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## A Practical Guide to International Joint Ventures

Babak Nikravesh
Daniel Zimmermann

### INTRODUCTION

An international joint venture is a collaboration among two or more persons to achieve some business objective outside the United States. The hallmark of a joint venture is flexibility, and there is no particular recipe for its creation. It can take a number of forms or, in the case of a contractual arrangement, none at all. It may be employed to achieve short- or long-term objectives, or both. It can be designed to endure for a specified term, until a specified event, or indefinitely (although, in practice, that seldom happens).

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The motivation for counterparties to enter joint ventures can also vary, as can their intended roles in the conduct of the joint venture. In some cases, a counterparty may have limited involvement aside from the contribution of a critical local business license, concession, or contract. In other cases, both parties may be expected to contribute substantial resources to the enterprise, from cash and assets to personnel and know-how. In short, a joint venture can mean different things to different people, taking shape in accordance with those different expectations and purposes, and it is that inherent flexibility that makes joint venture arrangements so attractive, yet also so fraught with complexity.

This article aims to provide a practical and straightforward discussion of some of the legal issues that arise in negotiating, structuring, organizing, operating, and eventually terminating an international joint venture when at least one counterparty is a U.S. person. To that end, this article is divided into six parts. The first part looks at the process of negotiating, concluding, and executing an international joint venture agreement, with an emphasis on practical considerations for the joint venture lawyer. The second part addresses the structural considerations, including tax considerations, that go into deciding what form a joint venture should take. The third part identifies the issues arising in capitalizing and financing the enterprise. The fourth part focuses on the manner in which the joint venture operates and is controlled, and how operational and control disputes between the counterparties may be resolved. The fifth part highlights the legal concerns arising at the conclusion of the joint venture, from events triggering termination to the division of business assets. The last part concludes with a summary and a few final insights.

## PROCESS AND PRACTICAL CONSIDERATIONS

There can be various reasons for parties to pursue a joint venture. Risk sharing, cost savings, and access to technology, customers, local business knowledge, production sources, financing, or any number of other resources can inspire collaboration. The decision to enter into a joint venture is typically motivated by a recognition by one or more parties that pursuing a particular foreign business opportunity alone is not, for whatever reason, feasible at a particular time. Of course, a counterparty may hope to capture the opportunity for itself in the future, and therefore may build into the joint venture agreement the ability to buy out its co-venturer(s) or otherwise to secure greater control over the enterprise. Yet, at the time the joint venture is consummated, the parties usually believe that they need to cooperate and pool their resources in order to succeed.

**Defining the purpose and scope of the venture comprehensively and clearly is particularly important in the international context because language barriers and negotiation styles may lead to fundamental misunderstandings with respect to each party's expectations.**

### Preliminary Considerations

Defining the purpose and scope of a joint venture for parties that are looking to combine their resources and know-how, while allowing them to remain independent for other purposes, involves important strategic decisions that the parties must clearly understand and agree to. Defining the purpose and scope of the venture comprehensively and clearly is particularly important in the international context because language barriers and negotiation styles may lead to fundamental misunderstandings with respect to each party's expectations. Co-venturers typically do not commence their relationship by surgically limiting their allocations of resources or by specifically curtailing the purpose and scope of the joint venture. Nonetheless, each party may find it beneficial to determine for itself what the contemplated joint venture should not do and where the joint venture would compete with that party's existing or anticipated activities or business lines. Often, counsel is asked to limit the scope of the collaboration in the definitive agreement, after the term sheet stage, which can lead to protracted negotiations and frustrations on both sides. Once the purpose and scope of the joint venture are well defined, the parties and their counsel will have a much easier time rounding up the remaining terms of the contemplated deal and crafting a definitive joint venture agreement.

### Preliminary Agreements: Framing the Relationship With NDAs and MOUs

Joint ventures often involve highly sensitive technical and business data that need to be exchanged without jeopardizing each co-venturer's respective interest in its own confidential information. Therefore, comprehensive and tightly drafted nondisclosure or confidentiality agreements (NDAs) are a necessity.

