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Real Estate Joint Venture Waterfalls and Clawbacks: Variations and Complications

By Nathaniel M. Marrs, Esq., and Alan Van Dyke, Esq.[*]

INTRODUCTION

A joint venture or investment fund[1] distribution waterfall is typically a complex way to answer a simple question: When does the manager begin receiving distributions of promote, and how quickly is such promote (and, in some cases, how much of such promote is) ultimately paid? This article explores some of the many variations in distribution waterfalls that seek to answer this question in different ways. In so doing, a clear distinction is made between ''money'' partners (i.e., partners who contribute money to a joint venture) and the manager, with distributions of promote being made by the former in favor of the latter. In practice, however, this distinction may not be as clear, as managers will typically contribute at least some amount of money to a joint venture, and money partners may assume some part of the management of the joint venture (although neither complication typically alters the waterfall principles discussed in this article). In addition, it is assumed that the joint venture owns multiple investments, as the most interesting questions involving the distribution of promote generally arise only in that situation. Finally, the example waterfalls that are discussed involve only one level of preferred return and one level of promote as such simple waterfalls are sufficient to explain and illustrate the issues that are discussed. In practice, however, most joint venture waterfalls, particularly waterfalls used in real estate joint ventures, involve the use of multiple levels of preferred returns and promotes.

WHOLE VENTURE VS. DEAL-BY-DEAL PROMOTE

One of the threshold decisions that must be made with respect to the distribution of promote is whether it will be determined on a deal-by-deal or on a whole-venture basis. Under the deal-by-deal model, returns are generally calculated for each investment, and the manager receives its promote as profits are realized on the particular investment. In contrast, under a whole-venture model, the manager does not receive promote distributions until the money partners receive distributions equal to their total capital contributions to the entire joint venture plus a preferred return on all such contributions. Assuming that a joint venture incorporates a so-called ''clawback'' feature,[2] both the deal-by-deal model and the whole-venture model should result in the same aggregate sharing of profits over the life of the joint venture, with the only variable being the timing of receipt of such profits by the manager — earlier for a deal-by-deal model and later for a whole-venture model. Of course, timing is important, and a number of variations of the whole venture and deal-by-deal waterfall models are available to distribute promote in different fashions.

BASIC WHOLE-VENTURE WATERFALL

With a typical whole-venture waterfall, each money partner must recoup its total capital contributions to the joint venture and receive a preferred return on such contributions before the manager is entitled to receive any promote. A whole-venture waterfall is generally the most favorable to money partners from a time-value-of-money perspective, as it defers distri-

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[*] Latham & Watkins LLP, Chicago, IL.

[1] The waterfall concepts addressed throughout this article are relevant to both joint ventures and investment funds. For convenience, the term ''joint venture'' (and joint venture-related terms) are used throughout the remainder of this article, but the term ''fund'' (and fund-related terms) could just as easily be used.

[2] And assuming such clawback captures all elements of the waterfall, which is not always the case (as discussed in more detail below).

butions of promote to managers, and money partners therefore receive more distributions of joint venture profits sooner. Below is a simple example of a whole-venture waterfall.

> 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) Catch-up to 20% Overall Promote: Third, 50% to the [manager] and 50% 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);[3] and
> >
> > d) 80/20 Split: Thereafter, 80% to [all partners] and 20% to the [manager].

WHOLE-VENTURE COMPLEXITIES

Although a whole-venture waterfall is simpler than a deal-by-deal waterfall, it can result in some complexities, particularly at the manager level. For example, promote allocated to different manager team members may be more cumbersome to track with respect to whole-venture waterfalls because profits earned on early investments often are distributed to money partners to repay preferences, to be made up out of distributions from later deals. This could complicate dealings with team members who enter or leave in the middle of the life of a joint venture. In addition, a whole-venture waterfall can make it generally more difficult to track profit and loss 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 investment in one subsidiary (as a result of the performance of that investment causing the promote to be earned at that moment based on the performance of total capital in the joint venture) may be distributed, at least in part, by other subsidiaries that may or may not have the profits to support the amount of promote that has been earned (on such whole-venture basis).

