

A client's guide to property joint ventures - Common structures and traps for the unwary

1. Introduction

This article provides an overview of the most common property joint venture structures and their respective advantages and disadvantages, as well as considering some common issues which arise in connection with property investment and development joint ventures.

2. Overview of types of structure

2.1 The main types of joint venture structure are:

2.1.1 Partnership based structures:

- (a) General partnerships (including contractual joint ventures)
- (b) Registered limited partnerships
- (c) Limited liability partnerships

2.1.2 Private limited companies

2.1.3 Unit trusts

2.2 There are of course numbers of other vehicles that might be of relevance. For example, it may be attractive to use offshore vehicles for tax structuring purposes. Alternatively, certain types of investor may wish to acquire investments in vehicles which are listed on a recognised investment exchange. These types of structure are beyond the scope of this article, which instead focuses on those onshore vehicles which are encountered most frequently in practice.

3. Selecting the Vehicle

There are a number of factors which will need to be taken into account when structuring a joint venture:

3.1 *Nature of the Project*

Is this a development or investment project? What is the size of the deal? A relatively small transaction is unlikely to bear the costs associated with more complex structural arrangements.

3.2 *Relationship between the parties*

Long term business partners may be perfectly happy with a partnership structure in which they are jointly and severally liable for partnership debts, but that is unlikely to be appropriate where there are a number of passive investors.

3.3 *Tax*

Tax considerations will, whilst not necessarily the sole determining factor, be an important consideration in any joint venture structuring. Relevant points to consider include:

3.3.1 Should the vehicle be tax transparent?

3.3.2 Is it appropriate and/or feasible to try and use an offshore vehicle?

3.3.3 Can an SDLT saving be made through the use a particular type of vehicle?

The vehicle used can have a significant impact upon the tax liabilities of the joint venture partners and it is essential that tax advice is taken before the structure is put in place. Changing the structure at a later date may, in itself, give rise to tax liabilities.

3.4 *Limiting Liability*

Is it important to have a vehicle which offers participants limited liability and the ability to ringfence losses and liabilities in the joint venture?

Property joint ventures in particular can expose participants to numbers of potential hidden liabilities - for example, the law can impose a statutory obligation on owners to undertake extensive remediation work of contaminated land.

Of course, the benefit of limited liability offered by a number of structures may be restricted in many cases if a funder, landlord or other creditor insists upon the provision of guarantees or other personal security.

3.5 *Liquidity and Flexibility*

Is it important to have the flexibility to change the relative interests of the parties and/or bring in new investors? The eventual exit route also needs to be considered. If it is possible that the vehicle itself will be sold rather than the property, then that is likely to rule out certain types of structure.

3.6 *Funding*

Consideration needs to be given as to the manner in which the joint venture will be funded. For example, a limited company gives the flexibility to create different types of share capital and loan capital and is also able to offer a full security package to funders.

3.7 *Management and control*

The expectations of the parties as to management and control of the vehicle will also impact upon the choice of vehicle. Does the traditional limited company division between shareholders and the board suit the parties, or will all investors be involved in the day to day management?

3.8 *Confidentiality*

Are the participants concerned about any information regarding the joint venture being in the public domain?

4. Vehicle 1: General Partnerships (and contractual joint ventures)

4.1 General partnerships are governed by the Partnership Act 1890. There is no particular formality required to form a partnership, a partnership arises when two or more people carry on a business with a view to profit.

4.2 Similarly, there is no need to register a partnership or formally declare to the outside world that it has been formed. A partnership can arise simply from the conduct of the parties. It is possible that two individuals co-investing in property projects will as a matter of law be carrying on a partnership, regardless of whether they hold themselves out as partners.

4.3 If a joint venture is carried on through a partnership, then the joint venturers will be jointly and severally liable for all debts of the joint venture. The partners cannot ringfence losses and liabilities in the joint venture.