NDAs in domestic or other commercial contexts may have different terms for protection of technical and nontechnical information (*e.g.*, nontechnical information may not be subject to an absolute nondisclosure obligation without a time limitation). In an international joint venture, however, even nontechnical business information may remain sensitive over a longer period of time and should therefore be protected by a robust NDA between the co-venturers. NDAs often also include nonsolicitation and no-hire provisions and usually allow the parties to seek injunctive relief through courts of regular jurisdiction when necessary, even if alternative dispute resolution is mandated for certain other contested issues. Given different cultural and legal expectations, NDAs may take time to negotiate. In addition, determining choice of law and choice of venue in the international realm has obvious importance.

**[N]egotiation styles in the cross-border context vary greatly, and these differences can easily obstruct successful completion of the joint venture agreement.**

Once an NDA has been concluded, the parties are well advised to prepare a detailed memorandum of understanding, term sheet, or heads of agreement (MOU). An MOU typically contains a host of provisions fleshing out the joint venture structure, including governance matters, and reflects a common understanding about the nature of the joint venture's activities. In most circumstances, the MOU is nonbinding and simply an expression of interest by the co-venturers. Nevertheless, because the parties are potentially exchanging highly confidential information about their respective intellectual property positions, organizational structures, and inner workings in general, certain provisions can be expected to be binding. Aside from the nondisclosure obligations of the parties (which may be subject to separate agreements), certain binding provisions such as exclusivity or no-shop provisions, noncompetition provisions, and no-hire provisions are often included. In some situations, break-up fees or reverse break-up fees may also be warranted, although these mechanisms are rarely used, mainly because the co-venturers are typically optimistic at the start of their relationship.

The necessity for and the benefit of a well-negotiated MOU in most cases cannot be overemphasized. MOUs usually constitute the roadmap for the joint venture and incorporate the spirit of the relationship that the co-venturers are seeking to establish. Even when the provisions of an MOU are nonbinding, the parties view those provisions as the foundation on which the joint venture will be built. Moreover, while the MOU is being negotiated, the organizations behind the co-venturers will be able to explore how the relationship will work in the future.

### Obtaining Specialist Input

In drafting the MOU, it is often advisable to seek the advice of knowledgeable tax and intellectual property advisors to ensure that the parties' goals are achievable and will be implemented within an efficient framework that can produce the desired outcome. Many joint ventures involve a rigorous tax-structuring exercise as clients and their advisors consider tax objectives and weigh tax minimization strategies. Further, in technology joint ventures, the ownership of the resulting intellectual property is an important piece of the joint venture puzzle. At this stage, it is also equally important to have the proposal reviewed by local foreign counsel. This input is usually most valuable in the early stages of the drafting of the MOU, because certain assumptions of the counterparties will be based on this fundamental advice.

### Negotiating the Definitive Joint Venture Agreement

On completion and signing of the MOU, co-venturers typically proceed quickly with negotiation of the definitive joint venture agreement. The negotiation itself is usually guided by the spirit embodied in the MOU. If the MOU clearly states that the parties are equal partners, the negotiations for the joint venture should reflect that spirit. The parties need to tread carefully and should engage in a respectful negotiation because the ultimate relationship will be based on (and potentially tainted by) these discussions. Further, negotiation styles in the cross-border context vary greatly, and these differences can easily obstruct successful completion of the joint venture agreement. Sometimes even the location of the venue where the joint venture is negotiated may have negative connotations. Thus, in a joint venture of equals, the parties often choose a neutral venue so as to emphasize the balanced nature of the relationship between them.

