BDO KNOWS SPACs

TAX TREATMENT OF TRANSACTION COSTS AND START-UP EXPENSES

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.

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.

CREATING A SPAC IS NOT WITHOUT EXPENSE

A SPAC will incur various expenses during its life cycle. Some expenses are incurred pre-IPO, some will be incurred post-IPO but before a specific target company is identified, and some will be incurred in connection with acquiring the target company. Occasionally, an acquisition may fail, and another target may be identified, pursued and acquired, which will result in more costs. In some cases, the SPAC may fail to make any acquisitions and liquidate. The tax treatment of SPAC expenses varies depending on which of these categories applies.

UNDERSTANDING START-UP EXPENSES

Expenses incurred by a SPAC before a target company is identified are generally referred to as "start-up expenses." Start-up expenses must be capitalized unless they qualify for an election by the taxpayer to deduct a small amount of such expenses and amortize the remaining expenses over 180 months. The tax law makes a distinction between start-up expenses and ordinary and necessary business expenses, the latter generally being deductible currently as incurred in the carrying on of an active trade or business.

Based on case law, for a taxpayer to be engaged in a trade or business it must (i) undertake an activity intending to make a profit, (ii) be regularly and actively involved in the activity and (iii) have commenced business operations. Whether a taxpayer has commenced business operations depends on the relevant facts and circumstances. For example, obtaining some or all of the necessary equipment, licenses, contracts and personnel; soliciting sales; and beginning production or purchasing inventory may be relevant. The IRS generally takes the position that the absence of sales generating gross receipts means that an active business has not begun. However, at least one recent Tax Court decision has rejected this IRS position.

Pre-IPO and post-IPO expenses of the SPAC that are incurred before a target is identified will qualify for the start-up expense deduction and amortization election if they are:

- Paid or incurred to investigate the creation or acquisition of an active trade or business, or paid or incurred to create an active trade or business, or paid or incurred in connection with any activity engaged in for profit and the production of income, such as the investigation of the acquisition of investment property,
- Incurred before a trade or business commences, and
- Of a nature that had the expenses been incurred by an active trade or business they would have been currently deductible.

It should be noted that interest, taxes and research and development expense are subject to specific rules and are not considered start-up expenses.

If the SPAC files a timely election, it may deduct up to a maximum of $5,000 of start-up expenses in the year in which the taxpayer commences an active trade or business (but not before). The remaining start-up expenses are amortized on a straight-line basis over the 180-month period that begins with the month the active trade or business begins. If no active trade or business is commenced, this election is not available. In this case, the capitalized start-up expenses may be deductible as an uncompensated loss under a different set of rules. It should be noted that expenses associated with incorporating the SPAC and with the IPO itself are not considered start-up expenses. Such organizational expenses must be capitalized and can be amortized over 180 months once the expenses exceed $55,000. If the total expenses are less than $55,000, a portion of the expenses up to a maximum of $5,000 can be deducted in the year the corporation begins business with the remainder amortized over 180 months.

TRANSACTION COSTS

Once the SPAC has identified a specific target for acquisition, expenses incurred in pursuing that transaction must be capitalized or deducted based on their category. Generally, such expenses are deductible if they are not considered “inherently facilitative expenses” and are incurred before the earlier of the date of signing a letter of intent, exclusivity agreement or similar written communication by the SPAC and the target or the date the transaction is approved by the boards of directors.

Inherently facilitative expenses include the cost of appraisals, negotiating the structure of the transaction, drafting and reviewing the transaction documents, obtaining regulatory and shareholder approval and conveying property that is part of the transaction. Expenses that are inherently facilitative or are incurred after the specific target has been identified are capitalized into the tax basis of the assets or stock purchased.

Success-based fees that are contingent on an outcome, such as actually closing the transaction, are generally capitalized unless the taxpayer can demonstrate that the fees are not inherently facilitative and were incurred before the target company was identified. Alternatively, a taxpayer may elect to deduct 70% and capitalize 30% of such fees.

If an acquisition fails to close, the associated expenses may be deductible as an uncompensated loss. If the SPAC fails to conclude an acquisition and liquidates, any remaining capitalized expenses become deductible.

BDO INSIGHT

Obtaining tax benefits for expenses incurred by a SPAC can help reduce tax costs, and BDO can provide assistance in this regard.

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