

SPECIAL PURPOSE VEHICLES: USES AND ABUSES

April 2021 Update

I. Executive Summary

Special Purpose Vehicles (“SPVs”), or Special Purpose Entities, are interchangeable terms for a subsidiary company formed by a parent company, investment fund, family office, trust or other financial institution for a special purpose: as a vehicle to raise capital; to make investments; to hold assets; to isolate assets, liabilities, and risks from the parent company or fund (both legally and on the parents’ balance sheets); to securitize financial products; and to hold licenses and other assets or rights that may be subject to special regulatory requirements in mergers and acquisitions, joint ventures, or other business combinations or alliances. There are onshore and offshore SPVs, and a variety of jurisdictions and structures with differing attributes suited to facilitate a given special purpose. This advisory will discuss SPV uses and the structures and jurisdictions best suited to accomplish those uses, some of the domestic and international legal and regulatory regimes in place to combat SPV abuses, and how to avoid problems with U.S. and other jurisdictions’ legal, tax and regulatory authorities.

II. SPV Uses

- a. **Raising Capital.** SPVs are commonly used by venture capital funds, private equity funds, family offices, trusts and other financial institutions to raise capital for specific investment goals and isolate that capital from both the parent and other SPVs or ordinary subsidiaries held directly or indirectly by the parent. For example, a parent venture capital firm might form an SPV to invest in early stage biotechnology companies, and attract investors interested in that, while other SPVs owned by the same venture firm might focus on other industries and raise and invest capital from a completely different investor pool. In addition, the SPV is often able to borrow on more favorable terms than the parent could, since the SPV will typically use the assets it holds as collateral without the burden of the parent’s balance sheet. Domestic and offshore SPVs can be chained in ownership hierarchies to create “master feeder” structures that allow pooling of capital from different pools of U.S. and non-U.S. investors that will be jointly invested, and then used for the respective allocation of the returns on investment.

- b. **Securitization.** Both before and since the 2008- 2009 financial crisis, SPVs have been used to securitize bundles of loans and then sell tranches of those bundled loans to investors – for example, separating tranches of debt by seniority, maturity, and other risk profile characteristics, each of which may be separately attractive to different groups of investors. Once loan assets are transferred to an SPV, the SPV can issue its own debt, equity, or hybrid securities in different classes to effectively separate different risk pools of the loans it holds and market and sell the tranches to different investors.
- c. **Financial Engineering.** SPVs are commonly used to isolate assets and liabilities so as not to have them on the parent company’s balance sheet. Off-balance sheet accounting is used for manipulating the parent company’s debt-to-equity ratio, creditworthiness, and other accounting disclosures. Some of this use of SPVs has been the subject of post-financial crisis regulatory crackdown, but there are financial engineering uses of SPVs that remain within the bounds of U.S. Generally Accepted Accounting Principles (“GAAP”), as well as international accounting standards.
- d. **Financing.** An SPV can be formed to finance a new business or project without increasing the parent company’s debt burden and therefore debt-to-equity ratio. In addition, when an SPV finances with its equity, the equity of the parent’s shareholders is not diluted. As discussed in section II (a) above, an SPV can also allow targeted investing with the capital raised in specific projects, businesses and industries without the parent company directly invested, thereby exposing its balance sheet.
- e. **Holding Illiquid Assets and Asset Transfer.** SPVs can be used to hold illiquid assets, often single assets or related groups of assets. The SPV can then be transferred intact, carrying its other assets with it and on a “take it or leave it” basis, without the burdensome aspects of an asset sale, in which assets may be cherry-picked by the buyer.
- f. **National Licenses.** In both the United States and many non-U.S. jurisdictions, certain sensitive industries such as telecommunications and media, aerospace and defense, food and drugs, and information technologies, are required by domestic law to allow national licenses necessary to engage in those industries to be held by entities whose equity is in whole or in part owned by domestic shareholders. Some regulations have complicated debt and equity “attribution” rules used to assess compliance. An SPV can be used to isolate such national licenses in a compliant entity, irrespective of the parent business, joint venture, or other structure’s ownership.