### The Definitive Joint Venture Agreement

The joint venture agreement is the guiding document between the co-venturers and should allow the co-venturers to understand their respective positions and ultimately to achieve their respective goals. Structural choices, discussed below, can influence whether the agreement will be embodied in the organizational documents of the venture or in a separate agreement. For instance, if the joint venture is structured as a foreign corporation, the joint venture agreement is typically an instrument separate and apart from the corporation's constitutive documents. However, if the joint venture is structured as a pass-through entity such as a partnership or limited liability company (LLC), the joint venture agreement can be either a separate agreement or incorporated in the governing partnership or LLC operating agreement.

The joint venture agreement should not necessarily dictate every aspect of the relationship between the co-venturers, although it should define clearly each co-venturer's governance and veto rights. If there are more than two co-venturers, careful consideration must be given to the agreement's provisions for amendment. The agreement should, of course, include the necessary protections for important assets and interests of each co-venturer. Because joint venture relationships tend to develop organically over time, however, the co-venturers should take care not to legislate every detail, but rather to allow their representatives on the venture's governing body to work productively on solutions to the real-world issues that arise over the life of the joint venture. The definitive joint venture agreement will be symbolic to the extent that it embodies the spirit of the relationship between the co-venturers. The ideal agreement should be clear and precise, yet also forward looking and flexible.

## STRUCTURAL CONSIDERATIONS

There are numerous business and tax considerations driving the structure of an international joint venture, and the unique facts of each proposed arrangement will inform the joint venture lawyer of the structure that makes the most sense for his or her client. Structuring is best addressed early in the negotiation process, and timely coordination with domestic and foreign tax counsel is essential. The complexity of this analysis cannot be overstated.

### Location of Activities and Assets

Does the joint venture need to operate in, or have employees who reside in or work from, a particular place? If the venture's operations need to be located in a particular place, selecting a vehicle that can conduct business in that place is paramount. Moreover, the assets that a joint venture may need must be housed and used somewhere, and the place where certain assets are to be housed may differ from where they are to be used. Thus, counsel must take stock of a joint venture's personnel and assets and then consider how and where they are to be used in the conduct of the venture's business in a particular location.

**The joint venture agreement should not necessarily dictate every aspect of the relationship between the co-venturers, although it should define clearly each co-venturer's governance and veto rights.**

### Regulatory Considerations

Once it has been determined where a joint venture needs to operate, the next question is whether local law demands that the business take a particular form, have particular owners, or possess a particular license. Often the requirements are more strict when a new enterprise seeks a governmental grant or tax concession. Therefore, in selecting a structure, it is important to be cognizant of local legal and regulatory limitations. To appreciate fully these requirements, it is advisable to consider each proposed local activity and the regulatory regime applicable to each activity. If a particular form is mandated, the ability of the joint venturers to accommodate their own business and tax concerns may be more challenging.

### Liability and Operational Considerations

It is desirable from a commercial law perspective to select a joint venture form that will afford its owners limited liability protection in the places where the joint venture will operate. The structural considerations for the joint venture should always include a practical assessment of what the joint venture should be able to accomplish commercially. This assessment normally requires careful consideration of the local rules and regulations that guide the choice of entity. In certain jurisdictions, the choice of entity may indicate commitment to the marketplace and may also be important to gain market access to local sales channels. More importantly, the co-venturers may be guided by practical considerations such as easy access to local talent and licensing and regulatory environments that are conducive to facilitating and simplifying venture operations. In many instances, management of the joint venture will be located in a specific place, which may implicate the choice of jurisdiction. Further, minimum capitalization requirements may be a consideration in some cases that will influence the location of the joint venture. Depending on the specific exit strategies of the joint venture, a particular jurisdiction may be more or less advantageous. If an acquisition scenario is likely, then corporate governance structures of potential acquirers may also be taken into account when choosing a jurisdiction. Similarly, if an exit would most likely occur through a public offering of joint venture interests, corporate governance rules would form an integral part of the considerations for the decision on where to locate the entity ab initio. Finally, employee compensation, especially deferred equity compensation, may be a feature that would require careful review of the locale's corporate governance and tax regimes to ascertain the feasibility of the expectations and goals of the co-venturers.

