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# FOREIGN DOMICILED SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)

**SPACs that choose to domicile in "tax haven" jurisdictions, such as the Cayman Islands, face their own set of unique US tax considerations and reporting obligations. While a foreign domiciled SPAC may not have a US filing obligation, its US shareholders may have a disclosure obligation along with the tax consequences resulting from the application of the Passive Foreign Investment Company (PFIC) rules.**

To help facilitate compliance and reduce the impact of the PFIC rules for US shareholders, the SPAC may need to provide a PFIC Annual Information Statement (see QEF Regime below for further detail). Furthermore, depending on the Sponsor entity's domiciliation, there may be a reporting obligation as part of its US tax return with respect to the foreign domiciled SPAC.

## WHAT IS A PFIC?

A PFIC is defined as any foreign corporation that meets one of the two following tests, which are commonly referred to as the income test and asset test:

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| 1 | **75% or more of the gross income for the tax year is passive income ("Income Test"); or** |
| 2 | **50% or more of the assets produce, or which are held to produce, passive income ("Asset Test").** |

Passive income is generally deemed to include dividends, interest, royalties, rents, and annuities. As such, interest income generated from US Treasury obligations would be considered passive income.

Furthermore, although contested in the tax industry, working capital such as cash received from an IPO would be considered an asset generating passive income as the IRS argues that cash can generate interest income.

As such, foreign domiciled SPACs most likely will meet the Income Test and/or Asset Test and will be considered PFICs as a result until a "De-SPAC" transaction occurs.


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## US SHAREHOLDER TAX IMPLICATIONS OF INVESTING IN A PFIC

A US shareholder investing in a foreign domiciled SPAC meeting the PFIC criterion is subject to the PFIC rules. The PFIC rules are an anti-deferral regime set up to prevent US taxpayers from deferring US taxation on passive income generated by a corporation domiciled abroad.

**The PFIC rules contain the following three regimes:**

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| 1 | **Excess Distribution Regime;** |
| 2 | **Qualified Electing Fund ("QEF") Regime; and** |
| 3 | **Mark-to-Market ("MTM") Regime.** |

In addition to the taxable income implications of each regime, which are discussed below, a US shareholder will be required to file a Form 8621 as part of its US tax return. This form will report the regime under which the US shareholder elects into, if any, as well as any taxable inclusion under such regime.

**Excess Distribution Regime.** The Excess Distribution regime is the default regime for a US shareholder and is the most punitive of the regimes.

An excess distribution is a current year distribution which exceeds 125% of the average amount of distributions received during the preceding 3 year period, or shorter if the holding period is less than 3 years. The excess distribution is then ratably allocated to each day in the taxpayer's holding period of the PFIC stock.

The allocated amount to the current year is taxed at the ordinary income rate. The amount allocated to prior years is also taxed in the current year and is considered a deferred tax amount. The deferred tax amount is subject to tax at the highest ordinary income rate in effect for that respective year and is also subject to an interest charge.

**Lastly, it is important to note that gain on disposition of the PFIC stock is also considered an excess distribution.**

As such, if a US shareholder does not elect into the QEF or MTM regimes, then income generated from the investment will be fully taxed at ordinary tax rates as opposed to more favorable capital gains rates. Furthermore, the US shareholder may be taxed at a higher ordinary rate than their normal ordinary rate with respect to the deferred tax amount. They will also be subject to interest on the deferred tax amount.

**QEF Regime.** The QEF regime is much more favorable to the US shareholder compared to the Excess Distribution regime as it allows for the retention of income character (i.e. ordinary vs. capital) and gain derived from the disposition of such stock would be taxed at capital gain rates. However, as a trade-off, a US shareholder will include in current year taxable income their pro-rata share of the ordinary earnings and net capital gain generated by the QEF (i.e. PFIC; election is to treat PFIC as a QEF) regardless of whether or not a distribution is received.

Ordinary earnings will be taxed at ordinary income rates and net capital gains will be taxed at the long-term capital gains rate. Please note that the pro-rata share is determined on a class-by-class basis. As such, the Founder class shares issued by the foreign domiciled SPAC should not generate an income inclusion.

