPAC Merger. While the exercise of the nonqualified options does trigger compensation income equal to the spread between the exercise price and a value of private company stock on the date of exercise, it does then position the holder of the newly-issued private company stock to claim a built-in Section 1202 gain amount if the shares are priced higher in connection with the SPAC merger. Also, for those stockholders who hold both low-basis founder stock and preferred stock with a higher tax basis (either because the stockholder bought shares or attained basis by paying taxes upon the exercise of the nonqualified options), it may be possible to exceed the usual $10 million Section 1202 gain exclusion cap by selling $10 million worth of low basis public company stock first and then selling additional public company shares with a higher basis during subsequent years. Section 1202's five year holding period won't commence until stock is issued upon exercise of the nonqualified options. If the holder of a nonqualified option waits until the occurrence of the SPAC Merger and is issued public company stock, the taxable compensation is likely to be substantially greater and the eventual sale of the public company stock will not qualify for any Section 1202 gain exclusion.

Pre-SPAC Merger conversion of convertible debt and SAFE instruments.

The conversion of convertible debt and SAFE instruments into stock is not a taxable event to the holder, except to the extent shares are received for accrued interest. If a private company is going to participate in a SPAC Merger, it generally will benefit holders of convertible debt and SAFE instruments to convert into private company stock as early as possible for the reasons outlined in the preceding paragraph. If holders of convertible debt or a SAFE instrument wait until the occurrence of the SPAC Merger and are issued public company stock, the eventual sale of the public company stock will not qualify for any Section 1202 gain exclusion.

Pre-SPAC filing of Section 83(b) elections if there are stock grants.

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If private company stock subject to substantial risk of forfeiture under Section 83 is issued prior to a potential SPAC Merger, it often will make sense to file a Section 83(b) election within the required 30-day period and trigger taxable compensation equal to the then-fair market value of the stock. The amount of compensation triggered by the filing of the Section 83(b) election is often substantially less than the value subsequently placed on the stock in the SPAC Merger. If a holder of restricted stock waits until the occurrence of the SPAC Merger and is issued public company stock, the taxable compensation is likely to be substantially greater and the eventual sale of the public company stock will not qualify for any Section 1202 gain exclusion.

More resources.

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Code Section 1202 and Code Section 1045 planning. Venture capitalists, founders and investors who want to learn more about Code Section 1202 and Code Section 1045 planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss any Code Sections 1202 or 1045 issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] Aspects of SPAC Mergers that are cited as potential disadvantages include the market risk of holding public company stock and the dilutive effect of SPAC sponsor/founder shares that

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remain outstanding post-closing (typically, SPAC sponsors are issued 20% of the SPAC's equity for a nominal contribution to the SPAC; which dilutes the equity held by private company stockholders and SPAC investors post-SPAC Merger).

[ii] References in this article to "Section" are to sections of the Internal Revenue Code, as amended. This article generally assumes that the private company QSBS involved in the de-SPAC transaction was issued after the 100% percentage exclusion became applicable.

[iii] Although it is likely that the corporate tax rate will increase from the current 21% rate, it is also likely that the capital gains rate for high-income individuals will increase dramatically, potentially making seeking the Section 1202 gain exclusion an even more compelling planning option.

[iv] The SPAC will almost always fail Section 1202's requirement that QSBS can only be issued when a corporation's "aggregate gross assets" don't exceed $50 million, including the value of property exchanged for the issuance of the stock being vetted for QSBS eligibility (here the private company's stock)

[v] In a SPAC Up-C structure, the operating company is a partnership that is co-owned by the public corporation and the pre-merger owners of a target LLC. The SPAC Up-C structure is not used when the private company is a C corporation.

[vi] Reorganizations governed by Section 368.

[vii] Each holder of QSBS that is a separate taxpayer is entitled to exclude at least $10 million of gain per issuing corporation, subject to further percentage limitations based on when the QSBS was issued.

[viii] If the payment is treated as consideration paid for stock, private company stockholders will be eligible to claim Section 1202's gain exclusion if all of Section 1202's eligibility requirements have been satisfied, generally subject to the $10 million gain exclusion cap, or if the target stockholder has basis in the QSBS either or both the $10 million gain exclusion cap and 10X the amount paid for each share of QSBS purchased.

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[ix] If QSBS is exchanged for other QSBS or non-QSBS in a Section 368 reorganization, the holding period for the original QSBS is tacked onto the holding period for the replacement stock and the stockholder can claim Section 1202's gain exclusion once the original QSBS and the replacement stock has a combined five-year holding period, assuming all other Section 1202 eligibility requirements are satisfied. Assuming that the public company stock is non-QSBS, the Section 1202 gain exclusion would be capped at the gain built-in at the time of the SPAC Merger under the rules of Section 1202(h)(4)(b).

[x] Subject to the requirement that trusts are organized for bona fide family wealth transfer planning and personal business purposes, it is sometimes possible to gift stock to non-grantor trusts that qualify as separate taxpayers for federal income tax (and Section 1202) purposes.

[xi] If a private company stockholder is holding QSBS, only a taxable sale (if the stockholder has satisfied Section 1202's five year holding period requirement) or a Section 368 or Section 351 is acceptable. An asset sale would trigger corporate taxes at the private company level. The private company would then liquidate and it stockholders would claim Section 1202's gain exclusion, but the overall tax consequences would be less favorable than a straight stock sale. If the transaction involves the contribution of the QSBS into a partnership under Section 721, the QSBS status of the private company stockholders' stock would be forfeited.

[xii] If the private company stockholder's QSBS is subject to the 50% or 75% exclusion amounts, then those percentages will apply to the "built-in" Section 1202 gain when the public company stock is sold, resulting in the applicable percentage gain exclusion, with the balance of Section 1202 built-in gain being taxed at the 28% rate, and with the excess, if any, over the Section 1202 built-in gain be taxed at the applicable capital gains rates.

[xiii] In a stock-for-stock "B" reorganization, boot must be limited to a small amount paid for fractional shares. A taxable "failed" stock-for-stock reorganization can be accomplished by including a small amount of "boot," usually in the form of a cash payment. The exchange should fail Section 351's 80% control requirement,

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although attention would need to be paid to whether enough stock is being issued for cash to investors in the sale transaction to satisfy the 80% control requirement through a "global" or "overall" Section 351 exchange.

[xiv] The typical target stockholder will have a Section 1202 gain exclusion cap of $10 million, although it will be potentially higher if the stockholder has tax basis in his private company stock.

[xv] *Clark v. Commissioner*, 489 U.S. 726 (1989) and Revenue Ruling 93-61.

[xvi] See *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960) and Revenue Ruling 66-112.

[xvii] Obviously, if the private company stockholders haven't satisfied the five-year holding period requirement, they should negotiate for a non-taxable exchange of QSBS for public company non-QSBS. Of course, holding public company stock carries with it market risk while the stockholders wait out the aggregate (QSBS holding period plus public company stock holding period) five-year holding period before they can sell and claim Section 1202's gain exclusion.

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