Tax Executives Institute
Special Purpose Acquisition Companies and Current Capital Market Trends

Chris Lallo and Aparna Koneru
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Introduction
Options for unlocking value

Disparities in private market valuation are leading companies to look at public markets to access growth capital and/or alternative growth platforms.

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*In an Up-C structure, a newly formed corporation is the entity undertaking the IPO and sits above an existing limited liability company.*
## Overview of selected paths to public market

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<th>SPAC acquisition</th>
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<td>► Securities registered with SEC and listed on a major exchange&lt;br► Sold to public, institutional and retail investors</td>
<td>► Reverse merger with a listed Special Purpose Acquisition Company (“SPAC”)&lt;br► Blind pool of capital with up to 24 months to identify an acquisition</td>
<td>► Unregistered private placement using a broker dealer&lt;br► Rule 144A safe harbor allows reoffer and resale of restricted securities to Qualified Institutional Buyers (“QIBs”)</td>
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+ Widest universe of potential investors<br+ Publicity of public listing<br+ Access to follow-on capital<br+ Theoretically highest valuation<br► Quickest path to public listing<br► Open to stories that may otherwise be challenging in an IPO<br► Significant capital raised recently focused on Energy markets<br► Flexibility to structure acquisition consideration – cash and equity<br+ Quickest path to capital<br+ Build relationships with top institutions who can be critical to IPO success<br+ Less stringent disclosure requirements and liability<br+ Access to capital is less impacted by market volatility than IPO

- Time for SEC review process / market risk<br- Negative publicity of failed offering<br- Immediate costs of offering and ongoing infrastructure costs
- Lack of Wall Street coverage<br- Dilution from sponsor promote<br- Ongoing involvement of sponsor management team<br- Need to immediately ramp public company infrastructure<br- Near-term access to capital is more challenging than IPO
- Limited universe of potential investors<br- Less trading liquidity / monetization potential initially<br- Registration rights can dictate timing of eventual IPO<br- Cost of capital is often less attractive than public valuations
Certain public monetization alternatives
Traditional initial public offering
A traditional corporate IPO is the most common and well-known form of accessing public capital.

The traditional corporate structure generally results in two levels of tax (double taxation) – the public corporation pays tax on its earnings, and the shareholders generally pay tax on distributions received from the public corporation.

Traditional IPOs are well recognized and accepted in the public market.
Traditional initial public offering

Historically, IPOs are a desirable form of accessing public capital for a variety of reasons/circumstances:

► Insufficient qualifying income – traditional public company is not subject to any qualifying income or qualifying asset tests
► Long-term capital expenditure needs
► Desire to reinvest or grow through acquisition, as opposed to distributing out profits
► Global investor base
► Value based on prospective earnings growth (as opposed to a cash yield-based valuation).

If currently in partnership form, consider method of conversion (and timing) to corporation in preparation of IPO (e.g., assets-over, assets-up, interests-over, formless). To the extent partner’s share of liabilities exceed basis, tax may be recognized to Founders upon formation of the Public Company.
Special Purpose Acquisition Company (SPAC)
What is a SPAC?

A SPAC is a “blank-check” company that undertakes an IPO prior to completion of an acquisition

SPACs are formed by sponsors who believe their experience and reputation will allow them to turn a SPAC into a successful public company.

SPACs raise a set amount of capital in an IPO without identifying a target business to acquire.

Some SPACs focus on acquiring a target in a particular industry, while others have no set focus.

Examples of industry focus: Energy, Entertainment, Media & Entertainment, Metals and Mining, Healthcare, Technology, Consumer Sector,
Certain structure considerations upon SPAC formation

In an IPO, a SPAC generally issues units with a number of different securities, including shares of common stock and one or more class of warrants. Cash raised is placed in a trust account and not released till SPAC completes a business combination.

Warrant portion of the unit is intended to provide investors with additional compensation for agreeing to have their trust account for such period before the SPAC identifies a business.

Under the terms of the SPAC’s organizational documents, if SPAC is unable to complete a business combination, (typically 24 months), SPAC must return all money in the trust account. SPAC may seek extension through shareholder vote.
Certain structure considerations upon SPAC formation

SPAC sponsors acquire Class B shares for nominal consideration. Typically, results in SPAC sponsors owning 20% of the SPAC’s outstanding common stock.

Initial formation is a tax-free contribution of cash to the newly formed entity.

SPAC’s can either be incorporated as domestic or foreign entities.

Offshore SPACS typically have tax issues arising from their potential status as passive foreign investment companies (PFICs). PFIC rules are designed to prevent investors from inappropriately deferring U.S. tax on investment income through offshore funds or companies.
Certain structure considerations upon SPAC formation

An offshore SPAC will generally qualify as a PFIC during pre-acquisition period since SPAC has no operations and total assets essentially consist of a “passive” pool of money that sits in a trust account that generates investment income (interest).

