INDIAN JOURNAL OF LEGAL REVIEW

VOLUME 4 AND ISSUE 1 OF 2024

INSTITUTE OF LEGAL EDUCATION

INDIAN JOURNAL OF LEGAL REVIEW

APIS – 3920 – 0001 | ISSN - 2583-2344

(Free and Open Access Journal)

Journal's Home Page – https://ijlr.iledu.in/

Journal's Editorial Page - https://ijlr.iledu.in/editorial-board/

Volume 4 and Issue 1 of 2024 (Access Full Issue on - https://ijlr.iledu.in/volume-4-and-issue-1-of-2024/)

Publisher

Prasanna S,

Chairman of Institute of Legal Education (Established by I.L.E. Educational Trust)

No. 08, Arul Nagar, Seera Thoppu,

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INDIAN JOURNAL OF LEGAL REVIEW [IJLR – IF SCORE – 7.58]

VOLUME 4 AND ISSUE 1 OF 2024

APIS – 3920 - 0001 *(and)* ISSN - 2583-2344

Published by

Institute of Legal Education

https://iledu.in

SPACS- A BOON OR A CURSE?

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BEST CITATION - JHANVI JAIN & KARNIKA SINGH, SPACS- A BOON OR A CURSE?, INDIAN JOURNAL OF LEGAL REVIEW (IJLR), 4 (1) OF 2024, PG. 1504-1511, APIS – 3920 – 0001 & ISSN - 2583-2344.

INTRODUCTION

Special Purpose Acquisition Company or SPACs are an alternative method of getting unlisted companies listed without it going through the hassles of an Initial Public Offer (IPO). They are basically blank-check companies with no operations of their own, formed with the sole purpose of getting an unlisted company listed by acquiring or merging it. It has a life span of two years, and if it does not manage to merge with any other company in the span of 18-24 months it is liquidated and all its funds are returned to its original investors. SPAC came into existence roughly 20 years ago in the United States of America. SPACs were initially seen as a pump and dump scheme as they led investors to lose money by defrauding them into believing that they were going to merge with a company and pump up the prices and later the insiders would sell the shares before the truth could be exposed to the retail investors. This situation led the Congress to lay down a basic regulatory framework and posed a requirement for money to be deposited in a regulated escrow account and barring its use until the acquisition/ merger was complete.[2391]

[2391] Prashant Singhal, Pranav Sayta, 'Special Purpose Acquisition Company (SPAC) Ernst and Young' <https://www.ey.com/en_in/strategy-transactions/spac-services > last accessed on 6th December 2023

THE RISE OF SPACS

As we discussed above SPAC came into existence in the USA. Now, we will discuss its rise. SPACs were on the down low for a long time, until very recently in 2019. All of a sudden many hedge funds, private equity and venture capital firms and senior executives were drawn to the idea of SPAC. Later, the reason for it was attributed to the abundant cash with the investors and a series of new start-ups seeking capital to grow. Suddenly, the number of SPACs forming part of IPOs grew from 4% in 2013 to 30% in 2019[2392]. SPACs were seen as a reputable way of investing and as a good investment opportunity by the investors. SPAC was like Google Pixel was to I-phones in the mobile phone industry, it looked like it was there to stay and that it could work parallel to the IPO regime. Some of the initial case studies of India using SPAC to get listed in NASDAQ is Yatra being acquired by Terrapin 3 Acquisition Corp (TRTL) and a reverse merger of Videocon DTH with Silver Eagle Acquisition Corp to get it listed in NASDAQ.

Soon after the boost in SPAC transactions a data came to light. The redemption rate of the SPAC was ascertained to be 58% where the median rate was 73%. SPACs give investors an option to redeem their money at pro-rata basis because the investors are unaware of the target company before the IPO process has started and they should be given a free chance to recover their share. The redemption rate as of 2023 has gone up to 58%, there have been situations where the rates have gone up to 85% for instance Zoom Video Communications backed Cvent (an event management software company). In this case 85% of the investors redeemed their shares 2 days before its listing. Well-known companies like Grab Holdings and BuzzFeed merged with SPACs to get listed publicly, only to be disappointed by their share rates tumbling down. BuzzFeed could only raise $16 million out of the $288 million amount in the SPAC due to 94% of its investors redeeming their share. This gave rise to a question of whether SPAC was here to stay or was it just another fad like crypto which blew up like a hot-air balloon and popped as quickly as a helium one.

