US Inbound Corner | Navigating complexity

Navigating the Executive Compensation Planning for SPACs

Overview of SPAC

A SPAC (Special Purpose Acquisition Company) is a newly created company that uses a combination of IPO (Initial Public Offering) proceeds and may seek additional financing via a PIPE—Private Investment in Public Equity—to fund the acquisition of a private operating company. The proceeds raised in the IPO are placed in a trust account while the SPAC's management team seeks to complete an acquisition of an existing operating company ("target"), generally in a specific industry or geography, within the period stated in the SPAC's governing documents (typically, 18 to 24 months). If the SPAC successfully completes an acquisition, the private operating company target succeeds to the SPAC's public filing status and, as a result, the target effectively becomes a public company. If the SPAC is unable to complete an acquisition in the allotted time frame, the cash held in its trust account is returned to its investors (unless the SPAC extends its timeline via proxy process).

A SPAC's life begins with its initial formation, followed by its IPO, its search for a target, a shareholder merger vote, and finally, the close of an acquisition (or the return of the SPAC's proceeds to investors). The SPAC process differs from that of a traditional IPO in that the target company (which eventually becomes the public company post-acquisition) is not involved in the formation of the SPAC or the IPO phases. However, the terms of the units offered in a SPAC IPO and the agreements the SPAC has with its sponsor and management team ultimately influence the value that target company investors extract from a SPAC merger.

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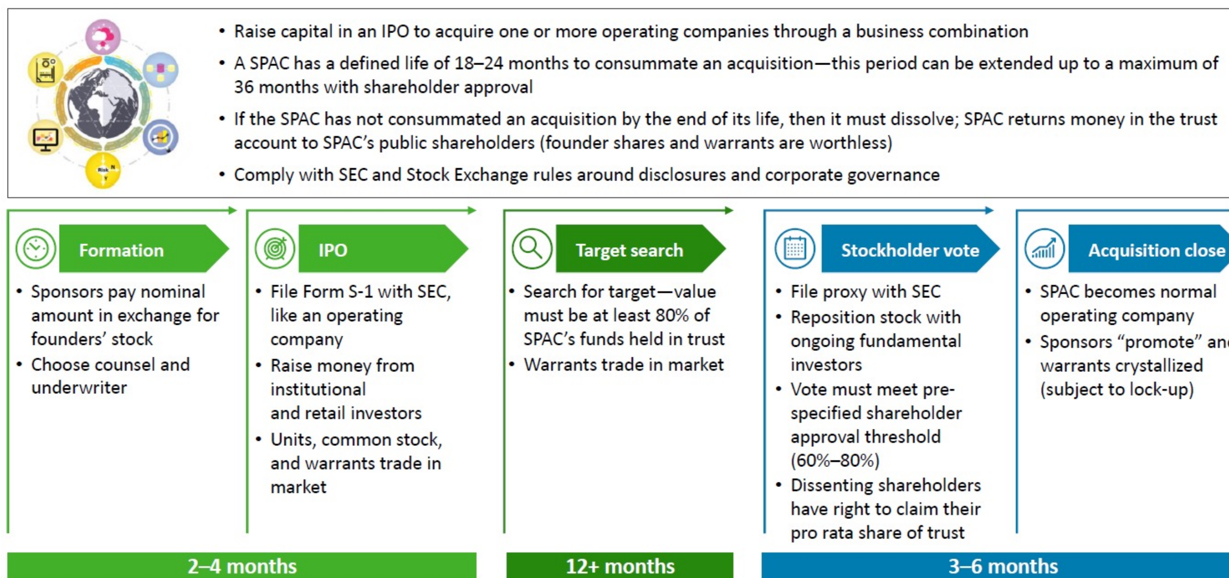

Executive Compensation Planning for SPAC

IPOs undertaken through a SPAC have unique tax considerations and complexities that can have significant implications throughout the SPAC life cycle for both buy-side (SPAC) and sell-side (target to be acquired by SPAC). SPACs can be formed with the flexibility to complete an acquisition of an existing operating company in the United States or a foreign operating company. In most cases, tax is central to financial reporting and transaction planning, and the post-SPAC company can emerge in a much more complex situation than prior to the SPAC transaction, especially in the cross-border SPAC transactions. Therefore, it is imperative to explore the expected new set of challenges and structure alternatives in order to be ready to operate as a public company. As one of the key tax considerations, many tax advisors urge the importance of advance planning surrounding executive compensation structures for private companies interested in entering the public markets via SPAC. Executive compensation decisions impact some of the most vital parties—both founders and employees—to a newly public company. In addition, there is very little lead time for SPAC transactions to establish executive compensation governance, processes, and tax planning/compliance between the signing and closing of the merger transaction. Therefore, unlike traditional IPOs with generally a longer lead time, it is even more crucial for companies interested in SPAC transactions to front-end these discussions to complete the analysis, design, drafting, and implementation of executive compensation timely.