From a tax perspective, if a partnership[4] intends to comply with the so-called ''fractions rule,''[5] then the allocations of profits and losses must comply with the substantial economic effect rules of §704(b)(2) and the Treasury Regulations promulgated under that provision. However, in circumstances where compliance with the ''fractions rule'' is not required, it is common not to comply with such substantial economic effect rules. More specifically, it is increasingly common for partnerships to use an allocation method commonly referred to as the ''targeted capital account'' method, where profits and losses are allocated so that each partner has an ending capital account balance equal to what that partner would receive under the partnership's waterfall distribution provisions if the partnership sold its assets at the value reflected in the partnership's capital accounts and liquidated. This ''targeted capital account'' method is intended to result in the allocation of taxable profits and losses that generally track the distributions actually made under joint venture waterfall.

BASIC DEAL-BY-DEAL WATERFALLS

As an initial matter, a true deal-by-deal waterfall, where each investment stands alone and the profits and losses of each investment are considered in isolation from the profits and losses of other investments, is rarely, if ever, seen in joint ventures today. In such a waterfall, the manager is entitled to keep any promote distributions earned with respect to any particu-

[3] Note that this ''catch-up'' level of a distribution waterfall is rare for real estate joint ventures but not uncommon for real estate funds.

[4] In the tax context, the term ''partnership'' also includes limited liability companies, limited partnerships, and most other entities used for the formation of joint ventures if such entities have not elected to be treated as a ''corporation'' for tax purposes. Reg. §301.7701-3(b)(1).

Unless otherwise stated, references in this article to ''§'' are to the Internal Revenue Code of 1986, as amended, and references to ''Reg. §'' are to the Treasury regulations thereunder.

[5] The so-called ''fractions rule'' established by §514(c)(9)(E) and the regulations thereunder is a short-hand reference to a very complicated set of tax allocation rules which, if applied properly, can assist certain UBTI-sensitive investors in partnerships avoid debt-financed UBTI. For a more detailed explanation, see David O. Kahn, *Help With Fractions: A Fractions Rule Primer*, 126 Tax Notes 953 (Feb. 22, 2010).

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lar investment, regardless of whether the joint venture's other investments are (or even the joint venture as a whole is) profitable.[6] In essence, this waterfall provides a manager a series of independent options on investment profits whereby managers have the possibility of being rewarded only for making good investments.

Instead, the far more common version of a deal-by-deal waterfall includes a make-up for unrecouped prior realized losses and some or all of the joint venture's general expenses. Under this model, the first tier of the joint venture waterfall requires a return of capital invested in all realized investments and some or all of the joint venture's general expenses (plus a preferred return thereon), but not capital invested in (or, potentially, joint venture general expenses attributable to) unrealized investments or any preferred return with respect thereto. Therefore, if an investment has been realized at a loss, distributions from future realized investments will be required to make up for that loss before reaching any other tier of the waterfall. Below is a simple example of such a waterfall.

> 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) Catch-up to 20% Overall Promote: Third, 50% to the [manager] and 50% 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].

In general, there are three factors that drive the shape of distribution joint venture waterfalls, including such deal-by-deal joint venture waterfalls: (1) the timing of periodic capital calls; (2) the determination of whether the applicable return of capital requirement, any return of general expense requirement, and preferred return thereon have been achieved; and (3) the determination of whether any applicable clawback is required. Calculations with respect to all three factors are generally simpler with a whole-venture waterfall as compared to a deal-by-deal waterfall. And they become even more complicated when some of the nuances of a typical deal-by-deal waterfall are examined in more detail, including what types of events actually constitute the realization of an investment (or the functional equivalent) — usually defined as a ''Disposition'' — under the typical waterfall language.

