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Real Estate Joint Ventures: Waterfall Structures, Developer Promote, IRR Lookback, Clawback and Catchup

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August 6, 2015
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Introduction

• A joint venture waterfall is a complex way to answer a simple question:

  ▪ When does the JV manager begin receiving distributions of promote and how quickly is such promote (and how much of such promote is) paid?

  ▪ Distinction will be drawn between JV “money” partners and JV manager
Whole Fund vs. Deal by Deal

• A “whole fund” waterfall provides for the return of all capital invested in the JV to a “money” partner (including with respect to multiple investments, in multiple investment JVs), plus a preferred return on such capital, prior to any distributions being made to the manager with respect to its promote.

• With multiple investment JVs, a “deal by deal” waterfall allocates capital (plus potentially other items, discussed later) on a deal by deal basis and provides for the distribution of promote to the manager after such capital, plus a preferred return thereon, is returned to the “money” partner.
Basic Whole Fund Waterfall (Not Partner by Partner)

Distributions. Distributable Cash from Investments will be distributed as follows:

a) **Return of Capital and Costs:** First, 100% to [all partners] until the cumulative amount previously and currently distributed to [all partners] under this Section (a) equals the aggregate Capital Contributions made to the [JV] by [all partners];

b) **8% Preferred Return:** Second, 100% to [all partners], until the cumulative amount previously and currently distributed to [all partners] under Sections (b) - (d) is sufficient to provide [all partners] with an 8% per annum return, compounded annually, on the aggregate Capital Contributions made to the [JV] by [all partners];

c) **[NOTE: NOT SEEN IN MOST REAL ESTATE JVS: Catch-up to 20% Overall Promote:** Third, 80% to the [manager] and 20% to [all partners], until the cumulative amount previously and currently distributed to the [manager] under this Section (c) equals 20% of the cumulative amounts previously and currently distributed pursuant to Sections (b) and (c);] and

d) **80/20 Split:** Thereafter, 80% to [all partners] and 20% to the [manager].
Whole Fund Complexities

Note that while a return-all-capital waterfall is simpler than a deal-by-deal waterfall, it can result in some complexities, particularly at the manager level.

- If the manager allocates promote among its team members on a return-all-capital basis, it may be more cumbersome to track than in the case of a deal-by-deal waterfall, because carry earned on early deals will often be distributed to money partners to repay preferences, to be made up out of proceeds from later deals. This could complicate dealings with team members who enter or leave in the middle of the life of a JV.

- It is more complex to structure P&L allocations with respect to investments made through multiple subsidiary entities, particularly where inter-company debt is employed for tax planning purposes, because promote economically earned as a result of the performance of an asset in one subsidiary may be distributed by another subsidiary that may or may not have the profits to support the distribution of promote.
Deal by Deal Waterfalls

- True deal by deal waterfall for multiple investment JVs is rare.
- Cumulative “realized” deal by deal waterfall is more typical.
Basic Deal by Deal Waterfall (Not Partner by Partner)

Distributions. Distributable Cash from Investments will be distributed as follows:

a) **Return of Capital and Costs**: First, 100% to [all partners] until the cumulative amount previously and currently distributed to [all partners] under this Section (a) equals the amount of Capital Contributions made to the [JV] by [all partners] with respect to (i) all Investments that have been disposed of or permanently written off or written down as of that time and (ii) all general [JV] expenses allocable to the Investments referenced in clause (i) [or, alternatively, all general [JV] expenses];

b) **8% Preferred Return**: Second, 100% to [all partners], until the cumulative amount previously and currently distributed to [all partners] under Sections (b) - (d) is sufficient to provide [all partners] with an 8% per annum return, compounded annually, on the amounts in Section (a);

c) **[NOTE: NOT SEEN IN MOST REAL ESTATE JVS: Catch-up to 20% Overall Promote]**: Third, 80% to the [manager] and 20% to [all partners], until the cumulative amount previously and currently distributed to the [manager] under this Section (c) equals 20% of the cumulative amounts previously and currently distributed pursuant to Sections (b) and (c); and

d) **80/20 Split**: Thereafter, 80% to [all partners] and 20% to the [manager].
There are four factors that drive the shape of deal by deal waterfalls:

1) Periodic capital calls.
2) Deal-by-deal determination of whether preferences have been met.
3) Rolling cumulative true-up.
4) Clawback.