4.4 A partnership is tax transparent - each partner is liable to tax on their own share of both income and capital profits and no tax is assessed on the joint venture itself.

4.5 A particular advantage of a partnership is that there is no obligation to file accounts or annual returns at Companies House, so the joint venture affairs can be kept confidential. There is also no requirement to have the joint venture accounts audited.

4.6 A significant disadvantage of a partnership structure however is the absence of a separate legal entity with its own externally recognisable management structure in which the assets and liabilities of the business can be vested and which can raise finance (including creating fixed and floating charges as security). Of course, that is not to say that a partnership cannot own assets or raise finance, but the absence of a separate legal entity does complicate the process.

4.7 In the context of partnerships, it is also worth touching briefly on contractual joint ventures. A contractual joint venture involves two or more individuals or entities agreeing contractually to co-operate in some way in relation to a project. As such they have largely the same characteristics as a partnership and the same advantages and disadvantages. In fact most will involve the sharing of revenues, costs or profits and will therefore constitute a partnership, even if the joint venture agreement states otherwise.

5. Vehicle 2: Limited Partnerships

5.1 Limited partnerships are governed by the Limited Partnership Act 1907, and need to be registered at Companies House.

5.2 A limited partnership will have both limited partners and a general partner. The liability of limited partners is limited to their capital contributions to the partnership. Capital contributions are therefore generally limited to a nominal amount, with the limited partners making further funding available by way of loan.

- 5.3 In order to benefit from limited liability, the limited partners are not permitted to have any involvement in the management of the partnership business. The general partner has unlimited liability for the partnership debts and will be the entity which runs the partnership business and enters into contractual obligations on behalf of the limited partnership. A limited company is usually used to act as the general partner which protects the underlying investors from personal liability.
- 5.4 As with a general partnership, a limited partnership is tax transparent (see paragraph 4.4 above).
- 5.5 Limited partnerships are not a particularly attractive vehicle from a liquidity point of view. Although further partners can be introduced into the structure, it is not as straightforward as, for example, allotting shares to a new investor in a limited company. It is also unlikely that a purchaser of the property would consider acquiring the interests in the limited partnership instead, whereas they may well be prepared to acquire the shares in a limited company.
- 5.6 Onshore limited partnerships were at one time a popular vehicle for property joint ventures, but with the advent of LLPs (discussed below) they have been used less frequently for genuine joint ventures. They are however still relatively common for investment funds.
- 5.7 One benefit of limited partnerships is that they are not subject to the Companies Act compliance regime in the same way as limited companies and LLPs, so generally they will not have to, for example, file annual accounts. However, in truth even that is not as straightforward as it might be as some or all of the partners (in particular the general partner) may themselves be onshore limited companies and therefore subject to the Companies Act regime.

6. Key Issue 1: Collective Investment Schemes

- 6.1 As well as offering an overview of the different types of structure which can be used, this article also considers some particular traps for the unwary in the context of property joint ventures. The first of these is the rules on Collective Investment Schemes (“CISs”) under the Financial Services and Markets Act 2000 (“FSMA”).

The offence

- 6.2 CISs are defined in section 235 of FSMA as follows:

“Any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income”.

- 6.3 Broadly speaking, a property joint venture arrangement will constitute a CIS if some or all of the investors do not have day-to-day control over the management of the property, and either the contributions and profits are pooled or management of the property as a whole is carried out by or on behalf of the operator of the scheme.
- 6.4 Many property joint ventures therefore fall within the scope of the legislation and it is easy to unwittingly operate an unauthorised CIS. This will commonly arise where a number of passive investors are participating in the arrangements who have no intention of participating in the management of the joint venture business

themselves. They are effectively investing in the skill and experience of the project manager (who would be the operator of the scheme in this context).

- 6.5 Although this type of scenario, perhaps involving high net worth and/or sophisticated investors jointly investing in property development and/or investment, may not be the type of arrangement which the legislation is designed to catch, the legislation is broadly drafted enough for this to be a problem in practice.

