NEWS ANALYSIS

SPAC Founders' Shares Are Compensation

by Lee A. Sheppard

America is back!

What does that even mean? It means the Blob is back. The Blob is a time-honored reference to our bipartisan foreign policy establishment, who never saw a war they didn't like and whose kids don't serve in the military. They want their wars back!

Members of the Blob use the revolving door in and out of government. When out of government, they occupy comfortable perches at consulting firms, think tanks, universities, weapons makers, and private equity funds like the Carlyle Group, which specializes in acquisitions of weapons makers. Some Blobsters (we just invented that word) get rich while out of government. People like to think of the denizens of the seat of government as power mad, and there's plenty of that, but there is even more money grubbing from viziers all the way down to flunkies who are just trying to cope with the area's high cost of living.

What's this got to do with taxes? A consulting firm provides a pretty nice payday, but for serious money, a Blobster needs to become a capitalist, which is hard for someone whose only asset is human capital. Critics gripe that one special purpose acquisition company (SPAC) that is looking to acquire a defense contractor recently raised capital while its Blob advisers were being actively considered for Cabinet posts (*The Intercept*, Jan. 10, 2021).

Secretary of State Antony Blinken, then-managing partner of the consulting firm WestExec Advisors, became an adviser to Pine Island Acquisition Corp., a SPAC that went public six days before Blinken was nominated. Blinken reported an investment in the SPAC and a profits interest in the sponsor, Pine Island Capital Partners. Pine Island's SPAC is still looking to acquire a defense contractor. Blinken also reported a profits interest and a limited partner interest in Social Capital Partnership (formerly Social+Capital Partnership), a SPAC sponsor partnership run by prominent SPAC promoter and Democratic Party donor Chamath Palihapitiya, to whom he gives geopolitical advice. Blinken will divest his investments, according to the administration.

Everyone suddenly has a SPAC. Former House Speaker Paul Ryan is chair of a SPAC, Executive Network Partnering Corp. Shaquille O'Neal has a SPAC. Alex Rodriguez has a SPAC, Slam, which will be looking for sports and entertainment opportunities but will not be bidding on teams. 23andMe is going public with a Richard Branson SPAC. Playboy will be returning to the public markets via a SPAC. In 2020, 229 SPAC initial public offerings raised $83 billion, while conventional IPOs raised $78 billion. As of this writing, some $50 billion has been raised for SPACs in 2021.

SPACs can be a get-rich-quick scheme for their founders, as the organizers and sponsors are dubbed. Founders of SPACs usually have experience in the business of the intended targets. How do Blobsters have business experience? Well, the armaments business is about government procurement — what the U.S. government will buy and what foreign governments are allowed to buy. Members of the Blob have the requisite knowledge.

SPACs have been discussed to death in these pages, but emphasis on the manageable corporate tax issues ignores the creature climbing out of the swamp: the compensation of the founders. They're service providers, and they have ordinary income.

Background

A SPAC is a route to an IPO of a private target.

A special purpose acquisition company is a quintessential cash box, according to Victor Hollender of Skadden, Arps, Slate, Meagher & Flom LLP, who spoke at the 10th annual International Bar Association Finance and Capital

Markets Tax Conference. A SPAC is SEC-registered and listed on Nasdaq or NYSE when it is created, with no history. It issues shares to the public and then looks for a target. SPACs are also called blank-check IPOs.

A SPAC enables its target to become publicly traded without having to initially disclose earnings history and other material information. The target will have to file a Form S-4 for the acquisition vote and a super Form 8-K for the acquisition, then make regular SEC disclosures once it is acquired. The SPAC process only avoids the target participating in the Form S-1, which may not disclose non-managing founders.

SPACs are often Cayman organized, so they would have PFIC issues. SPACs have two years to find targets, so they could overrun the one-year start-up exception period during which a foreign corporation can hold passive assets without becoming a PFIC (section 1298(b)(2)). Investors want to make qualified electing fund elections (sections 1293, 1295). Fractional warrants, which can't be exercised until the target is acquired, are issued to the public as units together with SPAC shares. Under final regulations, no QEF election can be made for warrants, even though they arguably are treated as PFIC shares (section 1298(a)(4), reg. section 1.1295-1(b)(2)(iii)). (Prior coverage: *Tax Notes Federal*, Feb. 1, 2021, p. 843.)