The Indian company which got listed in NASDAQ is ReNew power. This company is an Indian origin company backed by Goldman Sachs. It went on to get listed in the NASDAQ by merging with a SPAC. ReNew power merged with a New York based RMG Acquisition Corporation II, this company was already listed in the NASDAQ, and was working as a SPAC for ReNew power. This was a one of a kind experience in the Indian industry and the reason it caught the eyes of so many people was because of the way it gave a significant push to its valuation. The valuation of the company jumped from $4 Bn. to a, whooping $4.4 Bn. Experts are of the opinion that such increase in valuation wouldn't be achievable if it would have gone through the traditional methods of an IPO. Although, the ministry of corporate affairs has clarified that any Indian company listed in the Foreign stock exchange will not be considered to be listed in the Indian stock exchange unless it goes through the regulatory guidelines of an IPO.[2393]

The data denoting the number of Special Purpose Acquisition (SPAC) in United States shows a steady growth in transactions from 2003 to 2007. SPAC had completed 65 transactions and was at an all-time high in 2007. It raised about $11Bn in proceeds. The world had its eyes on SPAC when suddenly the financial crisis of 2008-09 hit us and SPACs came down to a number of 17 in 2008 and rapidly to an embarrassingly low number of 1 in 2009. After the crisis ended SPACs again started to go in an upward trajectory when suddenly in 2020 and 2021 it made a spectacular jump to 248 and 613 respectively from a relatively low number of 59 in the year 2019. This sudden increase was attributed to the pandemic. We

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[2392] Eric Watson, 'Why companies are joining the SPAC boom' <https://www.pwc.com/us/en/services/consulting/deals/library/spac-boom.html> last accessed on 5th December 2023

[2393] Mike Bellin, 'Goldman Sachs is shrinking its SPAC business amid regulatory crackdown and market turmoil' <https://www.cnbc.com/2022/05/09/goldman-sachs-is-shrinking-its-spac-business-amid-regulatory-crackdown-and-market-turmoil.html> last accessed on 6th December 2023

have already discussed its implications above. The years 2020 and 2021 were a golden period for SPACs.[2394] The hedge funds were the ones who profited the most out of it. They used to enjoy the interest accrued until the companies were merged, if after the merger the investors decided to redeem their share original amount, the shares were still sold with a warrant, which could either be sold or could be used as relatively cheap stake in the company they were merged with. In 2021, a lot of celebrities started endorsing SPACs by being sponsors or assuming leadership roles. It gave SPAC a significant push. India wanted to be a part of this fad as well, which leads us to the next part of our paper.

INTRODUCTION OF SPACs IN INDIA

The Global buzz through SPAC impacted India to a certain extent too. We have already discussed a few case studies with regards to the introduction of SPACs in the Indian context. Now, let us discuss the regulatory changes which have to be made to incorporate SPAC in the Indian scenario. In, March of 2021, SEBI instituted an expert committee to evaluate practicality of the introduction of SPACs in the Indian context. SEBI discussed with the Parliamentary Standing committee on finance about inculcating a dedicated framework for SPACs in the Indian Capital Markets. The Ministry of Corporate affairs in its Company Law Committee report, 2022 made observations on SPAC. SPACs are used for indirect listing of existing companies/ businesses and offer privately held companies to access public markets.

The CLC recommended that an act should recognize SPAC transactions and include supporting provisions under the act. The listing of domestic SPACs is to be regulated by SEBI. SPAC seems to be a suitable regulatory framework for the multiple IPOs and unicorns being introduced in India. In a scenario where SPAC is being introduced in India a new regulation has to be accompanied by compliance of old regulations as well. Let us discuss one of the regulations which will be affected.