The calculation is generally simpler in the case of a return-all-capital calculation.
Deal by Deal Waterfalls (cont.)

Before the manager is entitled to a distribution of promote, money partners are entitled to receive:

1. Return of Capital
   A. In the case of a whole fund model, a return of all capital contributions (no matter what for) made as of the time of the distribution.
   B. In the case of a deal-by-deal model, a return (only) of all capital contributions attributable:
      • to the investment giving rise to the distributable proceeds (including expenses attributable to the investment),
      • to all investments previously disposed of, written off or written down as to which there are unreturned capital contributions, and
      • to any general JV expenses (e.g. manager fees and other JV non-deal expenses) allocable to that investment, and to the extent not previously returned, to any previously disposed of investments [or, alternatively, all general JV expenses].
      • In the case of a current income distribution, capital contributions attributable to the investment giving rise to the proceeds to be distributed, but only to (i) determine how to distribute those proceeds and (ii) determine whether those proceeds are credited against shortfalls attributable to other investments that have been disposed of, written off or written down.

2. Preferred Return on all capital contributions described in 1A (for whole fund) or 1B (for deal by deal), as applicable.
Dispositions

• In the case of a deal-by-deal calculation, the partnership agreement typically will not require capital to be returned or the preferred return to be calculated on a money partner’s capital contributions until the investment to which those capital contributions are attributable has been “Disposed of.” A “Disposition” may include:
  ▪ A sale, exchange or other disposition of the investment.
  ▪ Receipt of proceeds in complete liquidation of the JV’s entire interest in the investment (or partial liquidations of a portion of such interest).
  ▪ Sometimes, receipt of proceeds in connection with a refinancing or recapitalization of an investment.
Current Income Distributions (No Income Source Division)

In the case of a basic deal-by-deal calculation, a distinction is typically drawn between a Disposition and a current income distribution. In such a case, a current income distribution would be distributable proceeds attributable to any realization event that is not a “Disposition.” These may include:

- The distribution of rental payments or interest payments or other non-liquidating distribution.
- Proceeds from a refinancing or recapitalization (if not included as a “Disposition”).
The common theme is that an event that gives rise to a current income distribution is not an appropriate event to “close out” an investment, while a Disposition is. A Disposition triggers a reckoning with respect to an investment, while judgment continues to be withheld in the case of a current income realization, because the investment is expected to yield additional proceeds.
Example

- JV has a deal-by-deal waterfall.

- For $1000, JV buys (i) a note secured by an office building and (ii) an option to acquire equity interests in the LLC that owns the office building. JV allocates $1 to the option and $999 to the note.

- Shortly thereafter, JV sells the note to an unrelated party for $900, its fair market value.
  - There is no indication that the option should be written down (note that for this purpose, the relevant value is $100, not $1, because the waterfall looks to the unreturned capital in an investment, which includes all classes of interests in the investment).

- Shortly thereafter, JV sells another investment at a $1000 gain.
• Result - The $900 proceeds from the sale of the note is distributed to the money partners as a return of capital. Because this is not a Disposition, the difference between the $999 allocated to the note and the $900 of proceeds is not required to be made up from the gains realized on the disposition of the other investment.

• Rationale: it is not appropriate to come to a conclusion about the performance of the investment until the option (or the LLC interests received on the exercise of the option) is disposed of.

• A sale of 50% of the option and 50% of the note for $450 would be a Disposition of 50% of the investment, and the $50 loss would be required to be made up from the gains on the other realized investments.
Write-downs and Write-offs

- Write-downs and write-offs are treated as having the effect of a Disposition.

- Important: a write-down or write-off is **not** a “mark to market,” but is supposed to reflect a permanent decline in the value of an investment.
Waterfall with Income Source Division (e.g., Current Income vs. Disposition Proceeds)

