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# Joint Ventures Between Property Owners and Developers

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## INTRODUCTION

This article examines certain economic and tax considerations that arise in connection with structuring a real estate development joint venture (''Development JV'') between a property owner and a developer. Such a joint venture usually involves the transfer of the owner's real property to the Development JV in exchange for a continuing debt or equity interest (or both) in the Development JV. Owners are motivated to participate in Development JVs because they believe they can monetize their property more effectively on an after-tax basis through a joint venture than by an outright cash sale. For example, a joint venture may allow an owner to defer taxable gain and share in upside development income and profit. Developers may be interested in Development JVs because of the ability to limit their upfront capital requirements by avoiding a straight cash purchase of real property. Developers may also desire the ability to share development risk with the property owner. This article focuses on three key aspects of Development JVs:

- Whether the owner's property contribution to the Development JV follows the ''Debt Model'' or the ''Equity Model,'' as described below;
- Whether the owner's property, when developed by the Development JV, will constitute investment property or dealer property; and
- The impact of these factors on the monetization of property through the Development JV's cash ''waterfall.''

This article does not deal exhaustively with these three topics and is not intended to provide tax or legal advice. Instead, it attempts to provide Development JV advisors and their clients with a basic framework for analyzing these fundamental issues.

## DEBT MODEL vs. EQUITY MODEL

If a property owner conveys property to a Development JV in exchange for an interest in the Development JV, that interest will typically be debt or equity, or both, or a hybrid of the two. In other words, the contributed property, like any balance sheet asset, must be financed with corresponding amounts of debt or owner equity. This article refers to those different methods of financing the contributed owner property as the ''Debt Model'' and the ''Equity Model,'' although there are various combinations and hybrids of those two basic financing methods.

The Debt Model typically involves the outright sale of the owner's property to the Development JV for a promissory note that is payable in installments. The installment note is often secured by a mortgage on the contributed property in favor of the owner. However, the installment loan documents typically provide that the installment loan obligations and the security for the same will be subordinated to any senior institutional development loan obtained by the Development JV, and the senior lender will almost certainly require such subordination, as to both installment loan repayment and installment loan lien priority. Depending on the nature of the development, the installment loan may include partial release provisions requiring the release of the installment loan liens as to certain portions of the property upon payment to the installment lender of a designated release price or the occurrence of other stipulated release conditions. As an accounting matter, if the Development JV purchases real property from the selling owner under an installment note, the Development JV's assets increase by the cost of the purchased land. That increase in assets is financed by an increase in the Development JV's liabilities, in the form of the installment note payable to the selling owner. Under most circumstances, there should be no change in either the owners' equity portion of the balance sheet or individual owner capital accounts associated with an installment note purchase.

In contrast, under the Equity Model, the property owner contributes the property to the Development JV in exchange for an equity ownership interest in the

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Development JV. If the Development JV is treated as a partnership for federal income tax purposes (as typically would be the case with an LLC or limited or general partnership), the contributing owner would receive capital account credit for the agreed book value of the contributed property less liabilities, if any, assumed by the Development JV in connection with the contributed property.[1] Under the Equity Model, the Development JV's assets increase by the agreed book value of the contributed real property, which is financed by a corresponding increase in the owners' equity portion of the Development JV's balance sheet.

## TAX TREATMENT OF THE TWO MODELS AT FORMATION

With the installment note version of the Debt Model, any taxable income or gain resulting from the sale of the property to the Development JV is recognized by the seller as s/he receives payments, either at closing or under the installment note.[2] A pro rata portion of each payment is recognized as gain or income. The applicable pro rata portion is the gross profit on the sale, i.e., selling price minus the owner's adjusted basis in the property, divided by the total contract price.[3] For example, if the seller's gross profit is $100,000 and the total contract price is $1 million, then 10% of each installment note payment typically would be recognized as income or gain. Note that, in determining the total contract price, any liabilities of the installment seller assumed by the buyer in connection with the sale are excluded.[4] Finally, because it often is important to be able to defend the total price paid for the property by the Development JV — e.g., because long-term capital gain treatment will be sought for the gain on the sale — the parties should strongly consider obtaining an appraisal of the property in connection with the sale if the seller will have a continuing interest in the Development JV.