III. SPV Structures and Jurisdictions

SPVs vary in structure by jurisdiction. In the U.S., the limited liability company (“LLC”) and the limited partnership (“LP”) structures are commonly used. Both are structures authorized by state corporate laws, and generally combine the limited liability protection for shareholders of a corporation (shareholders, in the absence of some kind of fraud, are only liable to the extent of their capital contributions) and the “pass-through” taxation of partnerships (no taxation at the business level; taxes on profits and losses are “passed through” to the equity holders, in the SPV case, generally the parent or parents). Corporations are less favored, in large part because they are taxed at the corporate level, although the impact of the 2017 Tax Cut and Jobs Act, which lowered the U.S. federal corporate tax rate to a flat 21%, has yet to be measured and is intended to be raised to an as-yet unknown amount by the Biden administration.

Outside the U.S. (generally called in this context “offshore”), the different laws and tax regimes of these jurisdictions have given rise to elaborate and colorfully named structures, such as the “Double Irish Dutch (or Dutch Antilles) Sandwich,” a strategy to move profits from higher tax rate jurisdictions to a lower tax rate jurisdiction, impairing the higher rate jurisdiction’s tax base (called “base erosion and profit-shifting”) tax avoidance structure that used a loophole in Republic of Ireland tax law to avoid taxes by “sandwiching” a Dutch or Dutch Antilles company between two Irish subsidiaries in a vertical chain of ownership. The tax loophole was closed in 2015 (although existing structures, including some of the biggest names in the U.S. tech sector, had until 2020 to comply), but new structures have taken its place (for fans of the colorful structure names, one of the principal new ones is called “the Single Malt”).

A few examples of these offshore jurisdictions, structures and their frequent uses are:

- a. British Virgin Islands. The British Virgin Islands, usually abbreviated “BVI,” is a British territory in the Caribbean Sea east of Puerto Rico, and is one of the most popular offshore financial centers in the world. Approximately 40% - over 400,000 – of the world’s offshore companies are BVI BCs. Virtually all the BVI population lives on the largest island, Tortola, which is home to the capital, Road Town. BVI uses the U.S. dollar as currency, is English-speaking, and uses the English Common Law legal system. BVI Business Companies (“BCs”) “limited by shares,” the preferred SPV corporate form under the governing BVI Business Company Act of 2004, are full legal entities able to engage in a range of business activities, including finance and insurance and hold accounts at BVI banks. BVI BCs are exempt from

BVI income tax on profits, capital gains, dividends, rents, royalties, and many other charges. BC shares are also exempt from estate or gift taxes, and, with the exception of land ownership transactions, all transactions by a BVI BC are exempt from stamp duty. A BC is required to have only one shareholder (who need not be a beneficial owner), one beneficial owner, and one director, all of whom can be the same natural person, and who need not be a BVI citizen or resident, making a BVI BC a natural subsidiary of a U.S. corporation, LLC or other business entity. No officers are required, and if none are appointed, the director or directors act in a managerial capacity. BVI BCs are extremely confidential; BVI is not a party to international information-sharing agreements. The BC's corporate charter, its "Articles of Association," is the only document on public record, but they usually do not indicate names of shareholders, beneficial owners, or directors. BC minutes, resolutions, and consents are not public, and are generally maintained by the BC's registered agent. Corporate governance is extremely flexible (not even an annual meeting is required), and shareholders' and directors' meetings unfortunately need not be held in the British Virgin Islands, and can be held by telephone or by proxy. Finally, a BVI BC need not prepare, maintain, or file any financial records or accounts, audited or otherwise, as long as records sufficient to show the BC's transactions are maintained; however, the records need not be maintained in the BVI.

- b. The Cayman Islands. The Cayman Islands are another English language, English legal system offshore destination in the western Caribbean Sea. The Caymans share virtually all of BVI's tax exemptions and corporate governance flexibility features. Some analysts consider the Cayman confidentiality rights somewhat less protected by local regulatory structure than in the BVI. Nevertheless, the Caymans have emerged in particular as a major offshore banking center, with, like the Bahamas, nearly 300 banks and holding, as of 2016, shadow banking assets over 2,000 times the Island's GDP. The Caymans are also a major home for the insurance industry (as is Bermuda), and host of an estimated 75% of the world's hedge funds and half the hedge fund industry's assets under management, and other alternative investment vehicles, often structured in hierarchical "master feeder" chains as previously described. The Caymans, like BVI, allow the formation of segregated portfolio companies, especially useful for mutual funds and similar investment vehicles. Unlike the BVI, Cayman investment funds must generally be locally audited.
- c. Curacao. Curacao, the largest of the former Dutch Antilles (dissolved in 2010), located in the southern Caribbean Sea, has long been a popular jurisdiction for offshore holding company/SPV structures, most famously the afore-mentioned "Dutch Antilles Sandwich," in which an Antilles

