SPAC Alpha

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PFIC Rules: A trap for unwary SPACs

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Marcum LLP is the #1 ranked auditor in the SPAC IPO market in terms of number of total engagements since 2015. Marcum has represented issuers, worked with underwriters and targets of special purpose acquisition companies, and has wide-ranging experience in initial public offerings and subsequent business combinations entered into by SPACs. Over the last 5 years, Marcum has been involved with more SPAC transactions than any other audit firm and is one of the only audit firms to have a dedicated SPAC practice.

What are PFICs?

Most U.S. shareholders of passive foreign investment companies ("PFICs") don't really understand the unique rules that apply to foreign corporations holding passive assets even for a relatively short period of time. Most tax advisors think of PFICs as foreign unregistered mutual funds that invest solely in stocks, bonds and other securities. However, PFIC rules can cause potentially harsh tax results for U.S. SPAC investors who believe they are simply investing in a newly formed operating business. U.S. investors and foreign SPACs should recognize this proverbial trap for the unwary and plan ahead of time.

A PFIC is generally any non-US corporation that meets one of two tests: the gross income or the assets test. A SPAC is a PFIC if:

- either 75% or more of its gross income for the tax year comes from passive income, or
- 50% or more of its assets produce, or are held to produce, passive income.

Passive income generally includes dividends, interest, rents and royalties (other than rents or royalties derived from the active conduct of a trade or business) and gains from the disposition of passive assets.

Publicly traded corporations apply the assets test based on the value of the corporation's assets generally based upon the quarterly average of assets. Passive assets include working capital such as cash and other current assets readily convertible into cash. SPACs are blank check companies with no business activities. IPO proceeds are typically deposited in a trust account that invests in US treasury obligations. These proceeds are the biggest asset on the company's balance sheet. In addition, the only income generated by SPACs in the initial years after the IPO is the interest income earned in the trust. As a result, SPACs formed outside the U.S. meet the PFIC income and assets tests right after the IPO and therefore U.S. shareholders investing in these entities are subject to the PFIC regulations discussed below.

SPAC PFIC tax implications to U.S. shareholders

A U.S. shareholder investing in SPACs that are PFICs is subject to the rules contained in Sections 1291 through 1298 of the Internal Revenue Code. The specific rules depend on the action or inaction of investors and the PFIC itself. One set of rules applies to PFICs that are qualified electing funds ("QEFs") and the second set of rules applies to PFICs that are not QEFs.

Under Code Section 1291, a U.S. person that is a shareholder of the PFIC pays tax and an interest charge on any gain recognized on the sale or other disposition of its ordinary shares, rights, or warrants and any "excess distribution" made to the U.S. shareholder.

Under these rules:

- the U.S. shareholder's gain or excess distribution will be allocated ratably over the U.S. person's holding period for the ordinary shares, rights or warrants;
- the amount allocated to the U.S. shareholder's taxable year in which the U.S. person recognized the gain or received the excess distribution will be taxed as ordinary income;
- the amount allocated to other taxable years of the U.S. shareholder and included in its holding period will be taxed at the highest tax rate in effect for that year and applicable to the U.S. holder; and

- the interest charge generally applicable to underpayments of tax will be imposed in respect of the tax attributable to each such other taxable year of the U.S. shareholder.

The harsh results of these rules are the result of inaction either by the U.S. investor or the PFIC. However, a U.S. investor can mitigate these harsh PFIC tax consequences by making a QEF election that is described under the heading Qualified Electing Fund Election below.

Excess Distribution

An excess distribution is a current year distribution on stock to the extent it represents a ratable portion of the total distributions during the year that are in excess of 125% of the average amount of distributions during the three preceding years. For this purpose, any excess distribution received during the 3-year period is taken into account only to the extent it was included in gross income.

Deferred Tax Amount

The term "deferred tax amount" in regards to a distribution or disposition of PFIC stock is an amount equal to the sum of:

- The aggregate increase in taxes, plus
- The aggregate amount of interest on that increase in taxes.

The aggregate increase in taxes is calculated by multiplying each portion of the excess distribution allocated to a prior PFIC year by the highest tax rate in effect in that prior year. The aggregate increase in taxes is reduced by an applicable foreign tax credit. The foreign tax credit is really not applicable to SPACs that are formed in the Cayman Islands and the British Virgin Islands as these jurisdictions do not impose income taxes.