US investors in a SPAC that is characterized as a PFIC should make a (i) qualified electing fund (QEF) election or (ii) “mark-to-market” election. Otherwise, investor’s gain upon disposition of the SPAC units, regardless of holding period, would be subject to 35% ordinary income tax plus a punitive interest charge.

QEF election would not apply to warrants. On sale of warrants, investor would be subject to the adverse tax consequences listed above. However, upon exercise of the warrant, QEF election would apply to newly acquired shares if made for other Class A shares.
Certain structure considerations upon SPAC formation

The SPAC could qualify for the start-up exception, but that would only exempt the SPAC from PFIC status for its first taxable year in which the SPAC has gross income.
Certain structure considerations upon SPAC acquisition of a target business

To the extent target business is in corporate form, Target could be merged with and into a merger sub of SPAC in a reverse cash merger. Such merger is treated as a taxable stock acquisition under Rev. Rul. 73-427 and Rev. Rul. 67-448.

To the extent, Target Owners want to continue their interest through an ownership in the SPAC, a tax-free reverse merger under Section 368(a)(2)(E) could be effected. Amount of boot should be considered when structuring type of reorganization.

Merger options unavailable for target in partnership form. If target business is in partnership form and historic owners of business want to continue their ownership through equity interest in the SPAC, it is challenging to structure a tax-free transaction for target owners.

Parties could consider an Up-C structure for historic owners of a target business in partnership form.
Certain structure considerations upon SPAC acquisition of a target business

Alternatively, for a target business in partnership form, parties could consider formation of a new corporate entity (TopCo) whereby (1) SPAC would be merged with a subsidiary of TopCo and (2) Target owners would contribute their interest in Target to TopCo. Such transaction would be tax-free to Sponsor, Public and Target Owners (Section 351), but would likely require a delisting and relisting of the public entity.
Up-C structure
What is an Up-C structure

The Up-C structure – which offers tax benefits to pre-IPO investors and Founders– has been expanding among companies

Alternative public monetization strategy for entities that do not qualify for the tax efficiencies provided by REITs and MLPs.

Encourages a diverse investor base (as compared to MLPs and certain other publicly traded vehicles).

The tax receivable agreement (TRA) effectively reimburses the Founders for a substantial portion of the tax cost realized upon monetization.

Can derive the most benefit from this structure if Founders are monetizing highly appreciated assets.

Founders remain in a partnership structure and able to keep advantage of Section 199A deduction, if relevant.

Typical Up-C organizational structure

*Assumes existing company is in partnership form as compared to corporate form.
Step 1: Recapitalization of OpCo LLC

Transactional Steps

- OpCo LLC recapitalizes its existing classes of units into a single class of units, the “OpCo Units”, with each Founder’s OpCo Units reflecting the relative value of its pre-recapitalized interest in OpCo LLC.

Considerations

- The value of each OpCo Unit will equal the value of each share of common stock issued by PubCo in Step 2.
- This step ensures that the OpCo Units will be exchangeable for class A shares on a 1:1 basis. To the extent, a profits interest is desired by management of OpCo LLC, additional considerations must be made.
- Valuation would likely be based on the IPO value (see Step 2).
- The recapitalization would generally be tax-free to the Founders and OpCo LLC.
Step 2: PubCo IPO and purchase of OpCo Units

Commercial Considerations
- Public investors and SEC compliance
- Use of proceeds
- Control of operations

Transactional Steps
- The Founders form a corporation to be used as an IPO vehicle by contributing nominal consideration to PubCo in exchange for high-vote, low value shares (Golden Shares). Alternatively, the PubCo’s certificate of incorporation authorizes a second class of Class A Shares that have a low-vote and high-value.
- PubCo makes an initial public offering of the Class A Shares to the public in exchange for cash.
- PubCo contributes the IPO proceeds to OpCo LLC in exchange for OpCo Units.
- The limited liability company agreement of OpCo LLC is amended, and OpCo LLC, the Founders, and PubCo enter into the Exchange Agreement and optional Tax Receivable Agreement.
Up-C structure – tax considerations to Step 2

The formation of PubCo, the Founders’ contribution of nominal cash to PubCo in exchange for the Golden Shares, and the public’s contribution to PubCo in exchange for Class A and Class B Shares are tax-free to the Founders and PubCo.

The admission of PubCo as a member of OpCo LLC (as a result of PubCo’s contribution of the IPO proceeds to OpCo LLC in exchange for OpCo Units) generally would be tax-free to PubCo, the Founders, and OpCo LLC. The contribution would dilute the Founders’ interests in OpCo LLC.

