

Property Development Joint Ventures Risks, Financing and Taxation Issues

- **David Colenso, Partner,
Deacons Graham & James, Brisbane.**

This article focuses on property development joint ventures. Selection of a joint venture structure is often distracted or even driven by tax efficient considerations. Participants can lose sight of the woods for the trees - passing over the original motives and benefits for the joint venture by emphasising tax above all other issues. The original purpose for the joint venture must remain paramount in selecting the structure and vehicle. Risk and financing issues should be primary considerations while taxation remains secondary.

This article explores these considerations and:

- analyses the myriad of risks facing property development joint ventures;
- looks at ways to eliminate or minimise those risks;
- addresses the critical finance issues; and
- highlights particular tax features and consequences.

1. OVERVIEW

1.1 Joint ventures may take many forms. Most commentators will point to the 3 broad categories of joint venture:

- (1) a separate legal entity ("Vehicle"), such as an incorporated joint venture company with shares owned by the Participants;
- (2) a legal relationship recognised by law ("Structure"), such as a partnership (common law or limited liability) or a trust (unit or discretionary);
- (3) a purely contractual relationship which, in itself, is not a separate legal entity and does not fit into the accepted legal definition of trust or partnership relationships. They are governed by the joint venture agreement which creates the contractual relationship between the Participants.

Essential to all of these categories is the coming

together of at least 2 businesses or investors ("Participants") for a common business purpose.

- 1.2** This article discusses why Participants enter into a property development joint venture and some of the risks which will be encountered. More importantly, it also addresses ways in which those risks can be eliminated, minimised or apportioned between the Participants and other outside parties by appropriate structuring and documentation.

2. WHY HAVE A JOINT VENTURE?

2.1 Motives

Most joint ventures arise from an idea, opportunity, risk or a time when a Participant can see a benefit in joining with another Participant to further a common business goal. Often those original reasons for getting together in the first place are forgotten or pushed to the background by issues such as tax.

"Firstly, it is essential to look at what the 'mission' and objectives of the business venture are. This seems a very obvious first step, but unfortunately often not thought through and clearly articulated in the enthusiasm of starting a venture. If it is not clearly defined, the steps that follow can be misdirected".¹

Discussed below are some of the original motives and benefits for the formation of property development joint ventures and how those motives can dictate the appropriate Structure of the joint venture.

2.2 Finance

Many of Australia's large (and not so large) property developments in recent years have shown a willingness by many companies to consider joint venture arrangements as a suitable means of financing them. Innovative examples include the \$520 million Collins Exchange office tower at 333 Collins Street, Melbourne.² After the

spectacular crashes of property developments and developers in the late 1980's, financiers placed even greater scrutiny on asset backing and balance sheets. Under lenders' prudential guidelines now, the balance sheet of a developer or builder on its own may not be sufficient to raise the required finance for a major project. The assistance of a financier may be needed - one who is prepared to fund the project on the basis that it is given an equity share in the project and not merely assume a secured lender's position in the project.

2.3 Spreading Financial Risks

Clearly a joint venture is one possible way of spreading financial risks to enable financial institutions to participate in large projects while not exceeding their prudential limits. Companies can spread the costs and risks of a project while allowing a flexible combination of technical, financial and market knowledge and strengths. By spreading financial risks a joint venture is a means of achieving business and economic objectives which ordinarily would be far beyond the capabilities of one company operating alone.

Given the ever-changing property market, a joint venture permits experimentation in the high risk/high profit end of a market without necessarily incurring an unlimited liability for a developer. Participants can "dip a toe in the water" of a new area of investment, a speculative development or engage new technology or management techniques without placing all their capital at risk.

2.4 Off Balance Sheet

Property acquisition and development incurs very high debt during the early stages of acquisition of land and construction. That debt on its own may be unacceptable both to developers and financiers and could affect existing financial ratios of companies. Depending on the ultimate structuring of a transaction, a joint venture is one way of ensuring that the project and subsequently the debt is "off balance sheet".³

2.5 Foreign Investment

The *Foreign Acquisitions and Takeovers Act* ("FATA") administered by the Foreign Investment Review Board ("FIRB") provides a strong incentive for joint venture formation by foreign investors. Generally, there is a 15% threshold on foreign investment in certain companies and even stricter control on foreign investment in urban land.⁴ While FIRB is often willing to waive the requirements of the *Act* to encourage foreign investment into Australia, the restrictions have forced foreign investors to involve Australian Participants in their ventures.

The FATA relies on a variety of tests to establish the extent of foreign participation in a joint venture through board and voting control. Those types of tests or conditions of approval imposed by FIRB have a great impact on the selection of a Vehicle for the venture but also on the selection of venture Participants and the ultimate Structure of the joint venture itself.⁵

2.6 Sharing Resources

Quite often the only reason a developer needs other Participants in a project is to achieve a benefit which the developer is unable or unwilling to achieve single-handedly without complementary resources. Apart from finance, other considerations are:

- (1) market knowledge and access;
- (2) industry intelligence;
- (3) development or building skills;
- (4) design or other trade skills;
- (5) site availability; or
- (6) industry contacts.

