ACCOUNTING FOR JOINT VENTURES

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The ELA “Lease Accountants Conference”
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Accounting for Joint Ventures
The ELA Lease Accountants Conference

Agenda

I. Overview
II. Tax Issues
III. Accounting Issues
IV. Conclusion
I.A. What is a Venture? Joint Venture?

- The dictionary defines venturing as a risky proposition.

  1. **Venture**: An undertaking involving chance, risk or danger

  2. **Joint Venture**: A united activity of two or more in an undertaking involving chance, risk or danger
I.A. What is a Joint Venture?

- Business people label a wide range of cooperative activities between enterprises as JVs.
  1. An enterprise equally owned
  2. A separate specific business or project
  3. Joint controlled activity
  4. A profit making undertaking involving the coordinated use of assets and other resources
  5. Strategic alliance
I.B. Accounting for Joint Ventures: Business Purpose

Why enter into a joint venture?
- Risk sharing
- Access to capital
- Access to knowledge
- Capture economies of scale
- Volume expansion and diversification
- Optimize tax and accounting outcomes

What are the attributes of a successful joint venture?
- Alignment of interests
- Understanding of objectives
- “Skin-in-the-game”
- Execution
- Trust
I.C. Accounting for Joint Ventures: Review of GATX-Sponsored Joint Ventures

- Thirty-three joint ventures
- Forty-five partners
- Aircraft, facilities, marine, rail, real estate, and technology assets
- GATX partners include:
  - Pitney Bowes Financial Services (diversified)
  - EMD, a division of General Motors (locomotives)
  - Kansas City Southern Railroad (railcars and locomotives)
  - Commonwealth Bank of Australia (RVGs)
  - Lombard Group (technology and RVGs)
  - Rolls-Royce PLC (aircraft engines and aircraft)
  - I.M. Skaugen (marine)
  - CB Richard Ellis (real estate)
  - Credit Lyonnais (aircraft)
  - Air Liquide (facility)
I.C. Accounting for Joint Ventures: Review of BALCG-Sponsored Joint Ventures

- Fifteen joint ventures
- Twenty-five partners
- Aircraft, facilities, marine, rail, real estate, and technology assets
- BALCG partners include:
  - Ford Motor Credit Company (commercial aircraft, rail and facility financings)
  - BancBoston Leasing (merged with FleetBoston Leasing) (commercial aircraft, rail and facility financings)
  - Oshkosh Truck Corporation (motor vehicles)
  - AT&T Corporation (commercial aircraft, rail and facility financings)
  - MediaOne (formerly the lease portfolio originated by U.S. West Financial Services) (commercial aircraft, rail and facility financings)
  - Washington Mutual (commercial aircraft)
  - EDS Corporation (commercial aircraft)
I.D. Choice of Legal Framework

■ Limited Partnership
  • Strong venture liability insulation
  • Tax pass-through
  • Long “legal precedence” history

■ General Partnership
  • Weak venture liability insulation (unlimited, joint and several)
  • Tax pass-through
  • Long “legal precedence” history
I.D. Choice of Legal Framework

- **Limited Liability Company**
  - Strong venture liability insulation
  - Tax pass-through
  - Little “legal precedence” history

- **Corporation**
  - Strong venture liability insulation
  - Not a tax pass-through (unless 80% or more ownership residing with one party)
  - Long “legal precedence” history
II.A. Tax Issues: Formation

1. Significance of legal entity: Separate taxpayer of pass-through entity.
   - A corporation is generally taxed on its income
   - A partnership or a “check the box” entity (e.g., LLC) is subject to a pass-through regime
     - A *partnership acts as a conduit*, through which its various items of income and loss flow to the individual partners, who must annually report their shares of those items on their own income tax returns.
     - *Character, timing and amount* of income or loss allocated to each partner may be subject to limitation or adjustment.
     - However, 40% limitation relating to the half-year convention for depreciation purposes is applied at the separate entity level (subject to anti-abuse provision).
II.A. Tax Issues: Formation

2. Basic statutory scheme. The basic statutory provisions dealing with the formation of a partnership are fairly straightforward and easy to apply:

   • *Section 721: Nonrecognition.*
     Both the partnership and its partners generally do not recognize any gain or loss on the transfer of property to a partnership in exchange for an interest in the partnership.

