The Special Purpose Vehicle – Facilitating Business and Investment Across the Globe

Examples and Best Practices

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The overall investment landscape is evolving rapidly, and investment structures continue to adapt to the ever-changing needs and objectives of stakeholders. And although such structures are typically tax driven, a successful investment architecture will address salient legal and business objectives as well. But regardless of the mix of concerns to be addressed, most investment structures make use of special purpose vehicles to achieve desired results.

Special purpose vehicle (or SPV) is a generic term used to refer to any legal entity that is set up to meet a specific business or investment purpose. The choice of entity and place of domicile of the particular SPV will vary depending on the facts and circumstances. For example, in some cases an onshore corporation will meet the exigent needs; in other cases, an offshore partnership; and, in others, perhaps a trust might be appropriate. But all SPVs have one thing in common: they are created to meet a particular business or investment objective.

The threshold question to address when contemplating the use of an SPV is whether one is actually necessary. The presence of extraneous entities in a business or investment structure adds cost, complexity and risk. A properly-drafted partnership agreement or set of corporate bylaws can sometimes obviate the need for additional legal entities. On the other hand, a far more common situation arises where an SPV is necessary but is somehow absent from the legal architecture. A “missing SPV” can cause a myriad of tax, legal and compliance issues.

Examples: Business/Investment Objectives in Forming SPVs

A few representative examples of business and/or investment objectives that can be met utilizing SPVs include the following.

Providing Liability Protection

Where it is conceivable that particular assets and/or activities could generate legal liability in the future, the assets and/or activities can and should be placed within an SPV to isolate that liability from affecting adjacent assets or activities. A common fact pattern calling for an SPV structure would be where multiple real estate parcels are owned outright by an individual (or a group of investors), or by and within the same legal entity. Without an SPV in place between the parcel(s) and the owner(s), a plaintiff with a legal claim against one of the parcels would have access to the aggregate value of all of the parcels under common ownership in seeking satisfaction of the claim.

If each parcel were instead owned within separate legal entities (each a lower tier SPV), and each lower tier entity was in turn owned by a common holding entity (the upper tier SPV), a plaintiff could seek damages solely against the value of the parcel giving rise to the claim. And note that if the lower tier SPVs are all limited liability companies (LLCs), and each is wholly owned either by the upper tier SPV or by the owners themselves, there would be no tax filing requirements on the part of the lower tier SPVs.

Facilitating Mergers, Acquisitions, and/or Pubic Offerings

The legal form and/or jurisdiction of domicile of an acquisition target can raise any number of business or tax issues for a potential acquirer. An acquirer has no control over the legacy legal structure of the target company ... whether it be a limited liability company (LLC), partnership (general or limited), corporation (C or S), etc. Where the existing legal format is problematic for an acquirer, pre-transaction tax structuring must often be employed to remedy the situation. And tax structuring will typically include the formation of one or more SPVs.

For example, an S-corporation is precluded statutorily from having C-corporation shareholders. But when a C-corporation seeks to acquire an S-corporation, the use of an intervening LLC, coupled with a simultaneous F-Reorganization and certain other steps, can sometimes allow the transaction to proceed. Another example would be where a privately-held partnership seeks to undertake an initial public offering (IPO). Public shares must be in the legal form of a C-corporation. However, liquidation of the partnership and reformulation as a corporation prior to the IPO can raise certain business issues and/or create tax inefficiencies. In this situation, an SPV in the form of a C-corporation can be created to own 100% of the partnership interests, and that corporation, in turn, goes public. This is commonly referred to as an "Up-C" structure.

Raising Public Capital

SPVs are extremely common in the alternative investment sphere. A timely example would be that of the special purpose acquisition company (or SPAC). An SPAC is an SPV in the form of a corporation, designed to aggregate investor capital and go public prior to merging in a target operating company. Utilizing an SPAC to access public capital is leaner, quicker, and less costly than the traditional IPO approach. SPACS burst on the scene during 2018, and since then over 272 have been taken public, representing over $88 billion of investor capital.

Other Alternative Investment Architectures

Co-invest vehicles are SPVs designed to allow additional capital to be invested alongside but remain segregated from a traditional private equity or venture capital investment. Sponsor funds are SPVs where the lead private investor or arranger first locates an investment or target company, and then forms an SPV to aggregate outside private capital. Co-invest vehicles and sponsor funds are almost exclusively pass-through partnerships or LLCs, acting as conduits between underlying investments and the ultimate investors. Investment results are determined and investor allocations are made within the SPV.