Invariably, each Participant in a joint venture has something special which may not be readily available in the market - some special expertise, resources or market position which is both required by and often best developed in concert with other Participants. Essentially, *"the combined resources of the Participants are intended to be greater than the sum of its constituent Participants."*⁶

To ensure that resources (and not just ultimately profits) are shared between the Participants in the joint venture, the Structure must be well planned to identify the timing, nature, quality and other parameters of the resources and the extent to which they will be shared by the Participants in the joint venture development.

Documentation of the sharing of resources by the participants can be achieved by the following methods:

- (1) secondment contracts for key employees of Participants to be seconded to the joint venture;
- (2) licenses to the joint venture for the use of technology, confidential information or know-how which one of the Participants brings to the joint venture;
- (3) loan agreements where joint venture Participants are providing capital;
- (4) enabling legislation where the government or a government authority is a participant;
- (5) leases to the joint venture of property or facilities owned by a Participant;
- (6) partly paid shares in a joint venture company which would allow the joint venture to call on the Participants' shareholders and their financial resources if the joint venture required further capital;
- (7) marketing agreements - particularly where a participant with market information or penetration will market the joint venture's project; and
- (8) management or operation contracts - used where one participant will devote its skills for the benefit of the joint venture.

2.7 Sharing Risk

While the financial burden of a project may be too great for one participant, similarly the desire to spread risk is another primary motive behind forming a joint venture. Indeed, risk minimisation is one of the key roles which most consultants will play in a property joint venture.

These range from lawyers who draft the joint venture documentation and construction contracts to advisers such as building cost consultants, selling agents and financiers.⁷

At a very basic level, structuring may entail Participants taking shares in a joint venture company in the same proportion as their financial contribution to the venture. Essentially, if there is a loss or profit then it is shared proportionally to the equity contribution of each shareholder.

However, the complexities of larger projects and the demands of financiers dictate that the risk must not only be apportioned but also the Participant best able to bear a certain risk does so - not forgetting that if a Participant is unable to bear the risk then the other Participants will be vulnerable - the risk may crystallise and will ultimately rest with someone.

In a nutshell:

*“successful structuring of a joint venture involves identifying the risks of the joint venture, allocating them to the Participants best able to bear them, allocating other risks to external parties who can more efficiently bear them than the Participants, and documenting the manner in which those risks are allocated and borne”.*⁸

In part 3 of this article the author discusses the various categories of joint venture risks in property development and methods to eliminate, allocate or minimise them.

2.8 A Warning

While deserving of an article on its own, an important point needs to be made about structuring joint ventures. Solicitors are most often called on to advise on and document joint venture Structures. Given the risks discussed in part 3 of this article, advising all Participants poses an important and difficult matter for solicitors. *Waimond Pty Ltd v Byrne*⁹ illustrated that a solicitor can be negligent in carrying out the instructions of the manager of a joint venture who held legal title to a property when that constituted a breach of trust, especially where the solicitor failed to obtain instructions from the Participants who were the beneficial owners of the land.

3. RISK

3.1 Identifying Risk

In analysing any property development all risks need to be identified, addressed and, if possible, eliminated or minimised. The risks can then be allocated to the Participant willing to accept them in order to achieve the various objectives of all Participants. In identifying the risks, Participants need to determine the likelihood of occurrence and, if they were to occur, their impact on the project. In allocating the risks amongst the Participants it is essential to assess the ability of a Participant to undertake or bear the risk.¹⁰

3.2 Financial Risk

The life of a property development project means that there will be different financial risk profiles at various stages of a project's life. Beginning with the primary risk of availability of finance through to take-out risk at the end of the project, financiers play a pivotal role in development projects.

(1) Source

Finance is principally from 2 sources:

- (a) equity contribution from Participants by:
 - (i) shares in a joint venture Vehicle (ordinary or redeemable preference); or
 - (ii) debt (unsecured, secured or subordinated); or
- (b) third party debt (financiers, capital market investors, underwriting agreements or loan facilities).

(2) Rate or Currency Movement

Long term projects also face the uncertain risk of movement in currency exchange rates and inflation. Depending on the size and needs of a particular project, those risks can be hedged or minimised by currency swaps or sales contracts in foreign currency with CPI linked funding or indexed bonds.¹¹

(3) Cost Over-run

During construction of the project there is a cost over-run risk. Will the actual cost of the project be as budgeted for in the feasibility? This risk can be avoided by a fixed price construction contract and a fixed component of interest cost or an interest rate component in the finance facility. Some financiers may also require additional security or support in the form of bank guarantees or letters of credit to cover potential cost over-runs.

(4) Time Over-run

Delay in construction of the project will pose a time over-run risk. Not only will this result in increased interest costs for the project but, at the other end, this will result in a delay in receipt of rental income. Fixed price and fixed time construction contracts will minimise this risk. It is also usual for financiers to appoint their own quantity surveyors to monitor the progress of a development.