   • *Section 722: Partners' “Outside Basis.”*
     Each contributing partner takes a basis in the partnership interest received equal to the sum of the adjusted basis in any contributed property, plus any cash contributed.

   • *Section 723: Partnership’s “Inside Basis.”*
     The partnership takes a transferred basis in contributed property equal to that of the contributing partner.
II.A. Tax Issues: Formation

3. Property contributions:
   - *Appreciated (or depreciated) property.* If a partner contributes property that has an inherent gain or loss at the time of contribution, this “built in” gain or loss must be taken into account, using any “reasonable basis,” by the contributing partner.
   - *Depreciable property.* In general, the partnership simply steps into the shoes of the contributing partner; just as the partnership “inherits” adjusted basis, it succeeds as well as to the partner’s method of cost recovery.
   - *Encumbered property.* When a partner contributes encumbered property to a partnership, the partnership replaces the partner as obligor on the loan. Thus, the contributor is simultaneously relieved of the liability on the loan, and as partner, becomes responsible for a share of all of the partnership’s liabilities, including the one encumbering the property.
II.A. Tax Issues: Formation

- X and Y form an equal (50/50) partnership. X contributes an asset worth $500 with a basis of $100. Y contributes $500 in cash.

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<thead>
<tr>
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<th>X</th>
<th>Y</th>
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<tbody>
<tr>
<td>Property</td>
<td>$500</td>
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<tr>
<td>Cash</td>
<td>($100)</td>
<td>$500</td>
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<tr>
<td>Basis</td>
<td>$400</td>
<td>($500)</td>
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<td>$400</td>
<td>$0</td>
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</table>
II.A. Tax Issues: Formation

- If XY partnership thereafter sells the asset, Y will be unfairly taxed on the lurking gain attributable to the asset.
  - IRC 704(c)(2) permits the partnership to allocate all of the gain to X.
  - As an alternative the partnership agreement could specially allocate the depreciation to Y, up to the built-in gain, with the excess, if any, allocated to X.

<table>
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<tr>
<th>Basic Allocation</th>
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<tr>
<td></td>
<td>X</td>
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<tr>
<td>Depreciation</td>
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<tr>
<td>Gain on sale</td>
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<tr>
<th>Alternative Allocation</th>
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<tbody>
<tr>
<td>Depreciation</td>
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<tr>
<td>Gain on sale</td>
</tr>
</tbody>
</table>
II.A. Tax Issues: Formation

4. *Organization and syndication expenses.* Neither organization nor syndication expenses are currently deductible. Organization expenses may be amortized over a period not less than 60 months and syndication fees are non-amortizable capital expenditures.
II.B. Tax Issues: Maintenance of Accounts

- The financial accounts of a partnership, including its capital accounts, must be maintained and adjusted periodically to take into account the partnership’s activities for the year (operations, contributions, distributions)

  1. Principle. A partnership is not technically a taxpayer. Its primary function for tax purposes is to facilitate the computation of each partner’s share of the joint venture’s profit or loss.

  2. Income (loss). A partner’s outside basis and capital account must be increased (decreased) for income (loss).
II.B. Tax Issues: Maintenance of Accounts

3. **Contributions.** A partner’s outside basis is increased by the adjusted basis in any property contributed, plus any cash contributed. However, a partner’s capital account is increased by the fair market value of any property contributed, plus any cash contributed.

4. **Distributions.** A partner’s outside basis is decreased by the adjusted basis of the property distributed, plus any cash distributed. The partner’s capital account is decreased by the amount of cash plus the fair market value of any property distributed to that partner.

