Establishing a new Venture Capital or Private Equity Fund

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How can selecting the right fund structure help new fund managers gain a competitive advantage?

When establishing a new Venture Capital or Private Equity fund, a compelling value proposition is essential. In the first of a series of three articles for new fund managers, designed to provide an overview of the fund establishment process, this article outlines popular fund structure options and explains how choosing the right fund structure can help new fund managers build a compelling value proposition and ensure a more successful capital raising campaign.

Fund structure options

There is no standard Venture Capital or Private Equity fund structure, although the internationally preferred structure is the limited partnership. In Australia, options for fund structure include bespoke unit trusts, Early Stage Venture Capital Limited Partnerships (ESVCLPs), Venture Capital Limited Partnerships (VCLPs) and Managed Investment Trusts (MITs).[1]

The most appropriate fund structure for a new Venture Capital or Private Equity fund will depend upon a number of factors, including:

- the size of the fund
- the investment strategy
- the sector, industry and stage of development of target portfolio entities
- the tax resident status and level of sophistication of the target investor group.[2]

Unit trusts and MITs

A unit trust structure can provide considerable flexibility and allow for bespoke fund structure design.

Funds structured as unit trusts are either managed by the trustee or have the investment management functions outsourced to a (often related) special purpose investment management entity. Investors in a unit trust obtain units and have rights and obligations governed by the unit trust deed.

Generic unit trusts are not subject to restrictions on the class of asset in which the fund may make an investment, restrictions on the quantum of such investments, any rules regarding compulsory diversification of the investment portfolio or the total fund size.

As a general rule, a unit trust is a tax flow-through vehicle, which means that income, profits, gains and losses of the trust flow-through to the unit holders who are then taxed according to their respective tax status.

Some of the key legislated tax concessions that are available to investors and the fund manager of a Venture Capital or Private Equity fund, structured as an ESVCLP or a VCLP, are not available in respect of a unit trust. Further, the ATO has recently released rulings indicating it will treat income from the disposal of assets by Private Equity funds on revenue account. However, if the trust qualifies as a MIT, it can elect to treat qualifying assets on capital account. MITs also have the benefit of a reduced level of withholding tax.

VCLP

The VCLP, which was introduced to encourage foreign investment in Australian venture capital, provides an exemption from income tax on profits (capital and revenue) from the disposal of eligible investments by certain foreign partners of the VCLP,[3] and treats the carried interest of the fund manager on capital account. The VCLP structure provides no such tax advantages for Australian resident investors, who would need to rely on case law principles to determine the status of any gains or profits realised.

Funds structured as VCLPs are either managed by the general partner of the limited partnership, or have the investment management functions outsourced to a (often related) special purpose investment management entity.

Footnotes:

1. This article does not deal with Listed Investment Companies.
2. The laws which govern fund structures in Australia are complex. It is beyond the scope of this article to comprehensively detail all material aspects of the relevant laws.
3. As a result of the introduction of Division 855 of the ITAA97, which exempts non-residents from Australian income tax in relation to capital gains from the sale of investee companies in defined circumstances, this benefit is now largely redundant for non-resident limited partners of VCLPs.

Investors in a VCLP obtain limited partnership interests and have rights and obligations governed by the limited partnership deed.

Unlike standard incorporated limited partnerships, the VCLP is a tax flow-through vehicle allowing distributions to be taxed in the hands of the investors. The ability to claim losses will depend on an individual investor's circumstances. One of the restrictions of VCLPs is that they must only invest in eligible venture capital investments, which broadly excludes investing in entities whose predominant activities include property development or land ownership, banking, providing capital to others, leasing, factoring, securitisation, insurance, construction or the acquisition of infrastructure facilities and making passive investments.

VCLPs must have a minimum fund size of AUD$10 million. There is no restriction on the maximum fund size of a VCLP.

VCLPs are generally used for mid-market Private Equity funds that are likely to target foreign investors.

ESVCLPs

With an ESVCLP, income and capital gains derived from, or from the disposal of, eligible venture capital investments are exempt from tax in Australia in the hands of both domestic and foreign investors.

The tax-free treatment is a significant legislative incentive which helps mitigate the risk of early stage venture capital opportunities, and has the potential to considerably increase a fund’s internal rate of return and assist it to attract a wider pool of investors. As with VCLPs, losses do not flow through to the limited partners.

Funds structured as ESVCLPs are either managed by the general partner of the limited partnership, or have the investment management functions outsourced to a (often related) special purpose investment management entity.

As with VCLPs, one of the restrictions of ESVCLPs is that they must only invest in eligible venture capital investments. Also, an ESVCLP must have an approved investment plan which demonstrates a focus on early stage venture capital.

Whilst the legislation does not define early stage, the starting point is that the gross assets of an investee at the time an ESVCLP makes its first investment in it must not exceed AUD$50 million. This relatively high threshold could include expansion stage investments.

The fund must be structured as a limited partnership and have committed capital of at least AUD$10 million and not more than AUD$100 million.

ESVCLPs are generally used for funds that are targeting Australian resident investors and that have an investment strategy that is focused on early stage high-growth opportunities.

Conclusion

The choice of fund structure has important implications for investors and fund managers alike, including:

- taxation treatment of investor distributions and the carried interest of the fund manager
- Australian Financial Services Licensing obligations
- levels and complexity of regulatory compliance, and
- the extent of restrictions on the fund’s investment strategy and size.

Together, these implications can impact revenue outcomes, internal rates of return and the composition of a fund’s ultimate investment portfolio. An astute decision on fund structure can help fund managers to improve their competitive advantage and assist to ensure a more successful capital raising campaign.

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The information included in this article is current as at 1 September 2011 and is not, and should not be substituted for, legal advice. Fund managers should seek professional tax and legal advice before making a decision on the most appropriate fund structure to use. The Board of Taxation is currently undertaking a review of all collective investment vehicles and, as at the date of publication, no recommendations had been handed down. The outcome of the review and any recommendations made may alter the information contained in this article.

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