M&A Tax Talk: Private equity insights
IPOs and the resurgence of SPACs

KEY TAKEAWAY
Exit strategies involving initial public offerings (IPOs) present unique tax considerations and potential opportunities that can drive value to private equity (PE) funds and portfolio companies. IPOs undertaken through a special purpose acquisition company (SPAC) may have additional business and tax complexities.

Introduction
PE funds seeking a full or partial exit in a portfolio company investment may consider opportunities with private buyers, as well as with public equity markets. Recently, IPOs effectuated via a SPAC have gained momentum as a popular exit strategy for PE funds.

What is a SPAC?
A SPAC is a listed shell company that raises money from the public markets (and sometimes private investment) for the purpose of acquiring a private company. SPACs are also sometimes known as “blank check companies” given their broad investment mandate, and although they have been utilized for a number of years, there has been a recent resurgence of SPACs in capital markets that has presented another potential opportunity for PE funds to dispose of their portfolio companies.¹

The process of a SPAC combining with a target business into a publicly traded operating company is known as a “De-SPAC transaction” and may require shareholder approval. Depending on the value of a transaction relative to the amount of proceeds raised in a SPAC’s IPO, the SPAC may seek additional capital in connection with a De-SPAC transaction through debt financing or subsequent equity offerings to private investors (commonly referred to as private investments in public equity (PIPEs)).

SPAC business considerations
While a SPAC IPO may appear similar to a traditional IPO, the SPAC IPO has some distinct differences. For example, a SPAC IPO involves both the pre-IPO investors of the portfolio company (the PE fund) and sophisticated SPAC financial sponsors negotiating the deal. Because of this, the process of undertaking a SPAC IPO is sometimes more similar to a private sale than a public offering and will likely include more thorough buy-side due diligence procedures when compared with a traditional IPO, where underwriters and legal counsel may focus more on capital market considerations. Like an IPO, the selling PE fund typically will not fully cash out and will receive equity in the SPAC as part of a De-SPAC transaction. In certain situations, the SPAC’s sponsor may also transfer a portion of its founder shares or warrants to the selling PE fund as part of the overall business deal. In addition, most SPACs usually have a limited shelf life and are required to invest capital within two or three years before they are required to return the funds to investors. This timing requirement may significantly accelerate the timeline to negotiate a deal if a target is not identified early in the SPAC’s life cycle.

IPO tax structures
IPO tax structures can vary depending on specific facts and circumstances. The primary tax structure considerations depend on the US federal income tax classification of the portfolio company:

• Corporate portfolio company:
If the portfolio company going public is operated through a C corporation, a new Pubco is typically formed to hold the existing operations and to issue shares to the public.

• Partnership portfolio company:
If the portfolio company going public is operated through a partnership (or limited liability company treated as a partnership), the partnership will commonly restructure into a new corporate Pubco. Alternatively, many PE funds often utilize an umbrella partnership or C corporation structure involving a new Pubco (the so-called Up-C structure) to maintain ownership in a “pass-through” structure until ready to sell the investment and monetize certain tax attributes through a tax receivable agreement (TRA).

Pre-IPO readiness tax considerations
Preparing for a traditional IPO exit or an IPO through a SPAC can often be a complex and time-consuming process involving numerous stakeholders as compared with a private sale or investment. In addition to the significant regulatory and financial reporting requirements, there are a number of tax considerations that should be evaluated by the PE fund and the portfolio company tax department, including:

• IPO tax structure: Typically the primary tax focus of IPO transactions, an efficient legal entity and tax structure is critical for enhancing after-tax cash proceeds to pre-IPO investors. SPACs may require unique structuring considerations.

• Tax attributes: IPOs may provide the PE fund with the opportunity to monetize certain tax attributes through TRAs. However, an IPO (or subsequent sell-down) may result in a section 382 ownership change, which may limit the Pubco’s ability to utilize existing tax attributes such as net operating losses (NOLs) and tax credits.

• Accounting for income taxes: Compliance with public financial statement reporting and disclosure rules may increase the requirements with respect to accounting for income taxes.

• Jurisdiction: The jurisdiction of incorporation of the Pubco can present additional tax complexities, such as application of non-US tax rules, withholding taxes, and added compliance and tax filing requirements.

• Earnings and profits (E&P): E&P of the Pubco may need to be maintained to determine the tax treatment and corresponding withholding obligations of post-IPO corporate distributions made to shareholders.

• Executive compensation: Management incentive and deferred compensation plans should be analyzed for compliance with applicable tax rules, including certain provisions applicable to public companies that may limit tax deductions, such as IRC sections 162(m) and 280G.

¹See https://spacinsider.com/stats.
Portfolio companies operated through either a corporation or a partnership for US federal income tax purposes can implement an IPO structure involving a SPAC.

Corporate IPO structures
Corporate portfolio companies can consider a number of structures to implement an IPO, including issuing new shares to public investors, directly listing shares on public markets, or by implementing a "reverse merger" whereby a shell company, which may have new capital raised from the public markets, merges with the portfolio company. In a reverse merger, the pre-IPO investors typically exchange their shares in the portfolio company for a majority of the shares in the Pubco. A reverse merger is often utilized by PE funds, as it is perceived to be a quicker and more cost-effective method of "going public," and is also frequently used for an IPO of a corporate portfolio company involving a SPAC. As a reverse merger IPO is often intended to be structured as a tax-free reorganization under IRC section 368, it is important that proper consideration be given to application of the relevant tax rules (especially if cash consideration is involved).

Partnership IPOs and the Up-C structure
A common goal of implementing an IPO structure involving a portfolio company operated as a partnership is to enable the PE fund and other existing partners to access capital markets through a Pubco, while retaining their interests in a "pass-through" tax structure (which is generally more tax-efficient for the partners) until the pre-IPO owners are ready to sell their remaining ownership stake by exchanging their partnership interests for cash or stock in the Pubco.