DISPOSITIONS

In a typical deal-by-deal waterfall, the joint venture will not require capital contributions, any return of general expense requirement that is allocated on a deal-by-deal basis or the applicable preferred returned thereon to be returned to a money partner until the investment to which those capital contributions, general expenses, and preferred return thereon are attributable has been ''Disposed'' of. A ''Disposition'' may include:

1) a sale, exchange, or other disposition of an investment, or other receipt of proceeds in complete or partial liquidation of an investment; and
2) sometimes, receipt of proceeds in connection with a refinancing or recapitalization of an investment.

In a typical deal-by-deal waterfall, the distribution of current income would not be treated as a distribution resulting from a ''Disposition.'' Such current income may include:

1) rental or interest payments made to the joint venture or other non-liquidating distributions relating to the joint venture's investments; and
2) if not otherwise included as a ''Disposition,'' receipt of proceeds in connection with a refinancing or recapitalization of an investment.

[6] Of course, this assumes that there is no potential clawback requirement, which is probably a good assumption if this type of waterfall is used.

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The common theme under a typical deal-by-deal waterfall 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'' under such a waterfall triggers a reckoning with respect to an investment, while judgment continues to be withheld in the case of a current income distribution, because the investment is expected to yield additional future proceeds.

Example:

- JV has a typical deal-by-deal waterfall that is generally the same as the waterfall example in the Basic Deal-by-Deal Waterfalls section above, but with a 10% per annum, non-compounding, preferred return.
- For $1,000, JV buys office building number 1 at the beginning of year 1.
- During the first year, office building number 1 generates $100 in cash in the form of net rent.
- For $500, JV buys office building number 2 at the beginning of year 2.

During the second year, office building number 1 does not generate any cash, but office building number 2 generates $50 in the form of net rent.

During the second year, office building number 2 declines $250 in value and is worth $250 at the end of year 2.

- At the end of year 2, building number 1 is sold for $1,500.
- There are no general JV expenses.
- *Result* — $1,200 of the $1,500 in proceeds from the sale of building number 1 is distributed to the money partners as a return of capital ($1,000) plus preferred return ($200). $100 of the remaining $300 (representing 20% of the $500 net profit from the sale pursuant to the ''catch-up'' tier of the waterfall[7]) is distributed to the manager as promote, and $200 of such $300 is distributed to the money partners. $30 of the cash from net rent with respect to building number 1 and building number 2 is distributed to the manager as promote, and the remaining $120 of such cash is distributed to the money partners. Such cash from net rent from both buildings is distributed within a specified period of when it is generated. Because building 2 has not been disposed of, the $250 loss in value is not required to be made up from the profit realized on the disposition of building 1. In addition, all cash from net rent for buildings 1 and 2 is distributed from time to time (within a specified period of when generated) pursuant to the last promote tier of the waterfall, without regard to the capital (or preferred return thereon) attributable to buildings 1 and 2.[8]

WRITE-DOWNS AND WRITE-OFFS

Under a typical deal-by-deal waterfall, write-downs and write-offs are treated as the equivalent of a ''Disposition.'' In most cases, the concept of such a write-down or write-off is not based on ''mark to market'' but is supposed to reflect a permanent decline in the value of an investment — thus, the term ''permanent'' write-down/write-off is often seen. In addition, in some cases a distinction is made between write-downs (where a portion of the value of an investment has decreased) and a write-off (where the entire value of an investment has been reduced to zero), with only the latter being treated as the equivalent of a ''Disposition.''

DEAL-BY-DEAL WATERFALL WITH INCOME SOURCE DIVISION (E.G., CURRENT INCOME VS. DISPOSITION PROCEEDS)

Of course, it could be argued that the distribution of current income in a typical deal-by-deal waterfall is odd for a real estate joint venture owning fully-developed buildings generating substantial amounts of ongoing cash flow. As seen in the above example, current income distributions in such a waterfall may not be run through the return of capital or preferred return levels but instead skip directly to the promote level, where the manager receives its specified promote percentage of every distribution. On the other hand, a typical whole-venture waterfall would likely distribute all current income distributions 100% to the money partners for a long period of time, because such distributions likely would not be sufficient to exceed the money partners' aggregate capital contributions to the joint venture plus the applicable preferred return thereon. For this reason, some real estate joint venture waterfalls distinguish between distributions based on income source, with, e.g., current income divided up pursuant to one waterfall and disposition

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[7] In the event there would not have been enough distributions in excess of capital plus preferred return to equal 20% of the total net profit, such excess would have been distributed 50/50 to the money partners and the manager pursuant to the ''catch-up'' tier of the waterfall.