> ***Founders have paid pennies for shares potentially worth millions or hundreds of millions of dollars.***

SPACs are so popular lately, and targets are identified so quickly, that the problem may not be the PFIC running out the start-up period. It might be the opposite. Hollender explained that investors would have short-term capital gain when the SPAC acquires the target and investors sell their shares. By its terms, a SPAC that doesn't find a target within two years of its IPO has to return the proceeds to the public shareholders. Public shareholders have the right to be redeemed if the SPAC doesn't find a target. Most SPACs don't find targets and have to return money to investors.

The acquisition of the target and its combination with the SPAC may take several corporate forms. Regardless of whether the target is U.S. resident or foreign, a Cayman SPAC and a double-dummy structure is the most common. The dummies merge into the SPAC and the target under a new foreign parent (sections 351, 368). It's easy to walk into an inversion problem when a foreign SPAC acquires a U.S. target, so the SPAC usually domesticates in an F reorganization, causing gain recognition to shareholders (sections 368(a)(1)(F), 1248, 7874). (Prior analysis: *Tax Notes Federal*, Jan. 18, 2021, p. 409.)

Founders get subordinate class B shares of a SPAC, usually for a nominal amount (fractions of a penny per share). These junior shares have no access to SPAC proceeds, which are held in trust (SEC Rule 419). Upon the combination with the target, founders' shares are automatically converted to 20 percent of the class A shares identical to the class A shares issued to the public. That is, founders' shares are dilutive and their value does not depend on future profits, according to Hollender. Founders have only upside. Even if their SPAC fails, they lose only their nominal investment and have to give the SPAC trust proceeds back to the investors. Founders are typically prohibited from selling their shares for a year after the acquisition. Ryan's lockup period will be three years.

So founders have paid pennies for shares potentially worth millions or hundreds of millions of dollars. They don't want their tax advisers telling them it's compensation. Some tax advisers have taken the position that founders are comparable to entrepreneurs, making the entire proceeds of the IPO capital gain. That'd be news to the public shareholders, who've been told that the founders have special expertise that they will deploy in identifying and acquiring targets. The founders didn't build the target's business.

The nearly guaranteed payday for founders has not gone unnoticed by sophisticated investors, which can include hedge funds. So more recent SPACs, like those of Ryan and hedge fund manager Bill Ackman, have modified the typical founders' compensation arrangements. Ryan's founders will have options to buy shares and a waterfall dependent on share appreciation. Ackman's founders will have options exercisable only if the target appreciates 20 percent over the acquisition price (*The Wall Street Journal*, Aug. 20, 2020).

Natural habitat of the foreign policy Blob. (Pierre-Jean Durieu@Bigstock.com)

Section 83

SPAC founders receive property in connection with the performance of services.

Section 83 is not limited to a corporate employee receiving restricted options on employer equity that he sells simultaneously with exercise. The service provider does not have to be an employee. The transferor need not be the service recipient.

So even if SPAC founders could be viewed as having made a bargain purchase, they'd be tagged with compensation because they got their bargain by dint of performing services for the SPAC. Section 83 doesn't even require a bargain purchase. Congress wanted to end the tax deferral and capital gain conversion that service providers granted nonqualified restricted shares were able to achieve.

Section 83 is very broadly worded. It doesn't affect just property exchanged for services. It reaches property transferred in connection with the performance of services. When that transfer happens, it requires a service provider to recognize ordinary income of any excess of fair market value over the amount paid for the property. The transfer occurs when that property becomes either transferable or no longer subject to a substantial risk of forfeiture.