- All distributions are divided based on income source, with, e.g., current income divided up pursuant to one waterfall and disposition proceeds divided up pursuant to another waterfall.
- Disposition proceeds waterfall is generally the same as the whole fund or deal by deal waterfalls discussed previously.
- Current income waterfall is also similar, except that the capital contribution-based component of the waterfall is typically eliminated and the manager is entitled to receive promote after returning distributions sufficient to achieve a specified preferred return on (but not return of) the applicable capital contribution amount.
Distributions Distributable Cash from any Investment will **initially be apportioned** (solely as an interim step) among all Partners (including the manager) in accordance with their relative Percentage Interests in such Investment (based on Capital Contributions made by the Partners to such Investment). The amount apportioned to the manager will be **distributed** to the manager. The amount apportioned to each other Partner will be **divided** between such other Partner and the manager and **distributed** as follows:

a) **Return of Capital and Costs**: **First**, 100% to the Partner until the cumulative amount previously and currently distributed to such Partner under this Section (a) equals the aggregate Capital Contributions made to the JV by such Partner;

b) **8% Preferred Return**: **Second**, 100% to such Partner, until the cumulative amount previously and currently distributed to such Partner under Sections (b) - (d) is sufficient to provide the Partner with an 8% per annum return, compounded annually, on such Partner’s aggregate Capital Contributions;

c) **Catch-up to 20% Overall Carried Interest**: **Third**, 80% to the manager and 20% to such Partner, until the cumulative amount previously and currently distributed to the Partner under this Section (c) with respect to amounts initially apportioned to the Partner equals 20% of the cumulative amounts previously and currently distributed pursuant to Sections (b) and (c); and

d) **80/20 Split**: **Thereafter**, 80% to such Partner and 20% to the manager.
The general sharing of JV proceeds is a 2-step process. First, all proceeds are **apportioned** among all partners, including the manager, in proportion to their capital contributions with respect to the asset that generated the proceeds. The manager’s pro-rata share is then **distributed** to it. The other partner’s pro-rata share is then **distributed** to such partner and, possibly, the manager, in the respective amounts determined by the “waterfall.”
Partner-by-Partner Waterfall (cont.)

- On a Partner-by-Partner basis, the proceeds allocated to each other Partner in Step One are “run through the waterfall” to determine the allocation of each manager’s share between the manager and such Partner.

- Partner-by-Partner waterfall accommodates different treatment among the partners, such as reduced promote or fees for large partners or opt-out rights for some partners (mostly fund concepts) or a default where a partner fails to fund. It also avoids allocation of manager fees to the manager’s capital, which is beneficial from a tax perspective.

Residual - 80% PARTNER/20% MANAGER

Catch-up
20% PARTNER/80% MANAGER
Preferred Returns

- IRRs vs. absolute dollar thresholds
- IRR vs. capital plus preferred return
- Preferred return compounding methodology
- Order of return of capital/preferred return
Clawback

- Purpose:
  - The purpose of the clawback is to maintain the appropriate sharing ratio between the money partners and the manager, in light of the fact that the promote is paid out deal by deal. Underperforming investments can be among the last to be Disposed of. Unless they were already written down when the promote was calculated on prior profitable Dispositions, the manager may receive over-distributions of promote, based on the JV’s entire portfolio, in the case of a deal-by-deal calculation. While it is theoretically possible to get into a clawback situation with a return all capital calculation, the possibility is remote in most cases.
  - Some JV agreements permit the manager to defer promote distributions to avoid getting into a clawback situation.
Clawback (cont.)

• Mechanics:
  
  ▪ A typical clawback will require the manager to contribute to the JV, to be distributed to each affected money partner, the sum of the amounts determined for each money partner equal to the greater of either:

  (i) the excess of promote distributions attributable to a money partner’s interest over 20% (or other promote percentage) of profits attributable to a money partner’s interest, or

  (ii) the amount by which the sum of a money partner’s capital contributions and preferred return exceeded total distributions received by it.
Clawback (cont.)

- But contrast typical methodology with a “reverse waterfall” giveback obligation, which is sometimes seen in real estate JVs.
Clawback (cont.)

• After-Tax Calculation:
  - The aggregate clawback payments typically do not exceed the aggregate clawback distributions, reduced by Tax Distributions, plus tax attributed to built-in gains on assets distributed in-kind (based on the value on the date of distribution).
  - The reduction for taxes on built-in gains reflects the fact that the gain resulting in the tax will be recognized outside the fund and would not have given rise to a Tax Distribution, and thus will not be picked up by the Tax Distribution reference.
Interim Clawback

- Some JVs provide for an interim clawback, which require the clawback calculations described above to be made periodically. Any over-distributions are contributed to the fund and distributed to the money partners in the same manner as the clawback at the end of the JV.