[8] The same result would occur with respect to refinancing proceeds generated by buildings 1 and 2 if refinancings are not included as a ''Disposition.''

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proceeds divided up pursuant to another waterfall. Under this type of waterfall, disposition proceeds (defined as proceeds resulting from the sale or other disposition of an investment, specifically excluding any current income distributions such as rent) may be distributed pursuant to a waterfall that is generally the same as the whole venture or deal-by-deal waterfalls discussed above, while current income is distributed pursuant to another waterfall that is similar to such waterfalls, except that the capital contribution level of the waterfall is 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. In general, distributions of current income under this type of waterfall need to be made to money partners only to the extent of the amount of the relevant preferred return (i.e., 8% in the waterfalls discussed above), excluding the amount of capital used to calculate the preferred return.[9]

PARTNER-BY-PARTNER (WHOLE-VENTURE) WATERFALL

In addition to the nuances discussed above, another less well understood nuance exists with respect to the calculation of manager promote on an all-partner versus a partner-by-partner basis. The waterfalls discussed above all calculate manager promote on an all-partner basis. Below is an example of a waterfall that calculates promote on a partner-by-partner basis.[10]

> 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 pro rata share of 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 Promote: Third, 50% to the manager and 50% 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.

In general, the sharing of joint venture distributions under a partner-by-partner waterfall is a two-step process. First, all distributions are apportioned among all partners, including the manager, in proportion to their capital contributions with respect to the investment that generated the distributions, and the manager's share resulting from such apportionment is then distributed to it. Second, each other partner's share resulting from such apportionment is then distributed to such partner and, possibly, the manager, in the respective amounts determined by the ''waterfall.'' In essence, the distributions allocated to each partner other than the manager in the first step are run through the waterfall to determine the allocation of each such partner's share of such distributions as between the manager and such partner.

Such a partner-by-partner distribution waterfall accommodates different treatment among the partners,

[9] Both whole venture and deal-by-deal waterfalls with this type of income source division will allow for the distribution of current income to managers as promote at an earlier time than a typical whole-venture waterfall. Of course, deal-by-deal waterfalls of this type (compared to whole-venture waterfalls of this type) will allow for it sooner. Often, the main difference between such deal-by-deal waterfalls compared to such whole-venture waterfalls is that, in such a deal-by-deal waterfall, the current income generated by a specific investment must be returned to money partners from time to time only to the extent of the preferred return measured on the capital invested in the specific investment generating that current income, whereas in such a whole-venture waterfall, the current income generated by investments (in the aggregate) must be returned to money partners from time to time to the extent of the preferred return measured on the aggregate capital invested in the entire joint venture. However, hybrid models are available. *See* Nathaniel M. Marrs, Louis D. Hellebusch, & Krishnakshi Das, *Variations in Structuring ''Whole Fund'' And ''Deal By Deal'' Carried Interest Or Promote In Real Estate Funds And Joint Ventures*, Real Est. Fin. J. 5 (Spring 2009).

[10] This distinction between all-partner waterfalls and partner-by-partner waterfalls is relevant only for joint ventures with multiple money partners, which certainly is not always the case.