Some of the important tax considerations around executive compensation planning for SPAC sponsors include:

- Accelerated equity-based compensation via vesting of restrictive stock units (RSUs)
- Sec. 280G golden parachute issues
- Sec. 162(m) rules limiting deductibility of compensation paid to some executives

Accelerated equity-based compensation

Many private companies go public via a SPAC transaction through a business combination commonly referred to as a de-SPAC transaction, which is similar to a reverse merger if the target is a C corporation. It is critical to assess the target company's existing equity-based compensation, including the determination of whether the SPAC merger transaction is considered a liquidity event that triggers vesting and settlement of restricted stock units (RSUs). RSUs are a form of deferred compensation whereby a company promises to pay shares in the future upon settlement of an underlying vested unit. Many executives believe that the de-SPAC transaction will automatically accelerate the vesting of all their equity, including RSUs. However, this is not always the case as the type of change in control event required to trigger vesting is not likely to contemplate a SPAC transaction. If the target entity wishes to accelerate vesting with the de-SPAC transaction, it could amend the RSU grant documents to include transactions in which an acquirer does not obtain a majority stake.

Companies, in particular privately held companies, must also consider requirements of Internal Revenue Code Section 409A that applies to nonqualified deferred compensation such as RSUs. Section 409A lays out strict rules for the timing of deferral elections and of distributions of deferred compensation. Failure to satisfy the requirements results in harsh tax consequences, including immediate income inclusion of vested deferred compensation and a 20% excise tax, along with potential interest and penalties for employees. Accordingly, it is important to confirm that RSU vesting and payment provisions comply with Section 409A.

Section 280G golden parachute issues

In general, Section 280G denies a deduction for an "excess parachute payment" and Section 4999 imposes a 20% excise tax on the recipient of an "excess parachute payment." In general, an "excess parachute payment" situation arises when the aggregate compensation triggered in connection with a change in control of a corporation with respect to a disqualified individual exceeds three times that individual's average taxable compensation over the prior five-year period. A "disqualified individual" is generally an officer, highly compensated individual, or 1% shareholder of a corporation.

In the context of a SPAC transaction, it is important to note that a Section 280G change in control event may occur when there is a change in effective ownership, namely when a person or group of persons acquires or has acquired at least 20% or more of the voting power stock in the last 12 months or when there are changes in the board of directors that are not endorsed by a majority of board members. Due to this "change in effective control" element included in the definition of change in control, an ownership change in the de-SPAC transaction that triggers accelerated vesting of equity compensation could result in the application of Section 280G. Notwithstanding the foregoing, in the event of a potential excess parachute payment situation, a privately held C corporation has the opportunity to exempt payments from Section 280G and avoid the Section 280G lost deduction and Section 4999 excise tax under a special shareholder disclosure and vote process.

Limitations on the deductibility of executive compensation

Companies intending to go public should also be cognizant of Section 162(m) rules that limit deductibility of compensation paid to covered employees of a publicly held corporation. Under Section 162(m), a publicly held corporation cannot deduct compensation it pays to a covered employee to the extent the compensation exceeds $1 million per tax year. Covered employees generally are the principal executive officer, principal financial officer, plus the next three highest paid officers. Furthermore, once an individual is a covered employee then that individual will continue to be a covered employee in subsequent years. Accordingly, target entities need to identify the executives and the compensation for which deductions will become limited under Section 162(m), and whether under generally accepted accounting principles, a deferred tax asset is required for financial statement reporting. Final Section 162(m) regulations (T.D. 9932) also limit the deduction for any compensation otherwise deductible for the tax year ending on or after the date its SEC registration statement becomes effective. The regulations also eliminated the exception under prior regulations for post-IPO payments made under preexisting equity incentive plans if they are disclosed to investors as part of an IPO process.

Key takeaway

Preparing for an IPO through a SPAC can often be a complex and time-consuming process involving numerous stakeholders. In addition to the significant regulatory requirements, there are a number of tax considerations that should be evaluated, especially for the cross-border transactions involving inbound companies, including the executive compensation matters discussed above. Management incentive and deferred compensation plans should be analyzed for compliance with applicable tax rules, including certain provisions applicable to public companies. Companies should further consider that a cross-border SPAC target could face numerous complex international tax issues—e.g., treaty access, global intangible low-taxed income (GILTI), passive foreign investment companies (PFICs)—which may materially impact the economics of the SPAC transaction. Proactive planning for executive compensation arrangements considering the issues outlined above is one of the key tax aspects that can certainly help the private companies, including the foreign-owned U.S. companies intending to go public via SPACs, be prepared for the first day as a public company.

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