If certain Founders hold their interest in OpCo LLC through corporate entities, such entities may be merged into a merger sub of PubCo in a tax-free transaction. Corporates entities could also be contributed to PubCo, but there is concern on whether such transaction would be tax-free to Founders due to potential Section 368(c) control issues associated with the Golden Shares.
The OpCo LLC agreement should be amended to provide the method that OpCo LLC will use to allocate gain / loss from the sale of applicable Section 704(c) property with respect to any Section 704(c) layer that is created on or after the admission of PubCo into OpCo LLC (as a result of a contribution to OpCo LLC or revaluation of OpCo LLC). Up-C structures typically utilize the traditional method with curative allocations limited to gains on sale under Section 704(c).
Step 3: Subsequent exchanges of OpCo Units for Class A Shares

**Commercial Considerations**
- Control trade-off
- Monetization of assets / liquidity
- TRA mitigates U.S. federal income tax to Founders on monetization
- Timing
- Ultimately, PubCo acquires 100% ownership of OpCo LLC
- Market reaction to TRA (i.e., little to no impact on value of PubCo)

**Transactional Steps**
- In the future, the Founders may exchange their OpCo LLC Units for Class A Shares pursuant to the Exchange Agreement and then sell their Class A Shares to the public on the secondary market.

1 OpCo Unit + 1 Golden Share = 1 Class A Share
The Exchange Agreement would permit the Founders to exchange their OpCo Units (plus one Golden Share) for Class A Shares on a one-for-one basis (taking into account customary conversion rate adjustments for stock splits, stock dividends, and reclassifications) from time to time (e.g., quarterly or provided the exchange does not cause OpCo LLC to be treated as a “publicly traded partnership”).

Upon a Founder’s exercise of an exchange right, PubCo would contribute its stock to OpCo LLC, which, in turn, would distribute the Class A Shares to the Founder in redemption of the Founder’s OpCo LLC Unit(s) in OpCo LLC.

For U.S. federal income tax purposes, the Founder would be treated as selling its OpCo Unit(s) to PubCo and would recognize gain equal to the difference between the fair market value of the Class A Shares and its outside basis in the OpCo LLC Unit(s) exchanged.
Up-C structure – tax considerations to Step 3

Such Founder would take a cost basis in the Class A Shares (i.e., fair market value).

Such gain would be capital in nature, except to the extent it is attributable to ordinary assets, and would be long-term capital gain if the Founder has held the OpCo Units for at least one year (including the period the prior interest in OpCo LLC was held).

Although the exchange would be taxable to the Founders, PubCo should recognize no gain or loss on the exchange of Class A Shares for OpCo Units. PubCo would take a cost basis in the OpCo Units (i.e., the fair market value of the PubCo stock).
Since the exchange is taxable, Founders generally do not exchange unless they want to liquidate their investments, in which case they would immediately sell the Class A Shares received in the market. If, however, a Founder does not sell its Class A Shares immediately after an exchange, on a subsequent sale of the Class A Shares, the Founder would recognize gain or loss equal to the difference between the sales price and the fair market value of the Class A Shares on the exchange date.

Since OpCo LLC would have a Section 754 election in effect, PubCo generally would receive a basis step-up (under Section 743(b)) with respect to its share of the inside basis of OpCo LLC’s assets.
Tax Receivable Agreement:
► Founders and PubCo may enter into a Tax Receivable Agreement pursuant to which PubCo would pay the Founders a portion (typically 75% to 85%) of the tax benefits realized from the basis step-up resulting from the exchanges.
► Impact of tax reform on TRA should be considered.
  ► Reduced benefit of TRA due to lower corporate income tax rates.
  ► There could be an increased value in the TRA due to application of bonus depreciation to 743(b) step-up.
► Certain events (ex. change in control) could result in an early termination payment as part of the Tax Receivable Agreement.
Up-C structure – TRA considerations

Tax Receivable Agreement:
- Payments under the TRA would be treated as additional purchase price paid by PubCo for the OpCo LLC Units, and, for tax purposes, we generally advise exchanging members to report the payments as contingent installment sales proceeds.
Key takeaway of TRA

Benefit of ‘step-up’

After making the TRA payments, PubCo retains 15%* of the tax benefit received from the ‘Step-up’

FMV = $100

‘Step-up’ = $50

Share of inside basis = $50

Under the TRA, Founders receive 85%* of the tax benefit received by PubCo from the ‘Step-up’ on an annual basis (as the Step-up results in a reduction in tax to PubCo)

The TRA payment enables the Founders to monetize their assets while effectively paying only a portion of the tax bill

*Subject to negotiation.
Comparison of IPO structures
Public company structure comparison

Income tax focus

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<tbody>
<tr>
<td>Formation</td>
<td>High</td>
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<td>Moderate</td>
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<td>Administration</td>
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<tr>
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<tr>
<td>Use of equity as currency</td>
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<td>Low</td>
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<td>Pre-IPO due diligence</td>
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**Tax efficiency**

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<td>Formation</td>
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<td>Distribution of proceeds</td>
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<td>Long-term</td>
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<td>Effect of TRA</td>
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**Operational features**

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<td>Sponsor control</td>
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<td>Flexibility</td>
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**Notes:**

1. In the case of an MLP, the annual tax reporting statement (form K-1) issued to the public is typically perceived as administratively complex. In the case of an Up-C, annual TRA calculations (if applicable) are typically complex.