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such as reduced promote or fees for some (but not all) partners, rights for some money partners to opt out of funding capital for certain prohibited types of investments,[11] or where some (but not all) money partners fail to make a required capital contribution. It also more easily avoids the allocation of any fees paid by the joint venture to the manager with respect to the manager's distributions. This can be beneficial from a U.S. tax perspective, as such fees are generally treated as ordinary income when received, but frequently are not deductible by an individual payor; thus, to the extent an individual is both a payor and a recipient of such fees, there is a negative tax consequence.[12]

PREFERRED RETURNS

The final nuance with respect to the formulation of joint venture distribution waterfalls is the specific methodology utilized to calculate the preferred return to which the money partners are entitled. In the examples discussed above, the preferred return is conceptually analogous to an interest rate on a principal balance (with the principal balance being the applicable amount of capital contributions), but many alternative and supplementary formulations are utilized in distribution waterfalls, including internal rate of return (IRR)[13] and absolute dollar thresholds. Even when a more simple interest rate formulation is used, there are different methods of calculating that interest rate, including compounding rules mandating compounding on a more frequent basis (e.g., monthly vs. annually), which result in a higher effective annual rate. Finally, in some cases, the order of the waterfall steps can affect the calculation of preferred return. For example, if a simple interest rate formulation of preferred return is utilized and the return of capital tier of the waterfall is before the preferred return tier (as so calculated), then the preferred return can in some cases be more quickly achieved when compared to a waterfall utilizing the same preferred return with the order of such tiers reversed, because the capital amount to which such interest rate is applied over time is more rapidly reduced.

There is some ambiguity as to the nature of a preferred return for tax purposes. However, to the extent the preferred return only represents a hurdle that must be met before the manager shares in profits attributable to the money partner's capital, as is the case in the examples in this article, the preferred return should not be considered a "guaranteed payment" for tax purposes. To be a guaranteed payment, a payment must be "determined without regard to the income of the partnership."[14] This suggests that to be a guaranteed payment, there must be some source of payment other that the income of the partnership, such as the capital of another partner or contributions from another partner. Thus, in joint ventures where the manager's capital is subordinated to a preferred return on the money partner's capital, the preferred return may well constitute a guaranteed payment. Recent proposed tax regulations have injected some uncertainty into the definition of "guaranteed payment" for tax purposes, relating primarily to how the amount of a guaranteed payment should be measured.[15] However, some practitioners believe that those regulatory changes, if not clarified, could also lead to the expansion of the types of preferential distribution arrangements that could be treated as guaranteed payments for tax purposes.

CLAWBACK

Even after a joint venture waterfall has been formulated and applied, it usually is not the end of the story, as most joint venture agreements, particularly agreements with waterfalls allowing for the distribution of promote before a whole venture formulation would allow, contain a so-called "clawback" provision.

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 or at least on a more frequent basis than a whole venture formulation would allow. Underperforming investments can be among the last to be "Disposed" of in a typical deal-by-deal waterfall. Unless they were already written down when the promote was calculated on prior profitable "Dispositions," the manager may receive overdistributions of promote, based on the performance of the joint venture's entire portfolio, in the case of a typical deal-by-deal calculation. While it is theoretically possible to get into a clawback situation with a whole-venture waterfall, the possibility is remote in most cases.

A typical clawback provision requires the manager to contribute to the joint venture, to be distributed to each affected money partner, after-tax promote distributions equal to the sum of the amounts determined for each money partner equal to the greater of either:

[11] This type of right is generally only seen in funds or fund-like vehicles.

[12] Note: Other partners generally do not care whether a manager essentially pays a fee to itself with respect to what would otherwise be distributions of promote. As a result, typically such structuring can be accomplished quite easily.

[13] For some of the issues associated with the use of IRRs, see Nathaniel M. Marrs & Stephen G. Tomlinson, *Deficiencies of IRRs and TWRs as Measures of Real Estate Investment and Manager Performance*, Real Est. Fin. J. 1 (Winter 2006).

[14] *See* §707(c).

[15] REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015).

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(i) the excess of promote distributions attributable to such money partner's interest over 20% (or other promote percentage) of profits attributable to such money partner's interest; or

(ii) the amount by which the sum of such money partner's capital contributions and preferred return (each calculated on a whole-venture basis) exceeded total distributions received by such money partner.

