CONSEQUENCES OF PFIC STATUS FOR NON-U.S. SPACS

The recent resurgence in the popularity of special purpose acquisition companies—commonly known as SPACs—as an investment alternative and a way to raise capital quickly and create rapid growth for target companies does not come without complexities and certain tax risks. In particular, where a non-U.S. SPAC is used, various U.S. tax implications should be considered at the outset to mitigate—or prevent—the foreign SPAC from falling within the scope of the U.S. passive foreign investment company (PFIC) rules, which could have adverse tax consequences for U.S. shareholders.

This article offers a high-level overview of the potential U.S. federal income tax implications of foreign SPACs and some steps that can be taken to avoid the application of the PFIC rules. For more information on the U.S. tax implications of SPACs, see BDO's article **Important Tax Issues When Navigating a SPAC Transaction**.

SPAC FORMATION AND ACQUISITION CYCLE

A SPAC is a company with no commercial operations that is formed specifically to raise capital through an initial public offering (IPO) for the purpose of acquiring an existing (U.S. or foreign) company. Typically, sponsors invest nominal capital up front to form the SPAC. The SPAC then raises capital by issuing units to public investors in an IPO. If additional capital is needed to finance the acquisition, a SPAC may raise funds through a private issuance of additional equity (commonly referred to as a "private investment in public equity" or PIPE). Finally, the SPAC acquires a target business with the capital it has raised in the IPO (known as a "de-SPAC transaction").

SPAC JURISDICTION

An important initial consideration when forming a SPAC is whether to incorporate the company in the U.S. or offshore. Ideally, for tax purposes, the jurisdiction of the SPAC generally should match the jurisdiction of the potential target company. However, if the SPAC plans to acquire a foreign target, it typically will be formed in a foreign jurisdiction, such as the Cayman Islands or British Virgin Islands due to their beneficial tax and legal environments. The SPAC can subsequently be migrated to the target jurisdiction or a favorable third-country jurisdiction before the de-SPAC transaction. This approach is preferable because it would be tax inefficient for a domestic SPAC to own a foreign target since the earnings of the foreign target would be subject to U.S. tax under the Subpart F and GILTI regimes. If the SPAC plans to acquire a U.S. target, it will generally be formed in the U.S. or be migrated to the U.S. before the de-SPAC transaction because any dividends paid by a U.S. target to a foreign SPAC would be subject to U.S. withholding tax. Additionally, the foreign SPAC may be subject to the inversion rules in Internal Revenue Code Section 7874 on the acquisition of a U.S. target or be subject to other "outbound" taxation rules that affect the target shareholders.

FOREIGN SPACS AND THE PASSIVE FOREIGN INVESTMENT COMPANY RULES

The use of a foreign SPAC may potentially give rise to unfavorable consequences for U.S. investors if the foreign SPAC is considered a passive foreign investment company (PFIC) for U.S. tax purposes.

Generally, a foreign corporation is a considered a PFIC if it meets either the "income test" or the "asset test." The income test is met if at least 75% of the foreign corporation's gross income for the tax year is passive income. For these purposes, passive income generally means income of a kind that would be considered foreign personal holding company income if the foreign corporation were considered a controlled foreign corporation (CFC), such as dividends, interest, rents and royalties. The asset test is met if at least 50% of the average percentage of assets held by the foreign corporation during the tax year are assets that either produce or are held for the production of passive income. A corporation's average assets for the taxable year are measured by reference to its gross asset values at the end of each quarter of the corporation's taxable year.

Because a SPAC prior to an acquisition is essentially a "blank check" company with no business operations and no assets other than cash raised in an IPO, a foreign SPAC is likely to be treated as a PFIC. However, certain exceptions may apply to remove the PFIC taint from a foreign SPAC.

PFIC EXCEPTIONS

Start-Up Exception

Generally, a foreign corporation will not be treated as a PFIC during the first taxable year in which it has gross income ("start-up year") if it satisfies three conditions:

1. No predecessor corporation was a PFIC;
2. The corporation establishes that it will not be a PFIC for either of the first two taxable years following its start-up year; and
3. The corporation is not, in fact, a PFIC for either of the first two taxable year following its start-up year.