company, usually a Curacao NV (“Naamloze Vennootschap” - a public company, like an American public corporation), is formed to hold shares in a subsidiary Dutch BV (“Besloten Vennootschap”- a private, limited company, equivalent to an LLC, a German GmbH, or a French SaRL). The resulting structure can access the wide Dutch tax treaty network and permits the tax-advantaged receipt and holding of dividends from worldwide operations. The official language is Dutch, but English is widely spoken, and the corporate charter (“Articles of Association”) may be in any language and format. NVs and BVs have no minimum capital requirement, can have one shareholder and director (who can be the same person) can be 100% foreign-owned, and can elect tax-exempt status if they accept disclosure of beneficiaries and activities, realize income only from investments and related activities and licensing of intellectual property rights (Curacao sunset its general tax exempt regime in 2019). Also, companies engaged in international e-commerce are taxed at 2% and export companies at 3.2%, making Curacao and attractive destination for those activities. Up to 5% of total revenues can under certain circumstances be tax exempt to qualifying shareholders if paid as dividends. Curacao has no withholding tax, so dividends can be delivered to shareholders of whatever domicile without withholding. Also, very usefully for advanced structuring, Curacao permits seeking advance tax rulings, usually valid for five years, to determine whether a given structure is a “permanent establishment” and otherwise qualifies for Curacao tax exemptions on foreign profits. Annual shareholders meetings are required, but audits are not. Annual financial records must be maintained, but need not be filed.

- d. Singapore. Singapore has become the go-to jurisdiction for SPVs focused on Asian investments, for hedge funds, family offices and other investment firms. Singapore is English-speaking and has an English Common Law-derived legal system, which continues to refer frequently to English law precedent. The currency is the Singapore dollar, the tax system is flexible, bureaucracy and corporate governance requirements are minimal, and the local infrastructure is better than North American and European standards. Singapore also benefits from ready access to China, Japan, South Korea, Australia, Malaysia, Indonesia, and Southeast Asia, and lawyers, accountants, and other advisors commonly work with clients throughout the region. Traditionally, U.S. and other non-Singapore investors form a “Pte. Ltd.” company, a private company limited by shares and with at least one, but no more than fifty, shareholders. Shareholder liability is limited to paid-in capital, and dividends paid to shareholders are not taxable. Shareholders and foreign directors are eligible for an employment visa, which helps with parent company secondments to the Singapore subsidiary. At least one director and one corporate secretary must be a Singaporean citizen, and there must be a Singapore registered, non-

p.o. box, address. However, effective January 14, 2020, Singapore introduced a new business form, the “Variable Capital Company,” or “VCC,” to provide a more flexible and confidential alternative for offshore funds than provided by the traditional Pte. Ltd. VCCs, as the name indicates, permit variable classes of shares and vertical chaining of VCCs, allowing for, for example, structuring for the Asian investor pool end of an onshore/offshore “Master Feeder” open-ended or closed-end fund structure. VCCs must maintain a shareholder registry, but it need not be publicly disclosed. Singapore is also used as a buy-sell hub for tax-advantaged corporate restructurings (see our “Restructuring a Multinational Corporation to Optimize Profitability and Efficiency,” available on our website at <https://kurtinlaw.com/articles-whitepapers/>).

These are just a few examples of the offshore jurisdictions available and some of their features and common uses. Others include the Bahamas, Belize, Bermuda, Cyprus, the English Channel islands Guernsey and Jersey, the Republic of Ireland (until recent U.S. tax changes, the leading jurisdiction for offshore profit-shifting by large public corporations like Apple, Google, and other technology sector giants), Luxembourg, Nevis, and Malta, each of which has their own attributes. Structuring of an offshore business, whether subsidiary or standalone, should be done by U.S. counsel and accountants working in cooperation with their offshore jurisdiction counterparts. Use of “offshore-company-in-a-box” kits available on the Internet is no more advisable than downloading forms for significant transactions, and can lead to significant liabilities and/or not achieve the business purpose sought.