Constructive receipt has always been contentious, so service providers went to court. One employee howled that the Fifth and 16th amendments were violated when she was taxed on vested restricted shares that were still subject to transfer restrictions. Importantly, the Second Circuit responded that Congress can rationally decide which value suppression features should be respected (*Sakol v. Commissioner*, 574 F.2d 694 (2d Cir. 1978), *cert. denied*, 439 U.S. 859 (1978)). The Fifth Circuit was no more receptive to constitutional arguments that ultimately concerned timing of sale (*Pledger v. Commissioner*, 641 F.2d 287 (5th Cir. 1981), *cert. denied*, 454 U.S. 964 (1981)).

Section 83 does not require a bargain purchase. The Tax Court, in a reviewed decision with two dissents, held that section 83 applies to all restricted property transferred in connection with the performance of services, regardless of the amount paid for it. The taxpayer contended that section 83 should not apply when FMV was initially paid for shares as a matter of law. But the court responded that the FMV price doesn't turn compensation into an investment (*Alves v. Commissioner*, 79 T.C. 864 (1982), *aff'd*, 734 F.2d 478 (9th Cir. 1984)).

In affirming, the Ninth Circuit explained:

> The statute applies to all property transferred in connection with the performance of services. No reference is made to the term "compensation." Nor is there any statutory requirement that property have a fair market value in excess of the amount paid at the time of transfer. Indeed, if Congress intended section 83(a) to apply solely to restricted stock used to compensate employees, it could have used much narrower language.

SPAC founders never have any risk of forfeiture. They do have transfer restrictions even after their junior shares metamorphose into regular shares. Because of the proximity of the performance of services, section 83 would apply even if the price paid for the class B shares was FMV. The founders, who do a lot of work to find and acquire the target, are providing services for which they are not separately compensated. They can't argue that they're just like other investors. And the features that trigger section 83 are fact questions.

Nonetheless, some advisers promote the "cheap stock" theory that founders are just lucky investors, relying on two obsolete cases decided before section 83 was enacted in 1969. In the first, the operating company executive identified the same-industry target, hatched the acquisition plan, hired the banker, and then paid a nominal price for shares of the new acquisition company after letters of intent were sent. The Tax Court sustained the taxpayer's low valuation as FMV, and concluded there was no compensation on that basis (*Berckmans v. Commissioner*, T.C. Memo. 1961-100).

In the other case, the executive identified the target, planned the acquisition, executed the purchase agreement, and then paid nominal prices for shares of a listed cash box company and a new acquisition company used in the transaction. The Tax Court held that the executive had compensation based on intent and participation in the deal. It also viewed the compensation question as a function of value (*Husted v. Commissioner*, 47 T.C. 664 (1967), *acq.*, 1968-2 C.B. 1). (Prior analysis: *Tax Notes*, Apr. 2, 2018, p. 23.)

There's not much daylight between the two cases; the marginal differences affect valuation. Congress overruled both decisions, as well as the Supreme Court decisions they relied on (*Commissioner v. Smith*, 324 U.S. 177 (1945), and *Commissioner v. LoBue*, 351 U.S. 243 (1956)). Section 83 broke the causal link between valuation and compensation. It would treat both situations as compensation based on the connection to past or future services, regardless of the value of the shares at the time of purchase or the employment status of the service provider.

Section 83 does not require a bargain purchase.

The cheap stock adherents concede that compensation is present when founders' shares have a value larger than the amount paid for them. "The receipt of founder shares for a nominal investment could be recharacterized as the payment of compensation for services provided by the sponsor if it were determined that the value of the founder shares at the time of issuance exceeded the amount invested," KPMG LLP lawyers recently admitted in these pages. (Prior analysis: *Tax Notes Federal*, Jan. 11, 2021, p. 241.) They advised sponsors to issue founder shares long before the SPAC goes public or identifies its target.

Hollender argued that appreciation attributable to the services founders provide to enhance the value of shares they already own is not reachable as compensation under U.S. law. Hollender noted that some SPAC sponsors in London plan to issue extra shares to the founders equal in value to the appreciation attributable to the acquisition in the form of a dividend in kind on their shares. That would be a clear compensatory transaction if performed in the United States, he admitted.

