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Joint venture structures - back to basics

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Considering entering into a joint venture? The first step is to decide on the most appropriate structure to achieve your commercial objectives. A number of factors will influence this, including liability, ownership of assets, taxation, flexibility of funding, disclosure and publicity. For the vast majority of clients, the main structural options are the limited partnership, the incorporated JV company, and the unincorporated JV.

Limited Partnership JV

A Limited Partnership (LP) is a separate legal entity which must have at least one general partner (GP) (responsible for management), at least one limited partner, and a private partnership agreement.

Limited partners enjoy limited liability provided that they do not take part in the management of the LP (subject to certain exceptions allowing strategic control), which can be particularly attractive to passive investors. GPs' liability is unlimited and joint and several with the LP (but usually residual after the LP's assets have been exhausted). Given the exposure, a GP is usually a limited liability company with nominal share capital.

Commonly, each JV party will be a limited partner, contribute capital to the LP and hold shares in the limited liability company GP in proportion to their respective interests. As shareholders, they will enter into a shareholders' agreement including wider rights and powers than those possible in a partnership agreement, without affecting the extent of their liability.

The LP also affords more privacy to the limited partners than the limited liability company. The partnership agreement and details of the limited partners' respective investments may be kept private (although the details of the GP will be public, allowing third parties to identify the limited partners and draw conclusions as to their interests in the LP).

One of the main benefits of an LP is that, while governed like a company, it is taxed in a similar way to an ordinary partnership. LPs are treated as transparent for New Zealand income tax purposes, generally allowing income, gains and losses of the LP to flow directly to the limited partners, whose personal tax status will govern how they are taxed. Transparency is useful for a variety of different JV parties - for example, tax exempt charities can have income attributed directly from the LP so that no tax is imposed, and JV parties that are not tax resident in New Zealand may be able to receive a credit in their home jurisdiction for any tax paid in New Zealand on income derived from the LP.

However, there are also a number of tax limitations on the use of LPs. From a commercial perspective, income, gains and losses can be attributed to limited partners in agreed proportions, however from a tax perspective partners are instead treated as receiving a share of all amounts in proportion to their partnership share. While LPs are, from a commercial perspective, relatively flexible in terms of further investment (as additional limited partners can easily be added to an LP), introducing new limited partners and selling existing partnership shares to entering partners can give rise to unexpected tax consequences. There may also be limits imposed by the "loss limitation rules" on the amount of deductions that a limited partner can claim.

Incorporated JV

With an incorporated limited liability company (JVCo), the JV parties (or their subsidiaries) are the shareholders, appoint the JVCo directors, and will often enter into a shareholders' or JV agreement. The JVCo shareholders receive dividends and, on the payment of income tax in New Zealand by the JVCo, the JVCo can attach imputation credits to dividends so as to reduce the effective double taxation of the JV shareholders. With a separate legal personality, the JVCo can own assets, enter into contracts, incur obligations and liabilities, make profits and suffer losses.

A clear advantage of a JVCo is that, generally, liability for the JVCo's debts and obligations is limited to the JVCo, protecting shareholders and directors (and their assets). Shareholders may be asked to guarantee the JVCo (for example to secure funding) which can reduce the limited liability protection provided by the JVCo, but in our experience this rarely outweighs the benefits of using a JVCo.

JVCos allow flexible funding options, for example by way of share capital or debt. However, JV parties should consider how using a JVCo could affect existing financial arrangements (such as requirements to keep certain debt-equity ratios), group accounting and existing management.

If expressly permitted by the JVCo constitution, directors may act in the best interests of the shareholders (or JV parties) rather than the JVCo, which can be helpful for the underlying shareholders. Shareholders do not owe fiduciary obligations to one another, although a shareholders' agreement can impose fiduciary-like obligations.