If there is less than 100% external financing being provided for a project, a cash flow deficiency could result if a Participant providing equity or finance cannot meet its obligations. Other Participants would be looking for cash offset accounts or a stand by finance facility to shore up a Participant's obligations if required.

(5) Take-out

Finally, on completion of the project there is a take-out risk. Will an investor be prepared to pay the value of the project which the Participants hope it will achieve on the market? Will the residual value of the asset match the market expectations at the time that the project is completed? Clearly the way to eliminate this risk is an end contract to buy the project or a take-out finance facility to replace the often higher interest charged in a construction finance facility.

The take-out risk is minimised if the anticipated rental income of the project will generate sufficient cash flow to service its debt. Any shortfall would need to be serviced or alternative take-out finance arranged. This brings into consideration tenant risk - the strength of the tenant and its ability to meet its rent obligations under the lease.

The take-out risk has a constantly changing profile. Changing construction market conditions, the various stages of a project's life, the competing needs of the Participants and the constantly changing perception of "value" in the property market will all impact on a Participant's or a financier's view of the level and acceptability of the risk. The Melbourne office market saw an example of take-out risk with 6 major office towers all reaching completion around the same time in the late 1980's - all competing for tenants in a depressed rental market with rising interest rates. Today, construction financiers are increasingly requiring take-out of construction debt on completion of the project by means of put options, property value insurance or pre-sale contracts.

3.3 Delivery Risk

(1) Construction Cost and Time Over-Run

During the construction phase of a project the burning question is "*Can this be completed on time and on budget?*". The answer to this question depends heavily on the identity of the building contractor and the provisions of the building contract. The building contract can (and should) protect a developer from construction cost over-runs by providing for fixed price or "turn key" delivery criteria. The risk of a contractor running overtime on a project and delaying the rental income referred to above can be minimised by appropriate liquidated damages clauses in the construction contract backed up with bank guarantees underwriting the contractor's obligations. Construction cost estimates are usually confirmed by quantity surveyors for the developer and the financier.

(2) Contractor Failure

Financial failure of contractors was a common feature of the property market crash in the late

1980's. Many construction companies who also took on a development risk found that the construction cash flows were insufficient to cover their rising interest commitments and the falling market conditions. Today, contractors' performance bonds or guarantees are required by developers and their financiers. They have the added effect of squarely placing any industrial relations problems on the building contractor and not on the project developer or financier.

During construction, the risk of physical damage to the project can be covered by insurance or force majeure clauses in the construction contract.

3.4 Participant Failure

What happens if a Participant is unable to meet its obligations to the joint venture? Participant failure is a real possibility - especially where equity contribution is required throughout the life of a development project. This can range from a simple failure to meet a call for capital when required to the receivership or liquidation of a Participant. The joint venture agreement (or the shareholders agreement in the case of an incorporated joint venture company) can minimise the risk of failure to meet a capital call by forfeiture provisions or buy-out provisions. Other remedies¹² which may be considered in the Structure documentation are:

- (1) termination by the innocent party;
- (2) the right to rectify;
- (3) loss of voting rights;
- (4) loss of profit rights;
- (5) dilution of interest;
- (6) compulsory sale; and
- (7) calling in of guarantees.

Obligations to the other Participants can be secured by cross charges or guarantees amongst the Participants and obligations to outside financiers can be secured by parent company guarantees or security over the joint venture assets.¹³

The consequences of participant failure are varied and need to be addressed against a background of equitable principles concerning:

- (1) penalties;
- (2) relief against forfeiture;
- (3) preferences;
- (4) voidable dispositions;
- (5) the Corporations Law;
- (6) disguised charges; and
- (7) fiduciary obligations.¹⁴

3.5 Political Risk

Property development projects are susceptible to political or government risk and interference. Both Federal and State Governments have areas of responsibility which can impact on projects. Indeed, many large scale development or infrastructure projects involve the State or Federal Government in some way - either as a vendor, Participant, user, tenant, taxing authority or governing

authority. All joint venture projects are subject to legislative change - especially in taxation arenas. While there can never be guarantees against changes in the tax regimes, the risk of additional tax or a variation of the tax treatment of joint venture profit can be minimised by advance tax rulings or determinations. Again, in the present political climate in Australia even those forward rulings or determinations could never be assumed to remain unchanged for a long period of time.

Political change itself is a risk to property development projects. Political parties and governments have differing agendas and "user pays" infrastructure projects are highly susceptible to changes in government policies. The Sunshine Coast Toll Road is an example of differing political persuasions altering the economic viability of a large infrastructure project. In some circumstances political risk can be reduced by force majeure clauses in the joint venture agreement or the construction contract.

Government default itself cannot be ignored. Title to land, government consents, planning approvals and government facilitation or approval at all levels can be terminated, varied or revoked. What is the effect of default by the Government? Joint venture financiers would be anxious to ensure that their recourse to assets and contracts remain on commercially acceptable terms.

Enabling legislation may be required for a major joint venture project. Privatisation of utilities like electricity or gas generation or transmission, toll roads or casino developments may require specific legislation to enable the project to proceed, or alternatively, to override existing legislation which would prevent the project from proceeding. The regulatory risk posed without supporting legislation will, in many cases, mean that the project will not proceed.