Under the Equity Model, if the Development JV is treated as partnership for federal tax purposes, the owner's contribution of appreciated property to the Development JV generally does not result in recognition of gain. Instead, the owner receives book capital account credit equal to the agreed net value of the property being contributed, presumably its fair market value net of any liabilities assumed by the Development JV in connection with the contribution, and the owner has carryover outside basis in his/her ownership interest in the Development JV equal to his/her adjusted basis in the property contributed.[5] However, there is an exception to this nonrecognition rule if the Development JV and other owners assume a share of the contributing owner's liabilities associated with the contributed property that exceeds the owner's basis in that property.[6] Also, as with the Debt Model, if it is important to establish the contributed property's fair market value at the time of contribution for tax purposes, the parties should obtain an appraisal at the time of contribution to document that value.

## SIMILARITIES AND DISSIMILARITIES BETWEEN THE TWO MODELS

Any joint venture structure typically addresses the following economic concerns:

- Provide for a preferential return of capital to any owners who are contributing a disproportionately large amount of capital to the joint venture relative to their interests in joint venture profits or else risk a taxable "capital shift" from those owners to the other owners.
- Provide any agreed preferential rate of return on the owners' unreturned capital contributions.
- Provide for the owners' agreed interests in joint venture profits once owner capital (and any preferred return thereon) has been fully paid.

Properly structured, either the Debt Model or the Equity Model can accomplish each of these basic objectives. For example, with respect to returning owner capital and a preferred return, the Debt Model allows the property owner to recoup the capital value of real property by repayment of the principal amount of the installment note that represents that capital value. That installment note can also provide the property owner with the desired preferred return in the form of interest on the installment note. In addition, the owner may receive a profits interest in the joint venture along with other owners, allowing him/her to share in profits after the required principal and interest payments on his/her installment note have been made.

Likewise, all those objectives can be achieved with the Equity Model. Owner capital can be returned on a preferred basis by establishing two classes of ownership, usually preferred for the capital providers and common for service provider sponsors/developers receiving profits interests. The JV agreement typically provides for preferred distributions until the preferred owners have received a complete return of their capital plus any agreed upon preferred return. At that point, the distributions typically "flip" to reflect each preferred and common owner's interest in the joint venture profits.

Although the two models share these same basic features, there are important differences that ultimately impact the decision about which one to use. These differences include, for example, the following:

- The Debt Model may be somewhat easier to document. Among other things, using the Debt

[1] Reg. §1.704-1(b)(2)(iv)(d). Unless otherwise stated, references to "Section" or "§" are to provisions of the Internal Revenue Code of 1986, as amended, and references to "Reg. §" are to provisions of the Treasury regulations thereunder.

[2] *See* Temp. Reg. §15A.453-1.

[3] Temp. Reg. §15A.453-1(b)(2)(v).

[4] Temp. Reg. §15A.453-1(b)(2)(iii).

[5] *See* §721, §722, §723.

[6] *See* §752(b).



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Model may make it possible to avoid having both common and preferred classes of ownership interest. That will simplify a host of provisions in the joint venture agreement. Therefore, for smaller deals or less sophisticated parties, the Debt Model may be the preferred option.

- With the Equity Model, the preferred returns on capital typically are not subject to state law usury limitations, in contrast to the interest rate on the installment note in the Debt Model. The Equity Model may therefore provide more flexibility if capital providers expect higher returns, or returns calculated on a basis other than simple interest (e.g., preferred returns based on internal rate of return calculations).
- For state law purposes, the Debt Model obviously results in additional debt on the Development JV's balance sheet. That additional debt may pose problems if the Development JV has a senior institutional lender, as typically is the case. Senior lenders may flatly prohibit other debt on the project or, as a condition to consenting to the other debt, may require subordination or inter-creditor agreements with the junior lender. Such subordination and inter-creditor issues typically do not arise when capital providers use the Equity Model.
- As discussed in more detail below, if an owner transfers appreciated investment property to a Development JV that will be a ''dealer'' as to such property, the Debt Model may be a better vehicle for preserving capital gain treatment for the owner.

There usually is no single ''right'' answer as to which structuring model to use for a particular deal. Instead, considerations like the ones above must be weighed in making that decision. It may simply come down to which model the parties, particularly the property owner/capital provider, are more comfortable with based on past experience.