A foreign SPAC generally should satisfy the first prong of the start-up exception because it is formed for the purpose of acquiring another business. In addition, if the de-SPAC transaction takes place in the same year as the IPO and the target company has sufficient non-passive assets, the SPAC is unlikely to be considered a PFIC in the first two taxable years following its start-up year and should meet the second and third prongs of the start-up exception. If the de-SPAC transaction takes place in the third year after the SPAC formation, the second and third prongs of the start-up exception are unlikely to be met.

CFC/PFIC OVERLAP EXCEPTION

A foreign corporation that is a CFC with respect to a U.S. shareholder is not treated as a PFIC with respect to that U.S. shareholder. Therefore, in cases where a foreign corporation is subject to both the U.S. CFC regime and the PFIC regime, the CFC regime generally would apply. Thus, to avoid PFIC treatment, sponsors of a foreign SPAC may take steps to cause the SPAC to be treated as a CFC before the de-SPAC transaction. This may be done by providing the sponsors of a SPAC with more than 50% voting rights in the SPAC or by holding the sponsor's shares via a U.S. LLC that is treated as a partnership for U.S. tax purposes. However, this strategy only works for U.S. shareholders of the foreign SPAC (greater than 10% owners by vote or value). The minority U.S. investors (less than 10% owners by vote or value) would generally not be able to avail themselves of the CFC/PFIC overlap rule and the foreign SPAC may continue to be treated as a PFIC with respect to these shareholders.

PFIC IMPLICATIONS FOR U.S. INVESTORS

If a corporation is determined to be a PFIC at any time, it will continue to be considered a PFIC as long as it is held by the U.S. investor. Adverse tax consequences potentially could arise for U.S. investors in a PFIC, including tax and interest charges on “excess distributions” and gains derived from the disposition of appreciated PFIC stock, with tax being imposed at the highest ordinary rate applicable for the year (i.e., the gains will not qualify for the long-term capital gains rate). In addition, the PFIC rules are viewed as overriding certain non-recognition provisions in U.S. tax law so that an U.S. investor in a foreign SPAC/PFIC is taxable even on what would otherwise be a qualified tax-free reorganization de-SPAC transaction.

A U.S. shareholder of a PFIC may be able to mitigate the adverse consequences of the PFIC regime by making either of the following elections:

- Assuming the PFIC stock is “marketable,” a qualified shareholder can elect to mark the stock to market at the end of each year and include the unrealized appreciation as ordinary income; or
- Make a “protective” QEF (qualified electing fund) election to include in income the investor’s pro rata share of net capital gains and earnings and profits on a current-year basis, whether or not the income was distributed. By making a QEF election, a shareholder may avoid the interest charge on deferred tax under the PFIC rules. Certain of the currently public foreign SPACs have offered information to their investors through SEC disclosures that may help enable U.S. investors to make a valid QEF election and also provide guidance on whether the SPAC is likely to be viewed as a PFIC.

BDO INSIGHT

While SPACs offer a number of advantages, U.S. investors need to be cognizant of the potential tax risks when they form and operate a non-U.S. SPAC. U.S. investors in foreign SPACS potentially may be subject to adverse tax consequences if the SPAC is treated as a PFIC for U.S. tax purposes. To mitigate or avoid these consequences, care must be taken in the timing of the life cycle of the foreign SPAC. If the de-SPAC transaction is to take place within a year of the IPO, the start-up exception may apply to avoid PFIC status for the foreign SPAC. However, if the timeline between the IPO and the de-SPAC transaction is longer than a year, the CFC/PFIC overlap rule should be considered. Finally, if a foreign SPAC is deemed a PFIC, a QEF election may be advantageous for certain U.S. investors.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, and advisory services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 70 offices and over 750 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of more than 91,000 people working out of more than 1,650 offices across 167 countries and territories.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. www.bdo.com

Material discussed in this publication is meant to provide general information and should not be acted on without professional advice tailored to your needs.

© 2021 BDO USA, LLP. All rights reserved.