Where a project involves a risk that a government may cancel the project, clauses in the joint venture agreement allowing recovery of liquidated damages from the government concerned (if a Participant) may be appropriate to alleviate the risk concerns.

3.6 Conclusion

As discussed above, one of the prime motives for forming a joint venture is to share or allocate risk:

- (1) among the joint venture Participants in return for a share in the profits of the joint venture; or
- (2) to external parties to the joint venture in return for a fee or payment.

Entitling Participants to a smaller share of the profits is the simplest way of sharing risk among Participants. Of course, on many occasions that will not be a satisfactory method of apportioning risk, particularly where outside parties are involved. Most risks can be minimised or allocated by way of a number of contractual, legislative, insurance, or financing methods.

4. FINANCE

4.1 Identity of the Borrower

Given the extraordinary range of joint venture Structures and Vehicles, financiers of property development joint ventures must identify and understand the nature of the business of the joint venture and the risks referred to above.¹⁵ The financier's requirements will depend upon the identity of the borrower i.e. whether the entire project will be financed as a project or whether each individual Participant will separately finance its own participation. The answer to that threshold question will determine a number of other essential finance agreement provisions.¹⁶

4.2 Joint Venture Objectives

The objectives of a joint venture or Participant in seeking finance to fund a property development include to:

- (1) finance the acquisition of the land;
- (2) facilitate construction of the project;
- (3) obtain the most cost efficient source of funds;
- (4) minimise recourse to the joint venture and the Participants; and
- (5) retain ownership for the desired period.

4.3 Financiers' Objectives

Financiers need to consider the risks throughout the life of a project and the changing nature of those risks as time goes on. Throughout the construction phase they will want to ensure (as will the joint venture itself) that the project is built on-time, on-budget and to the appropriate quality required. Once that is achieved the financier will look at the tenant risk to ensure that the project is leased to good quality tenants and that the project can generate sufficient income to service the level of debt that the project has incurred. Of course, the debt servicing ability of a project on completion will be a combination of a variety of factors such as the project's borrowings, the effective interest rate and the level of income being generated from the tenants. It is probably fair to say that financiers will never be comfortable with all those risks prior to starting construction. Realistically they will look to Participants for additional security or comfort. While financiers will assume some risk, their key objective is to minimise any down side that they may incur by financing the project. Financiers will be looking at the risks, where they lie and the ability of the joint venture or a Participant to bear those risks. Again, an assessment of that risk will include the reputation, track record, financial standing and capability of all major participants including the contractor under the construction contract. Financiers are also vitally concerned with the structure of the joint venture and the adequacy and recourse that the project structure and their securities will provide to them.¹⁷

4.4 The Project as Borrower

"In my experience legal issues arising from the

*financing of a joint venture tend to produce the highest level of dissatisfaction”.*¹⁸

As mentioned above, financiers need to focus on the threshold issue of whether a joint venture will be financed as a project or whether each participant will separately finance its own participation in the joint venture.

Obviously, where the joint venture is being financed as a project, financiers can take some comfort in demanding security over the entire assets of the joint venture. Ideally, they will require a first registered mortgage over the land coupled with security over the Participants’ shares or units in the joint venture Vehicle, their interests in the partnership or unincorporated joint venture and their other assets.

While liability of participants is essentially a negotiable issue with the financier, it is illusory for participants to believe that a company or unit trust structure still provides limited liability.

*“This advantage has been subjected to increasing attacks with the introduction of provisions in the ... Corporations Law which are aimed at piercing the corporate veil to extend liability in certain circumstances to directors personally.”*¹⁹

While limited liability is clearly a primary objective of Participants in choosing a Structure and financing facility, very few financiers will accept that they have no recourse to the Participants, their parent companies or directors if there is default or a breach of their prudential requirements.

4.5 The Participants as Borrowers

One of the reasons for forming a property development joint venture is to share resources. Quite often one participant will have development or construction expertise while the other has no expertise in those areas but has capital to provide to the joint venture. Each Participant will have a different borrowing capacity and credit profile. This means that participants can borrow money at different rates. Financiers of individual participants will look at:

(1) Security

Financiers will look at the Structure, Vehicle and the security being offered by both the joint venture and the Participants. Whether or not the joint venture is a partnership becomes a critical issue at this point.²⁰

Financiers will scrutinize carefully the joint venture agreement to see whether it allows a Participant to mortgage or charge its interest. Default by one of the Participants may allow a financier to step into its shoes but this, in turn, may only deliver to the financier an ability to continue funding the project to completion in order to obtain any realistic chance of receiving repayment. The “opportunity” to continue funding a shortfall is often not palatable as an option to the financier of a

defaulting Participant. Cross charges or cross mortgages between Participants raise complicated priority issues with financiers of Participants.²¹

(2) The Relationship Between Financiers and other Parties

The identity and reputation of the building contractor and the terms of the building contract are of vital interest to financiers. A financier will share a Participant’s concern that the contractor is efficient, stable and solvent and that the construction cost is fixed. This is even more critical if the financier agrees to continue funding the project after default by a Participant or by the joint venture itself. As a first step, financiers will want to take security over the Participant’s interest in the construction contract so that the financier can remedy a default to allow construction to continue - so avoiding the horrendous ill will and costs of delay, work ceasing and start-up.