## DEALER PROPERTY

In determining whether gain from the sale of real property will qualify as long-term capital gain (as opposed to ordinary income taxed at higher rates), the key question is whether the real property is held for investment (and thus treated as a capital asset) or whether, in contrast, it is ''inventory'' held primarily for sale to customers in the ordinary course of business. If the property is treated as inventory in the hands of the seller, the seller is classified as a dealer.[7] If the seller is a dealer as to an asset, any gain on the sale of the asset generally will be taxed at ordinary income tax rates.[8]

A number of factors must be weighed in the ''investor vs. dealer'' analysis. For example, the owner's original purpose in buying the property is critical.[9] How long the owner has owned the property can be important in establishing investment intent — the longer, the better.[10] The number of sales and level of development activity are also facts that can point to dealer status.[11] Whether the owner customarily engages in dealer activities is a factor, although the same person can be both a dealer and an investor as to different tracts.[12]

An exhaustive review of the ''investor vs. dealer'' analysis is beyond the scope of this article. Because of the fact-intensive nature of the analysis, it can be very difficult (and perilous) to state conclusively that any particular tract of land is ''investment property'' in the hands of a particular owner, except in the most obvious cases. However, assume that a property owner believes that s/he holds the property for investment and thus qualifies for long-term capital gain treatment on sale of the property. The issue then becomes how to preserve that favorable tax treatment if the owner will (i) sell the property to a Development JV that will be a dealer, and (ii) also receive an interest in the Development JV. In other words, under what circumstances does the owner's participation in a dealer Development JV taint the owner's status as an investor in conveying its property to the Development JV?

For example, assume the long-time owner of an appreciated, low-basis family farm intends to convey the property to a Development JV that will develop the farm into a residential subdivision and sell residential lots. Further assume that the owner will receive an interest in the Development JV as part of the transaction. The owner will want the gain it realizes on its initial conveyance to the Development JV to be treated as long-term capital gain, although the Development JV's subsequent gain on the sale of the developed lots will be ordinary income to the Development JV because it is selling lots as inventory. Under these circumstances, the Debt Model is likely the best planning vehicle for the owner to preserve long-term capital gain treatment on its initial sale of the property to the Development JV.

Under this approach, the owner would likely sell the property to the Development JV at its fair market value for an installment promissory note. Under these circumstances, the owner may want to maximize his/her capital gain on the sale to the related-party Development JV and minimize the Development JV's subsequent ordinary income on the sale of inventory lots. The owner should therefore consider obtaining an ap-

[7] §1221.

[8] *Id.*

[9] *See Daugherty v. Commissioner*, 78 T.C. 623 (1982).

[10] *See Pritchett v. Commissioner*, 63 T.C. 149 (1974).

[11] *See United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969).

[12] *See Fabiani v. Commissioner*, 32 T.C. Memo 941 (1973).



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praisal of the property to document that the sale price is reasonable. In addition to obtaining capital gain treatment, the owner can further defer recognition of gain based on its actual receipt of installment payments as outlined above.

However, this approach is complicated if the owner will receive an interest in the dealer Development JV consisting of more than 50% of its capital or profits. If so, the fact that the related-party Development JV is a dealer as to the acquired property can taint the owner's gain on the sale to the Development JV, converting that gain from capital gain to ordinary income.[13] However, it may be possible to avoid this outcome if the Development JV is structured as an S corporation rather than a partnership or limited liability company. In that case, the activities of the development corporation arguably should not be attributed to the related seller of the subject property.[14]

Of course, use of an S corporation as the Development JV vehicle creates its own risks. The primary risks are the prohibitions on an S corporation having (i) stockholders other than individuals and certain kinds of trusts and (ii) more than one class of stock.[15] The owners of an S corporation Development JV must be careful not to run afoul of these restrictions because losing the benefit of the S election could result in double taxation (corporate and individual) when the Development JV sells lots at a profit and then makes dividend distributions to its owners. Any S corporation Development JV should therefore avoid a capital structure that could create a risk of having more than one class of stock. For example, any debt owed to its shareholders, such as the installment note owed to any property seller who also receives stock, should be structured to qualify as debt rather than risk being recharacterized as an equity interest and, thus, a proscribed second class of stock.[16]

## INVESTMENT PROPERTY

As discussed above, gain on the sale of property held for investment and owned for more than 12 months should qualify as long-term capital gain. Also as discussed above, this analysis is complicated if the seller is an investor but the Development JV that acquires the property (and in which the seller receives a joint venture interest) is a dealer as to the property (as would be the case with the residential development example above). However, if both the seller and the Development JV hold the property for investment, life is much simpler from a tax perspective. In that case, the principal issue is not the character of the gain — i.e., capital gain versus ordinary income — but rather the amount of gain attributable to the seller upon its original conveyance of the property to the Development JV versus the amount of gain arising from subsequent investment returns on the property while owned by the Development JV.

