In a perfect partnership or joint venture (JV), the parties combine their disparate skills and resources and create a whole that is greater than the sum of the parts. Each party trusts the others to act in the best interest of the JV, and no party abuses that trust. Each party is allocated responsibility and authority consistent with that party’s skills, and no party interferes with any other party’s performance of its functions. The economic returns from the venture are divided in a manner that is commensurate with the respective contributions of the parties; all parties believe they are fairly compensated; and tax burdens are minimized.

Is such a JV possible? Perhaps only in a better world than this one. With proper planning, however, many common pitfalls can be avoided. This article summarizes several critical planning points. Address them collaboratively with your partners before activating your JV, and you may come close to the ideal described above.

The term “JV Agreement,” as used below, refers to any agreement that governs the rights of the JV participants.

**Defining the scope of the project**

Some real estate JVs are formed to develop a single building. Some are formed to acquire and develop an undetermined number of yet-unidentified properties. Most are formed for a purpose between these two extremes.

It may be appropriate to have either a narrowly defined purpose or a broadly defined purpose. It is very bad, however, to have a poorly defined purpose. The parties should have a clear understanding of the scope of their JV before committing their time and resources.

• Example: The parties intend to develop a 150-unit condominium tower but are able to obtain approvals for only a 120-unit tower. Will either party be able to obligate the other party to complete the project? A clear definition of scope in the JV Agreement should answer this question.

**Choosing a JV Entity**

The parties must choose the form of their JV from among an array of legal entities. These include the general partnership, limited partnership, Limited Liability Company (LLC), S-Corporation and C-Corporation. In most cases, the parties will organize an LLC. This form of ownership avoids entity-level income taxation; allows owners to deduct operating losses;
and grants the owners enormous flexibility in dividing the venture’s economic costs and benefits, tax burdens and management rights. Nonetheless, in some cases a corporation will be preferable. Consult an experienced business attorney before choosing the form of your JV entity.

**Contributions by the Parties**

Think broadly about the contributions that are expected from each participant in the venture. A participant’s contribution may include land, money, credit, relationships, expertise and/or services. Participants should be given economic credit for the value of the assets they contribute, whether those assets are tangible or intangible. Often, intangible assets are critical to the success of the venture, but they may be the most difficult to value at the outset.

- **Example:** Consider compensating contributors of intangible assets with disproportionate success-based or milestone-based returns.

The key is for each participant to value the contributions to be made by the other participants and for the relationship of financial rewards to contributions to be spelled out clearly in the JV Agreement.

The agreement also should contain clear mechanisms for motivating and/or enforcing agreed-upon contributions.

- **Example:** An agreement to contribute money may be enforced through mechanisms such as high-interest default loans or a “squeeze-down” of a defaulting partner’s profits interest.

- **Example:** An agreement to contribute intangible assets or services may be enforced via a clearly defined non competition covenant and/or a right to remove a nonperforming participant from the venture.

In some JVs, the parties may reasonably choose to rely on good faith rather than sanctions. The key is to think proactively about ways to protect the JV’s interest in each contribution that is critical to the venture. Remember: There are no “cookie-cutter” JVs.

**Splitting the Economic Pie**

It is a given that each participant must be fairly compensated, and there is no formula for achieving this goal that is “right” in all cases. Nonetheless, there are patterns that are commonly followed. Consider the following:

- **Example:** Money investors usually want to have their capital returned before any profit distributions are made to service partners. Indeed, it is not uncommon for money investors to demand a minimum cash-on-cash return (sometimes stated as an “internal rate of return”) before sharing profits with other participants.

- **Example:** Service partners frequently receive regular, fixed payments from the inception of the JV. Often, there is a trade-off between a service partner’s share of back-end profits and the level of fixed, front-end payments.

- **Example:** Service partners and contributors of intangible assets often receive an increased percentage of back-end profits that exceed a defined threshold.

A good way to test the appropriateness of your formula for splitting profits is to apply it to best-case, worst-case and intermediate-case projections. Think about the factors that may influence the economic success of your project, and try to devise a formula that, in each projected case, is most likely to be perceived as fair by all participants. Splitting the economic pie has important tax consequences. Hire an experienced attorney with tax expertise to draft your agreement.

**Division of Management Rights and Responsibilities**
In most successful JVs, day-to-day management responsibility is delegated to a single person or small committee, and only major decisions are reserved for approval by owner/investors. The key to a good management structure is a clear definition of project goals at the outset and thoughtful consideration of how the owners will want to be involved in a variety of possible scenarios.

Decisions reserved for owner/investor approval generally include some or all of the following: (1) selling the venture’s property other than in the ordinary course of business, (2) acquiring additional real property, (3) borrowing in excess of a defined amount, (4) adopting or modifying operating budgets, (5) hiring counsel, (6) prosecuting and settling lawsuits, (7) terminating and replacing the manager, and, of course, (10) terminating the venture.