Financiers will also scrutinise the strength of a tenant, particularly where the project is a purpose built development involving say, an anchor retail tenant, casino or a hotel operator. Again financiers will usually require direct covenants with the major tenant to secure the financier’s position in the event of default.

The financier’s right to step into the Participant’s shoes was illustrated in Brisbane’s Dockside development. A corporate joint venture vehicle, Stencraft Pty Ltd was incorporated to undertake the large retail, hotel and residential development. The Participants were Girvan Corporation, a property developer, Fricker Constructions, a building contractor and Westpac’s finance company arm AGC as financier. As Girvan followed by Fricker collapsed, AGC was left not only as financier of the project but also owner of the other participant’s shares. With its other 2 Participants in liquidation, AGC had no recourse to anything other than the project and the project assets. It had to complete the unfinished portion of the project and sell it on.

Financiers’ involvement in joint venture property developments raises important project management issues. Financiers will want to approve insurance arrangements, variations to the project’s plans and specifications, variations to the construction contract, development approval and building approval. For multi-tenanted projects, financiers will also want to exercise a degree of control over the leasing by setting down a leasing policy to ensure that the tenancy mix is adequate and suitable to service the debt or provide the required return on capital.

Financiers will control draw-down procedures for progress claims in the construction phase by appointing their own quantity surveyors to certify that everything is in order.

4.6 Conclusion

Financiers will look at the two distinct stages of property development projects - the development phase when the project is being constructed and the operation phase when the project is operating and generating cash flow. Debt funding by outside financiers is more usual during the construction phase because it is difficult to attract equity investment during this risky period. As a result of this, most joint ventures will seek to raise debt through a number of means. Raising equity by debenture issue as opposed to a straight project finance debt facility has the advantage that it provides access to a longer term debt. This allows matching of the funding liabilities against the project risks. Of course when a development is completed, tenanted and providing a cash-flow, it will be easier to refinance it by way of equity raising.²²

Finance is the lifeline of a property development joint venture project. Financiers assume a critical role in each major document and assume critical importance in each major relationship. Practically speaking financiers become “a third eye” and, de facto (if not in reality) an additional party to each important contract. Although they have a different perspective and risk analysis to the Participants, the interests of financiers will impact on the negotiation, documentation and the management of the project.

5. TAXATION

5.1 Introduction

“Stated at the outset, the choice of the right joint venture vehicle should primarily be motivated by commercial issues, one of which may comprise the resultant taxation effect of undertaking a transaction in a particular vehicle.”²³

Tax is one of the myriad of commercial issues which face joint ventures and Participants. By summarising some of the issues which need to be considered, the tax ramifications of the various joint venture Structures become easier to identify and consider. Participants should:

- (1) select a structure that best suits the investment parameters and commercial objectives of the Participants to facilitate mortgaging and charging, project management, asset management, control, default, sale of an interest, valuation and ultimate exit strategies;
- (2) create a structure which accommodates each Participant’s requirements of land and share ownership, asset management, FIRB approvals and financier’s requirements;
- (3) use a joint venture structure which is as simple as possible - a rational approach is required to avoid an unnecessarily complicated and convoluted structure;
- (4) assess risk to limit the liability of the Participants;
- (5) minimise stamp duty at both levels - transfer

of assets into the joint venture structure and on subsequent changes in interest.

“I subscribe to the view that the tail should not wag the dog. Stamp duty can often tempt parties to adopt bizarre structures for a project. Put simply, it is better not to sacrifice other structural advantages or imperatives to achieve a stamp duty saving”;²⁴

- (6) maximise the ease and minimise the cost of sale of equity in a project;
- (7) create a structure which facilitates access for new Participants to be introduced into the joint venture;
- (8) maximise flexibility to accommodate the changing risk and investment parameters of the Participants - bearing in mind the ever-changing risk profile referred to in chapter 3;
- (9) create a structure which is attractive to allow non-recourse financing and off-balance sheet financing; and
- (10) maximise:
 - (a) tax benefits (including depreciation allowances);
 - (b) access to tax benefits; and
 - (c) the distribution of pre-tax income.

5.2 Advantages and Disadvantages

The taxation features and consequences of each joint venture Vehicle or Structure are sufficiently broad enough to warrant an article on their own. However, it is interesting to briefly compare property joint venture Vehicles and Structures to hopefully narrow the scope of the exercise in selecting the appropriate structure for each distinctive property development joint ventures.

5.3 Types of Vehicles

In the introduction to this article I touched briefly on the three broad categories of joint venture associations:

(1) separate legal entity -

where a separate legal identity is created and the Participants hold investments in that equity. A company is the most typical form of this joint venture association.