As noted above, investment property includes any property intended to be held for an investment return over time, as opposed to being sold to customers as inventory in the ordinary course. Examples could include almost any income-producing property such as a hotel, office, retail, warehouse or multi-family project. Inventory also could include land acquired from the seller to be held for further investment appreciation.

For instance, consider the long-time owner of an appreciated, low-basis family farm discussed above. If the Development JV will develop the farm into a shopping center that it intends to lease up and hold for an indefinite period of time, the shopping center will be investment property. Of course, if it can be established that the Development JV acquired the property with the intent to construct a shopping center and immediately flip it, that would certainly call into question its investment intent.

Under these circumstances, either the Debt Model or the Equity Model likely could be used in structuring the Development JV. In either case, documenting the value of the real estate conveyed to the Development JV through an appraisal will be important. If the Debt Model is used with an installment note, so that capital gain will be recognized by seller under the installment method described above, it is important to make sure that the installment note is respected as a true debt and not recharacterized as equity. The installment note should therefore be structured as a genuine debt instrument, and the Development JV should avoid being so thinly capitalized with true equity as to increase the risk that the installment note will be recharacterized as seller equity.[17]

If the Equity Model is used under these circumstances for any of the reasons outlined above, the seller's built-in capital gain at the time of its contribution of the property to the Development JV generally will not be recognized.[18] Instead, the seller will receive capital account credit for the net fair market value of the contributed property (documented by an appraisal), and the seller's tax basis in the property will carry over to the Development JV.[19] The Development JV documents should then provide that, whenever the Development JV realizes gain on the disposition of the property, 100% of the amount of the property's built-in gain at contribution will be allocated to the seller.

Below is a simple ''decision tree'' that summarizes the formation tax analysis discussed above when investment property will be conveyed by an owner to a Development JV and the owner will receive a joint venture interest of some kind.

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[13] §707(b)(2).

[14] *See Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992).

[15] §1361(b)(1).

[16] *See* §1361(c)(5).

[17] §385(b).

[18] *See* §721, §722 §723.

[19] *Id.*



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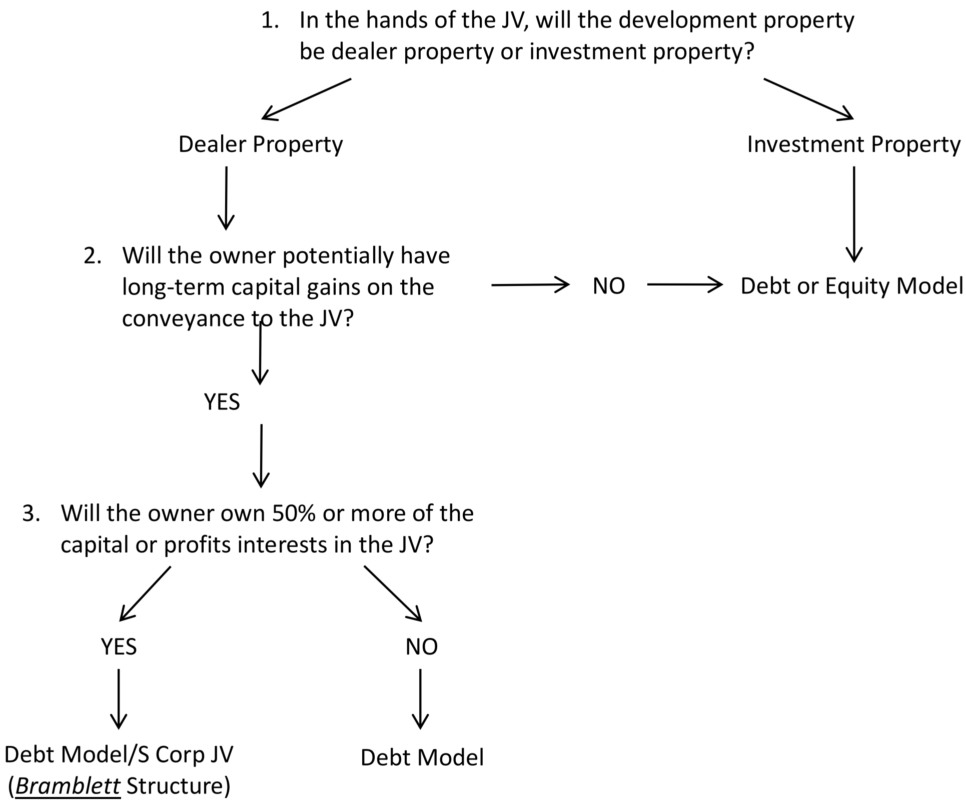
JV FORMATION DECISION TREE