An election into the QEF regime is made at the US shareholder level as opposed to the PFIC level. Furthermore, the first U.S. person who owns the stock directly or indirectly would make the election as part of their Form 8621 filing. The election must be made on or before the due date, including extension, of the US shareholder's tax return for the tax year in which they wish for the PFIC to be treated as a QEF. Once an election is made, that election remains in effect for all subsequent tax years unless IRS consent is received to revoke such election.

In order for the US shareholder to be eligible to make the QEF election, the PFIC must provide the US shareholder with a signed Annual Information Statement ("AIS"). The AIS provides the shareholder with the necessary information to compute their ordinary earning inclusion, net capital gain inclusion, and distributions. The ordinary earnings and net capital gains are computed based on US earnings & profits ("E&P") principles. E&P is loosely defined as a corporation's ability to pay a dividend to its shareholders and is analogous to US taxable income plus/minus certain specific adjustments.

Furthermore, the QEF election should be made in the initial year of acquisition of SPAC stock by the US shareholder. If the QEF election is not made in the first year, then the PFIC will be considered an unpedigreed QEF.

An unpedigreed QEF continues to also be subject to the Excess Distribution regime discussed above. To cleanse the QEF of the PFIC taint (i.e. Excess Distribution Regime), a US shareholder may be eligible to make a deemed-sale or deemed-dividend election. However, there may be US tax leakage as a result of such an election.

**It is also important to note that a QEF is not subject to the "once a PFIC, always a PFIC" rule in which a US shareholder will continue to consider a foreign corporation as a PFIC even after it no longer meets the Income Test or Asset Test. This is of particular importance once a De-SPAC transaction has occurred as the foreign corporation would most likely no longer qualify as a PFIC.**

**MTM Regime**. The MTM regime, while not as favorable as the QEF regime, is less punitive than the Excess Distribution regime as the deferred tax amount implications are avoided (i.e. highest ordinary rate and interest).

The MTM regime requires the US shareholder to include as ordinary income any stock appreciation based on the fair market value of the stock at the close of the tax year. To the extent there is stock depreciation as of the close of the tax year, a US shareholder is allowed a deduction, which is limited to the amount of the depreciation in value or the "unreversed inclusion" amount. The "unreversed inclusion" is equal to the cumulative ordinary income less any allowable deduction recognized in prior years.

Similar to the QEF election, the MTM election is made at the US shareholder level and not at the PFIC level. A US shareholder is eligible to make a MTM election with respect to marketable stock in a PFIC.

Marketable stock is generally defined as any stock which is regularly traded on a national securities exchange which is registered with the SEC or on a national market system established under Section 11A of the Securities and Exchange Act of 1934. As such, a US shareholder of a SPAC should be eligible to make a MTM election. An election, once made, remains in effect for each subsequent tax year unless the stock ceases to be marketable stock or the IRS approves of a revocation.

## PFIC STARTUP EXCEPTION

It is worth mentioning that there are exceptions to a foreign corporation being considered a PFIC. Of the various PFIC exceptions available, the "startup exception" is of relevance to a foreign domiciled SPAC. However, qualification for this exception is most likely limited.

The startup exception states that a foreign corporation would not be treated as a PFIC for the first tax year in which it has gross income if:

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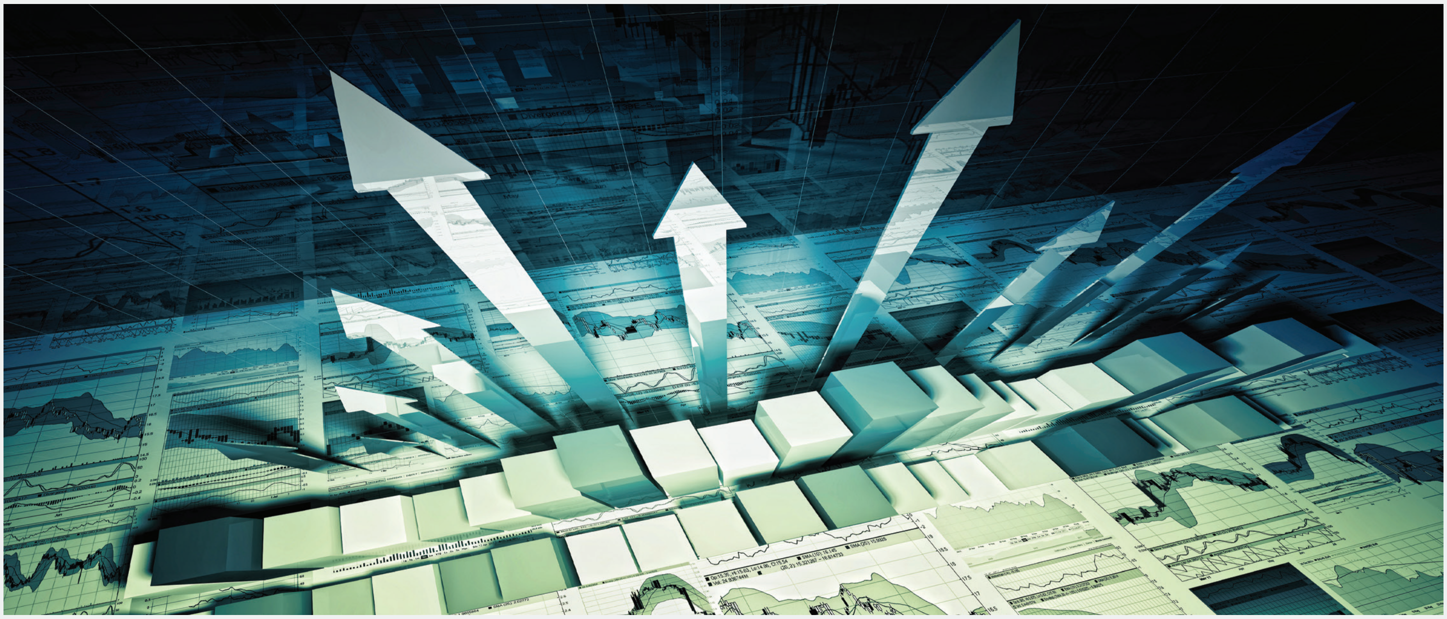
| **1** | **No predecessor of such corporation was a PFIC;** |
| **2** | **The corporation can satisfy to the IRS that it will not be a PFIC for either of the 2 years following the start-up year; and** |
| **3** | **The corporation is not a PFIC for either of 2 years following the start-up year.** |

Given the timeline of a SPAC, it is unlikely that the startup exception will apply unless the IPO and De-SPAC process were to occur within the same tax year.



## OTHER CONSIDERATIONS

**Sponsor Considerations.** To the extent that the Sponsor entity is a US domiciled entity, the issuance of the Founder class shares may result in the foreign domiciled SPAC being considered a Controlled Foreign Corporation ("CFC") until the IPO process is completed. As such, the domestic Sponsor entity may need to file a Form 5471 to disclose the acquisition. Furthermore, if the domestic Sponsor entity is treated as a corporation for US tax purposes, it may need to file Form 926 as a result of its vote and value interest acquired. If the Sponsor entity is treated as a partnership for US tax purposes, its partners may have a Form 926 filing obligation, which should be footnoted on the Schedule K-1issued to the partners.

**Warrants in Foreign Corporation — US Tax Implications.** For purposes of the PFIC rules, if any person has an option to acquire stock, such stock shall be considered as owned by such person. As a result, the Public warrants and Founder warrants issued by the foreign domiciled SPAC may be subject to the PFIC rules. Furthermore, it is important to note that a QEF election cannot be made with respect to warrants. As such, upon exercising warrants, if a US shareholder would like to treat a PFIC as a QEF,  the US shareholder may need to make a deemed-sale or deemed-dividend election mentioned above to avoid having an unpedigreed QEF and to avoid the "once a PFIC, always a PFIC" rule. Furthermore, there may be Form 8621 reporting obligations with respect to the warrants held.

**Domestication of a Foreign Domiciled SPAC.** Generally, the domestication of a foreign domiciled SPAC in the event a US based target business is identified can be structured to qualify as a type "F" reorganization. However, this may create issues under the startup exception to the extent the foreign domiciled SPAC previously qualified for such exception.

Furthermore, the exchange of warrants in the foreign corporation to the newly formed domestic corporation may create a taxable event for US holders of such warrants. If there is an unrealized gain on the exchange, this gain would be subject to the Excess Distribution regime in the year of exchange. However, this rule is based on proposed regulations released in 1992. As such, it may be a reasonable position for the US taxpayer to not comply with these rules. If the proposed regulations, however, are one day finalized, the proposed regulations may be retroactive to when released. As such, there are associated risks with such a position.