5. **Liabilities.** A partner’s outside basis is increased or decreased by his share of net new borrowings or net repayments, respectively. No adjustments are made to capital accounts when a partnership borrows or repays a loan, and the adjustments to capital accounts for contributed and distributed property are made net of liabilities.
II.C. Tax Issues: Allocations and Substantial Economic Effect

1. Allocation by agreement
   Section 704(a) states: “A partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.”

2. Subject to “substantial economic effect”
   Section 704(b) can be used by the IRS to override Section 704(a) if the partners’ agreed method of sharing these items lacks “substantial economic effect.”
II.C. Tax Issues: Allocations and Substantial Economic Effect

3. Two separate tests, both of which must be met to show substantial economic effect:
   • Economic Effect. The following three requirements must be met:
     1. The partnership must maintain capital accounts.
     2. Upon liquidation, liquidating distributions must be made in accordance with the positive balances in the partners’ capital accounts.
     3. If after liquidation any partner has a deficit in his capital account, he must be unconditionally obligated to restore that deficit.
   4. Substantiality. The general rule requires a positive pre-tax tax yield and that there be a “reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts received by partners independent of the tax consequences.”
II.C. Tax Issues: Allocations and Substantial Economic Effect

- X and Y form an equal partnership, each contributes $500 and XY Partnership purchases a depreciable asset. The partnership agreement provided that all depreciation is to be allocated to X, and that during the first year the partnership is entitled to claim $100 of depreciation.

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<tr>
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<th>Y</th>
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<tr>
<td>Beginning Capital Accounts</td>
<td>$500</td>
<td>$500</td>
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<tr>
<td>Distributive Share of Depreciation</td>
<td>($100)</td>
<td>($0)</td>
</tr>
<tr>
<td>Ending Capital Accounts</td>
<td>$400</td>
<td>$500</td>
</tr>
</tbody>
</table>
II.C. Tax Issues: Allocations and Substantial Economic Effect

• Assume that the asset is sold at “book” basis ($900). If the partnership agreement provides that X will receive $400 and Y will receive $500 of the proceeds, the special allocation will be respected. It has economic effect independent of the tax consequences.

• If instead the partnership agreement provides that the proceeds upon liquidation are to be divided equally among the partners, the special allocation would not have economic effect. Even though X has only $400 in its account, it would receive $450 upon liquidation.
II.D. Tax Issues: Level of Involvement

1. Management of a joint venture
   - Operations
   - Administration
   - Management agreements and decision-making

2. Contributed services versus products

3. Guarantees and other forms of support

4. Branding
II.E. Tax Issues: Undivided Interests

- Co-owned property may be accounted for as a separate depreciable property interest or as a partnership interest.
- Co-owners of property will not be treated as a partnership if they do not carry on a business for joint profit:
  - Profit is derived from independent sales of off-take
  - Expense sharing does not affect the analysis, particularly when sharing is based on their respective interests
  - Assignments can be made without consent
  - Co-owners do not hold themselves out as partners
- Significant joint activity at any time during the life of the arrangement may evidence an intent to share profits.
III.A. Accounting Issues: What is a Joint Venture?

1. Corporate Joint Venture establishes the framework. APB 18 (March 1971) defines a corporate joint venture as a corporation owned and operated by a small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group with the following five attributes:

   - **Purpose**: sharing risks and rewards in developing a new market, product or technology; combining of complementary technological knowledge; or to pooling of resources in developing production or other facilities
   
   - **Management**: active participation of each joint venturer may participate, directly or indirectly, in the overall management
III.A. Accounting Issues: What is a Joint Venture?

1. Corporate Joint Venture (cont.)
   - Relationship: ongoing relationship other than as passive investors
   - Ownership: seldom changes and its stock (or majority of it) does not publicly trade
   - Control: joint control
III.A. Accounting Issues: What is a Joint Venture?

