Different Pathways: Permanent Capital Vehicles vs. Limited Partnerships

*In our latest memo, **Roger Blears** and **Christine Ward** consider when and how permanent capital vehicles may be a more preferable solution for sponsors as an alternative to the ubiquitous limited partnership vehicle and explore to what extent arrangements may be combined.*

Permanent capital vehicle – onshore

If, being bold as brass with a great name as an entrepreneur or former investment banker, you can attract the confidence of investors, then consider raising 'permanent' capital in a private company – 'a permanent capital vehicle' ("PCV") as distinct from a typical limited partnership vehicle with a 10–12-year lifespan.

Make your initial investments and then, perhaps, float your PCV as a venture capital trust ("VCT").

Or, if the investments the PCV will make are not VCT qualifying, you could consider floating the PCV as an AIM investment company, to provide liquidity to your investors and perhaps also as a first step to listing on the main market as an investment trust or as a real estate investment trust, before your PCV realises capital gains on its investments.

A PCV will be charged to corporation tax on its income and gains, save for dividends received from underlying investee companies – dividends are generally exempt from tax in the hands of UK corporates (including investment trusts and VCTs). Furthermore, a PCV which is a VCT or investment trust will be exempt from tax on any gains realised in respect of shares in underlying investees.

Investors would be taxed on any distributions received from the PCV, and on gains realised on the sale of their shares in the PCV, subject to the exemptions mentioned in the preceding paragraph and to any other exemptions, e.g., exempt pension funds/charities.

An investment trust does pay corporation tax on its other investment income, in particular interest. If investment trust receipts on the underlying assets/contracts are treated as interest, then it might offset interest paid out on its bonds against and in reduction of its taxable receipts. If investment trust receipts are in the nature of quasi-equity then a special structure would be required to achieve this offset.

The income and capital gains of the qualifying rental business of a REIT are exempt from corporation tax (though if it develops a property development, any gains are taxed if the property is sold within three years of completion). A REIT is required to withhold income tax at the basic rate from its property income distributions ("**PIDs**"), unless paid to a tax-exempt body (pension funds, local authorities and charities) who, in turn, is exempt from tax. Other investors are liable to corporation tax or income tax, as the case may be, on PIDs received but receive a credit for the tax withheld. Therefore a REIT is broadly the same as investing using a tax transparent vehicle. They also enable small SIPPs to own a stake in large commercial property which they otherwise couldn't own directly, with the related benefit of liquidity for their holdings as their shares will be listed.

Permanent capital vehicle – offshore

You could form an offshore company in Jersey or Guernsey with a listing on The International Stock Exchange (TISE) as a non-tax transparent corporate vehicle that is not charged to Jersey or Guernsey tax on its non-Jersey or Guernsey profits.

A special tax regime applies to funds established as overseas companies. Unless the PCV is registered with HMRC as a reporting fund and complies with the applicable requirements, UK investors are liable to income tax on gains realised on the disposal of their shares in the PCV. However, if it is registered as a reporting fund, capital gains realised by investors will be charged to chargeable gains tax in the normal way. However, where the reporting fund receives income from its investments, investors are effectively taxed on that income whether distributed to them or not.

Therefore, there is no advantage for your UK investors in forming a PCV as an offshore vehicle if your assets will be primarily yield producing assets. You will only incur the additional costs of the PCV being offshore.

The tax treatment of non UK domiciled investors may be different.

So the decision as to whether to form an onshore or offshore PCV hinges on who your investors will be and whether or not the PCV assets will be yield-producing.

UK investors and yield-producing assets = onshore.

UK investors and growth assets = offshore, unless you plan a short pathway for an early listing in the UK as a VCT, investment trust or REIT, where intermediate offshore administration expenses would make no commercial sense.

Non UK investors = it depends.

There is also the option of forming an offshore PCV as a protected cell company (PCC) with a different investment strategy for each cell, a divisional structure where there is no cross contamination between cells.

Limited partnership

Alternatively, if the lustre, expense and regulation of a public markets listing are not for you and your investors, then you may prefer a tax transparent limited partnership.

This immediate tax transparency might better suit your tax exempt investors, particularly if your investment policy is to invest in leveraged MBOs or short turnaround distressed opportunities.

Or, if you are a young entrepreneur as yet to make your name and to prove that you can identify worthy investments, you may simply find it easier to raise a limited partnership fund where capital is committed for future drawdown rather than all being paid up front from the outset.