(2) legal relationship recognised by law -

a relationship where Australian law applies and implies a number of legal rules governing the relationship between the Participants. Examples of this are partnerships, trusts and agency relationships. Participants in these types of joint ventures may also form a company to act as a Participant in the legal relationship - most often this is a company which will act as a trustee or manager for the joint venture. This is sometimes referred to as a “hybrid joint venture” where there is both a

trust and corporate structure overlaying the relationship between the parties.

(3) contractual relationship -

a new entity is not created and the relationship does not fit within the accepted legal definitions of “trust” or “partnership”. It is essentially governed by the terms of the joint venture contractual document which provides for a sharing of profit, losses, expenses or payment of remuneration to the Participants based on the success of the joint venture.

5.4 Company

If a company acts as the joint venture vehicle it will own the assets of the joint venture and the Participants will only own shares in the company.²⁵ It would be treated as a separate entity for tax purposes and the rights of the Participants are regulated by the Articles of Association, the *Corporations Law* and usually a shareholders’ agreement between the Participants.

Tax Consequences

A company is a separate tax payer for tax purposes. Its profits can be distributed as dividends to the shareholders but the company itself is allowed the usual business deductions for expenses and depreciation.²⁶ The individual tax position of Participant shareholders is irrelevant to the company’s tax position. Dividends paid from taxed profits may be “franked” to the extent that company tax is paid on the profits. Franked dividends mean that resident individual shareholders will ultimately receive franking credits which will off-set income tax.

Advantages

- (1) As a separate single legal entity, it can hold the joint venture assets in its own name. This facilitates financing and, from a financier’s point of view, simplifies taking security over the joint venture assets.
- (2) Each shareholder has liability which is limited to the extent of unpaid capital in the shares held.
- (3) The company structure is well recognised within the Australian and foreign legal systems and is envisaged by the tax treaties which Australia subscribes to.
- (4) The *Corporations Law* and a voluminous body of case law creates a well regulated structure and management overlay on the corporate constituent documents and agreements. Again, this provides for certainty among Participants and outside parties such as financiers.
- (5) Distribution of profit is flexible - assuming that the company remains solvent and profits are available for distribution.
- (6) Transfer of shares and therefore transfer of a Participant’s interest is simple with minimal stamp duty consequences. However, care must

be taken with “land-rich” companies under the various stamp duty regimes.²⁷

Disadvantages

- (1) Tax losses arising to the company cannot be assessed by the individual Participants - they are “trapped” in the company and cannot be grouped or netted against other income of a Participant shareholder. This is a major distinction between a company Vehicle and a partnership or unincorporated joint venture. This is a primary tax consideration as many property development joint ventures take years to derive sufficient assessable income to off-set against early losses.
- (2) The imputation franking provisions mean that certain tax concessions cannot be passed on to the Participants on a tax free basis. This is particularly relevant in a property development joint venture because of the effect it has on the indexation component of capital gains and the depreciation allowance for building construction costs.
- (3) Acquisition and disposal of shares must be considered under the capital gains tax provisions of the *Income Tax Assessment Act*. Complex issues also arise on the winding up of a company.

5.5 Unit Trust

A unit trust joint venture structure combines some of the features of an incorporated joint venture with some of the features of an unincorporated joint venture. Although the beneficial interest in the trust property is represented by individual units similar to shares in a company, the unit trust does not have a distinct legal personality. The trustee of the unit trust holds the assets of the joint venture on behalf of the Participants. The Participants’ ownership of units gives each Participant an interest in the assets of the trust but not a divisible interest in any particular asset. The trust is both established and regulated by the trust deed. The unit trust joint venture can be structured to avoid the prohibitive fundraising rules in the *Corporations Law* provided that the trust satisfies one of the exemptions under section 66.²⁸

Advantages

- (1) The income of the unit trust is taxed in the hands of the unit holders so Participants are taxed according to their own tax regime. As a result each unit holder will receive pre-tax income so it can deal with that income in the manner which is most advantageous to it. This is particularly useful where some Participants are taxed at concessional rates and some are not.
- (2) A unit trust is more flexible than a company - it is not subject to the restrictive rules relating to maintaining capital or assisting in the

acquisition of interests in the Vehicle.²⁹

- (3) The trust deed affords flexibility for classification of units in to different categories to reflect the different contributions to the joint venture of the Participants. The trust deed can also cater for reclassification and redemption of interests which is fundamentally easier in a trust structure rather than in a company structure.
- (4) While the transfer of units is simple and similar to the transfer of shares in a company, the disposal or transfer of units is a separate taxable event. On the one hand there are various tax incentives available to the unit holder such as accelerated depreciation rates, investment and development allowance and these will diminish the cost base of the units for capital gains tax purposes. On the other hand, for shares, those benefits are retained in the company as potentially unfranked dividends. As a result there is a trade-off for access to pre-tax income against a potential increase in capital gain on disposal of units.

