

Fund Structuring 101

Structuring a venture capital or private equity fund (“**VC/PE Fund**”) can appear, at first glance, to be a complex process. Whilst there is undoubtedly complexity in the detail of any structuring exercise, the broad-brush strokes of VC/PE Fund structuring are actually relatively straightforward and are often based on a few key drivers.

Introduction

In this article we will run through some of the key fund structuring drivers from a UK standpoint, contrasting the pros and cons of the core VC/PE Fund structuring jurisdictions for UK GPs (being the UK, Jersey, Guernsey and Luxembourg; the “**Core Jurisdictions**”) and explaining why putting a VC/PE Fund in one jurisdiction over another, might be preferable.

Throughout this article we will refer to the sponsor of a VC/PE fund as the ‘GP’. This entity will generally be distinct from the general partner vehicle of the relevant VC/PE Fund but may or may not also be the designated manager (under the Alternative Investment Fund Managers Directive; “**AIFMD**”, where relevant).

Key takeaways

1. While Luxembourg has become the structuring destination of choice over the past five to 10 years, the arguments for structuring VC/PE Funds in the UK and/or Channel Islands are becoming stronger.
2. A European marketing passport under AIFMD can be essential where widespread (southern) European investor outreach is required, but it is very costly and is not necessary where European investor outreach is more limited or focussed in northern Europe.
3. Channel Islands and UK/Channel Islands hybrid VC/PE Fund structures offer the best VAT efficiencies.
4. All of the Core Jurisdictions generally work well for portfolio tax structuring, but as European substance requirements are tightened over time and following the introduction of the Qualifying Asset Holding Company regime in

the UK, the UK increasingly outcompetes Luxembourg for UK GPs.

GP considerations

Choices as to how to structure a VC/PE Fund are typically the preserve of the GP (absent an involved cornerstone investor) so it makes sense to start this overview with some high-level GP considerations. These may include:

1. **Choice of vehicle:** in reality, in a venture capital and private equity context there is no choice. Limited partnerships have been the preserve of venture capital and private equity funds for decades and quite rightly given their tax transparency and flexibility from an administrative perspective. Each of the Core Jurisdictions has well developed limited partnership regimes so, as a general rule, vehicle choice does not really drive jurisdictional structuring decisions.
2. **Market perception:** market perception can be an important consideration for some GPs. In this context, market perception can be split between business suitability (the ease with which a GP considers business can be done) and international reputation. UK based GPs will often perceive the UK and the Channel Islands to be more business friendly than Luxembourg, whereas Luxembourg can appear more internationally reputable to some GPs (often as a result of pass through European investor views). In reality, all jurisdictions have their pros and cons in this area and unless a GP (or cornerstone investor) has a strong preference, this is probably not a determinative point from a structuring perspective.
3. **Cultural alignment:** cultural alignment can be an important point, particularly when

dealing with service providers based in the jurisdiction. The UK and the Channel Islands provide an anglicised approach to service provision which UK GPs can find reassuring, particularly given the interaction between a GP's fund administrator and its investors. This cultural alignment can also spill over into regulatory interactions and the way in which a local regulator oversees both a GP's VC/PE Fund and its administrator. For these reasons and by dint of geography, Luxembourg has historically appealed more to continental European GPs but post AIFMD (and post Brexit) increasing numbers of UK GPs have also chosen the jurisdiction for their VC/PE Funds, notwithstanding potential cultural differences.

4. **Cost:** cost will always remain a relevant factor for a GP, although will generally be indirectly relevant as the VC/PE Fund (and therefore investors) will generally pick up the majority of the costs associated with its administration. As a general rule, administration costs in connection with Channel Islands VC/PE Funds are lower than equivalent Luxembourg vehicles. For UK GPs however, UK based vehicles have often been cheapest to run although in part, this has been a function of a GP retaining certain of the administrative functions rather than outsourcing them. Historically, among UK GPs it was not considered cost effective to locate a fund outside the UK unless the VC/PE Fund was targeting commitments of around £200m or more, but this should not be considered as a hard and fast rule.

Investor considerations

Investor considerations will generally fall into two buckets:

1. **Market perception:** investors, like GPs, will have their own jurisdictional preferences based on their years of investing in VC/PE Funds located in a variety of jurisdictions. Unless the investor is a cornerstone however, these views will not, provided they are a matter of preference only, typically be strongly enough held to be determinative.

2. **Investment restrictions:** certain investors can be restricted from investing in funds based in certain jurisdictions for legal/tax reasons and in these circumstances, unless a structural work around can be created (a feeder or parallel vehicle for example) this can be problematic and can be relevant in structuring. Similarly, certain investors are prevented or disincentivised from investing in certain jurisdictions and products with higher capital weightings and investment restrictions being variously applied.

Regulatory considerations

Post AIFMD, regulatory considerations can be a significant driver for structuring from a GP perspective and the choice here should really be made following a thorough review of anticipated distribution needs in terms of scope and jurisdictional breadth.

The basic decision to be made for UK based GPs is whether to embrace AIFMD and all that goes with it in terms of compliance, operational oversight, costs and regulatory inconvenience in order to secure a marketing (and perhaps management) passport, or whether to side step this and take a lighter (regulatory) touch and more cost effective structuring route. For VC (seed and growth capital) the European Venture Capital Funds Regulation ("**EuVECA**") regime can also provide an interesting light touch option. GPs should also consider the impact of Brexit if looking at UK based authorisation under AIFMD/EuVECA.