Tax Court Judge William M. Fay, dissenting in *Alves*, argued that a bargain purchase is statutorily required. In his view, there had to be a bargain element for there to be a compensatory transfer; otherwise, the purchaser was an equity investor. Tax Court Judge Meade Whitaker, dissenting, argued that the statute's broad language should be confined to compensation plans in which restrictions temporarily reduce the value of shares. The bargain element is the object of the tax. Both dissenters understood that the presence of a bargain element was a fact question.

The *Alves* dissenters were overruled by the Ninth Circuit, which held that a bargain purchase is not required. The price and value of shares subject to section 83 is a valuation issue, not an income recognition issue. Alves was in court because he didn't make a section 83(b) election, so he had to try to extricate his case from compensation characterization.

The Ninth Circuit stated in *Alves*: "Section 83(b), however, is not a limitation upon section 83(a). Congress designed section 83(b) merely to add 'flexibility,' not to condition section 83(a) on the presence or absence of an 'excess' . . . nothing in section 83(b) precludes a taxpayer who has paid full market value for restricted stock from making an 83(b) election [reg. section 1.83-2(a)]."

Shouldn't SPAC founders be making a protective section 83(b) election? Wouldn't that be a quick way out of the problem, given that the initial SPAC shares could probably have a low speculative value assigned to them? Founders are routinely advised to make these elections. A service provider has 30 days from the date of grant, within the year of grant, to elect to include the FMV of property in income. That election would start a capital gain holding period. Yes, there would be employment taxes and a higher ordinary rate on the elected amount.

Real founders — that is, people who actually start businesses — are advised to make section 83(b) elections for shares in corporations they created. Well, gee, don't they have a basis of zero if the company is their own creation? Not so fast. Shares are assigned a par value when a corporation is created. The IRS's attention can be piqued when a big cash event occurs (*QinetiQ U.S. Holdings Inc. v. Commissioner*, T.C. Memo. 2015-123, *aff'd*, 845 F.3d 555 (4th Cir. 2017), *cert. denied*, 138 S. Ct. 299 (2017)). The IRS could argue that the shares were issued in connection with the performance of services. (Prior analysis: *Tax Notes Federal*, July 20, 2020, p. 459.)

Are the cheap stock proponents conflating a valuation issue with a recognition issue? Most of the time, the target is not in view when the SPAC is formed, making it safe to elect a value of the nominal amount paid for the class B shares. Indeed in many SPACs, there are substantial redemptions by public shareholders, which means that there has to be another round of raising new capital through private placements to fund the acquisition. All those factors can be cited to justify a low value for class B shares.

But what if our SPAC is on the accelerated schedule suggested by Hollender? What if the target is in full view when the blank-check company makes its public offering? Then even the class B shares might have more than speculative value. Corporate lawyers advise that the SPAC should neither identify nor communicate with the target before the IPO, lest it have to register with the SEC as an investment company under the Investment Company Act of 1940.

Section 1061

Founders' shares are an end run around section 1061.

What is a SPAC? It is a private equity fund organized as a publicly traded corporation. It is a pot of sophisticated money looking for a target. Some big private equity fund sponsors like Carlyle are forming SPACs. The activity of a SPAC would easily fit within the broad definition of applicable trade or business (section 1061(c)(2)).

Section 1061 doesn't apply to corporations either as profits partners or as investment vehicles. The Tax Cuts and Jobs Act instituted a three-year holding period for capital gains treatment for profits passed through or realized on the disposition of a profits interest. Indeed, fund managers should be grateful for decisions like *Alves*, which paved the way for their own section 83(b) elections for zero value (Rev. Proc. 93-27, 1993-2 C.B. 343).

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to the taxpayer in connection with the performance of substantial services by the taxpayer in an applicable trade or business (section 1061(c)(1)). An API can also be a derivative — "any financial instrument or contract valued by reference to the partnership" (prop. reg. section 1.1061-1(a)). A section 83(b) election would not spare an interest from being an API (section 1061(a); reg. section 1.1061-4(b)(10)).