Disadvantages

- (1) Some foreign legal and tax regimes do not recognise the trust structure - Japan is an example of this. Many developers riding the wave of Japanese investment of Australia in the 1980's found that the trust structure proposed was not understood or recognised by the potential Japanese investor.
- (2) Income losses in a unit trust cannot be distributed to the unit holders. They are "trapped" and can only be carried forward to be applied against future income from the trust rather than other income of the Participants.
- (3) This "trapping" of losses usually dictates that the joint venture must be equity funded with any borrowings undertaken at the Participant level rather than by the joint venture as borrower. Obviously this means that joint venture assets must be made available as security for borrowings by individual Participants.

5.6 Partnership

The Commissioner has stated the criteria he will use to determine whether partners are carrying on a business.³⁰ He has also said in another ruling³¹ that he will treat co-ownership of income producing property as a tax partnership. A partnership creates a number of consequences for the Participants. Joint liability, the creation of partnership assets, subordination of loans by Participants to the venture and the application of the various State Partnership Acts are usually matters of considerable concern when documenting joint ventures. As a rule of thumb Participants in property development joint ventures do not want to create a partnership and

should take strenuous steps to avoid creation of a partnership. The unlimited liability of Participants in a partnership is obviously the greatest concern. It cuts across many of the risk issues referred to above.

Advantages

- (1) A partnership is transparent for tax purposes - tax losses can "pass through" the partnership to the individual Participants. This allows participants with differing tax regimes to be taxed appropriately.
- (2) The various state Partnership Acts around Australia and a sound body of case law mean that there is ample (and perhaps onerous) regulation of partnership relationships.

Disadvantages

- (1) Unlimited and joint liability for partnership debts and acts of other partners usually negates the attraction of a partnership to property development joint ventures. It creates unnecessary exposure by 1 participant to the actions of another participant.
- (2) The various United States jurisdictions do not recognise a common law partnership so it is arguably beyond the power of a U.S. corporation to enter into a partnership in Australia.
- (3) Transfer of interests in partnerships is a stamp duty nightmare without careful attention to partnership documentation because legal title to the underlying assets may also need to be transferred.
- (4) The capital gains tax regime includes a taxpayer's interest in a partnership and treats each partner's interest in each of the partnership's asset as a separate asset. The Commissioner's approach is set out in an income tax ruling.³²

5.7 Unincorporated Joint Venture

There is no income tax definition of an unincorporated joint venture. While a partnership is defined in section 6(1) of the *Income Tax Assessment Act* to mean an association of persons carrying on businesses as partners or in receipt of income jointly, it is well documented that this definition has two limbs. The first one accords with the legal definition of a partnership and the second is what is often referred to as a "tax partnership" i.e. persons in receipt of income jointly. This wider definition makes it more difficult to avoid a tax partnership and its consequences. Unless it is established that Participants share in the product of the joint venture rather than the proceeds of sale or profits, a tax partnership will arise. Mining joint ventures where participants share in the "product" or say an infrastructure project where the Participants share in the electricity produced are examples where a tax partnership may not arise.

The Act's definition of "partnership" covers not

only a common law partnership but also a consortium where the Participants receive income jointly (but do not derive or realise profits jointly). Such a consortium will be taxed as a "partnership" under the *Act*. If the consortium does not share profits **and** does not receive income jointly, then it will be neither a common law partnership or a "partnership" for the purposes of the *Act*, so instead the partners will be treated as if the income had been earned solely by them. In the latter case tax elections as to depreciation and the like can be made by the Participants separately rather than by the venture.³³

Advantages

- (1) "Pass through" of income and losses to participants.
- (2) Structuring can avoid unlimited liability and the consequences of common law partnership.

Disadvantages

- (1) Detailed and complete documentation of the entire relationship is required.
- (2) This structure would be difficult to use in property developments because the Participants have undivided interests in the land and need to jointly deal with their undivided interests in order to derive income.
- (3) The actual operations of the joint venture must reflect the strict terms of the agreement. For instance, if the Participants start acting jointly, receive income jointly and share profits then despite the terms of the joint venture agreement they could easily be found to be a common law partnership with the liabilities which attach to that structure.

5.8 Depreciation

Generally speaking the tax depreciation rates for plant are generous. However, where plant is affixed to land not owned by the owner of the plant, the Commissioner adopts a very strict view on the availability of depreciation of the plant. To claim tax depreciation the user of the plant must own the plant so the affixing of plant to the land could lead to a denial of depreciation deductions to a tax payer who does not own the land. The Commissioner adheres strictly to the general common law view that items affixed to the land become part of the land and are therefore owned by the land owner. Property development joint venture Participants need to consider carefully at what stage plant has become affixed and this will lead to considerations of common law tests of the method of affixation, the period of affixation and whether the plant owner has a right to remove the plant from the land. In tax ruling TR94/D26 the Commissioner sets out his views on the issue of ownership of fixtures for depreciation purposes. The ruling is particularly relevant where tenants of property development projects have physical possession and use of a tenant's fixture or where the tenant has a contractual right to remove the plant.

6. CONCLUSION

Each of the issues raised in this paper will lead to further investigation for each particular project, Vehicle, Participant and financier. There is no "boilerplate" which can be used between projects because of the very issues raised in this paper.