Consequences

- 6.6 The consequences of establishing and running an unauthorised CIS are serious. It is a criminal offence, the arrangements are unenforceable by the operator and the participants may recover both their investments from the operator of the scheme and compensation for loss.
- 6.7 Even leaving aside the prospect of criminal liability, there is a risk of a claim against the operator of a scheme falling within the rules (usually the property developer managing the development) from the passive investors should the project be less successful than anticipated.

Managing the risk

- 6.8 One way of avoiding the application of the CIS rules is to structure the arrangements so that all participants have day to day control over the management of the property. That does not mean that everyone has to be on site every day or that certain functions cannot be delegated to agents or employees, rather that investors must genuinely be involved in management. The mere fact that they have a right under the joint venture documentation to be consulted or to give directions will not in itself be sufficient.
- 6.9 Alternatively, the legislation in relation to CISs does contain a number of exceptions. A number of these are unlikely to be relevant to most property joint ventures. However, two exceptions which may apply are:

6.9.1 The existing business exception

This exception applies where the participants already carry on an existing business, and enter into the arrangements for commercial purposes wholly or mainly related to the first business. This could apply, for example, if the participants carried on a trading business and acquired the property to use in that business. It could also apply if the individuals are already carrying on a property investment or development business.

6.9.2 Limited company

A limited company (other than an Open Ended Investment Company) is not a CIS. So a typical structure involving the investors subscribing for shares in a limited company and the board of directors managing the business will not constitute a CIS.

- 6.10 If the joint venture arrangements do clearly fall within the definition of a CIS and no exemptions are available, then another option is to appoint an FSA authorised person to operate the scheme. There are numbers of providers of this type of service, although appointing an authorised person to operate a scheme will inevitably add to the cost and compliance burden of the joint venture.

- 6.11 Finally, the participants could consider setting up and operating the structure offshore so that the arrangements fall outside the territorial scope of FSMA (although the joint venture will of course be subject to any similar legislation in the jurisdiction in which the operator is located). Once again this will add to the cost and complexity of the arrangements and may not be suitable for all joint ventures, particularly if participants are based in the UK.

7. Vehicle 3: Limited Liability Partnerships (“LLPs”)

- 7.1 LLPs were introduced by the Limited Liability Partnerships Act 2000 and are essentially a hybrid between partnerships and companies. LLPs are separate legal entities and the members' enjoy limited liability, their liability being limited to their contribution to the capital of the LLP. In fact there is no legal requirement for members to contribute any capital to the LLP and for that reason funding is commonly provided by the members by way of loan.
- 7.2 One particular advantage that LLPs have over limited partnerships is that members of an LLP can be involved in the management of the LLP's business without losing their limited liability.
- 7.3 Although an LLP is a separate legal entity, it is transparent for tax purposes. So the LLP itself is not taxed on the income and capital profits it makes, but the members are taxed on their shares of those profits. This tax transparency has made LLPs extremely popular in recent times as a property joint venture vehicle (although it is not always the case that using an LLP will result in a lower tax bill than a limited company).
- 7.4 Unlike, say, a general partnership, LLPs can grant a full security package to funders, including floating charges, which individuals are not able to do. On the other hand, LLPs are subject to the same filing requirements as companies and so need to file annual accounts and returns at Companies House, as well as details of changes of members and other prescribed information. That means that information relating to the joint venture will be in the public domain if an LLP is used.