A partnership has to have an applicable trade or business, but it can be an investment partnership. An applicable trade or business includes any activity conducted on a regular, consistent, and substantial basis that consists, in whole or in part, of "specified actions" (1) raising or returning capital and (2) either investing in or developing securities, commodities, real estate, cash or cash equivalents, options, or derivatives referencing any of the foregoing, called "specified assets" (section 1061(c)(2), (c)(3)).

> ***Treasury lacks the power to apply section 1061 when a corporation is the investment vehicle.***

Under the final regulations' applicable trade or business activity test, each year's aggregate specified actions performed by related persons must be sufficient to constitute the regular, continuous conduct of a trade or business (reg. section 1.1061-2(b)(1)). Services are presumed substantial when a profits interest is exchanged for them (reg. section 1.1061-2(a)(1)(iv)). The presumption is intended to cut off arguments about the extent of specified actions in a particular year. The fund raised capital in one year. It hunted around for investments the next year. It bought targets the year after that. It sold them and returned capital in a later year. The life of a private equity fund mirrors that of a SPAC.

The final regulations also say that holding a profits interest in a subchapter S corporation does not avoid the statute (reg. section 1.1061-2(a)(2)(iv), Example 4). Now, an S corporation is a corporation for tax and other purposes. So some lawyers take the position that Treasury does not have the power to extend section 1061 to S corporations, prospectively or retroactively. (Prior analysis: *Tax Notes Federal*, Nov. 11, 2019, p. 987; *Tax Notes Federal*, Sept. 2, 2019, p. 1567; and *Tax Notes Federal*, July 22, 2019, p. 533.)

Treasury may or may not have the power to extend section 1061 to otherwise pointless little personal corporations that are used to hold profits interests. Because of the definition of API, Treasury clearly lacks the power to apply section 1061 when a corporation is the investment vehicle engaged in the applicable trade or business.

As this article was being written, House Ways and Means Oversight Subcommittee Chair Bill Pascrell Jr., D-N.J., introduced the Carried Interest Fairness Act of 2021 (H.R. 1068) to repeal what is left of favorable treatment for profits interests. Reps. Katie Porter, D-Calif., and Andy Levin, D-Mich., joined him. All managers' distributive shares from profits interests would be treated as compensation. Capital interests would still have capital treatment. The bill is estimated to raise $14 billion over 10 years.

What would tightening section 1061 look like for SPAC founder shares? The statute is very narrowly drafted. The definition of API would need to be fixed to pull in SPACs (section 1061(a), (c)(1)). The definition would have to be completely revamped to encompass founder shares in SPACs, which would have to be removed from the exception for capital investments, which includes interests subject to tax under section 83 (section 1061(c)(4)(B)(ii)). Happily, SPAC sponsors have already been imposing their own three-year lockups on founders. ■

NEWS ANALYSIS

Straight Talk on the Size of the Stimulus

by Martin A. Sullivan

Here's a compact set of talking points on the economic debate surrounding President Biden's proposed $1.9 trillion stimulus package.

Too Much?

It is probably true that the anti-recessionary stimulus Congress enacted in 2009 was too small. But that is no reason to believe Biden's $1.9 trillion proposal cannot be too large. In fact, by the same economic modeling that tells us the response to the Great Recession was too small, the president's current proposal is calculated to be excessive.

Unemployment Rate

Save yourself a lot of confusion and simply discard the use of the unemployment rate as an economic indicator. That's because it doesn't properly account for the effect of discouraged workers who drop out of the workforce. When workers leave the workforce, that makes the unemployment rate go down. It makes the economy appear to be improving when just the opposite is true. (Example: The unemployment rate is 5 percent because five workers are unemployed out of a workforce of 100. If one worker leaves the workforce, both the numerator and the denominator decline by 1. The unemployment rate is now 4/99 or 4.04 percent.)

> ***When workers leave the workforce, the unemployment rate goes down, making the economy appear to be improving when just the opposite is true.***

As alternatives, simply look at the number of employers or the ratio of employed persons to the working-age population. Since employment peaked in December 2019 at 158.8 million, it has declined by 8.8 million, to 150 million, as of this January. As shown in Figure 1, the ratio of employment to working-age population has plummeted from its recent peak of 77 percent in