However, such a simple formulation may not account for, or accurately track, distributions made pursuant to the ''catch-up'' tier of a joint venture waterfall or distributions made pursuant to other tiers of joint venture waterfalls with additional preferred return/promote tiers. This issue is particularly acute for deal-by-deal waterfalls, where more distributions are likely to be made over time (on a deal-by-deal basis) in aggregate amounts over the term of the joint venture that are sufficient to reach, but not exceed (i.e., not to the point that the full promote percentage of past and current profits is achieved), the ''catch-up'' tier of the waterfall, and money partners might nevertheless receive an aggregate amount at least equal to their capital contributions plus the preferred return thereon but promote distributions do not exceed 20% of aggregate profits. In this circumstance, if a typical clawback provision of the type referenced above is applied, then no amount would be required to be clawed back pursuant to either clause (i) or (ii) of that provision even though the waterfall, if applied on a whole-venture basis with respect to all prior contributions and distributions at the same time, would have resulted in less promote distributions to the manager than what the manager actually received. This is because such a clawback calculation ignores the ''catch-up'' layer of the distribution waterfall. As a consequence, a so-called ''reverse waterfall'' clawback provision may be required from managers by money partners. A ''reverse waterfall'' generally determines required clawback amounts based on the same waterfall used to calculate manager promote distributions in the first instance, but now applied at the same time with respect to all prior contributions and distributions (taking into account the time at which the contributions and distributions were actually made, but considering all such contributions and distributions in the aggregate at the same time on a whole-venture basis).

AFTER-TAX CALCULATION

For most clawback provisions, the aggregate required clawback payment is not permitted to exceed the aggregate amount of clawback distributions, reduced by the amount of ''tax distributions'' (i.e., distributions made to the manager to permit the manager to pay taxes with respect to the allocation of taxable joint venture income to the manager before the time at which the manager would otherwise be entitled to distributions under the joint venture waterfall). The justification for this result is that the manager should not be required to come out of pocket for amounts that it never received the benefit of (because they were paid to the IRS in the form of taxes).[16]

CLAWBACK TIMING

One of the most important elements of a clawback provision is when it is required to be applied. There is significant variation in this area, with some clawback provisions applied only at the end of the life of a joint venture (e.g., as part of the liquidation process) and some clawback provisions applied on a more frequent interim basis. If a clawback provision is applied on a more frequent interim basis, required clawback amounts are contributed to the joint venture and distributed to the money partners in the same manner as a clawback applied at the end of the life of a joint venture. In general, the resulting distributions to money partners are treated as flowing through the distribution waterfall, but careful attention should be paid to distributions made pursuant to the ''catch-up'' tier, as they will need to be adjusted to back out distributions that are recontributed by the manager pursuant to the interim clawback over time (and ''catch-up'' tier distributions can generally be tricky in this area for the reasons discussed above).[17]

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[16] Tax allocated to the manager as a result of built-in gains on assets distributed in kind (based on the value on the date of distribution) are also typically deducted from the manager's clawback amount because the gain resulting in the tax will be recognized outside the joint venture and would not have given rise to a ''tax distribution,'' and thus will not be picked up by the ''tax distribution'' reference. In addition, there are a number of nuances involved with the calculation of ''tax distributions'' that are beyond the scope of this article, including whether any required clawback payments themselves should be taken into account when calculating appropriate ''tax distribution'' amounts (to the extent such payments can be used as deductions against joint venture income allocated to the manager, thus resulting in a tax benefit to the manager).

[17] Of course, in addition to their effect on the timing (and potentially the amount) of distributions of promote addressed by this article, consideration must be given to the source and security of clawback obligations, particularly when applied at the end of the life of a joint venture. To this end, some clawback schemes may require a portion of promote distributions to be escrowed over time, while others may require clawback obligations to be backed by guarantees from the individuals receiving the promote (if such individuals have a sufficiently high net worth, and, if not, then such guarantees may also be required from, or backstopped by, other higher net worth individuals or entities). If guarantees are required from multiple individuals or entities, they are typically several, not joint.

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CONCLUSION

Many types and variations of waterfall arrangements are available to shape a manager's share of joint venture promote distributions in light of the joint venture's particular investment strategy and the desired goals of the joint venture money partners. In crafting such tailored solutions, however, all parties should be aware of the waterfall options and considerations addressed in this article.

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