2. Other Corporate Investments
   • APB 18 applies to other investments in common stock of 50% or less
   • An investor who has the ability to exercise significant influence over the investee should use the equity method
     • Presumption of significant influence at 20%
     • Facts and circumstances govern
   • Pro rata method is unacceptable in SEC filings even if there is an agreement which attributes the benefits and risks to the owners as if they held undivided interests
III.B. What is a Joint Venture? (cont.)

3. AIN-APB 18, #2, (November 1971) extends guidance to investments in unincorporated JVs and partnerships. It also carves out undivided interests.

4. SOP 78-9, *Accounting for Investments in Real Estate Ventures* (December 1978) provides guidance for real estate ventures (and other ventures by analogy) to narrow range of alternative practices. It applies to all of the following ownership arrangements:
   - Corporate joint venture
   - General partnership
   - Limited partnership
   - Undivided interest
III.C. Accounting Policy

1. Significant influence, joint control or unilateral control turns on decision making ability
   • Membership and voting rights on governing board
   • Selection, termination and compensation of officers
   • Establishment of policies
   • Establishment of capital and operating budgets
   • Amendments to the management agreement
   • Acquisition and sale of assets
   • Insurance settlements
   • Debt financing
   • Bankruptcy
III.C. Accounting Policy

2. Corporate Joint Ventures
   • General Partnership
     – Controlling GP should consolidate
     – Non-controlling should apply equity method of accounting
     – Jointly controlling GPs should follow JV accounting
     – Majority ownership may or may not establish control in absence of clearly indicated voting interests
     – Usually indicates control of a majority of the financial interests in profits or losses
     – Power to control may exist with lesser percentage of ownership, e.g., by contract, lease, agreement with other partners, or by court decree
III.C. Accounting Policy

3. Limited Partnership

- GPs should follow guidance for general partnerships if agreements substantively convey control to GPs over major operating and financing policies
- GPs may not control if LPs have “important rights”
- “Important rights” of the limited partners include the right to:
  - Replace the general partner(s),
  - Approve the sale or refinancing of principal assets, or
  - Approve the acquisition of principal partnership assets, may render the GPs noncontrolling investors
- An LP may be in control if GPs are not in control
III.C. Accounting Policy

3. Limited Partnership (cont.)

• Limited partners should use the equity method of accounting unless their interest is “so minor that the limited partner may have virtually no influence over the partnership operating and financing policy”

• The SEC staff understands that practice has viewed investments of more than “3 to 5 percent” to be more than minor [Topic No. D-46]

• EITF 98-6 did not resolve whether in non-real estate LP situations whether SOP 78-6 (“important rights”) or EITF 96-16 (“participating rights”) should be applied by analogy
III.C. Accounting Policy

4. Undivided Interest

• If real property owned by undivided interest is subject to joint control regarding major decisions, the owners “should” present their investments in the same manner as a noncontrolled GP [SOP 78-9, par. 11]

• If joint decision-making is not required and each real estate venturer is entitled to only its pro rata share of income, is responsible to pay only its pro rata share of expenses, and is severally liable only for indebtedness it incurs, it “may” use pro rate consolidation

• For other ventures (outside the extractive and construction industries), if the investor-venturer holds an undivided interest in each asset, is proportionately (i.e., severally) liable for its share of each liability, and no other separate legal entity exists, then it “displays” its investment on a proportionate gross basis [EITF 00-1]
III.C. Accounting Policy

5. Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs)
   • Relevant guidance depends on the governing provisions.
   • If the governing provisions are the functional equivalent of regular corporations, then APB 18 should be followed
   • Otherwise, the LLC/LLP should follow the guidance for unincorporated entities.
   • Open EITF agenda item.