An Up-C structure is intended to achieve this objective, along with the potential added benefit of allowing pre-IPO investors to receive payments for a portion of the value of certain tax attributes generated on, or delivered in connection with, the exchange of the partnership units (for example, additional tax-deductible depreciation or amortization as a result of a tax basis "step-up") under the TRA.

Up-C structures can also be undertaken with SPACs. To the extent the historical partners retain an interest in the operating partnership, they would generally be able to exchange their partnership units for cash or stock in the SPAC.

Illustrative ending Up-C structure

<table>
<thead>
<tr>
<th>Pre-IPO investors</th>
<th>SPAC Sponsor</th>
<th>Public</th>
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<tbody>
<tr>
<td>Exchangeable units</td>
<td>Pubco / SPAC</td>
<td></td>
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<tr>
<td>Operating Partnership</td>
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Tax receivable agreements
Overview
Since the mid-2000s, TRAs have become a common arrangement for pre-IPO owners to monetize certain tax attributes in connection with IPO transactions. TRAs are bespoke agreements that provide additional value to the pre-IPO owners for specified tax attributes that are typically not factored into the valuation of the portfolio company by public markets.

Under a TRA, the pre-IPO owners will generally be entitled to a certain percentage (typically 85% based on market precedent) of the cash tax benefit the Pubco derives from specified tax attributes, if, as, and when realized. The most common specified tax attributes include (i) tax basis generated in an exchange for cash or stock in the Pubco (an Exchange TRA) and (ii) NOLs (or tax basis) existing at the time of the IPO (an NOL TRA). Given similarities with SPAC IPO structures and certain traditional IPO structures, TRAs can also generally be entered into with SPACs, although there are fewer precedent transactions in which to observe the amount of the cash tax benefit pre-IPO owners have historically been entitled to receive.

Exchange TRAs
In the Up-C structure, the pre-IPO owners obtain liquidity by exchanging their partnership interests for cash or Pubco stock. As a result of the exchange, and assuming the partnership has made an IRC section 754 election, the Pubco is deemed to receive a tax basis step-up in its allocable share of the underlying assets of the partnership under IRC sections 743(b) or 734(b). This step-up is generally depreciated or amortized by the Pubco over a fixed number of years (for example, 15 years for intangible assets such as goodwill), which may reduce the post-IPO taxable income of the Pubco and result in cash tax savings.

Example | Exchange TRAs
Partnership X is currently owned by PE fund Y and is undertaking an IPO in an Up-C structure. Partnership X has made an election under IRC section 754. Pubco and PE fund Y enter into a TRA that provides that 85% of the cash tax benefits (determined on a "with and without basis"), if any, that Pubco recognizes from an increase in tax basis as a result of an exchange of Partnership X interests will be paid to PE fund Y.

In a post-IPO tax year, Pubco has $1,000 of taxable income (without regard to any additional amortization from the increase in tax basis as a result of exchanges). PE fund Y previously exchanged its Partnership X interest with Pubco in a taxable transaction that resulted in a tax basis step-up with respect to Pubco's interest in Partnership X's assets. Pubco's incremental tax amortization deductions resulting from this step up is $400 in that post-IPO tax year.

Assuming a combined US federal and state income tax rate of 25%, Pubco has an actual US federal and state income tax liability of $150 ($1,000 of income less $400 of amortization deductions multiplied by 25%). Pubco's hypothetical tax liability without the benefit of the amortization deductions would be $250 ($1,000 of income multiplied by 25%). Therefore, the cash tax benefit for the year is $100.

Under the TRA, 85% of the cash tax benefits from year 1 ($85) are paid by Pubco to PE fund Y.

Note that the amount paid under the TRA to PE fund Y is generally considered additional purchase price for the exchanged Partnership X interest (excluding any portion treated as imputed interest under IRC section 483) that could result in incremental tax basis step up and corresponding amortization deductions to Pubco. The tax benefit derived from these incremental deductions is typically included in the TRA and results in additional payments to PE fund Y.
NOL TRAs

Under a NOL TRA, for a Pubco inheriting NOLs from a corporate portfolio company (or from corporate partners of a partnership portfolio company, often referred to as “blockers” in PE fund structures) existing at the time of the IPO, pre-IPO investors receive payments from the Pubco generally equal to a portion of the cash tax benefit of the Pubco’s NOLs as they are used to offset taxable income in post-IPO tax years. Note, however, that an IPO may result in an IRC section 382 ownership change, which would result in an annual limitation on the use of Pubco’s NOLs and correspondingly reduce estimated value of payments to be made under a NOL TRA.

Other tax considerations for SPACs

There may be other tax complexities to consider with respect to IPO transactions involving SPACs, particularly if the PE fund exiting the portfolio company acquires an interest in the SPAC. For example, US shareholders of foreign entities with passive income and activities should consider the passive foreign investment company (PFIC) rules to determine if adverse US tax consequences may apply.

Similarly, closely held US SPACs should assess if the personal holding company (PHC) rules may apply, which could result in additional tax liability to the SPAC. A SPAC could be a PHC if more than 50% (by value) of its stock is owned by five or fewer individual shareholders (determined directly or indirectly, and taking into account application of complex constructive stock ownership and attribution rules that may aggregate ownership in certain investment funds and treat such entities as individuals for these purposes).

SPACs are back—for now

The resilience of public equity and traditional IPO markets has continued to present exit and liquidity considerations for PE fund investments, as well as unique tax considerations and potential opportunities to investors and portfolio companies. While SPACs have gained recent momentum, PE funds and market participants are watching whether this trend will continue.