Participants' motives, risks, finance and tax issues all produce a pallet of colours to be considered. As in interior design, one shade won't suit everybody.

FOOTNOTES

- 1 Alain Purnell "Joint Ventures - Forming a Consortium and Maximising Development Opportunities" in Australian Construction Law Newsletter Issue #7, October 1989, page 22.
- 2 For a case study discussion on the financing of this project, see "Joint Ventures in Property Development" by Dianne Wilson, Business Law Education Centre, 1989 pages 83-98.
- 3 For a detailed discussion of this topic, see M. Markovic "Off Balance Sheet Financing: The Legal Implications" (1992) 10 Company and Securities Law Journal, pages 35-60.
- 4 See sections 12A and 26A(2) of *Foreign Acquisitions and Takeovers Act 1975*.
- 5 See sections 8 and 11 of *Foreign Acquisitions and Takeovers Act 1975*.
- 6 Graeme Dennis "Joint Ventures - How to Select the Right Structure for your Project?" IIR Conferences, 29 March 1995, page 2.
- 7 See Alan Magnus (Editor) "Joint Ventures in Property: Structures and Precedents", Sweet and Maxwell, London, 1993, page 39.
- 8 Graeme Dennis - referred to above, page 3.
- 9 Australia and New Zealand Conveyancing Report, May 1990, page 230.
- 10 For elaboration of these risks and others, see Richard Ladbury "Financing Resource Projects", Australian Law Journal. Volume 62, 1988, page 937.
- 11 For a detailed discussion of these types of financing arrangements see J. Martin "Project Finance" in "Handbook of Australian Corporate Finance" 1989, Butterworths, Sydney, edited by Bruce at page 329.
- 12 See Neil Roberts "Default Clauses in Joint Venture Agreements" in Australian Mining and Petroleum Law Association year book, 1987, page 318.
- 13 For a detailed discussion of the relationship between financiers and Participants see Alan Millhouse "Financing Joint Ventures" in "Joint Ventures Law in Australia" edited by W. Duncan, Federation Press, 1994, page 144.
- 14 This has been discussed at great length in many articles. See for example John Lehane "Joint Venture Finance and some Aspects of Security and Recourse" in Austin and Vann (Editors) "The Law of Public Company Finance", Law Book Company, 1986, page 515 and Ken MacDonald "Joint Ventures

- *Breakdowns and Repair Rights Upon Default*", 1983 A.M.P.L.A. year book, page 209.
- 15 An excellent analysis of financiers' risks in property joint ventures is by Di Everett in "*Joint Ventures: a Problem for Lenders*" in Australian Banking Law Bulletin, Volume 10, Number 10, June 1995, page 86.
 - 16 For a detailed discussion of financing of joint ventures see Alan Millhouse "*Financing Joint Ventures*" referred to above at page 125.
 - 17 See Alan Millhouse at page 129 referred to above. See also Peter Fox "*Default/Insolvency - Enforcement - The Banker's Position*", Australian Mining and Petroleum Association Yearbook, 1991, page 85.
 - 18 Michael Gray "*Property Joint Ventures - Factors Relevant to Structures*", in Australian Construction Law Newsletter, Issue #11, April 1990, page 32.
 - 19 Allan Millhouse at page 130 referred to above.
 - 20 See Maree Chetwin "*Joint Ventures - A Branch of Partnership Law?*" (1991) 16 University of Queensland Law Journal 256.
 - 21 See Alan Millhouse at page 147.
 - 22 For an excellent analysis of financing joint ventures by using debentures and public offerings see Mike Gibson "*Financing Joint Ventures: Raising Money Through Private Investment*" IIR Conferences, 29 March 1995.
 - 23 Mark Cohan "*Critical Considerations in Planning, Negotiating and Establishing Property Joint Ventures*" in Australian Construction Law Newsletter, Issue #13 August 1990, page 31.
 - 24 Michael Gray "*Property Joint Ventures - Factors Relevant to Structures*" in Australian Construction Law Newsletter Issue #11, April 1990, page 31.
 - 25 See Ralph Pliner "*Incorporated Joint Ventures*" in Australian Mining and Petroleum Law Association Yearbook, 1991, page 5 and David Gonski's commentary on that article at page 23.
 - 26 Section 6(1) *Income Tax Assessment Act 1936*
 - 27 For a discussion on the stamp duty consequences of transfer of shares in landholding companies see Michael Gray's article on "*Property Joint Ventures - Factors Relevant to Structures*" at page 35 referred to above.
 - 28 This complicated issue is well analysed in the paper by Mike Gibson "*Financing Joint Ventures - Raising Money Through Private Investment*" referred to above.
 - 29 See section 160ZM relating to assessment of tax income by unit holders.
 - 30 See taxation ruling TR92/D28.
 - 31 Taxation ruling TR93/32.
 - 32 See income tax ruling IT2540.
 - 33 Graeme Dennis "*How to Select the right Structure for your Project*" referred to above, page 20.