6. AICPA Proposed SOP to replace SOP 78-9.
   • Issued November 21, 2000
   • Project renamed “Equity Method Investments”
   • No scheduled issue date
   • Advances hypothetical book liquidation method in allocating profit (loss)
III.C. Accounting Policy

7. Summary

- Legal entity / ownership structure matters
- Joint ventures have 5 distinguishing characteristics (notably joint control)
  - No venturer can have unilateral control
  - Voting power on control issues must be 50/50 (not 51/49)
- For other co-ownership arrangements, control or significant influence hinges on voting interests or decision making ability
  - 20-50% voting interest presumption, not iron-clad
  - All facts and circumstances analysis governs
  - FIN 35 provides additional guidance in the form of indicators that the investor does not have significant influence
- Equity method of accounting generally applies
III.D. Potential Implications of FASB’s SPE Project

The FASB had discussed the following example and alternatives in its April 3, 2002 meeting:

- An 80-20 JV Arrangement with Predetermined Activities
- Alternative A - the entity that holds an 80% economic interest (but technically has a 50% voting interest) is the primary beneficiary because of its level of economic interest
- Alternative B - There is no primary beneficiary because of the 50/50 split in voting interests even though the activities of the JV are predetermined

The proposed Interpretation addresses consolidation by business enterprises of an SPE to which the usual condition for consolidation does not apply:

- The SPE has no voting interests; or
- The SPE is not otherwise subject to control through ownership of voting interests.
III.D. Potential Implications of FASB’s SPE Project

Analytical steps to be taken:

- Is JV or venture an SPE?
- If SPE, consolidation or equity method based on voting interests or variable interest
- Apply voting interests model if equity investors meet all of the following conditions (paragraph 9):
  - Owners have voting rights and have ability to make decisions and manage the SPE’s activities that are not predetermined by governing provisions of SPE or by contract or other arrangements
  - The amount of equity investment is sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders
  - The equity investment is subordinate to all other equity investments and other interests for the entire life of the SPE
III.D. Potential Implications of FASB’s SPE Project

- The assets exchanged for the equity interest are not subordinated beneficial interests in another SPE
- The equity investment was not provided or financed directly or indirectly by the SPE or other parties with variable interests in the SPE.
- If a party that makes an equity investment that fails to meet one or more of the conditions in paragraph 9, that investment is a variable interest to be assessed under the Interpretation for consolidation.
- Heavily fact dependent and requires considerable professional judgment about structural features and related economics
III.E. Joint Venture Accounting (JVA)

- JVA is a special method of accounting arising from joint control over an entity
  - Each venturer has significant influence
  - Unique approach as neither holds a controlling or non-controlling interest
- Under JVA, no new basis/gain recognition accounting occurs upon formation (with exception as noted)
  - Applies to contributions of appreciated non-cash assets in exchange for an equity interest (outside the scope of APB 29)
  - Applies to certain contributions of businesses (outside the scope of APB 16)
  - If the venturer withdraws cash and has no commitment to reinvest, it may recognize gain
  - JV generally measures contributed assets at historical cost
III.F. Accounting for Contributed Property

- If JV is not an SEC registrant or included in the filings of a registrant, contributed assets are generally measured at fair value.
  - Appropriateness of using fair value measurements depends on ability to objectively determine fair value.
- Otherwise, assets contributed at historic cost.
- The SEC allows step up in basis of assets when all of the following exist:
  - Contribution of assets is to a new entity
  - One of venturers contributes cash in an amount equal to fair value of noncash assets contributed and such cash remains in JV or is used by JV in transactions with third parties
  - Neither venturer unilaterally controls JV
  - Venturers are unaffiliated
  - Equal allocation of equity, profits and losses between venturers
- Contributed assets that have depreciated will generally be measured at fair value.
III.G. Gain Recognition by Venturer on Formation

SEC requires facts and circumstances analysis:

**What is the nature of JV?**

- Continuation or expansion of existing business
- Change in interest
- Partial exiting or sale of business

