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EQUITY JOINT VENTURES: STRUCTURING CAPITAL CONTRIBUTION, WATERFALL AND OTHER PAYMENT PROVISIONS

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Overview

I. Capital Contribution Provisions

II. Waterfall and Other Payment Provisions

III. Tax Considerations

IV. Q & A

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I. Capital Contribution Provisions

- What is contributed and when
- Who controls the amount and timing of required contributions
- Consequences for failing to making required contributions
- Effect of contributions

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I. Capital Contribution Provisions

A. Initial Capital Contributions

B. Additional Capital Calls

C. Failures to Contribute

D. Property Contributions

E. Contributions of Encumbered Property

I. Capital Contribution Provisions

A. Initial Capital Contributions

1. What is contributed by the owners to start the venture
2. Timing of contributions
   a. At formation
   b. At later date
3. Is ownership grant contingent on contribution?
4. Disproportionate capital contributions

I. Capital Contribution Provisions

B. Additional Capital Contributions

1. Funding additional capital needs of venture
   a. Owners committed to funding additional capital
   b. Owners permitted to fund additional capital
   c. Outside capital raises
2. Who controls capital calls?
3. Conditions to calling additional capital
   a. Specified benchmarks
   b. Specified purposes

I. Capital Contribution Provisions

B. Additional Capital Contributions (Cont.)

4. Pledging capital call right
5. Deficit capital account restoration obligation
6. Joint and several liability of general partners
7. Dilution of existing owners
8. Lack of tax distributions
9. Effects on distributions
   a. Return of capital
   b. Rates of returns/preferred returns
   c. Level of priority

I. Capital Contribution Provisions

C. Failure to Contribute

1. Breach of Contract Claim
2. Member/Partner Loans
   a. Loan terms
   b. Conversion rights
3. Liquidated Damages
   a. Dilution
   b. Capital account reduction? (Be careful!)
4. Loss of voting or control rights

I. Capital Contribution Provisions

D. Property Contributions

1. Establishing relative values
2. Effectuating transfers of property
3. Addressing tax attributes of contributed property
4. Right to reacquire property
5. Contributing right to use property
6. Right to use contributed property

I. Capital Contribution Provisions

E. Contribution of Encumbered Property

1. Contribution of net value
2. Consent of creditor
3. Release of contributing owner
4. Beneficial debt terms
    a. Who gets benefit?
    b. Specially allocating the benefit
    c. Valuing beneficial terms

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II. Waterfall and Other Payment Provisions

- Provide for distribution of money and property from the entity to the owners
- Specify when distributions can be made or must be made
- Describe the relative priorities of the owners to distributions
- Usually are of the most important business consideration for the owners

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II. Waterfall and Other Payment Provisions

A. Priority Returns

B. Carried Interests/Promotes

C. Different Waterfalls for Different Situations

D. Profits Interests

E. Tax Distributions

F. Liquidation Provisions

G. In-Kind Distributions

H. Other Payment Provisions

I. Capital Shifts

II. Waterfall and Other Payment Provisions

A. Priority Returns

1. Similar to preferred stock in corporations
2. Certain owners receive distributions before others
    a. Invested capital
    b. Return on investment
        i. Absolute returns
        ii. Time-value returns
            A. Preferred return
            B. Internal rate of return (IRR)
                ➢ What if you cross an IRR once, but then fall below?

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II. Waterfall and Other Payment Provisions

A. Priority Returns (Cont.)

3. Drafting Considerations
   a. Compounding convention for preferred return
   b. Describing IRR calculation
      i. Formulas
      ii. Excel Functions
      - If you use both, <u>make sure they work the same</u>
   c. Try examples and compare to language in agreement and owners' expectations
   d. Schedule or Appendix of examples

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II. Waterfall and Other Payment Provisions

B. Carried Interests/Promotes

1. Certain owners' (usually "sweat equity") shares of distributions increase as incentive
   a. Based on return to investors
   b. Based on performance targets
2. Multiple levels of increase
3. "Catch-ups" for priority returns of investors
4. Based on overall returns ("crossed") or investment-by-investment
   - Clawback obligations

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II. Waterfall and Other Payment Provisions

B. Carried Interests/Promotes (Cont.)

5. Aggregate Basis
   a. All investors share in each distribution level pro rata
   b. Typical in real estate and operating companies
6. Investor-by-Investor Basis
   a. Proceeds divided among investors first (usually based on commitments or ownership percentages)
   b. Separate carried interest calculated for each investor
   c. Typical in private equity funds
   d. Can more easily charge investors different fees/costs

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II. Waterfall and Other Payment Provisions

B. Carried Interests/Promotes (Cont.)

Aggregate Basis Example

A and *B* each contributed $100 to the company. Investors get a 20% Preferred Return. *C* gets 20% carried interest. The Company makes a $400 distribution.