Larger institutional investors may prefer a limited partnership for the additional freedom it brings for them to negotiate the terms of participation or side deals.

First a PCV, then a limited partnership and then an investment trust?

If you anticipate that the income and gains in your fund are likely to be non-linear in the sense that they will only arise when underlying assets or structured contracts mature, an alternative strategy worth considering might be to:

- begin with an onshore PCV; and then to

- reorganise before the assets/contracts have increased in value by the liquidation of the PCV and the distribution of its assets/contracts to a tax transparent entity, in return for the issue of units in that tax transparent entity to investors.

This option might allow you to get off the ground quickly and at a lower cost if, initially, you lack the FCA authorisation to manage a limited partnership (see below).

You might establish a succession of such PCVs with planned reorganisations leading to their reorganisation into a succession of tax transparent entities.

If the tax transparent entities are structured so that they are not unit trusts then any realised profits will not be subject to corporation tax but will be treated as the income and capital gains of the underlying investors and taxed accordingly.

Then, once a sufficiently large AUM had been raised within such a series of tax transparent entities, an investment trust might be launched which:

- participates as a new investor in the series of tax transparent entities; and

- on the realisation of their underlying assets/contracts, a true up mechanism could be triggered which is dilutive of the existing holdings of units of investors in the tax transparent entities, in exchange for the prior issue to those investors of shares in the investment trust, thus providing the original investors with the liquidity of a listed investment trust share.

Bonds or preference shares and the speculative illiquid securities (SIS) restrictions

An onshore non-tax transparent PCV or an offshore non-tax transparent corporate vehicle that markets issues of bonds or preference shares to raise capital for investment purposes would be subject to the speculative illiquid securities (SIS) restrictions as regards their sale to retail investors.

These restrictions can be sidestepped, with the issue of PCV ordinary shares being the most practicable option or by the promoter being prepared to restrict the minimum investment to >£100,000.

The SIS restrictions might in theory also be sidestepped by the appointment of a discretionary client-by-client investment fund manager to act on behalf of retail investors in making investments on their behalf in the bonds and preference shares issued PCV but in practice it might be difficult to identify such a manager willing to take on this role.

The likely best option is to raise capital for a PCV by the issue of ordinary shares as their promotion is not caught by the SIS restrictions. You would then take your carried interest as a contractual right to be paid a performance fee rather than as the holder of ordinary shares in the PCV.

Regulation

The marketing of an opportunity to invest in the ordinary shares of a PCV or an offshore company would be subject to the direct offer financial promotion rules restricting the target retail client audience to those in respect of whom an authorised person could give a positive appropriateness assessment and where they are certified as HNW or sophisticated investors or restricted investors.

For promotional offers above €8m the prospectus rules may also apply.

Most (but not all) limited partnerships, on the other hand, are likely to be a collective investment schemes.

Contractual arrangements generally for the management of property of any description where investors' capital is pooled or managed as a whole will most likely also be a collective investment scheme (though there are some exemptions).

For example, if you offer to make investments on behalf of investors in the shares issued by one or more PCVs where you will manage their shareholdings as a whole on their behalf, this will be a collective investment scheme.

From a regulatory perspective any direct marketing of a collective investment scheme will be restricted by the non-mainstream pooled investment (NMPI) rules to per se professional investors (institutions etc); elective professional investors; or those to whom an authorised person can market a collective investment scheme pursuant to the collective investment scheme Fin Prom rules; essentially HNW and sophisticated investors in respect of whom one has undertaken a preliminary assessment as to suitability.

A body corporate is not itself a collective investment scheme, except for an LLP and an open-ended company, but arrangements for the management of shares in a body corporate are likely to be a collective investment scheme. There are some exemptions to this rule, that applying to EIS funds being perhaps the exemption most relied upon.

The NMPI marketing restrictions can be sidestepped if the investment opportunity is not marketed as a direct investment into the shares of one or more PCVs but as an opportunity for investors to appoint a discretionary fund manager to act on a client-by-client basis, where the manager will exercise discretion separately on behalf of each of its client investors and make investments in one or more PCVs which are suitable for each of them according to their personal circumstances – rather than managing all of their shareholdings 'as a whole'.

This would be the most suitable structure to adopt if, for example, you want to offer your investors the opportunity to invest in the shares of trading PCVs which offer business relief from inheritance tax after they have been held for two years.