The Issue of Capital and Disclosure Requirement Regulations 2018 (ICDR) details the provisions prescribing the eligibility criteria which has to be satisfied by the issuer in an IPO. It may be difficult for the SPACs to do the same, as it is a blank check company at the end of the day. Some of the criterias creating nuisance are stated below: -

1. The company should have an average operating profit of at least 15 crores in the last three years. The net tangible assets of the company should at the least be at Rs 3 crores, and the networth at Rs 1 Crore.

2. The company, if it changes its name in the last year, 50% of the revenue has to be earned by the company's activity after acquiring the new name.

The only way for companies to issue an IPO if the above conditions are not fulfilled, is by the way of Book Building process. The conditions mentioned above, pose a challenge for SPACs in India as it won't be able to satisfy the ICDR 2018.

Under ICDR, an offer document is to be issued before issue of an IPO, this document has to disclose the detailed description of the business and its profits and losses, in the last 3 years. SEBI rejects or revises the document with applicable disclosure requirements with the help of this offer document. SPAC does not give SEBI the opportunity to reject as the only thing revealed by SPACs are the promoters of the company before the IPO is initiated. Separate disclosure requirements and documentary requirements have to be crafted by SEBI in order to incorporate SPACs.[2395]

[2394]Max H. Bazerman, Paresh Patel 'SPACs: What You Need to Know' <https://hbr.org/2021/07/spacs-what-you-need-to-know> last accessed on 6th December 2023

[2395] Himanshu Dubey, 'An-overview-of-SPACs-and-related-concerns-in-India' https://vinodkothari.com/wp-content/uploads/2021/03/An-overview-of-SPACs-and-related-concerns-in-India.pdf last accessed on 6th December, 2023

IFSCA (Issuance and Listing of Securities) Regulations, 2021is the first Indian regulation which talks about the introduction of SPACs in the IFSCs like the GIFT city. The guidelines by IFSC state that a target should not be identified by SPACs prior to the IPO and they should have a set of provisions with respect to the liquidation and regulation in line with the IFSC regulations.

The IFSCA (Issuance and Listing of Securities) Regulations, 2021, deals with the contents of the offer document. The offer document has to contain all material disclosures which are true, correct, and adequate to enable the investors to take an informed investment decision. The lead manager is responsible for exercising due diligence and to verify the adequacy of all disclosures. The offer document is supposed to specify the instruments that they would invest in before the acquisition of the. They have also defined the threshold limits- the minimum issues size is $50 Million and the minimum post issue paid-up-capital to be held by sponsors is 15%-20%. Sponsors are supposed to have an aggregate subscription amount of at least 2.5% or an issue size of 10 million (the lower one of the two). The minimum share price in an IPO was fixed at $5 per share, and the minimum application size at $100,000. Before, the consummation of the SPACs the issuer should keep the entire proceeds in an interest bearing escrow account and shall invest in debt instruments mentioned in the offer document. That money could only be withdrawn by the SPAC issuer in order to pay taxes and general working capital expenses only after a special resolution is passed by the shareholders.

The SPAC issuers have to take prior permission from the majority shareholders before making any proposed business combinations. The shareholders have been given the right to redemption under this regulation. Shareholders can convert their securities to pro-rata portions of aggregate amounts deposited in the escrow account. SPAC should be completed within a proposed timeline or in any case it should be completed within 36 months of them listing it on the stock exchange. On failure of completion of the SPAC transactions the escrow accounts are liquidated. Similarly, if there is a change in control of the Special Purpose Acquisition Company (SPAC), the SPAC issuer must offer shareholders (excluding sponsors) the option to redeem their securities, converting them into a pro-rata share of the total amount in the escrow account. The SPAC issuer is obligated to complete the business combination within the disclosed timeline in the offer document, and in any case, not exceeding 36 months from the date of listing on a recognized stock exchange. Failure to complete the business combination within the specified timeframe will result in the liquidation of the escrow account. In the event of liquidation and delisting, sponsors will not be entitled to participate in the liquidation distribution. The SPAC issuer is responsible for ensuring that the fair market value of the business acquisition is at least 80% of the total amount deposited in the escrow account, excluding deferred underwriting commissions in escrow and any taxes payable on the earned income.[2396]