8. Key Issue 2: Property Investment Partnerships and SDLT

- 8.1 Another potential trap for the unwary in the context of partnership structures is stamp duty land tax, or SDLT.
- 8.2 Schedule 15 Finance Act 2003 contains complex provisions imposing charges to SDLT in certain situations, including where there are changes of partnership interests in “*property investment partnerships*”.
- 8.3 A property investment partnership is defined as “*a partnership whose sole or main activity is investing or dealing in interests in UK land, whether or not the activity involves construction activities on the land in question*”. “Partnership” for these purposes includes general partnerships, limited partnerships and limited liability partnerships, and so property joint ventures carried on through one of these structures can fall within the scope of this definition.
- 8.4 Whilst most people are aware that an SDLT charge may arise on the purchase of a property or an interest in property, many are unaware of the potential for a charge to arise when there are changes in partnership interests in a partnership that invests or deals in land. A charge could arise in the following circumstances:

- 8.4.1 where an existing partner sells some or all of their share to a new or existing partner;
 - 8.4.2 where a person becomes a partner or increases their existing share in the partnership and one or more existing partner(s) reduce their partnership share (or retire from the partnership); and
 - 8.4.3 where the partners change their profit shares.
- 8.5 Perhaps somewhat surprisingly, the rules apply when there is a change in the proportions in which the partners share in the *income* profits of the partnership. This is not what one would necessarily expect given that SDLT is usually payable when a capital disposal is made.
- 8.6 Broadly speaking, in order for a charge to SDLT to arise in these circumstances there needs to be either (a) a payment (not necessarily in cash) being made by the person acquiring the share or increased partnership share; or (b) a withdrawal of money from the partnership by the partner selling or reducing their share.
- 8.7 If the rules do apply then there are detailed provisions for calculating the amount of SDLT payable.
- 8.8 The rules on SDLT and “*property investment partnerships*” are complex. The text above only summarises them briefly and cannot offer a comprehensive analysis, but it is essential for anyone considering a property joint venture structured through a partnership, limited partnership or LLP to be aware of the potential for charges to SDLT to arise other than on the sale of property, and to take advice before implementing any sales or transfers of partnership shares or changes in profit shares if the rules may apply.

9. Vehicle 4: Limited company

9.1 *Overview*

- 9.1.1 The limited company is probably the most familiar of all the vehicles which may be used. Investors and lenders are likely to be comfortable dealing with a limited company, and of course a limited company is a separate legal entity with limited liability - so, unlike in a general partnership, the shareholders in a limited company will be able to ringfence any losses and liabilities relating to the joint venture.
- 9.1.2 Furthermore, if using an onshore company, the joint venture vehicle will be subject to a general body of company law, principally contained in the Companies Act 2006, which is generally recognised and understood and which offers a strong layer of residual protection for investors and lenders. Lenders will also benefit from the fact that a limited company can offer a full security package including granting a floating charge over its assets.
- 9.1.3 However, there are of course disadvantages to the use of a limited company – for example the 2006 Act imposes a layer of regulation which does not apply to partnerships. This has consequences in terms of confidentiality (various filings will need to be made publicly available, including year end accounts) and imposition of legal obligations such as directors’ duties (discussed in more detail below).

9.1.4 The flexibility of a share capital structure means that it is relatively easy to introduce new equity capital into the joint venture. In terms of an exit, it is easier to sell or float an interest in a company (including the entire membership interest, i.e. the entire issued share capital), than in a limited partnership or LLP.

9.2 *Tax Issues*

9.2.1 Although a detailed look at tax rules is beyond the scope of this article, there are two points of general principle worth noting here.

9.2.2 First, there will be a stamp tax advantage on the sale of shares in a company which owns property assets, as opposed to a sale of the properties themselves. Depending on the value of the properties SDLT will probably be charged at 4%, whereas share transactions worth over £1,000 attract stamp duty at 0.5%, regardless of the value of the underlying property assets.

9.2.3 Secondly, using a company is likely to give rise to a double charge to taxation. A company will pay corporation tax on any profits it makes, and there will also be a charge to tax when it distributes money into the hands of shareholders by way of dividend (or salary/bonus). This lack of tax transparency does not automatically mean however that the overall tax burden will be greater if a limited company is used. This will depend on various factors, including the rates at which the limited company pays corporation tax and at which the shareholders pay income tax.