## MONETIZATION — THE JV CASH "WATERFALL" GENERALLY

Whether the Development JV will follow the Debt Model or the Equity Model, the fundamental drafting challenge for the Development JV counsel is the same: to ensure that the Development JV's agreement accurately reflects (and its tax-related provisions are consistent with) the owners' business deal. This requires that the cash payment and distribution provisions in the JV agreement reflect the cash distribution ''waterfall'' desired by the owners. It also means that the technical tax language in the JV agreement must result in allocations of taxable income, gain, and loss that are consistent with the economic understanding of the owners as embedded in that cash waterfall. These concepts are discussed in more detail below.

Determining an appropriate economic structure for a Development JV involves challenges that are not present with a real estate joint venture established for an existing, stabilized commercial building. Development JVs entail all the risks associated with construction and construction financing. These can include construction pricing risk, construction delays, contractor problems, market changes during construction, interest rate risk (assuming an unhedged floating rate construction loan), leasing (to the extent that it is a speculative project), and risks associated with recourse construction financing. Successfully calibrating these risks with appropriate economic rewards and incentives for the owners can be difficult at the outset, because pricing these risks in the form of JV returns involves assumptions and guesswork about the future.

The first task is to make sure the owners' business deal provides them with appropriate risk-adjusted returns if the deal is successful. In other words, if the Development JV produces enough cash to pay operating expenses and scheduled debt service, how do the owners want to carve up any remaining cash that is available for owner distributions? This is usually a function of two factors: (i) the relative value of the owners' contributions to the JV; and (ii) each owner's respective overall risk associated with the Development JV. Obviously, all other things being equal, the greater an owner's JV contribution and the greater the risk borne by that owner, the greater the returns that owner will require as an inducement to participate in the JV. However, assessing those two factors is not always simple with a Development JV.

For example, on the first point, valuing an owner's contribution is obviously easy if the owner will simply write a check for a cash contribution to the Development JV. But if the owner will instead contribute or convey appreciated real property, it raises the question of exactly how the property will be valued for purposes of either a capital contribution or installment sale. If an owner will contribute services — as will often be the case with a Development JV — then valuing those services for purposes of determining economic rewards can be even more difficult, since



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the value of services is inherently more subjective than the value of tangible assets like real estate. The service partner in a Development JV may therefore expect negotiation — perhaps extensive — regarding the appropriate valuation of his/her services for purposes of establishing the cash waterfall.

The second point, owner risk assessment, can also be difficult. As noted above, Development JVs entail inherent construction and development related risks. But the same development project may present very different risks based on a number of other factors. For example, if the parties decide to use more debt and thus greater financial leverage, they have increased the risk. If they decide to do a completely speculative development with no pre-sale or pre-leasing, they have increased the risk. Those sorts of increased risks bear most heavily on capital providers and loan guarantors. Those parties will expect their potential Development JV investment returns to reflect their increased risk.

Because of the extra risk associated with new development projects and the difficulties of ''baking in'' that risk when determining the parties' interests in joint venture profits, it may make sense for a Development JV to make liberal use of guaranteed payments to the owners to compensate them for specific services or risks. That is especially true during the pre-stabilization development period. Such guaranteed payments could, for example, include a guarantee fee equal to a stated percentage of the amount of any guaranteed loan; a development fee equal to a certain amount or percentage of project costs; a construction management fee; an asset management fee; and brokerage, leasing, and property management fees. The types and amounts of fees are usually limited only by the developer's imagination and market constraints.

The nature and amount of guaranteed payments to Development JV owners will obviously impact the owners' overall risks and returns. That in turn will affect distributions — including capital, preferred return and profits — to the owners in the cash waterfall after any agreed-upon guaranteed payments have been made. The details of that cash waterfall may also vary significantly depending on whether the Debt Model or Equity Model is used, as discussed in more detail below.