The SPAC and sponsors must also ensure the absence of any related party transactions or connections involving sponsors or their associates in the business combination. Regarding post-business combination activities, the regulations stipulate that the resulting issuer (the entity trading on the stock exchange after a SPAC's business combination) must promptly disclose transaction details to the recognized stock exchange. The resulting issuer is required to meet the listing eligibility criteria within 180 days to maintain its listing on the recognized stock exchange.

Sponsors' shareholding in the resulting issuer is subject to a one-year lock-up period from the date of the business combination closing. Similarly, promoters, promoter groups, controlling shareholders, directors, and key managerial personnel of the resulting issuer must adhere to a one-year lock-up period from

[2396] V.K. Unni, 'Special Purpose Acquisition Companies – The Evolving Regulatory Regime' https://www.iimcal.ac.in/FinLab/email-template4/res/07.pdf last accessed on 6th December, 2023

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APIS – 3920 - 0001 *(and)* ISSN - 2583-2344
Published by
Institute of Legal Education
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the date of the business combination closing. We have talked about the regulatory framework which speaks about how SPAC affects the issuers and shareholders. Now, let us proceed to the part where we see how the government will be impacted when SPAC comes in.[2397]

TAXABILITY OF SPAC TRANSACTIONS

After the essential purpose of SPAC i.e. to raise capital through IPO, a target is identified and with the approval of shareholders of the SPAC, it is acquired by way of a reverse merger, which is also called a de-SPAC transaction. In the Indian scenario, this de- SPAC transaction is like a Cross-Border Outbound Merger as an Indian target company merges into the Foreign SPAC entity. While mergers and amalgamations are typically tax neutral under the Income Tax Act of 1961, this is not applicable for outbound mergers. Section 47 of the Act specifies the transactions that aren't regarded as a 'transfer' for capital gains taxation.[2398]

Section 47 clause (vi) of the Act restricts any such transaction which entails the transfer of capital assets by the amalgamating company to the amalgamated company unless it is an Indian company. However, Section 47 will not come to the rescue of Indian targets as in a de-SPAC transaction the amalgamated company will always be a foreign entity. Furthermore, capital assets shall be transferred at a fair value otherwise it will attract the rigors of Section 50C of the Act. Therefore, in almost all cases cost of transfer of capital assets will be higher than the cost of acquisition thereby attracting a Capital Gain tax.

Even the Indian target's stockholders are not immune. Section 47 clause vii exempts the transfer of shares under a scheme of amalgamation if the amalgamated company is an Indian company. In addition, the minimum purchase amount of shares by the SPAC entity should match the fair market value of the Indian Target's shares. If the acquisition value is less than the fair market value, Section 50CA's anti-abuse clause is triggered. The fair market value is anticipated to be significantly more than the acquisition cost, resulting in a hefty tax burden for the Indian Target's shareholders.

The levy of stamp duty on mergers is perhaps a significant hurdle to SPAC listing. In accordance with the Supreme Court judgement in the case of Hindustan Lever Ltd vs. State of Maharashtra, it is the scheme affecting the merger (order of the court/tribunal) which is an instrument under the Stamp Act. It is not required that there should be a real transfer of property. Further, for the purpose of determining the valuation of stamp duty, shares, and other relevant factors of the transferor company is taken into account. Stamp duty is obligatory since a merger cannot be completed without judicial approval. As a result, even though there is no real transfer of assets in a de-SPAC transaction, it is charged stamp duty.[2399]

Tax Implications post de-SPAC transaction.

