



BDO KNOWS SPACs

# TAX TREATMENT OF SPAC FOUNDER SHARES

Special Purpose Acquisition Companies (SPACs) are publicly traded companies formed for the sole purpose of raising capital through an IPO and using the IPO proceeds to acquire one or more unspecified businesses in the future. The management team that forms the SPAC (the “sponsor”) forms the entity and funds the offering expenses in exchange for founder shares. There are various tax considerations and complexities that can have significant implications both during the SPAC formation process and down the road.

## ISSUES RELATING TO FOUNDERS SHARES

The SPAC sponsors are responsible for forming the SPAC entity, raising capital in the SPAC IPO transaction, identifying potential targets for acquisition, promoting the acquisition among the SPAC shareholders and consummating the acquisition. SPAC sponsors typically do not have an employment agreement or management agreement with the SPAC and are not permitted to receive compensation for their services. As a result, the sponsors are generally granted an initial, separate class of shares for nominal consideration. These “founder shares” automatically convert to public shares on the completion of an initial De-SPAC transaction, in which a target business is acquired by the SPAC. After the IPO and before the De-SPAC transaction, founder shares are junior to the public shares in that they are not entitled to any cash in the trust account holding the proceeds of the SPAC IPO. In addition, founder shares have no redemption rights prior to a De-SPAC transaction or a liquidation.

Since the initial investment for founder shares is insignificant and can be worth substantially more after a successful De-SPAC transaction, there is a question of whether the sponsors should be treated as receiving disguised compensation for services through the acquisition of founder shares at a bargain price. If the founder shares were issued to the sponsors at the time of the IPO or at the time the De-SPAC transaction was successfully concluded, the founder shares would immediately be worth much more than the sponsor paid for them.

BDO is dedicated to helping both sponsors and target companies navigate going public through Special Purpose Acquisition Companies. In a series of articles, we'll provide an introduction outlining the current SPAC market and talk through tax, accounting, and valuation considerations to keep in mind. You can find the full series on our [Special Purpose Acquisition Companies Hub Page](#).

In these cases, compensation by way of a bargain purchase seems clear because there would be an established market value for the shares, which is much greater than the amount paid by the sponsors. However, when the sponsors purchase the founder shares, there generally is no identified target for a De-SPAC transaction and the SEC registration statement has not been filed, meaning the IPO has not yet been approved. At this stage, a successful IPO and a subsequent successful De-SPAC transaction are contingent on future events over which the sponsors do not have full control.

Accordingly, the value of the founder shares can be difficult to determine. The tax law generally does not impute value to the future services of individuals. Also, the SPAC usually has minimal assets available outside of the trust used for the general operating capital needs of the entity. The timing of the issuance of the founder shares should be considered when planning a SPAC to avoid any unnecessary timing issues that may cause undesirable tax consequences.

SPACInsider.com. In 2020, SPACs are set to have their best year yet with \$25.3 billion raised over 62 IPOs averaging the highest SPAC volume yet of \$407.4 million – and that's just through July. Additionally, with the success of the likes of Virgin Galactic, DraftKings, and Nikola going public through SPACs in recent years, we saw the highest funding in history with Pershing Square Tontine Holdings raising \$4 billion.

## TREATMENT OF WARRANTS

As mentioned above, the founder shares have warrants attached. The tax treatment of warrants depends on the type of warrant issued, i.e., investment warrants with equity or compensatory warrants. For those warrants that are not considered compensatory, the investment warrant rules should apply.

When warrants are issued in connection with stock as part of a package deal, the price is allocated to each piece based on the relative fair market value of the warrant and the stock. When an investor exercises a warrant to buy the underlying stock, they pay the stated strike price to the issuing company. The basis in the shares acquired is based on the amount allocated to the warrant originally, and the amount paid upon exercise of the warrant.

Compensatory warrants issued for services are taxed like compensatory non-qualified stock options, i.e., they are not taxed upon receipt as long as the warrants are priced at fair market value (which is usually the case). The exercise date of the warrant is the taxable event. Section 83(a) of the Internal Revenue Code provides that if property is transferred in connection with the performance of services, the excess of the FMV of the property over the amount paid for the property generally is taxable income to the service provider in the first tax year in which the property is transferrable or not subject to a substantial risk of forfeiture. The transfer of the stock upon exercise of the option begins the holding period for capital gains purposes. Provided the transferred shares are substantially vested at the time of the transfer, the service recipient would be entitled to deduct compensation in accordance with its method of accounting. For the transfer upon exercise of unvested shares, the service recipient would be entitled to deduct the amount of compensation in its tax year that includes the year end in which the service provider realized the income.

## BDO INSIGHT

Founder shares are a key component of a SPAC providing a mechanism for rewarding SPAC sponsors; however, there are potential undesirable tax consequences that can be mitigated by careful planning. SPAC sponsors should ensure they have trustworthy and experienced advisors in place to evaluate these nuances for their specific situation.

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