**[A]pplication of U.S. anti-inversion rules could cause foreign corporations to be treated as domestic companies for U.S. income tax purposes.**

## Tax Considerations

Once the parties have determined where the joint venture needs to locate its assets, people, and operations, and once the legal and regulatory requirements of those locations have been identified, the joint venture lawyer should consider matters of taxation. To do so, counsel must be familiar with the tax regimes of the jurisdictions in which the co-venturers and the joint venture itself are or will be formed and operated, being mindful of the many types of taxes that may apply. Income taxes, gross receipt taxes, sales taxes, value added taxes, stamp duties, taxes levied on contributions of property, withholding taxes, and employment taxes are among the taxes that should be considered, with varying degrees of emphasis. Counsel must also be sensitive to the peculiar tax goals of each joint venturer, which will be largely driven by each venturer's own tax position and vision for the enterprise. For instance, one venturer (carrying forward operating losses) may intend for earnings of the venture to be repatriated as earned, but the other venturer (having neither losses nor an immediate need for additional revenue) may prefer for earnings to accumulate in the joint venture. The competing objectives of the parties cannot always be reconciled in the joint venture itself, but sometimes can be accommodated through separate tax planning by each venturer. For example, a venturer's interest in a partnership joint venture vehicle may be held through a corporate holding company.

Counsel must also be aware of any anti-abuse rules that could defeat the parties' tax planning. For instance, application of U.S. anti-inversion rules could cause foreign corporations to be treated as domestic companies for U.S. income tax purposes. With these points in mind, counsel must seek to achieve tax goals that are relevant to every joint venture, namely to (1) minimize tax costs on formation and capitalization of the venture, (2) maximize operational tax efficiencies, and (3) maximize tax-efficient exit strategies.

### Joint Venture Structure

A joint venture may be structured in several ways. It may be a contractual undertaking (perhaps to pursue a joint marketing or development program) that does not require formation of an actual entity. Care is warranted, however, because even a contractual alliance may create a separate entity for U.S. income tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits from it.

More commonly, a joint venture will take shape as a separate business entity, in which case the parties must decide (1) what kind of entity to form and in what jurisdiction, (2) whether to own an interest in the entity directly or through special purpose holding companies, and (3) whether the entity should conduct its business in other jurisdictions directly (as through a branch) or through subsidiaries. When these choices are taken into account, the joint venture can easily evolve into a complex multi-tier structure involving one or more intermediate holding and operating companies. There are many factors to consider in establishing a multi-tier structure, including (1) each entity's potential exposure to local taxation; (2) the exposure to capital tax or duty on the initial issuance of shares; (3) potential withholding taxes—and the availability of domestic law or treaty relief—on intercompany dividends, interest, and royalty payments; and (4) thin-capitalization rules and transfer pricing limitations on intercompany transactions.

### Holding Company Considerations

In a multi-tier structure, it is imperative that cash and assets are able to move between the top-tier joint venture vehicle and the lower-tier operating companies as freely as possible with minimum tax and transaction costs. Intermediate holding companies formed in tax-favorable jurisdictions are employed largely to achieve this objective by exploiting favorable domestic law and treaty relationships to minimize withholding taxes, facilitate earnings removal strategies (to lessen the impact of operating in high-tax jurisdictions), and minimize tax on a disposition of a subsidiary. Thus, selection of the ideal holding company jurisdiction would require, among other things, that (1) the operating company's jurisdiction of formation or operation imposes no (or low) withholding taxes on payments of dividends to the holding company parent, (2) the holding company's jurisdiction of formation or operation imposes no (or low) taxes on dividend income, and (3) the holding company's jurisdiction of formation or operation imposes no (or low) withholding taxes on payments of dividends to the joint venture parent entity.