- Distributions to money partners are treated as flowing through the waterfall. The “catch-up” layer of distributions must be adjusted to back out distributions that are recontributed by the manager pursuant to the interim clawback.
Escrow, Clawback Guarantee

• Because JV manager entities are typically special purpose entities with no assets other than their interest in the JV, steps must be taken to secure the payment of the clawback.

  ▪ Some JVs require that a portion of the promote distributions be escrowed by the JV. Clawback payments are then first made from the escrow. The escrow usually has a formula-based cap.
Guarantee:

- JV agreements may require the manager to secure guarantees of the clawback obligation from its members or partners. Such guarantee is typically several, and not joint.
Fee Waiver

- Common in funds; not common in JVs; but same principles apply and can be used to a manager’s benefit.
- A fee waiver is a mechanism by which a manager’s fee is reduced (in advance of the year for which it would be owed, to avoid “constructive receipt” issues), and the manager or an affiliate gets a “credit” against its capital contribution obligation.
- The “credit” really represents a variation of a profits interest – the manager gets a special allocation of income or gain equal to the avoided capital contribution, and a pro-rata share of income and gain above that.
Fee Waiver (cont.)

• The money partners should be economically indifferent – the capital that they would otherwise contribute to pay the fee is instead applied, in lieu of the manager’s avoided capital contribution, to acquire investments.

• To preserve character as a profits interest for tax purposes, there is a special clawback or other arrangement to ensure that the manager’s priority return that is equal to the avoided capital contribution is from income or gains that accrued after the date the applicable investment is made.

• This provision is not for the benefit of the investors, it is to preserve the manager’s beneficial tax treatment.

• The Treasury Department recently published proposed regulations that affect how fee waiver arrangements are treated. While some arrangements may need to be modified to comply with the new regulations, it is expected that fee waiver arrangements, if properly structured, will continue to be viable.
Capital Accounts and Tax Allocations

- Capital accounts reflect each partner’s ownership interest in the assets of a partnership.

- The sum of the partners’ capital accounts represents the partnership’s total equity.

- Capital accounts are not the same as tax basis, though tax accounting principles apply.
“Parallel Universe”

- Think of capital accounts as reflecting the partners’ ownership interests in a partnership in a parallel universe where:
  - the value at which an asset is carried on the partnership’s books represents fair market value; and
  - adjustments to those values represent real economic gain or loss that is reflected in the capital accounts of the partners who are entitled to that gain or who bear that loss.
- Not infrequently referred to as the “third set of books.”
Basic Capital Accounting Rules

- Each partner’s capital account is increased by:
  - its capital contributions, with in-kind contributions reflected at net fair market value, and
  - its share of the partnership’s income.

- Each partner’s capital account is decreased by:
  - distributions to it, and
  - its share of the partnership’s losses.
What are the function of capital accounts in Joint Ventures?

- Except for special circumstances such as “fractions rule” partnerships, they typically are **not** used to determine a partners economic entitlements.

  - Economic entitlements are generally determined by the distribution waterfall.

- They typically **are** used as a benchmark for tax profit and loss allocations.

  - Capital account allocations begin with taxable income, with certain adjustments to align with the principles of the parallel universe.

  - “Tax follows book.”
“Targeted” or “Forced” Allocations

- Under a “targeted” or “forced” allocation arrangement, partnership profit & loss is allocated so that at year end, each partner has a capital account balance equal to the amount such partner would receive if the partnership sold its assets at the value reflected in the capital accounts and liquidated.

- More traditional “tiered” allocation provisions use a different methodology, but are designed to reach the same result.
Limitations on Losses

- Subject to the minimum gain rules, a partner cannot receive an allocation of losses that would result in a deficit balance in its capital account.

- Capital accounts reflect a partner’s interest in the equity of the partnership. A partner who does not have a positive capital account balance no longer has any equity at risk.

- The loss must be allocated to partners who have positive balances, and thus who still have equity at risk. Sometimes called “disproportionate losses.”
The JV Manager/Money Partner partnership admits Co-Manager who contributes no capital, but agrees to provide services to the partnership in exchange for 20% of the profits. JV Manager and Money Partner each contribute an additional $100 to the partnership, which is spent on currently deductible fees.