Waterfall Step	Member A	Member B	Member C
Return of Capital	$100	$100	$0
Preferred Return	$20	$20	$0
80-20 Carry	$64	$64	$32
Total	$184	$184	$32

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II. Waterfall and Other Payment Provisions

B. Carried Interests/Promotes (Cont.)

Investor-By-Investor Example

A and *B* each contributed $100 to the company. *A* has 20% preferred return, *B* has 10%. *C* gets 20% carried interest.

Waterfall Step	Member A		Member B	
% of Contribution	50%		50%	
Distribution Share	$200		$200	
Member	A	C	B	C
Return of Capital	$100	$0	$100	$0
Preferred Return	$20	$0	$10	$0
80-20 Carry	$64	$16	$72	$18
Total	$184	$16	$182	$18

II. Waterfall and Other Payment Provisions

C. Different Waterfalls for Different Situations

1. Common situations with separately-stated waterfalls
   a. Current cash flow
   b. Capital events
   c. Liquidation
2. Be careful that there is no overlap in the trigger events for different situations
3. If distributions in one waterfall are affected by distributions made under other waterfalls, make sure provisions are carefully coordinated
4. Remember a catch-all (no orphaned money)

II. Waterfall and Other Payment Provisions

D. Profits Interests

1. Equity incentive compensation
   a. Not taxable when received
   b. Can generally qualify for favorable long-term capital gains treatment on sale
2. Waterfalls must generally provide that profits interests only share in gains and profits of the entity
3. Can be subordinated for all distributions
4. Can share in distributions of current profits and subordinated only on liquidation
5. Remember tax distributions

II. Waterfall and Other Payment Provisions

E. Tax Distributions

1. Typically pass-through entities for tax purposes, so owners (not the entity) pay taxes on entity's income
2. Tax is imposed on owners for entity's income, <u>even if there are no distributions</u> (phantom income/dry income)
3. Should entity cover taxes attributable to its activities (like C corporations), or should owners cover?
4. Tax distributions are intended to cover owners' tax liabilities if the entity does not otherwise make distributions
5. No tax distributions similar to mandatory capital contribution obligation

II. Waterfall and Other Payment Provisions

E. Tax Distributions (Cont.)

6. Special considerations
   a. Mandatory v. if cash available v. discretionary
   b. Assumed tax liability v. actual tax liability v. pro rata
   c. Applicable tax rate
   d. Annual or quarterly (estimated taxes)
   e. Timing (corporate v. individual payment deadlines)
   f. Offset against other distributions
   g. Measured by cumulative or annual distributions
   h. Priority where insufficient funds

II. Waterfall and Other Payment Provisions

F. Liquidation Provisions

1. Specifically address how assets are distributed in liquidation
2. Can be the same as normal waterfall (or any other specific waterfall) or unique
3. Can be in accordance with capital accounts
   a. The old way
   b. Usually not how business people think about economics
   c. Makes tax allocations extraordinarily important

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II. Waterfall and Other Payment Provisions

G. In-Kind Distributions

1. Entity distributes property instead of cash
2. Property is typically not as fungible as cash, so it matters what property you get
3. Are in-kind distributions prohibited?
4. Do certain owners have the right to choose what property is distributed to whom?
5. Do all owners share equally in each form of property?
    a. Distributions of undivided interests in property
    b. Often unwieldy to manage after distribution

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II. Waterfall and Other Payment Provisions

G. In-Kind Distributions (Cont.)

6. Special Situations
   a. Crown Jewels
   b. Contributed Assets
7. Does an owner want a first right to asset on liquidation?
   - Consider right to distribution of asset with obligation to contribute value in excess of liquidation rights
8. Valuations
   a. Fair market value
   b. Formulaic value

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II. Waterfall and Other Payment Provisions

H. Other Payment Provisions

1. Payments of fees
2. Obligations to pay outstanding liabilities before distributions
3. Best practices for drafting
    a. Do not to include in "distribution" provisions
    b. Have separate coordinating provisions
    c. Be clear about whether payment is a distribution or fee

II. Waterfall and Other Payment Provisions

I. Capital Shifts

1. What is a capital shift?
2. Example

   A and *B* are partners of *AB*. All distributions are 50-50. *A* contributes $100, *B* contributes $0. If *AB* is liquidated, *A* and *B* would each get $50. So, $50 of capital has been "shifted" from *A* to *B*.
3. Where the owner to whom the capital is shifted performs services for the entity or other owners, it is typically taxable as ordinary income on the amount of the shifted capital
4. Tax treatment not always clear where no services

II. Waterfall and Other Payment Provisions

I. Capital Shifts (Cont.)

5. Capital shifts can usually be avoided if invested capital has a priority in the liquidation waterfall
   - In Example, *A* would get $100 back, so no shift to *B*
6. Parties should be especially careful when drafting liquidation provisions when services are involved