9.3 *Offshore companies and listed companies*

9.3.1 This article focuses primarily on English private limited companies but it is of course possible to use offshore companies and this may be attractive in certain circumstances for tax structuring purposes.

9.3.2 Equally, there are numbers of quoted property investment and development companies both in the UK and in other jurisdictions. There will obviously be additional regulatory issues for these companies by virtue of their quoted status which are not covered in this article, and an investor will also need to bear in mind that the value of an investment in a listed property company may be affected by factors other than the general state of the property market and that particular company's business – for example, shares in a listed company will be subject to price pressures which affect equity markets generally (and which may be largely irrelevant to private companies), and generally tend to trade at a discount to net asset value.

10. Key Issue 3: Directors' Duties

10.1 *Background*

10.1.1 All directors of English companies are subject to directors' duties, which are owed to each company of which an individual is a director. These are imposed on directors under both the Companies Act 2006 and general common law principles. Some of the key duties imposed on directors include a duty to act in good faith to promote the success of the company, a duty to avoid conflicts of interests, and a duty of confidentiality.

- 10.1.2 These duties are owed by directors to the company itself (generally considered to be represented by the shareholders as a body, at least while the company is solvent), rather than to other directors or any particular shareholder. Any breach will need to be enforced by the company, so this will generally be at the discretion of the board or the shareholders (although see section 10.2.7 below). If no action is taken one or more shareholders can apply to court for approval to bring an action on behalf of the company.
- 10.1.3 The consequences of a breach of directors' duty can be serious in financial terms but a breach of directors' duties in itself will only lead to civil, not criminal, consequences.

10.2 *Joint venture issues*

- 10.2.1 Directors' duties are particularly relevant in a joint venture context for two main reasons.
- 10.2.2 First, often the directors of a joint venture company will effectively be nominees for a shareholder. This immediately puts those directors in a position where they have a potential conflict of interest between their duties to the joint venture company, and their duties to the shareholder they are representing.
- 10.2.3 Secondly, directors of property joint venture companies often hold numerous directorships of property companies, some of which may have no direct or indirect interest in the joint venture. Again, these directors are immediately putting themselves in a position where there is a potential conflict between their duties to these various companies.
- 10.2.4 One potentially serious problem which we often come across in practice is where a director of one property company seeks to exploit a new property opportunity through another company. This may be for entirely legitimate reasons, for example his co-directors may feel that the new opportunity is unsuitable for the existing business. Even so, it is important to ensure that issues of directors' duties are properly dealt with at an early stage. If this is not done then the worst case scenario is that the director could be required to give an account of profits in respect of the new venture.

10.3 *Managing the Risk*

- 10.3.1 English law struggles with the concept of directors' duties in joint venture and corporate group situations. It is difficult in practice to reconcile, say, two separate duties of confidentiality owed to companies in the same market sector. A director cannot simply forget information obtained in one board meeting when he goes to the next.
- 10.3.2 Whilst there is no neat solution to these problems, it is possible to mitigate the risks. Steps that might be taken include:
- (a) Ratification of any actual or potential conflict of interests which the director may have (by either the board or the shareholders, depending on the precise requirements of the situation).

- (b) Obtaining informed and documented consent from the shareholders of existing companies to the pursuit of an opportunity outside that company.
- (c) Including appropriate provisions in the joint venture agreement (and where relevant the articles of association of the joint venture company) to, for example, limit the scope of possible activities of the joint venture company.
- (d) Taking steps to limit appropriately a particular director's access to board papers and deliberations on certain issues.

10.3.3 There is no single solution for resolving conflicts of interest and the approach will need to be tailored to the particular circumstances. However, in general terms if a director ensures that appropriately documented informed consent is obtained from shareholders of all relevant companies in advance of undertaking any potentially conflicting activities then this will go a long way to mitigating any risk of personal liability which might arise.