2. Although the tax implications of use of MLP units as acquisition currency is perceived as complex, it is typically highly tax efficient.

3. In most IPO structures other than a reverse merger into an existing public entity, a new “clean” legal entity is used. In the case of an IPO that is structured as a merger into an existing legal entity, tax and other due diligence may be appropriate.

4. Depending on the specific facts, the legacy business owners may be required to recognize non-cash taxable income upon the formation of the public vehicle (e.g., when the amount of liabilities assumed by the corporation exceeds the tax basis of the assets transferred to the corporation).

5. It is widely speculated that significant income tax legislative changes may be made in 2017 with the incoming presidential administration. These changes could impact the tax efficiency of corporate structures, for example by lowering corporate income tax rates.

6. The sponsor of an MLP typically controls the MLP through a general partner interest. Similarly, voting control in the public corporation is typically retained by the sponsor group in the case of an Up-C IPO.
Certain provisions from the TCJA to consider on public company structures

- Lower Corporate Income Tax Rate
  - Choice of entity considerations
  - Impact on value of TRA in an Up-C structure
- Section 199A Deduction
  - Choice of entity considerations
- Bonus depreciation
  - Applicability to Section 743(b) step-up
  - Impact on value of TRA in an Up-C structure
Questions?
Christopher J. Lallo

Function in EY

- Chris Lallo joined the Houston office of Ernst & Young LLP in 2008 and currently leads the Transaction Tax Practice for the Southwest Area. He was formerly a partner at Fulbright & Jaworski LLP. His practice is focused on both domestic and international tax matters with broad-based experience in the area of tax planning related to domestic and cross-border mergers and acquisitions, including taxable and nontaxable transactions, cross-border investments, financing structures, withholding issues, capital market transactions and securities offerings. He is also a past Chair of the Tax Section of the Houston Bar Association.

Professional Experience and Clients

- Significant experience in advising domestic and international energy companies in connection with upstream, midstream, downstream and oilfield service company transactions.
- Significant experience in mining and other transactions in the natural resources sector.
- Represents buyers and sellers of public and private organizations in various types of transactions, including cross-border transactions, taxable and nontaxable stock and asset transactions.
- Represents clients in connection with tax issues related to acquisition financing structures and debt restructuring transactions.
- Has worked on a significant number of large inbound oil and gas transactions and has advised numerous clients on tax issues associated with inbound investment structures.
- Has written numerous articles and is a frequent public speaker at professional conferences.
- Counseled clients in private equity transactions. Represents investors and companies that have been acquired by private equity funds, providing tax counsel on acquisitions and divestures. Provides counsel on tax matters for both domestic and foreign funds.
- Counseled clients in international tax planning. Represents clients in connection with global structure planning and business transactions from a tax perspective.
- Clients include both U.S. and foreign based multinational businesses.

Education/Certifications

- B.B.A. in Accounting from Texas A&M University.
- J.D. from The University of Texas School of Law.
- Certified Public Accountant in Texas.
- Licensed Attorney in Texas.
Aparna T. Koneru

Manager - Transaction Advisory Services – Transaction Tax

Tel: +1 713 750 5159
Fax: +1 713 750 1501
Email: aparna.koneru@ey.com

Function in EY
- Aparna is a manager in Ernst & Young’s Houston office in the Transaction Advisory Services – Transaction Tax group. Aparna’s primary responsibilities include transaction tax structuring, tax due diligence, and post-transaction implementation for clients. Aparna advises her clients in connection with upstream, midstream and oilfield service company transactions.

Professional Experience and Clients
- Aparna has knowledge and experience with U.S. international tax matters, including cross-border mergers and acquisitions, taxable and nontaxable transactions, cross-border investments, and tax-efficient financing structures.
- Aparna represents both U.S. and foreign-based multinational corporations and has advised numerous clients on tax issues associated with inbound investment structures.
- Aparna represents private equity funds, and portfolio companies that have been acquired by private equity funds. She provides tax counsel on acquisitions and divestures. She also provides assistance on tax issues related to acquisition financing structures and debt restructuring transactions.

Education/Certifications
- J.D. from The University of Texas School of Law.
- Licensed Attorney in Texas.