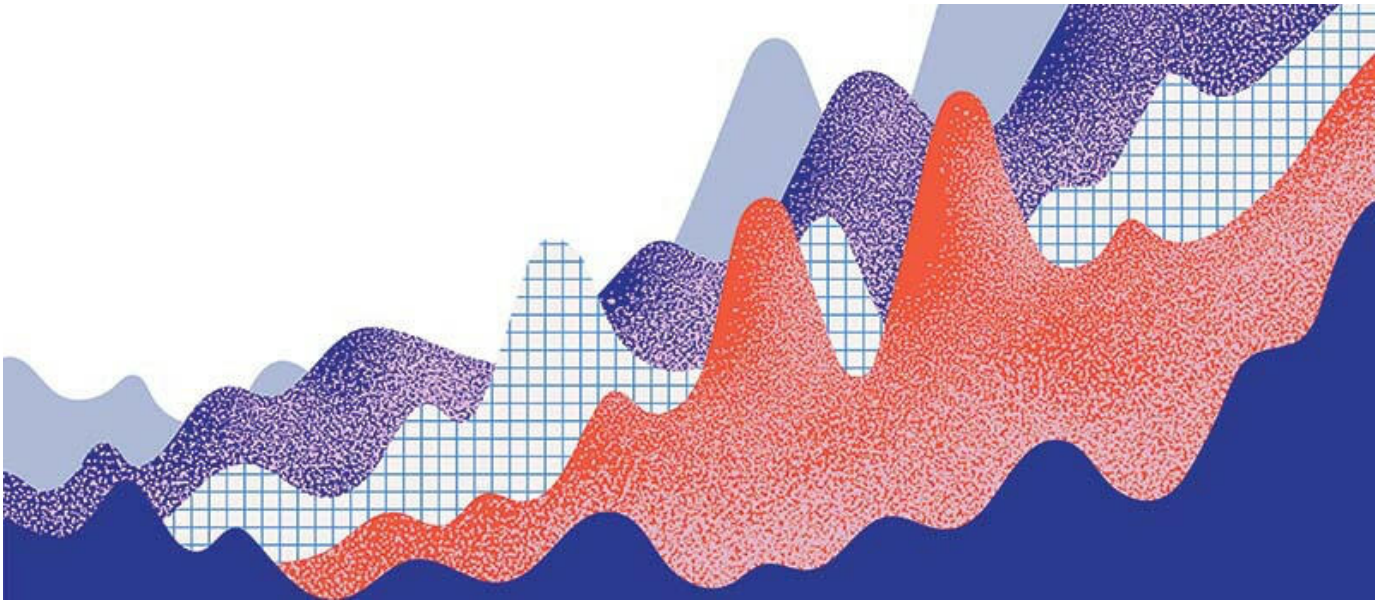
Special purpose acquisition companies and employment related securities

Personal tax



28 March 2022

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Key Points

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What is the issue?

A special purpose acquisition company is a company without a business or assets but with a management team and a strategy to identify and acquire attractive targets.

What does it mean to me?

There are potentially different outcomes for warrants which are taxed solely under employment related securities rules, solely under the securities options code, or taxed under both.

What can I take away?

It is unclear whether HMRC is splitting the warrant into two separate assets and applying the rules separately, or treating the warrant as a single asset to which both sets of rules apply.

When we talk about employment related securities, we usually think about shares being acquired by employees. Warrants are a tool that businesses can use to reward key employees or investors. They give an individual the opportunity to buy stock in a company at a preset price, for a set period of time. While stock option terms are often short, warrant contracts are often long, lasting up to 15 years.

The recent popularity of the special purpose acquisition company (SPAC) as an investment vehicle raises interesting questions about the taxation of warrants for UK sponsors. Are they employment related securities or not? Or could they be both at the same time (a Schrödinger warrant?), leading to a surprising and potentially beneficial outcome for the sponsor.

What are SPAC sponsor warrants?

A SPAC is a company without a business or assets but with a management team and a strategy to identify and acquire attractive targets. Based on the credentials and experience of management and the strength of its strategy, the SPAC raises capital through an initial public offering. It then has a defined period of time to identify and acquire an appropriate target or business (often known as the ‘business combination’). Compared to traditional investment structures, the ability of a SPAC to raise funds quickly and flexibly makes it attractive to potential investors.

The typical equity structure of a SPAC will often comprise a combination of both shares and warrants, which are held by the sponsors and public shareholders.
A sponsor typically subscribes for its warrants by paying an acquisition price, which grants the holder the future right (usually on a business combination) to purchase

shares in the SPAC at the exercise price.

If the value of the shares at the point of exercise exceeds the price paid for the shares (i.e. the acquisition price of the sponsor warrants plus the exercise price), the sponsor will acquire a valuable SPAC shareholding for a relatively modest capital outlay.

Why are employment related security considerations relevant?

Employment related securities are ‘securities’ acquired by an employee by reason of their employment (which includes by a director in connection with their holding of office). Normally, this is a straightforward factual test that can be determined by looking at the context in which an individual acquired the securities in question.

However, securities can also be *deemed* to have been acquired by reason of an individual’s employment, as a result of the application of ITEPA 2003 s 421(B)(3) (the deeming provision). Under the deeming provision, where a right or opportunity to acquire securities is made available by a person’s employer (or by a person connected with a person’s employer), it is automatically deemed to have been acquired ‘by reason of’ that person’s employment or office.

This gives rise to the practical risk that individual sponsors who are also directors of the SPAC are treated as acquiring employment related securities.