<table>
<thead>
<tr>
<th></th>
<th>JV Manager</th>
<th>Money Partner</th>
<th>Co-Manager</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$0.00</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>Contribution</td>
<td>+100.00</td>
<td>+100.00</td>
<td>0.00</td>
<td>+200.00</td>
</tr>
<tr>
<td>Expense</td>
<td>-100.00</td>
<td>-100.00</td>
<td>0.00</td>
<td>-200.00</td>
</tr>
<tr>
<td>Closing Balances</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$0.00</td>
<td>$2,000.00</td>
</tr>
</tbody>
</table>

No portion of the expense may be allocated to Co-Manager, because that would result in a deficit balance in its capital account.
What is Minimum Gain?

- In general, “minimum gain” is the difference between the aggregate capital accounts of the partners and the amount of the partnership’s non-recourse debt.

- Remember, in the parallel universe, the partnership’s capital accounts reflect the fair market value of its assets.
  - Once the aggregate capital accounts of the partners are less than the amount of non-recourse debt, it is the lender, not the partners, who bears any incremental loss of the partnership.
  - Where non-recourse debt exceeds the partnership’s capital, the equity is wiped out and the loan is treated as if it is underwater.
Sources of Minimum Gain

- Depreciation of an asset purchased using non-recourse debt.
  - Partners generally are permitted to claim depreciation deductions even though the lender bears the economic cost.

- Distribution of proceeds of a borrowing against an asset when the FMV of the asset is greater than the amount reflected in the partnership’s capital accounts.

- The “minimum gain chargeback” ensures that the partner that received the benefit of the deduction or distribution bears the corresponding economic burden.
Example

The JV Manager/Money Partner partnership borrows $8,000 from a bank, and using its $2,000 of capital, buys an apartment building for $10,000, the building is depreciated at $350 per year, and operating income exactly equals the sum of operating expenses and distributions, so there are no retained earnings. Assume interest only is paid on the debt. After 10 years, the capital accounts of JV Manager and Money Partner are as follows:

<table>
<thead>
<tr>
<th></th>
<th>JV Manager</th>
<th>Money Partner</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>10 Yrs Depreciation</td>
<td>-1,750.00</td>
<td>-1,750.00</td>
<td>-3,500.00</td>
</tr>
<tr>
<td>Closing Balance</td>
<td>-$750.00</td>
<td>-$750.00</td>
<td>-$1,500.00</td>
</tr>
</tbody>
</table>
Example

• Partnership has $1,500 of minimum gain because if the apartment building were conveyed in satisfaction of the $8,000 debt, the partnership would recognize gain equal to $8,000 less its $6,500 basis.

• The capital accounts of JV Manager and Money Partner are allowed to go negative by the amount of inherent tax gain the partnership’s assets (minimum gain).

• If Money Partner had loaned the $8,000 to the partnership (or guaranteed the loan), the entire $1,500 of depreciation would have been allocated to Money Partner because Money Partner bore that economic loss as lender. This would occur by virtue of the rules governing “partner minimum gain.”
Example

The value of the building owned by the JV Manager/Money Partner partnership has increased to $20,000 over 10 years, and the lender is willing to loan the partnership $5,000 more, to be distributed to the partners:

<table>
<thead>
<tr>
<th></th>
<th>JV Manager</th>
<th>Money Partner</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Balance</td>
<td>-$750.00</td>
<td>-$750.00</td>
<td>-$1,500.00</td>
</tr>
<tr>
<td>Distribution</td>
<td>-$2,500.00</td>
<td>-2,500.00</td>
<td>-5,000.00</td>
</tr>
<tr>
<td>Closing Balance</td>
<td>-$3,250.00</td>
<td>-$3,250.00</td>
<td>-$6,500.00</td>
</tr>
</tbody>
</table>

The total minimum gain of the partnership has increased to $6,500 ($13,000 non-recourse debt – $6,500 tax basis). If the lender were to foreclose, the partnership would recognize $6,500 of gain, which would be allocated $3,250 to each of JV Manager and Money Partner. That is the “minimum gain chargeback.”
Liquidation of the Partnership

- Consistent with the underlying economic principles of capital accounts, upon liquidation of a partnership, each partner should receive an amount equal to its capital account.

- This should be true whether liquidating in accordance with capital accounts or a distribution waterfall.
Importance of Tax Distributions

- Profit allocations can result in income to a partner before the partner is entitled to a cash distribution under the distribution waterfall. Sometimes loans are made, rather than tax distributions, to be repaid when the JV Manager receives its carry distribution.