There are various ways in which voting rights may be divided among investors. Commonly, votes are divided on the basis of contributed capital. However, where there are distinct classes of owner interests, it is reasonable to consider assigning voting rights on the basis of what each class has at stake.

- Example: If a class of investor has a sizeable preferred return and only a small percentage of back-end profits, it may be reasonable to give that class limited rights to vote on operating budgets but an absolute right to terminate the venture if defined milestones are not achieved.

Handling Irreconcilable Differences

When super-majority approval is required for a major decision, or authority is divided equally among an even number of owners, a deadlock can occur. It is critical that the JV Agreement establish a deadlock procedure. Otherwise, the consequence of a deadlock may be a disorderly liquidation of the venture, to the economic detriment of all owners.

A common deadlock mechanism is the "buy-sell" procedure, under which one owner offers to buy the interest of the other for a price equal to the amount the offeree would receive if the JV liquidated after selling its property for an amount stated by the offeror. The offeree then has the choice of accepting the offer or buying the offeror’s interest for an amount determined under the same formula. This approach may be modified to reduce unfair treatment of parties with limited financial resources.

Transfers of Ownership Interests

Generally, each participant wants the right to transfer its interest freely but does not want other participants to have that right! The choice of a procedure for transfers of interests must balance these competing desires. In choosing a procedure, the participants should consider each participant’s role in the venture, and how a transfer of that participant’s interest could frustrate the expectations of the other participants.

Many JV Agreements grant only limited transfer rights and provide that transferees receive no management or voting rights without the consent of the other owners. Other agreements permit owners to sell their interests subject to a right of first refusal or right of first offer. Each alternative has advantages and disadvantages.

Partnership/LLC Tax Issues

Most real estate joint ventures are now organized as LLCs because the LLC form of ownership provides the parties with limited liability, pass-through taxation, and a great deal of flexibility in allocating individual elements of the overall economic package. This flexibility comes with a price—the tax rules that govern an LLC and its members (the same rules that apply to partnerships) are extremely complex. It is thus critical that the parties engage experienced tax counsel when organizing their LLC. Following is an overview of tax issues that should be addressed when the LLC operating agreement is drafted:

- **Contributed property.** When an LLC is formed, and one member contributes property, the members must agree on the value of the property and must credit that value to the contributor’s capital account. If the agreed value is greater than the tax basis of the
property, the “built-in” taxable gain must be allocated to the contributor when it is recognized by the LLC. If the value is uncertain, the members may instead decide to treat the property as having a lower value and compensate the contributor with a priority allocation of the LLC’s profits. There are numerous ways of doing this, all of which have different tax results.

**Issuance of a capital interest to a service provider.** If a service provider is granted an immediate percentage interest in the LLC’s capital and profits, the formation of the LLC will result in a tax liability for the service provider. If the IRS adopts regulations proposed in May 2005, and the members plan carefully, there generally will be no tax liability for the other members.

**Issuance of a profits interest to a service provider.** If a service provider is granted an interest in the LLC’s profits, but not its capital (i.e., the service provider would receive nothing if the LLC liquidated immediately after formation), there generally will be no immediate tax burden for any member if the members treat the profits interest as having no current value.

**Avoiding capitalization of development fees.** In general, fees paid to a real property developer must be capitalized. If a developer that is a member of the project LLC is compensated with income allocations rather than fees, the other members may obtain a tax benefit equivalent to an immediate deduction of the developer’s compensation. This technique does not always work! Consult an expert.

**Phantom income.** If cash from operations is distributed first to return invested capital, there will commonly be “phantom income” for members with “carried interests” (also called “promotes”). It is unacceptable to most service providers to have taxable income but no cash. There are several ways to handle this, including so-called “tax distributions” or “tax loans,” as well as “flip flop” allocations. Each approach subjects the investors to a different level of risk.

**Use of developed property as compensation.** In a condominium development, it may be possible to compensate the developer on a tax-deferred basis by distributing rental units to the developer rather than cash. Careful financial modeling should be undertaken to see whether this makes sense for a particular project.

Is a simple agreement possible? The “tax provisions” in many LLC operating agreements are lengthy and complicated. Can this be avoided? Some practitioners have adopted a deceptively simple drafting approach that provides a “cash distribution waterfall” together with a statement that taxable income shall be allocated to make the members’ capital accounts consistent with the waterfall. The only advantage of this approach is a simple agreement. It gives no clear guidance to the company’s tax-return preparers, and it prevents the use of any of the techniques described above.

If the participants in a JV carefully consider these and other planning points at the JV’s inception, and the JV Agreement is well-drafted, many pitfalls may be avoided, and a successful JV may be achieved. An experienced business attorney can help you realize this goal.

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