Permanent Establishment and its Taxability

The Indian target loses its legal existence post the merger and becomes a branch/permanent establishment of the SPAC, which is essentially a foreign entity. One of the most significant elements of International taxation is the creation of a permanent establishment. Profits of a foreign firm are typically taxable in India only if the company maintains a permanent establishment in India. Moreover, only the income due to such permanent establishment is taxed. A combined reading of Sections 92F(iiia) and 92F(iii) of the Income Tax Act reveals the definition of a permanent establishment as a fixed place of business through which the enterprise's business is either entirely or partially carried out.

[2397] Dhruv Singhal, Ketaki Gor Mehta, Ravi Shah, Sonakshi Arora & Avani Dalal, Tax Implications on SPAC: To SPAC or Not To SPAC?https://corporate.cyrilamarchandblogs.com/2022/05/role-of-ifsc-in-the-indian-spac-dream-an-overview-part-3/ last accessed on 6th December 2023

[2398] Devarsh Shah and Dharmvir Brahmbhatt, Tax Implications on SPAC: To SPAC or Not To SPAC? https://cbcl.nliu.ac.in/taxation/tax-implications-on-spac-to-spac-or-not-to-spac/ last accessed on 6th December 2023

[2399] S.R. Patnaik, Surajkumar Shetty 'Assessing Indian tax considerations for successful offshore listing of Indian companies' https://tax.cyrilamarchandblogs.com/2020/09/assessing-indian-tax-considerations-for-successful-offshore-listing-of-indian-companies/ last accessed 6th December 2023

As discussed above, once the de-SPAC transaction is concluded, Indian Target loses its legal existence in India and hence becomes a permanent establishment of the foreign SPAC entity. It is worth noting that such a foreign entity (SPAC entity) has no real operations and derives all of its revenue only from the Indian permanent establishment. This is where the real problem is. Permanent Establishment is taxed at 40% rather than the standard rate of 30% (or lower, depending on the company). Considering that the Indian Target company will have to pay 40% tax on its net income after being acquired by SPAC, as opposed to a 30% tax (or lower), the obvious question is whether the additional tax paid by the Indian Target company for listing on a foreign stock exchange is an equitable trade-off, given that a more economical way to list on the foreign exchange might also exist.

Taxability of other incomes of SPAC entity

Aside from the taxability of the Indian branch as a PE of SPAC in India, it is critical to ensure that SPAC's "place of effective management" ("POEM") is not in India. While, in most cases, the resulting foreign entity will have no other business rather than its establishment in India, only in case generates other income, POEM becomes significant. If SPAC's managerial staff is based in India, or if key management decisions affecting SPAC are made by SPAC's directors or officers while they are based in India during a financial year, SPAC's POEM could be found in India. If SPAC's POEM is found to be in India, it will be considered a tax resident in India and will be subject to Indian taxes on its worldwide earnings.

DOWNFALL OF SPAC

In 2022, the rush that the investors came in with in 2020 and 2021 diminished as soon as adrenaline diminishes from our system after a good run. The investors had lost their appetite by then and had no more gold mines to dig. Suddenly, SPAC crashed and the number of transactions came down to 86 in 2022 and 22 in 2023 (August). The main reason for this fall could be attributed to the regulation introduced by the SEC. The spokesperson for Goldman Sachs told CNBC in an interview that they planned on reducing involvement in the SPAC business because of the changing regulatory framework. Let us discuss what regulatory framework led big financial names to back out of SPACs.