**Accounting**

- Not acceptable until the earnings process is completed
- Not likely to be accepted since difficult to distinguish from continuation
- Okay if all 4 conditions set forth below are met
### III.G. Gain Recognition on Formation

<table>
<thead>
<tr>
<th>Conditions</th>
<th>Accounting</th>
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<tbody>
<tr>
<td>1. Measurability</td>
<td>■ Fair value of contributed assets must be clearly measurable</td>
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<td></td>
<td>■ Generally need a significant cash contributing investor</td>
</tr>
<tr>
<td>2. Realizability</td>
<td>■ Party contributing non-cash assets must have received cash or other monetary assets which are readily convertible to cash without concern of collectibility</td>
</tr>
<tr>
<td></td>
<td>■ No requirement to contribute back cash/monetary assets</td>
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</table>
III.G. Gain Recognition on Formation

**Conditions**

3. Permanent transfer of risks and rewards

4. No distinguishing returns

**Accounting**

- Risks and rewards of ownership for portion “sold” must have been permanently transferred to other investors with substantial certainty
- No payback arrangements, i.e., take-or-pay agreement
III.H. Allocations

■ Background
  • Venture agreements may allocate items differently
  • Such agreements may also provide for changes in allocations at specified times or upon the occurrence of specified events

■ Principles
  • Substance over form and consideration of underlying values (loss contingencies)
  • Analyze to determine how a GAAP increase or decrease in net assets will affect cash payments over the life and on liquidation
  • Specified profit and loss allocation ratios should not be used to determine an investor’s equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis
III.H. Allocations

■ Example

• If a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocation all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them…

• Then there is no substance to the purported allocation of depreciation expense.
III.I. Guarantees by Venturers

- Forms of Guarantees
  - Product, service, supply or offtake guarantees
  - Lease e.g., rentals or residual values
  - Debt guarantees
  - Keepwell agreements

- Existing GAAP guidance on related party sales involving leases
  - Analysis involves whether a genuine passage of risks and rewards to a third party purchaser-lesser has occurred.
  - When underlying lease is a finance lease, substantial risks and rewards have passed to the lessee. Vendor records full profit.
III.I. Guarantees by Venturers

• When underlying lease is an operating lease, current profit recognition turns on (a) risks and rewards transferred to outside investors and (b) extent of independent ownership interest.

• E&Y example: If a company sells equipment for $100 to a 50/50 joint venture, the significant of the risks of ownership retained would be based on $5 ($100 x 50% x 10%). Assuming that risks retained do not exceed $5, then the seller could record 50% of the profit on the manufacturing effort at the time of sale.
III.J. FASB Exposure Draft on Guarantees

- Disclosure of obligations provided directly by a venturer (separate and apart from JV obligations) required for fiscal periods starting after December 15, 2002
- Recognition of obligations entered into on or after January 1, 2003 required – fair value is measurement objective
III.K. Related Party Transactions

- Related party disclosures [FAS 57]
  - Pertains to transactions including sales, transfers, services, borrowings, arms-length vs. non-arms length pricing
- Contribution of leases and lease-leasebacks [FAS 98]
- Income tax disclosures
  - Undistributed earnings
  - Foreign JVs
### IV. Conclusion

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<th></th>
<th><strong>Tax</strong></th>
<th><strong>Accounting</strong></th>
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<tr>
<td><strong>Legal entity</strong></td>
<td>Generally a pass through or disregarded entity</td>
<td>Relevant to analysis</td>
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<tr>
<td><strong>Contributions</strong></td>
<td>Generally carry over basis</td>
<td>Generally carry over basis for JVs; otherwise fair value</td>
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<tr>
<td><strong>Income Allocations</strong></td>
<td>As agreed, subject to substantial economic effect</td>
<td>As agreed, based on substance as internal consistency between cash and earnings (HLBV proposed as single method)</td>
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IV. Conclusion - Tax Accounting

See “An Overview of Selected Aspects of Federal Taxation of Partnerships and Its Application to Leasing”

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