**The ability of taxpayers to elect the tax characterization of foreign entities adds a considerable element of complexity, as well as opportunity, to tax planning.**

### U.S. Tax Classification of Entities

When choosing among entity types, it is important to recognize that foreign entities are generally classified in one of three ways for U.S. income tax purposes: as a corporation, a partnership, or an entity disregarded from its owner. A corporation is an entity that is itself subject to income tax on its earnings. See IRC §11. A partnership is a fiscally transparent, or "pass through," entity, whose earnings flow through to its owners directly without an entity level of taxation. See IRC §701. A disregarded entity is a "tax nothing," meaning it is treated as a branch or division of its 100-percent owner rather than as a separate taxpayer. See Treas Reg §301.7701–2(a). Under the so-called "check the box" entity classification rules (Treas Reg §§301.7701–1—301.7701–3), taxpayers are largely permitted to choose which U.S. tax classification they would like an entity to have (although corporate classification is mandated for certain foreign entities, and partnerships require at least two owners). The ability of taxpayers to elect the tax characterization of foreign entities adds a considerable element of complexity, as well as opportunity, to tax planning. The joint venture advisor must help the client decide whether the venture (or a constituent entity) should be fiscally transparent for income tax purposes, and if so, whether it should be a hybrid entity (*i.e.,* one that is fiscally transparent for U.S. income tax purposes but not for local tax purposes) or a reverse-hybrid entity (*i.e.,* one that is fiscally transparent for local but not for U.S. income tax purposes).

### U.S. Tax Consequences of Entity Classification

There are numerous tax considerations when choosing among entities, including the following:

**Opportunity for Tax Deferral.** A fundamental difference between corporate and fiscally transparent entities is the opportunity for deferral of U.S. tax, which is at the heart of U.S. international tax planning. U.S. taxpayers are subject to U.S. tax on their worldwide income. Foreign corporations, however, are only subject to U.S. tax that is effectively connected with a U.S. trade or business or earned from U.S. sources. See IRC §§881–882. But for the application of certain anti-deferral rules (discussed below), the earnings of a foreign corporation doing business abroad are not subject to U.S. tax until such time as those earnings are repatriated to the U.S.

Deferral is desirable to the extent the U.S. effective income tax rate on joint venture income exceeds the rate that is imposed locally (including taxes imposed at the intermediate holding company and operating company levels). Deferral is possible when a foreign entity that is treated as a corporation for U.S. income tax purposes is used, but not in the case of a fiscally transparent entity like a partnership. As noted above, a partnership is a conduit for U.S. tax purposes, and its partners are taxed currently on its earnings. The unavailability of deferral can be a major impediment to the use of a fiscally transparent entity if the U.S. tax on the entity's earnings is not expected to be fully offset by foreign tax credits (discussed below). Thus, if deferral of U.S. tax is a critical driver, either the joint venture vehicle itself, or a foreign holding company interposed between the U.S. owner and a joint venture vehicle, must be a corporation.

**Exposure to U.S. Anti-Deferral Rules.** The ability of taxpayers to defer from U.S. tax the earnings of foreign corporations is limited by anti-deferral rules. See, *e.g.,* IRC §§951, 1291. These rules are intended to deny the benefits of deferral in circumstances where Congress felt the use of foreign corporations was abusive, *e.g.*, in the case of income of certain controlled foreign corporations (CFCs) from tax haven activities and investments. A foreign corporation is a CFC if those of its U.S. shareholders who own 10 percent or more of its stock (measured by voting power) own more than 50 percent of its stock (measured by voting power or value). See IRC §§951(b), 957–958. If the anti-deferral rules apply, a 10-percent U.S. shareholder may be required to recognize, as a deemed dividend, so-called "Subpart F" income earned by a CFC. See IRC §951.