The Securities and Exchange Commission (SEC) guidelines broadly imposed the following regulatory requirements: -

- The SEC's primary mandate is to protect investors. The surge in SPAC activity raised concerns about inadequate disclosures and potential risks to investors, including retail investors. The SEC implemented measures to ensure that investors have access to more information about SPACs and the companies they target.
- They imposed stricter disclosure requirements for SPACs, particularly related to the target companies and the financial projections provided. The goal was to provide investors with a clearer picture of what they were investing in and the associated risks.
- The SEC increased scrutiny of accounting and reporting standards for SPACs and their target companies. This was aimed at ensuring accurate and transparent financial reporting, which is crucial for investors' decision-making.
- It also made changes to the traditional IPO process for SPACs. For example, it required SPACs to account for certain warrants as liabilities rather than equity instruments, which had an impact on financial reporting and regulatory compliance.
- The SEC signaled its intent to scrutinize SPACs more closely and issued guidance to market participants. This heightened regulatory oversight was

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intended to curb potential abuses and promote fair market practices.[2400]

These regulations were brought in to demarcate the bounds within which SPACs should function and to protect investors interest and ensure market integrity. Although, the regulations turned out to be counterproductive to their initial aim and discouraged SPAC transactions. A Thomas Reuters report on SPAC discussed the reason for such fall back. The report highlighted how the SPAC transactions has gone in rising due to its limited legal compliances. Credit Suisse a Swiss bank backing a significant number of blank-check companies hinted at SPAC being a way to bend the rules of the IPO market. The bank's role as an underwriter was also affected by the SEC regulations. Banks when backing up an IPO are supposed to go through a plethora of compliances and due diligence and also have to buy a chunk of the company's securities risking losses.[2401]

In the case of a SPACs, a bank's responsibilities as an underwriter conclude once the blank-check company successfully goes public through its IPO. However, the bank earns a part of its compensation only when the SPAC successfully completes an acquisition. When the SPAC eventually reveals details about a merger, the underwriters for the SPAC are no longer accountable for making predictions or statements regarding the future performance of the company to be acquired and subsequently listed on the stock market. A data projected that the companies which got listed through SPAC in 2019 had shown a down of 36% till 2022 March. This data when compared to the 14% decline in shares of companies which went public through IPO is quite heart wrenching for the investors. Banks earned an amount of almost $8 Billion in the name of SPAC related fees. It added up to almost 6.5% of the US investment banking fees collected by major banks.

OUR ANALYSIS

The United States of America turned out to be the perfect case study for us to look into while examining the need for SPAC in the Indian context. The regulatory challenges and the tax implications are a secondary point while debating if SPACs should be introduced. The primary thing to consider was how it impacted the investors, the promoters of SPAC and the acquired company. As we discussed in the above chapters SPAC after its initial hype turns out to be nothing but a farce for all its stakeholder. The IFSCA Regulations, 2021 have made ample provisions to incorporate SPAC and have also taken care of the loopholes in the ICDR Regulation. Still, the regulators might not be able to alleviate the concern that SPACs can be used as a way to defraud investors by the promoters.

The dilemma faced by companies considering a foreign listing, particularly through the Special Purpose Acquisition Company (SPAC) route. While SPAC listings offer fast and easy access to foreign capital markets and cheap capital, the authors argue that the associated tax burden makes it necessary for target companies to carefully consider the decision. The recent 2020 amendment to the Companies Act, 2013, allowing direct cross-border listing for Indian companies without additional taxes, is presented as a more economical alternative. However, this route is criticized for its time-consuming and compliance-intensive nature

In conclusion, SPAC from investor's point of view can be seen as method used to influence them into making conflicting investment decision and playing a gamble on a company they know nothing about, based on nothing but the SPAC's sponsors. Even though, it allows unlisted companies to get listed quicker than IPOs, it still poses a threat for the company to lose its market standing. The SPAC bubble seems to be deflated, as the minimal regulatory framework which was the nectar for the bees has been

[2400] https://www.sec.gov/files/33-11048-fact-sheet.pdf last accessed 6th December 2023

[2401] Bansari Mayur Kamdar and Medha Singh, 'SPAC boom fizzles as investors cash out on big names' https://www.reuters.com/markets/europe/spac-boom-fizzles-investors-cash-out-big-names-2021-12-17/

sucked out of it, by SEC. SPAC still continues to exist on the down low. For us, SPAC seems like a mirage which looks enticing from a far off a distance unless you get to close when it turns out to be nothing but a mound of sand.