Arrangements which offer retail investors relief from inheritance tax in respect of shares issued by PCVs (an "estate planning service")

There are a number of different approaches in the market to structuring arrangements by which capital is raised from private investors for investments that will attract business relief from inheritance tax. All of them seek to avoid the arrangements from being a unregulated collective investment scheme and from falling within the ambit of the UK Prospectus Regulation when raising capital.

The alternatives are:

- First, a MiFiD retail client based relationship with investors where a business relief estate planning service can be distributed widely to retail investors.

The service contemplates the portfolio manager acting on behalf of investors, on a client-by-client basis, making investments which meets an investment policy selected by each investor.

This is the most robust arrangement in our view.

- Second, a MiFiD professional client based relationship with authorised financial advisers who act as the agent of their clients where a business relief estate planning service can be distributed widely to retail investors.

  The service contemplates the portfolio manager acting on behalf of authorised financial advisers (acting as the agent of investors, again also on a client-by-client basis, where investments are to be made which meet an investment policy selected by or for each investor) where the client of the portfolio manager is the authorised financial adviser (as a professional client of the portfolio manager) not the underlying retail investor and where the retail investor has appointed his authorised financial adviser as his agent with express authority to provide all ongoing instructions to the portfolio manager on his behalf.

  This is also a robust arrangement in our view and lends itself to the offering of a number of model portfolios for selection by the adviser on behalf of their client though there are some slight disadvantages compared to the first approach.

- Third, an alternative investment fund ("**AIF**") where it can be argued that the arrangements are not a UK collective investment scheme by virtue of the 'individual investment management arrangements' exemption in Article 1 of the Schedule to the FSMA Act 2000 (Collective Investment Schemes Order 2001) (SI 2002/1062).

  This is a plausible regulatory structure up to a point, but there are weaknesses in the argument.

The obvious example of this exemption being applied in practice is when private client stockbrokers bulk up their orders on behalf of their clients to buy and sell shares on a stock market.

In our view this exemption is not targeted at arrangements for the provision of an estate planning service where the portfolio manager will exercise discretion on behalf of investors as a whole not only as to when to sell and buy shares on their behalf but also additional discretion as to the exercise of voting and other rights attaching to the shares acquired for clients.

A component part of this arrangement is that investors must also be able to withdraw their portfolio from the arrangements at any time. Whilst this may not happen very often or at all the consequences might cause practical difficulties.

- Fourth, an AIF where it can be argued that the arrangements are not also a UK collective investment scheme by virtue of the 'Bodies Corporate' exemption in Article 21 of the Schedule to the FSMA Act 2000 (Collective Investment Schemes Order 2001) (SI 2002/1062).

  This arrangement doesn't work at all in our view and share offers are also likely to fall within the ambit of the UK Prospectus Regulation when raising capital.

AIFs

Any PCV or tax transparent entity that is categorised as an alternative investment fund (AIF) – a collective undertaking with an investment policy with no explicit conditions as regards pooling or the management of property as a whole (a broader EU concept as distinct from the UK concept of a collective investment scheme) will also require an authorised alternative investment fund manager (AIFM).

If the AIFM manages an ungeared portfolio exceeding €500m or a geared portfolio of more than €100m the AIFM will need to be a fully authorised AIFM and you will also need a depository to look over his shoulder.

Below these AIF thresholds a PCV (but not a tax transparent entity) can register with the FCA as a its own internal AIFM and therefore avoid the cost of an FCA authorised AIFM.

Tax transparent entities require an external AIFM.

Therefore, a PCV might be preferred on the grounds of lower running costs and regulation because of this ability to register as its own AIFM.

Conclusion

Investment fund succession planning can begin with the low operating costs and the minimal regulation applicable to an onshore non-tax transparent private company – a permanent capital vehicle. This is an option not always considered.

Though there may also be very good reasons to begin with a GP/LP limited partnership.

Additionally, if returns are likely to be non-linear you might contemplate a succession of :

- onshore non-tax transparent PCVs, leading to
- a number of tax transparent entities leading to
- an investment trust, a VCT or a REIT

which would eliminate the tax leakage inevitable with a non-tax transparent PCV by ensuring that any profits (whether income or gains) are only ever realised within a transparent vehicle or a vehicle, such as an investment trust, VCT or a REIT, that doesn't pay corporation tax on its gains.

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