Subpart F income includes, among other things, passive income like most dividends, interest, rents, or royalties. See IRC §§952, 954. Subpart F treatment of such passive income can be largely avoided, however, when CFCs have elected to be fiscally transparent for U.S. income tax purposes (see Treas Reg §301.7701–

3(a)(2)), although such an election does not necessarily resolve Subpart F concerns with respect to other types of income, *e.g.*, income from intercompany sales or services. Avoiding application of anti-deferral rules allows the efficient reallocation of resources among the joint venture's subsidiary operations and facilitates earnings removal strategies, *e.g.*, by financing high-tax foreign subsidiaries with debt from low-tax jurisdictions so as to maximize deductible interest payments.

**Foreign corporations . . . are only subject to U.S. tax that is effectively connected with a U.S. trade or business or earned from U.S. sources.**

**Flow-Through of Losses and Special Allocations.** A fiscally transparent entity has a number of advantages over a corporate entity, including the ability for losses incurred at the joint venture level to flow through to its owners and thereby offset their taxable income. If substantial losses are anticipated in the early years of the joint venture, counsel should consider selecting partnership classification for U.S. income tax purposes.

Entities treated as partnerships for U.S. income tax purposes afford owners a greater degree of flexibility in structuring their business relationship than corporations. Unlike shareholders of a corporation, partners of a partnership are generally free to allocate among themselves income, loss, credits, deductions, and other tax items. See IRC §704(a). Thus, partnership classification may be more desirable to the extent joint venture partners intend particular allocations of income, loss, or other tax items. However, special allocations that lack "substantial economic effect" may be disregarded. See IRC §704(b).

**Availability of Foreign Tax Credits.** The U.S. system of worldwide taxation places U.S. persons doing business abroad at risk of double taxation on the same income: once by the foreign country in which business is conducted, and then again by the U.S. To mitigate this risk, U.S. persons are allowed a tax credit against their U.S. income tax liability for certain foreign taxes paid. The credit is allowed for any income, war profits, or excess profits tax paid or accrued during the tax year by the taxpayer to any foreign country or U.S. possession. See IRC §901. Taxpayers who are eligible to claim a foreign tax credit generally include U.S. citizens and residents as well as U.S. corporations. See IRC §901(b). U.S. partners of a partnership also are eligible to claim their share of creditable foreign taxes incurred by the partnership. See IRC §901(b)(5). However, if the foreign joint venture entity is classified as a corporation, a foreign tax credit is generally available only to corporate owners holding 10 percent or more of the foreign corporation's voting interests. See IRC §902. Thus, noncorporate U.S. persons (or corporate persons with a less than a 10-percent voting interest) who wish to claim a foreign tax credit should consider using a fiscally transparent entity to conduct business abroad.

A joint venture structured as a foreign corporation may be desirable to a 10-percent corporate owner because it would provide that owner control over the timing of income recognition (generally, at the time a dividend is paid) and over the use of foreign tax credits. Foreign tax credits are subject to limitation, and when a U.S. corporation is not in a position to use certain credits, it may be desirable to keep them preserved in the foreign subsidiary until they can be used. Fiscally transparent entities do not allow this degree of control because their earnings are subject to immediate U.S. tax.

**The advantages of fiscally transparent entities are magnified in the international arena. . . . [N]o gain or loss is generally recognized on a transfer of property to a foreign partnership in exchange for a partnership interest.**

**Tax Efficient Contributions of Property**. It is generally easier to transfer appreciated assets to fiscally transparent entities in a tax-efficient manner than to corporations. For example, a transfer of assets to a corporation is tax free only if the transferors are in "control" of the transferee following the transfer, meaning that the transferors as a group must own, immediately after the transfer, at least 80 percent of the total combined voting power and value of the corporation. See IRC §§351, 368(c). This control requirement may inhibit parties from contributing additional assets to the corporation other than at the initial formation stage. In contrast, transfers to partnerships are not subject to any similar requirement. See IRC §721(a).