11. Vehicle 5: Unit Trusts

- 11.1 The unit trust is a variation on the basic common law trust concept. The unit trust has no separate legal personality. All assets of the Trust are legally held by the trustees, with the beneficial ownership of the Trust divided into units owned by unitholders. This is a similar structure to share capital in a company, and has the same advantages of liquidity and flexibility.
- 11.2 There are a number of types of unit trusts, based both onshore and offshore, some of which have been specifically established for use in property investment. Examples include:
 - 11.2.1 Onshore authorised property unit trusts (UK based unit trusts authorised by the FSA to promote and sell to retail investors)
 - 11.2.2 Onshore unauthorised property unit trusts
 - 11.2.3 Offshore property unit trusts (for example, Jersey Property Unit Trusts or "JPUTs")
- 11.3 The tax regime which applies to unit trusts will differ according to the particular tax status of the trust concerned. However, many types of trusts set up for the purposes of property investment will benefit from rules designed to try and ensure an element of tax transparency for investors and eliminate the double taxation issue which arises with companies, discussed above at paragraph 9.2.
- 11.4 As with partnerships, property unit trusts will constitute collective investment schemes if they fall within the territorial scope of FSMA and the other legislative requirements are met, and accordingly the concerns discussed in section 6 above will apply.
- 11.5 Unit trusts can be combined with other vehicles which this article has considered. For example, rather than the trustees of the unit trust holding property directly, they may be the limited partner in a limited partnership which actually owns the property.

11.6 One potential drawback of unit trusts is that they do involve an additional layer of structuring. For example, a unit trust structure might involve a professional trustee who acts as trustee. Although that trustee will hold legal title to the trust assets there will then need to be a separate property management or development agreement dealing with the running of the underlying property business.

12. Issue 4: Financial Promotions

12.1 As has already been seen in relation to CISs, there are provisions in the Financial Services and Markets Act 2000 which can operate as a nasty trap for the unwary. Another example of this is the financial promotions restriction. The basic rule under the Act is that a person “*must not in the course of business communicate an invitation or inducement to engage in investment activity*”.

12.2 This basic rule is simple enough, but there is a significant amount of underlying guidance as to how the various constituent parts of that rule should be interpreted.

12.3 For the purposes of this article however, we will assume that if an investor is marketing shares in a property joint venture company to a circle of potential investors (or indeed investments in any structure constituting a CIS), at some point that person will be making a financial promotion.

12.4 The consequences of breaching this restriction are serious. It is a criminal offence and can be punished by up to two years imprisonment.

12.5 There are two main ways in practice in which we normally see the financial promotions restriction being dealt with.

12.5.1 *Authorised Person*

The financial promotion restriction will not be breached if the relevant communication is made or approved by an FSA authorised person. This may be an attractive route for vehicles which are CISs and have already appointed an authorised person as operator.

12.5.2 *Exemptions*

(a) There is also a lengthy list of statutory exemptions in the Financial Promotions Order (SI 2005/1529) which do not rely on the involvement of an authorised person. Some are of general application, whilst others will only be of assistance in very specific circumstances.

(b) The two which are perhaps most relevant generally are the ability to make financial promotions to sophisticated investors, and also high net worth individuals, companies or unincorporated associations. As one would expect there are numerous conditions which need to be fulfilled in order to rely on these exemptions, but they are frequently relied on in practice.

13. Conclusion

- 13.1 As one might expect, there is no simple answer as to what the most appropriate structure for a property joint venture is. Each has their own advantages and disadvantages and as was discussed at the beginning of this article, the choice of vehicle will depend very much on the specific circumstances of the project and the parties involved.
- 13.2 Whatever structure is used, it is essential however that the agreed commercial terms are documented at the outset to minimise the risk of potentially costly disputes arising at a later stage and that the structure is carefully analysed to ensure that no unexpected liabilities arise.

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