Structuring Cross Border Investment(s)

Both inbound and outbound investment structures will often utilize one or more SPVs in order to meet business or tax objectives. A common example would be where an offshore investor owns a U.S. trade or business that is operated through a U.S. domiciled corporation. Offshore corporate shareholders are deemed passive with respect to U.S. trade or business activity and, therefore, generally would not have a U.S. tax filing requirement. Conversely, an offshore partner in a trade or business that is operated as a partnership here in the U.S would be deemed to be participating in that activity directly and would, therefore, have a U.S. tax filing requirement.

Since offshore partners would typically prefer not to file U.S. tax returns, they will often set up an SPV in the form of a U.S. corporation to own their partnership interest. The intervening U.S. corporation converts the offshore owner's interest from active to passive and thus eliminates the annual tax filing requirement. This type of SPV is commonly referred to as a "blocker," since it "blocks" an adverse tax consequence.

Best Practices

The actions listed below help to ensure that an SPV meets its business objectives and ensures its viability.

Establish the Appropriate Legal Structure

Today, the limited liability company (or LLC) is very popular. This structure is designed to provide liability protection and tax benefits. The goal is to "ring-fence" or isolate the LLC's potential liabilities to the assets of the LLC and separate the LLC's assets from the owners' assets.

For income tax purposes, an LLC is a "flow-through" entity; in general, this means the members who own the LLC report their share of the LLC's income and expenses on their personal or corporate income tax returns. An LLC is required to have its own "Operating Agreement" which governs how the business is to be conducted; this and other offering documents, for example the private placement memorandum (PPM), help explain to potential investors the nature of the investment and the entity's business purpose.

Be sure to consult your professional advisors to help you determine and implement the optimal legal structure for your business and investment activity.

Obtain a Tax Identification Number (TIN) for Each SPV

This helps to delineate the business activities for each SPV and streamline tax compliance. Typically, once an LLC has two or more members (owners), the LLC is required to file its own federal and state income tax returns. Thus, the SPV is required to identify itself with its own TIN.

For an SPV to open a financial account with a bank or other financial institution, the entity must have a TIN.

Maintain a Separate Set of Books and Records for Each SPV

Often the SPV's activities are relatively straightforward; but nonetheless, it is important to maintain a complete set of books and records for the SPV's business activities. A set of books and records for the entity helps match revenue and expenses and measures performance, for example key performance indicators (KPIs). This helps guide management's efforts; provides more robust and accurate reporting to the SPV's owners and investors; and, facilitates preparing the entity's tax and other regulatory filings, financing and ultimately selling the entity or its assets.

Many SPVs use QuickBooks and sometimes Excel; although sometimes reporting the owners' shares (allocation) of the SPV's income and expenses to the SPV's owners and investors can be cumbersome.

Identify the Required Compliance Tasks and Requirements

Dodd-Frank and heightened investor scrutiny have raised the bar on key compliance, administrative, accounting and tax issues. One of the SEC's examination priorities is expense allocation – in other words, how the entity's managers fund the entity's costs and expenses and who is responsible for which activities. Some expenses are the responsibility of the managers (and the management company) while other costs and expenses can be borne by the entity and indirectly by the investors themselves. Examples of entity-level expenses include the entity's audit and tax returns and, under certain circumstances, the entity's accounting and reporting cost. In many cases, the SEC has levied fines for noncompliance.

Carry the Appropriate Type and Amount of Insurance

By purchasing insurance coverage for the risks and perils the SPV and its owners may face, the owners can protect their investment. This is especially important with real estate, as illustrated in the example described above.

Closely Track Filing and Reporting Deadlines

SPVs can be especially challenging because they often fly under the radar screen, remain dormant and unnoticed – until there's a problem. Many SPVs are established to make a particular, one-time investment (e.g., a private equity investment or an acquisition). The entity may or may not have investments (capital calls) after the initial investment. After that and absent financing costs (e.g., debt service), the SPV may be required to make only estimated tax payments, regulatory filings and the entity's administrative expenses every year. And sometimes an affiliate or management company funds these expenses on behalf of the SPV. Otherwise, an SPV might remain dormant for years until there's a material event (e.g., sale of the SPV's investment or sale of the SPV itself).

Sometimes, managers don't pay close attention to the SPV and deadlines slip through the cracks. Failure to handle an SPV's legal and regulatory requirements and burdens can lead to unnecessary late fees, fines and penalties and possibly a loss of reputation and investor complaints.

In Closing

Special purpose vehicles can be an attractive and economical way to facilitate and manage business and investment activities.

Contact Us

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