A JVCo also provides flexibility of ownership. JVCo shareholders can quite easily transfer or acquire shares without disrupting the business. However, transferring shares can have adverse tax consequences impacting on the JVCo's ability to carry forward tax losses and to retain valuable imputation credits for shareholders. From a tax perspective, a significant disadvantage of a JVCo is that any capital gains generally cannot be distributed tax-free to New Zealand tax resident shareholders during the JVCo's life, and cannot be distributed tax-free to non-resident shareholders at all.

Further tax consequences can arise from the transfer of assets by the JV parties into the JVCo. For example, an asset which has increased in value since it was acquired by the relevant shareholder, which is then transferred to the JVCo (perhaps in exchange for shares on incorporation), may bring about a tax liability for the JV party. For this reason, the JV party may decide to lease the asset to the JVCo instead, but this can also have tax consequences. Tax consequences may also arise if shareholders deal with the JVCo on non-arm's length terms.

Unincorporated JV/partnership

With an unincorporated JV (UJV), the JV parties make different contributions through their existing structures to create a business venture or achieve a common objective, and typically have an agreement detailing their rights and obligations with respect to each other and third parties. Profits and losses flow through to the JV parties themselves, and are treated according to the relevant JV party's tax status. While a UJV is not a separate legal entity, this is not usually a critical factor to those deciding whether to choose this type of JV structure.

A UJV may be deemed to be a partnership and subject to partnership law, affecting the share of profits, losses and liabilities between the JV parties. A partnership is an arrangement whereby partners carry on business in common with a view to making and sharing a profit. The "partners" have unlimited joint (sometimes several) liability for the partnership's debts and obligations and their partners' acts and omissions, and owe fiduciary duties to each other. Partners contribute property to the partnership (often bringing about tax consequences), which is held on trust by the partners and available to satisfy the partnership's debts.

The tax treatment of a UJV that is a partnership is broadly similar to that of LPs as discussed above, with UJV partnerships treated as transparent for tax purposes. One key and beneficial difference in tax treatment is that UJV partnerships are not subject to the loss limitation rules that apply to LPs, permitting the JV parties to claim full deductions for all tax losses attributed from the UJV partnership in an income year.

In a UJV that is not a partnership, the JV parties keep their respective businesses separate (although they may, for example, jointly use assets and facilities) and share costs up to the stage of production or output. The JV parties can agree to allocate profits and losses differently. Unless agreed otherwise, each JV party collects profits for its own separate account and retains ownership of its property. While each JV party will not have statutory liability (as the UJV is not a partnership), their liability could still be unlimited, which is why each JV party may decide to use a limited liability company as the JV party.

Whether or not a legal partnership is created by a UJV requires a detailed assessment of all the facts and relevant law. Expert tax and legal advice and a well-drafted JV agreement can go a long way to ensuring that the wrong structure is not inadvertently adopted.

A UJV can be more attractive to lenders, who can maximise their tax deductions and who may have concerns about a JVCo's ability to pay dividends. However, UJVs are probably less marketable, compared to shares in a limited liability company.

Conclusion

Each of the JV structures described above requires varying degrees of integration by the JV parties, offers different levels of liability protection and presents a range of tax consequences to consider. The LP may provide the "best of both worlds," allowing both limited liability and tax transparency. However, the key tax limitation inherent in an LP, that JV parties may be limited in the level of deductions they can claim for losses attributed from the LP in a particular income year, should be borne in mind. If this limitation is of concern, but tax transparency is still desirable in a potential JV structure, it may be worth considering the use of a UJV (whether a partnership or not) with JV parties that are themselves companies, in order to obtain both tax transparency and limited liability for the JV parties.

For any new venture, the JV parties' circumstances, relationship, objectives and appetite for risk and liability should therefore all be carefully considered before deciding on an appropriate JV structure. Numerous other factors, including employment law issues, competition law, and industry-specific regulations will also likely influence the choice of JV structure. If contemplating establishing a new JV, the first step will always be to consider the advantages and disadvantages of each possible structure and agree on the right one upfront.

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