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III. Tax Considerations

A. Initial Capital Accounts

B. "Layer-Cake" Allocations

C. "Target" Allocations

D. Gross v. Net Allocations

E. Tax Consequence of Accruing Return

F. Built-in Gains and Losses – § 704(c)

G. Disguised Sales – § 707

H. Anti-Mixing Bowl Rules – §§ 704(c)(1)(B) and 737

I. Revaluation Events

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III. Tax Considerations

A. Initial Capital Accounts

1. Affect allocations and, potentially, distributions
   - ➢ Liquidations in accordance with capital accounts
2. Easy when all owners contribute cash – equals cash contributed
3. More difficult with property contributions – must value property
4. Waterfall provisions often imply values of properties.
5. Be careful of capital shifts
   - ➢ Value of contribution does not equal capital account

III. Tax Considerations

B. "Layer Cake" Allocations

1. Sets forth a specific order for allocating profits and losses among owners
   - ➢ Similar to distribution waterfall
2. Generally used when liquidations are in accordance with capital accounts
   - ➢ This means the allocations determine the economics
3. Special allocations of items more likely to be respected
4. Be very careful when preferred returns accrue
   - ➢ Typical approach of reversing prior profit and loss allocations may not be what is intended

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III. Tax Considerations

B. "Layer-Cake" Allocations (Cont.)

5. If you get unusual allocations, the liquidation rights might not be what the owners intended
   - Consider a "target" allocation for year of liquidation and, if it is before the filing of the prior year return, the prior year

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III. Tax Considerations

C. “Target” Allocations

1. Allocations made match capital accounts to a “target”
2. Normally used when liquidation is pursuant to a waterfall rather than in accordance with capital accounts
3. Typically made to target the liquidation waterfall
    a. Does not satisfy “substantial economic effect” safe harbor
    b. Relies on “partners’ interests in the partnership”
4. Can target waterfalls or items other than liquidation
    a. Need to make sure liquidation in accordance with capital accounts

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III. Tax Considerations

C. “Target” Allocations (Cont.)

5. Can be coupled to some extent with special allocations
    - More risk of special allocations being disregarded than with layer-cake approach

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III. Coordinating Tax with Waterfalls

D. Gross v. Net Allocations

1. Gross allocations
   a. Allocate gross profits separately from gross losses
   b. Can result in some owners being allocated profits and other owners being allocated losses in the same year
   c. Can result in some owners being allocated profits even if the company has net losses and vice versa
   d. Easier to get capital accounts to intended levels
   e. Easier to make special allocations

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III. Coordinating Tax with Waterfalls

D. Gross v. Net Allocations (Cont.)

2. Net allocations
   a. Allocate only net profits or net losses
   b. More likely to result in capital accounts that do not match intended levels
   c. More difficult to make special allocations

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III. Coordinating Tax with Waterfalls

E. Tax Consequences of Accruing Return

1. Does it create a capital shift?
   a. Liquidation rights change if
      i. owners with invested capital have different accruing returns
      ii. owners with no invested capital get "deemed" return
   b. Does it matter?
      i. Possible compensation if owner providing services
      ii. Bargain sale principles if owner is just investor

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III. Coordinating Tax with Waterfalls

E. Tax Consequences of Accruing Return (Cont.)

2. Allocations
   a. Current income often allocated to those owners first
      i. Current income usually ordinary income
      ii. Consider making special allocations on capital events
   b. Gross allocations required if insufficient net profit?
      i. For substantial economic effect, probably
      ii. Is IRS allowed to require gross allocations?
      iii. Partners interests in the partnership?

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III. Coordinating Tax with Waterfalls

F. Built-in Gains and Losses – § 704(c)

1. Contributing owner specially allocated built-in gain/loss
2. Methods of accounting for book-tax differences
   a. Traditional
   b. Traditional with curative allocations
   c. Remedial method
      i. Addresses "ceiling rule"
      ii. Creates phantom income and loss items
   d. Allowed to use different methods for different assets

III. Coordinating Tax with Waterfalls

G. Disguised Sales – § 707

1. Contribution of property and related distribution
2. Presumption of sale if within 2 years
3. Exceptions – Treas. Reg. § 1.707-4
   a. Guaranteed payments
   b. Preferred returns
   c. Operating cash flow
   d. Reimbursement of preformation expenditures
4. Be careful of shifting liabilities – treated as distributions
5. Prior prop regs for disguised sale of partnership interests

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III. Coordinating Tax with Waterfalls

H. Anti-Mixing Bowl Rules – §§ 704(b)(1)(C) and 737

1. Distribution of contributed asset to non-contributing partner (§ 704(b)(1)(C))
2. Distribution of non-contributed asset to partner contributing another asset (§ 737)
3. Seven year rule
4. Remember that adding a member to a disregarded entity holding property is treated as contributing property

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III. Coordinating Tax with Waterfalls

I. Revaluation Events

1. Treas. Reg. § 1.704-1(b)(2)(iv)(f)
2. Includes
   a. contributions in exchange for ownership interest
   b. distributions in reduction of ownership interests
3. "Reverse 704(c)" principles
4. Be careful of effect on allocations
   a. Allocation of book gain or loss may result in different allocations of current income
   b. "Locks in" character of built-in gain

IV. Q & A

Liner's Practice

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Liner's Culture

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