It might be argued, justifiably, that sponsor warrants are not being acquired by reason of an individual sponsors’ employment or office; instead, the warrants simply reflect the commitment of significant upfront value in exchange for the highest level of risk capital. However, the potential for the deeming provision to apply means that it is prudent to consider the possible employment related security implications.

Dead or alive?

The question is then whether sponsor warrants are employment related securities or not – or perhaps whether they are both.

The difficulty in applying the employment related securities legislation to warrants is that the legislation expressly *includes* warrants within the definition of ‘securities’, whilst also expressly *excluding* ‘securities options’. Since ‘securities options’ is defined as a ‘*right to acquire securities*’ (and a warrant is essentially a right to

acquire securities), the legislation is effectively saying that warrants are both employment related securities (taxable under the employment related securities rules) and not employment related securities (and so taxable under the securities options code).

HMRC acknowledges this conflict (ERSM20150). It attempts to resolve it by taking the view that if warrants are straightforward options to acquire securities which do not carry any additional rights (the example is given of voting or dividend rights), then they should be classed as ‘securities options’ and not securities for employment related securities purposes.

Alternatively if the warrants do contain other rights, HMRC says that both sets of rules may potentially apply, as it may be the case that a warrant is a security in respect of the additional rights but one which also contains a securities option to be regarded separately. It is unclear in this scenario whether HMRC is effectively splitting the warrant into two separate assets (one being the option and the other consisting of other rights) and applying the two sets of rules separately, or whether HMRC would treat the warrant as a single asset to which both sets of rules apply.

Potential outcomes

Warrants taxed solely under the employment related securities rules

Very broadly, if a sponsor warrant is an employment related security that constitutes a ‘restricted security’, a chargeable event may arise for the sponsor warrant holder, triggering an income tax liability. Sponsor warrants are likely to be treated as ‘restricted securities’ (ITEPA 2003 s 423) if there are provisions attaching to the securities which reduce their market value.

Being an employment related security, the income tax charge that could arise when the restrictions cease to apply can be mitigated by making an election under ITEPA 2003 s 431, the effect of which is that the tax point under the restricted securities regime is moved to the date the warrant is acquired.

If the price paid for the warrant is equal to or exceeds the unrestricted market value of the warrant at the time of acquisition (which should be relatively easy to achieve if the SPAC has little or negligible value at the time of grant), there should be no future liability to income tax on exercise. Instead, any growth in the value of the

warrant should be subject to capital gains tax.

Warrants taxed solely under the securities options code

If a sponsor warrant is treated as a ‘securities option’ acquired by reason of the sponsor’s employment, the warrant should be taxed under the securities options code (the Code).

No income tax should be payable on acquisition of the warrant by the sponsor; however, the exercise of the sponsor warrants to acquire shares in the SPAC in the event of a business combination could constitute a chargeable event.

Where a chargeable event occurs, the amount of any gain that would be subject to income tax would broadly be calculated by deducting the consideration given for the shares in the SPAC (i.e. the acquisition price of the sponsor warrants plus the exercise price) from their market value.

For illustration purposes, suppose each sponsor warrant is acquired for £1 and each sponsor warrant entitles the warrant holder to purchase one share in the SPAC for £10. At exercise the market value of each share in the SPAC is £40. Income tax would be payable on:

£40 – (£1 + £10) = £29 per warrant.

Where the shares acquired are not disposed of, this could lead to a large dry income tax charge when the sponsor warrants are exercised.

Unlike the position under the employment related securities rules, it is not possible under the Code to make a s 431 election to take any future growth in value outside of the income tax regime.

Taxation under both the employment related securities rules and the securities options code

Treating sponsor warrants with additional rights as a single asset, and applying both the employment related securities rules and the Code, could be seen as a recipe for double taxation. However, if HMRC’s manuals are interpreted in this way, it could lead to a surprising and potentially beneficial outcome – a result that arguably is more aligned with the true nature of sponsor warrants as a capital investment.

If both regimes apply, under the employment related securities rules, a s 431 election could be made at the time the sponsor warrants are acquired, moving the tax point upfront with no income tax to pay provided unrestricted market value is paid.

Under the Code, there would still be an income tax charge when the sponsor warrants are exercised. However, as well as deducting the acquisition cost and the exercise price when calculating the gain, ITEPA 2003 s 480(3) also allows a deduction for ‘the reduction in value of any employment related securities’ (the ‘s 480 deduction’).

Although the purpose of the s 480 deduction is primarily aimed at situations where exercising options will dilute other shares which the same person holds, there is nothing on the face of s 480 which talks about any ‘other’ securities reducing in value: the reference is to ‘any’ (employment related) securities reducing in value.

Could the s 480 deduction therefore apply to the reduction in value of the sponsor warrant itself? In other words, could it be said that exercising the warrant is both the exercise of an option under the Code and extinguishes the warrant as a security in its own right? A sort of Schrödinger warrant?

If correct, then the value lost on the warrant being exercised would need to be calculated. If exercise is close to a business combination, it might be anticipated that the value of the warrant is close to the market value of the shares into which they would convert (such that the value of the warrant is essentially the market value of the SPAC share less the acquisition cost and the exercise price).

Using the same facts in the above illustration, the amount in respect of which an income tax charge might arise on exercise under the Code could therefore be broadly said to be the market value of the SPAC shares at the time of exercise (£40) less (the acquisition price (£1) plus the exercise price (£10) plus the s 480 deduction (£40 - £11 = £29)); i.e. nil.