Qualified Electing Fund Election

The second set of rules applies to PFICs that are qualified electing funds (QEFs), under Code Section 1293. If a U.S. investor has made a QEF election, it includes currently in gross income his or her share of a PFIC's net capital gains (as long term capital gain) and other earnings and profits (as ordinary income), on a current basis, whether or not distributions are made, in the taxable year of the U.S. person in which or with which the SPAC's taxable year ends.

The election to be a QEF is made at the U.S. investor level under Code Section 1295(b), rather than the PFIC level, on a shareholder-by-shareholder basis. The election must be made by the first U.S. person who either owns stock directly or indirectly in the PFIC. For example, a U.S. partnership that directly owns stock in a PFIC must make the election. This investor level election is available only when the PFIC complies with the prescribed reporting requirements for determining the company's income and other requirements necessary to carry out the PFIC provisions. If the PFIC fails to comply with the reporting requirements, the QEF election cannot be made by the U.S. investor. Once this election is made, it cannot be revoked without the consent of the IRS and it will remain in effect even if the shareholder liquidates his investment in one tax year and then reinvests in the PFIC in a later tax year. A U.S. shareholder may make a separate election to defer the payment of taxes on undistributed income inclusions under the QEF rules, but if deferred, any such taxes will be subject to an interest charge as described above.

The election does not apply to any option to buy stock of the PFIC. If a shareholder who owns stock of a PFIC subject to a QEF election exercises an option to purchase additional shares of stock of that PFIC, the stock received will be subject to the QEF election. However, that stock will also be subject to the deferred tax and interest charge rules because the holding period of the stock includes the period the option was held, during which time it is considered to be stock of a PFIC that is not a pedigreed QEF.

A PFIC with a QEF election in place for the first year of the U.S. shareholder's ownership is known as a "pedigreed QEF." A U.S. shareholder of a pedigreed PFIC is not subject to the deferred tax and interest charges on receipt of a distribution or disposition of the PFIC stock.

Mark to market election for marketable PFIC stock

Shareholders of SPACs whose stock is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission (SEC) or on a national market systems established under section 11A of the Securities and Exchange Act of '34 are able to make the mark-to-market election describe below.

The purpose of making the mark-to-market election described under Code Section 1296 is for the U.S. shareholder to include in income each year an amount equal to the excess fair market value of the PFIC stock as of the close of the tax year over the shareholder's adjusted basis in the stock. Similarly, the shareholder is allowed a deduction for the lesser of the excess of the adjusted basis of the PFIC stock over its fair market value as of the close of the tax year, or the "unreversed inclusions" with respect to the PFIC stock.

The unreversed inclusions are the excess of the mark-to-market gains for the stock included by the shareholder for earlier tax years, including any amount which would have been included for any prior tax year but for interest on tax deferral rules, over the mark-to-market losses for the stock that were allowed as deductions for earlier tax years.

Under Code Sec. 1296(k), the mark-to-market election applies to the tax year for which the election is made and to all later tax years, unless the PFIC stock ceases to be marketable, the IRS consents to the revocation of the election, or the U.S. person elects or is required to mark-to-market the PFIC stock under another Code provision. In cases where U.S. shareholders own PFIC stock of several foreign corporations, the election must be made for each foreign corporation separately.

PFIC Annual Information Statement

Under Code Section 1298(b)(2), a corporation shall not be treated as a PFIC for the first taxable year the corporation has gross income, if no predecessor of the corporation was a PFIC; the corporation satisfies the IRS that it will not be a PFIC for either of the first two taxable years following the start-up year; and the corporation is not in fact a PFIC for either of those years. Given the nature of SPACs as blank check companies with no current active business, it is unlikely SPACs qualify for the start-up exception. Even after the acquisition of a company or assets in a business combination, the Company may still meet one of the PFIC tests.

In order to comply with the requirements of a QEF election, the SPAC should provide its U.S. shareholders a PFIC annual information statement in order to enable the U.S. holder to make and maintain a QEF election.

Final Observations

The rules dealing with PFICs, QEF and mark-to-market elections are complex. U.S. investors should consult their own tax advisors with respect to their investment in SPACs and the application of the PFIC rules under their specific circumstances. Getting caught in a mouse trap is one thing; getting caught in a tax trap is an experience you can do without!

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