IV. Legal and Regulatory Cautionary Notes

Particularly since the financial crisis of 2008 - 2009, both the United States and multinational authorities have enacted measures to combat tax evasion, money laundering, bank secrecy, and other criminal activity for which SPVs have sometimes been used. ***That does not mean than SPVs cannot be used for tax-efficient business and personal financial structuring, nor for other business efficiencies, but it does mean that greater care must be taken to avoid crossing the line of illegality than was perhaps the case in the past.*** To avoid crossing the line, U.S. legal advisors and advisors from the offshore jurisdictions must work together, along with tax and/or accounting advisors. Among the post-financial crisis measures to consider when structuring offshore SPVs (and this is a non-exclusive list) are:

- a. The 2017 Tax Cut and Jobs Act (the “2017 Tax Act”) discourages U.S. businesses with substantial multinational operations from maintaining cash income in overseas tax havens like the Republic of Ireland to avoid U.S. taxation if and when the cash was “repatriated” to the

United States. The 2017 Tax Act deters so-called “inversions” with the “deemed” repatriation over eight years of currently deferred foreign profits at a rate of 15.5% for liquid (cash and cash equivalent) profits and 8% for illiquid (reinvested foreign) profits. This is a step towards “territorial” taxation, in which earnings are taxed where earned, as most tax jurisdictions do, and are not subject to U.S. worldwide taxation, as practiced now. The 2017 Tax Act also eliminates federal income tax on dividends received by a U.S. corporation from a 10% owned non-U.S. subsidiary. The 2017 Tax Act further discourages inversions by imposing excise taxes on insiders of U.S. corporations that expatriate to non-U.S. jurisdictions, and taxes dividends paid to domestic shareholders of the foreign company at ordinary income rates. Finally, the 2017 Tax Act imposes a minimum tax of 10% on income of certain domestic corporations before allowing deductions for interest, royalties, and other payments by the domestic corporation to foreign affiliates. Sections of the 2017 Tax Act are the subject of intended repeal or modification by the new Biden administration, which wants to raise the corporate tax rate to something above the 21% rate set by the 2017 Tax Act, but which may leave other parts of 2017 Tax Act intact, including likely the inversion-discouraging provisions. The Biden administration also seeks to raise capital gains tax rates to the same or nearly the same levels as ordinary income tax rates, and to eliminate the “carried interest” loophole for hedge fund and other private equity management fees, by which those fees are taxed at the lower capital gains rate, instead of as income.

- b. The Foreign Account Tax Compliance Act (“FATCA”) requires non-U.S. financial institutions to report on accounts held by U.S. taxpayers, and requires U.S. financial institutions to withhold a portion of payments made to non-U.S. financial institutions that do not comply.
- c. The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) was enacted in the U.S. in the immediate wake of the financial crisis to improve financial institution stability, transparency, and reduce the risk of systemic failure, as well as to provide enhanced consumer protections. Although Dodd-Frank is wide-ranging, for the purposes of SPV use, it notably requires many private equity and hedge fund managers to register as financial advisors for the first time and enhances disclosure and reporting requirements for alternative investment vehicles. Congress relaxed some of Dodd-Frank’s restrictions in 2018.
- d. The Basel III Accords are a global standard on bank regulation that have tightened standards for bank capital reserves and liquidity to reduce systemic risk to financial institution stability,

improved disclosure, and institution-wide supervisory standards, to prevent the stereotypical rogue trader from sinking his or her institution.

- e. U.S. and International Accounting Standards have been tightened and to some extent harmonized in response to the financial crisis. The International Financial Reporting Standards (“IFRS”) require that an SPV’s assets be consolidated with its parent if the SPV is controlled by it, with “control” established by a multi-part test, including whether the parent has the majority of risk and benefit from the SPV’s activities, whether the parent undertakes activities on the SPV’s behalf, and whether it effectively controls, or manages, the SPV. U.S. GAAP has moved towards the IFRS standard, and has dropped the assumption that SPV assets and liabilities should appear off the parent balance sheet in favor of a similar “effective control” analysis.

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