- Example: JV Manager and Money Partner form a partnership by contributing $200 and $1,800, respectively. Money Partner is entitled to a return of all capital and preference before any carry is paid to JV Manager. The partnership uses the $2,000 to make two $1,000 investments. The partnership disposes of Investment #1 for $2,500, for a profit of $1,500, when the accrued preference is $450.
Example

- JV Manager is entitled to 10% of the $1,500 profit with respect to his invested capital. JV Manager is also entitled to 20% of Money Partner’s share of the profit, or $270, and Money Partner is entitled to the remaining $1,080.

- However, under the distribution waterfall (a return-all-capital waterfall), Money Partner is entitled to its capital and preference ($2,250) before carry distributions to JV Manager.

- Unless tax distributions are provided for, JV Manager will receive an allocation of gain attributable to the carry of $270 with no corresponding cash distribution to pay the taxes.
Tax Distributions (cont.)

• The tax distribution provision **overrides** the general waterfall provisions.

• Typically only the manager would get tax distributions.
  
  ▪ **Rationale:** because of the money partners’ distribution priorities, it is the manager, rather than the money partners, that runs the risk of “phantom” or “dry income” (i.e. taxable income without cash).
  
  ▪ i.e., the manager’s promote distribution rights may lead to allocations of income to the manager ahead of the distribution of corresponding cash to the manager.
Tax Distributions (cont.)

- Money partners sometime negotiate a tax distribution provision that covers them as well as the manager, in case the portfolio generates enough “dry income” so that money partners are also affected.

- This has the effect of “spreading the pain,” although if a high percentage of the money partner interests are held by persons not subject to U.S. tax, it has the effect of increasing the manager’s share of the pain.
Tax Distributions (cont.)

• Typically the calculation of a tax distribution is required to take into account the deductibility of state and local taxes, prior unused tax losses and the character of the income or gain realized by the partnership.

• “Tax Distributions” should be defined as the aggregate distributions that would have been made had the manager received only tax distributions, rather than amounts that were actually distributed as tax distributions. This is important in calculating the clawback amount.
Section 83(b) Elections

The JV Manager’s carry may be subject to vesting, with the unvested portion subject to repurchase on unfavorable terms if certain covenants are breached. Individual members of a JV Manager may also own interests in the JV Manager subject to similar conditions.

Under Section 83 of the Internal Revenue Code, property (including an interest in a partnership) that is transferred in connection with the performance of services and is subject to a “substantial risk of forfeiture” generally gives rise to compensation income when the forfeiture provisions lapse, in an amount equal to the excess of the fair market value at the time the restrictions lapse over the amount paid for the interest.
Individual, an employee of JV Manager, a Partnership, pays $100, its fair market value, for a 10% interest in JV Manager. The interest vests ratably over 5 years, and is subject to repurchase at cost by JV Manager if Individual voluntarily ceases employment with JV Manager or its affiliates. Assume Individual remains employed by JV Manager until the interest is fully vested.

<table>
<thead>
<tr>
<th>Year End</th>
<th>Value of 20% of interest</th>
<th>Income (excess of value over $20)</th>
<th>Tax at 40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>$25</td>
<td>$5</td>
<td>$2</td>
</tr>
<tr>
<td>Second</td>
<td>$35</td>
<td>$15</td>
<td>$3</td>
</tr>
<tr>
<td>Third</td>
<td>$50</td>
<td>$30</td>
<td>$6</td>
</tr>
<tr>
<td>Fourth</td>
<td>$75</td>
<td>$55</td>
<td>$11</td>
</tr>
<tr>
<td>Fifth</td>
<td>$100</td>
<td>$80</td>
<td>$16</td>
</tr>
</tbody>
</table>

Because the income inclusion may not correspond to any cash proceeds from the interest, the resulting tax could create a significant financial burden. Under current interpretation of Section 83, this result obtains even though Individual paid fair market value for the interest in JV Manager.
Section 83(b) Elections (cont.)

Under Section 83(b) of the Internal Revenue Code, a recipient of property subject to a substantial risk of forfeiture can make an election to include in income as of the date of issuance the difference between fair market value and what is paid for the property. If Individual made the Section 83(b) election in the example above, he/she would recognize no gain on receipt, having paid fair market value for the interest, and would have no further income when it vested.

Caveat: The election must be filed with the IRS within 30 days of the transfer of the property and there are NO EXTENSIONS available.