The advantages of fiscally transparent entities are magnified in the international arena. A U.S. shareholder's transfer of tangible assets to a foreign corporation in a transaction that would ordinarily be tax-free in the domestic context generally will remain tax-free in the cross-border context, provided that those assets are used by the foreign corporation in the conduct of an active trade or business outside the U.S. See IRC §367(a)(3). Certain types of assets, such as inventory and accounts receivable, are not eligible for this exception. See IRC §367(a)(3)(B). In addition, even when eligible tangible assets are transferred, a U.S. shareholder incorporating an existing foreign branch will still recognize gain to the extent it had previously deducted branch losses in the U.S. See IRC §367(a)(3)(C). Moreover, the active trade or business exception is unavailable when a U.S. shareholder contributes intangible property such as patents, copyrights, trademarks, or licenses to a foreign corporation. See IRC §367(a)(3)(B)(iv). When that occurs, the U.S. transferor is treated as if it sold the intangible property in exchange for a stream of royalty payments contingent on the productivity, use, or disposition of the intangible and payable over the useful life of the transferred intangible, capped at 20 years. See IRC §367(d); Temp Treas Reg §1.367(d)–1T(c)(3). In light of this deemed royalty regime, taxpayers often prefer to transfer intangible property to a foreign corporation by way of a license rather than as a contribution to capital.

In contrast, no gain or loss is generally recognized on a transfer of property to a foreign partnership in exchange for a partnership interest. Although the Internal Revenue Service is authorized to issue regulations treating as taxable certain transfers of property to a partnership with foreign partners, to date no such regulations have been issued. See IRC §721(c).

**Tax-Efficient Removal of Property**. Assets generally may be removed from a partnership without triggering U.S. tax. See IRC §731(a). There are exceptions, however, such as when the amount of cash (or cash equivalents) distributed exceeds a partner's adjusted basis in its partnership interest. See IRC §731(a)(1). Moreover, any built-in gain or loss on a distribution of property must be allocated to the partner who contributed the property if the distribution occurs within 7 years of contribution. See IRC §704(c)(1)(B). In contrast, assets that are held in a corporation are not easily removed without tax consequences. A distribution of property from a corporation would be treated as if the corporation sold the property and then distributed the proceeds in a taxable dividend. See IRC §§301, 311.

## CAPITALIZATION AND CONTRIBUTIONS

The parties to a joint venture must decide on their initial and subsequent contributions to the joint venture. In determining their contributions—whether in cash, services, or property—the parties must identify those resources that the venture will need to succeed. The contribution of assets to a joint venture raises a number of important tax issues. Some countries impose a capital tax on contributions to a local company or the issuance of securities. Minimization strategies for such taxes may exist, such as issuing debt in lieu of some equity to the venturers, although care must be taken not to violate minimum capital requirements, and excessive debt-to-equity ratios may raise other problems as well.

The contribution of assets by U.S. persons to a foreign joint venture also raises the U.S. income tax issues discussed above. As noted previously, many of the tax complications can be mitigated if the contribution is made to a fiscally transparent vehicle. However, a contribution of services in exchange for equity interests in the joint venture will normally be taxable to the service provider, whether or not the service recipient is a corporation or partnership.

Of course, a joint venture may also gain access to assets of the counterparties through other means. For instance, intangible assets may be licensed to the joint venture, or purchased by the joint venture using capital obtained through equity or debt financing. In either case, the parties may need to ensure that their transactions pass muster under applicable transfer pricing rules (including IRC §482 and corresponding non-U.S. rules), which generally require commercial transactions to be consistent with an arm's-length dealing between unrelated persons. The application of transfer pricing rules in the joint venture context is somewhat uncertain when there are equal co-venturers, although in practice joint venture counterparties are seldom true 50-50 partners.