## CASH WATERFALL: DEBT MODEL vs. EQUITY MODEL

The joint venture cash waterfall describes the disbursement — in terms of both payment priority and amount — of the joint venture's cash flow. Typically, first priority is given to required debt service payments owed to senior lenders and operating expenses to third-party creditors. These outside creditors have state-law payment priority and usually have the ability to disrupt ordinary joint venture operations, either through lien enforcement rights or simply by cutting off goods and services to the joint venture if they are not paid timely. Next in priority typically are debt repayments — for example, on an installment note used to purchase a Development JV's real estate — and guaranteed payments to joint venture owners and their affiliates. The cash waterfall should specify the exact order of priority as between these debt and guaranteed payments to owner and their affiliates. After debt service and operating expenses (whether to third parties or joint venture owners) have been paid, then the cash waterfall will provide for the distribution of any remaining cash to the joint venture equity holders. For example, if there are both common and preferred classes of equity interests, the cash waterfall in the joint venture agreement typically would provide for cash distributions first to any preferred owners in the amount of their accrued cash preference and then in the amount of their unreturned capital. After that, as the last ''bucket'' in the cash waterfall, any remaining cash would be distributed to the preferred and common owners in accordance with their agreed-upon interests in joint venture profits. In summary, most joint venture cash waterfalls typically follow this basic model:

(1) JOINT VENTURE REVENUES
less
(2) SENIOR REQUIRED DEBT SERVICE AND SENIOR LENDER REQUIRED RESERVES
less
(3) THIRD-PARTY OPERATING EXPENSES
less
(4) GUARANTEED PAYMENTS TO OWNERS/OWNER AFFILIATES THAT ARE NOT SUBORDINATE TO OWNER DEBT SERVICE/PREFERRED RETURN PAYMENTS
less
(5) INSTALLMENT NOTE/OTHER OWNER HELD DEBT PAYMENTS, IF APPLICABLE
less
(6) PREFERRED RETURN PAYMENTS TO PREFERRED EQUITY HOLDERS, IF APPLICABLE
less
(7) GUARANTEED PAYMENTS TO OWNER/OWNER AFFILIATES THAT ARE SUBORDINATE TO OWNER DEBT SERVICE/PREFERRED RETURN PAYMENTS
less
(8) ANY OTHER PAYMENTS TO JOINT VENTURE RESERVES
less
(9) DISTRIBUTIONS TO EQUITY OWNERS IN ACCORDANCE WITH THEIR INTERESTS IN JOINT VENTURE PROFITS

## CONCLUSION: MAKING SURE THE TAX TAIL DOES NOT WAG THE BUSINESS DOG

Development JVs, like most real estate joint ventures, are structured as pass-through entities for fed-



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eral tax purposes. Development JVs formed as general or limited partnerships or limited liability companies will be treated as partnerships for federal income tax purposes (unless they affirmatively elect to be taxed as a corporation). An S corporation using a *Bramblett*-type structure as noted above will also be taxed as a pass-through entity, allowing it to avoid the double tax that results when a C corporation sells an asset for a profit and then makes a dividend distribution to its owners.

Entities taxed as partnerships are subject to the complicated federal partnership tax rules relating to the establishment and maintenance of capital accounts and allocations of taxable income, gain, and loss. In particular, those rules require that if the allocations of income, gain, deductions, and credits in a partnership's partnership agreement do not have ''substantial economic effect,'' then those allocations will instead be determined based on ''the partner's interest in the partnership.''[20] The Treasury Regulations promulgated under §704(b) of the Internal Revenue Code outline the circumstances under which allocations will be deemed to have ''substantial economic effect'' and provide a safe harbor for allocation provisions.[21]

One element of the substantial economic effect safe harbor is the requirement that the partnership agreement provide that any final liquidating distributions to the partners must be in accordance with their respective positive capital account balances.[22] Joint venture agreements often include such a provision to satisfy the safe harbor. Therefore, when a Development JV's assets are ultimately monetized and cash is available for distribution to the owners, it is important that the partners' capital account balances result in distributions that reflect the partners' business intent regarding the priority and amount of distributions, as reflected in the partnership's agreed cash waterfall. Accordingly, joint venture agreement allocation provisions often require, in essence, that the partnership's taxable income or gain for a particular year be allocated among the partners so as to result in capital account balances that would equal the amounts due to the partners if the partnership assets were sold for their adjusted book value, partnership liabilities paid, and remaining proceeds distributed in accordance with the partnership cash waterfall at the end of that tax year.

The arcane tax provisions in most joint venture agreements relating to allocations and capital accounts are thus of great practical importance, as they ultimately have very real economic consequences. It is obviously critical to have tax counsel or tax accountants carefully review the allocation and distribution provisions of a joint venture agreement, particularly one that involves multiple classes of ownership, preferred returns, or other ''bells and whistles.''

[20] §704(b).

[21] Reg. §1.704-1(b)(2).

[22] Reg. §1.704-1(b)(2)(ii)(b).



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