While there are a number of advantages to embracing the AIFMD kite mark (e.g. investor risk weighting as mentioned above and a cross border management passport for some GPs), in reality the key benefit attaching to AIFMD is the availability of a marketing passport. Where a GP secures AIFMD authorisation, it will be free to market interests in its VC/PE Funds across all member states. This can vary in importance for GPs depending on where they anticipate sourcing capital, both within and outside of Europe, noting that marketing outside of the AIFMD umbrella is still relatively straightforward across around 10 European countries and particularly across northern Europe.

For venture focussed GPs, EuVECA can be utilised as an alternative to AIFMD. EuVECA provides all the distribution advantages of AIFMD (i.e. a pan European marketing (and management) passport) but with few of the compliance burdens. Since its introduction in 2013 there has not been huge interest in EuVECA principally due to the restrictive nature of what an EuVECA authorised manager could invest in, but following changes to the regime in 2017, the qualifying investment definition was widened and provided the specified investment requirements do not conflict with a GP's investment objectives, EuVECA can now provide an easy and cost effective marketing passport for seed and growth capital VC managers.

It is worth noting that when considering regulatory wrappers and distribution routes, a GP should also consider how a structure is tailored to achieve compliance. GPs can themselves become regulated under AIFMD which carries the highest cost and administrative burden, can use a service provider to achieve the same result (with a medium cost position) or can remain on the side line and push the regulatory burden onto the general partner of the VC/PE Fund (more common with Channel Islands based products and generally cheapest).

Tax

When most people think about fund structuring, tax is probably top of the agenda but for VC/PE Funds, it's important but not always determinative from a jurisdictional perspective as all of the Core Jurisdictions offer well understood and effective options. Provided a VC/PE Fund is structured as a limited partnership (or equivalent - SCSp in Luxembourg), direct taxes are largely irrelevant as the fund vehicle will be treated as tax transparent. The arbitrage between jurisdictions therefore is largely generated by portfolio level tax structuring and indirect tax efficiency. Since the introduction of BEPS in 2016 there is also a discussion to be had about 'substance' and the wider impact of this and the BEPS anti-avoidance provisions applicable to VC/PE Funds and their holding structures, but a detailed look at this is beyond the scope of this article.

At a high level, Channel Islands funds generally remain the most tax efficient as there is no VAT chargeable on any costs that can be met by the Channel Islands fund vehicle (i.e. the VC/PE Fund falls outside of scope of the European VAT regime). With UK and Luxembourg based structures, VAT efficiency is achieved through reliance on the investment management exemption, so any investment management services provided together (in particular in Luxembourg) with many of the common administrative supplies consumed are treated as exempt, with no VAT charged whenever possible. By combining this approach with VAT grouping as between the GP and the VC/PE Fund, it is possible to minimise VAT leakage but fundamentally these structures are not as efficient as the Channel Islands alternative. A hybrid option combining a UK based VC/PE Fund with a Channel Islands based SPV general partner can be used to replicate the Channel Islands VAT position but with UK fund presence for improved perception and treaty access. For UK based GPs, cross border supplies (of advisory/management services) are favourably treated in both the Channel Islands (outside of scope) and Luxembourg (treated as exempt for the purposes of the receiving party and standard rated for the supplier) so there is no particular arbitrage here.

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Portfolio tax structuring can be complex and a full discussion of this is beyond the scope of this article, but it's worth noting that most cross border transfers of dividend income and capital in a European focused portfolio are generally covered under the Parent-Subsidiary Directive (as enacted in most EU jurisdictions through the participation exemption) and each of the Core Jurisdictions have extensive double tax treaty networks which can be helpful in reducing

residual withholding taxes on cross border transfers.

Maintaining treaty access is an important element of overall VC/PE Fund structuring and establishing 'substance' and 'commercial purpose' are key in this process. For the past five to 10 years, Luxembourg has been the lead jurisdiction in capturing these benefits.

For UK GPs in particular however, the introduction of European initiatives such as ATAD III and the UK's QAHC regime, have begun to shift the spotlight away from Luxembourg, back to the UK, where for UK based GPs it's now easier to generate 'substance' and 'commercial purpose' through the collective domiciliation of the GP, the VC/PE Fund and any associated holding companies (structured as QAHCs).

The real substance generated through collective UK domiciliation, rather than manufactured substance generated in Luxembourg through clustering administered entities, is cheaper to administer, less complex and arguably more effective (particularly in connection with treaty access for certain southern European jurisdictions).

Conclusions

At a high level, VC/PE Fund structuring is relatively straightforward and whether a GP chooses a European, UK or Channel Islands based option, there are tried and tested pathways which will always yield a favourable result. As to which structuring jurisdiction to choose depends on a range of different considerations which will be specific to each GP both in terms of what they are and their relative importance.

While AIFMD and EuVECA offer straightforward and appealing European distribution pathways, the compliance burden associated with the former and the investment restrictions associated with the latter should be carefully considered before a GP opts into compliance and GPs should not be afraid to operate outside of these European regulatory umbrellas where circumstances dictate that this is appropriate.

Although Luxembourg has been the favoured VC/PE Fund structuring jurisdiction for some years from both a distribution and portfolio tax structuring perspective, the introduction of the QAHC regime in the UK coupled with increasing European substance requirements creates an increasingly compelling argument for pure UK structures or UK/Channel Islands hybrid structures.

If you are looking at fundraising and/or structuring and would like to discuss any of the points raised in this article in more detail, please feel free to contact us using the details below.

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