The parties also must be mindful that the venture may not be financially self-sufficient for some time. To that end, the parties should decide among themselves how and in what proportions they will respond to capital calls from the joint venture, and whether external equity finance should be pursued at some point. The parties also should consider the extent to which the joint venture will be financed with debt, and whether that debt financing will be related-party or third-party debt. A guarantee or pledge is often necessary to secure the latter.

Capitalizing a joint venture with related-party debt can serve a number of purposes. Debt can provide a means to extract earnings from the enterprise in addition to whatever profits may be reaped by the owners. Subject to thin capitalization or other limitations, a company paying interest would usually be allowed an income tax deduction to reduce its exposure to local country taxation. Such "interest-stripping" measures are particularly useful when a joint venture operates in a high-tax jurisdiction, because the removal of earnings to a lower-tax jurisdiction can help the enterprise manage its overall effective tax rate. However, the payment of interest is often subject to local withholding taxes, and the related-party lender should therefore consider carefully whether there is domestic law or tax-treaty relief from withholding tax. Moreover, to fully benefit from an interest-stripping strategy, the lender's interest income ideally would be subject to low (or no) income taxation in its country of formation or operation.

## OPERATIONS AND CONTROL

Practitioners often hear that a joint venture will survive or fail depending on the execution of the venturers' business plan. Because many joint ventures are conceived as partnerships of "equals," tailoring operational control over the new enterprise to the realities of the business is critical. Initially, the venturers need to decide whether to co-manage the newly combined joint venture business themselves or to delegate responsibility to separate management. Generally speaking, co-venturers tend to engage separate management (usually comprised of persons from within their own ranks) if the joint venture has complex operational needs. If, on the other hand, operational needs are minimal, separate management is often not required and the joint venture can lean heavily on the institutional operational capabilities and know-how of each venturer.

As in the case of closely held U.S. businesses, the venturers may want to restrict management from entering into transactions or operational actions that would fundamentally affect the joint venture, its finances, or its operational independence. Depending on the composition of the governing board, this would in most instances entail imposing substantial operational restrictions on the management of the joint venture. Often, the following matters require prior approval of the co-venturers:

- Material changes or cessation of the business of the joint venture;
- Any sale of all or substantially all the joint venture's assets;
- Any authorization of a new class of securities, issuance of new securities, granting of rights to acquire new securities, reclassification of existing securities, or changes in the rights attaching to any issued securities, which results in additional securities ranking senior to or in parity with securities held by the co-venturers;
- Any redemption or repurchase of any equity securities, or payment of any dividends or distribution on any equity securities of the joint venture;
- Any amendment, waiver, or deletion of any provision of the joint venture agreement or any other document to which the joint venturer is a party that adversely impacts the equity holdings of a co-venturer;
- Any change in the size, term, or manner of election of the governing board of the joint venture;
- The creation or disposal of any subsidiaries, the purchase or disposal of equity in companies, or the merger or amalgamation of the joint venture entity or any subsidiary with any other entity; and
- Any transfer of shares held by the joint venture entity other than to a wholly owned subsidiary.

These restrictions are typically imposed through super-majority voting provisions, even in circumstances where one of the venturers has less than 50-percent voting control in the joint venture. In situations where deadlock is possible, as discussed below, mechanisms should be implemented that would prevent a complete standstill of the joint venture's operations.

**[S]tructuring decision-making in such a way as to avoid deadlock, or providing appropriate mechanisms for resolving deadlock (*e.g.*, mandatory mediation and binding arbitration), are critical.**

## TERMINATION AND EXIT

Few joint venturers have failure in mind when starting out. In fact, counsel is often admonished not to focus too much on the downside risks of the transaction, but rather to view the upside potential of a successful venture. Recognizing the potential of a successful collaboration, yet being mindful of risks, are not mutually exclusive propositions, although balancing them appropriately may be difficult in practice. In many instances, it may be appropriate for counsel to approach the matter of a possible termination in such a way that the parties do not view the conclusion of the venture as a failure.

Particularly in joint ventures of purported equals, the parties may be inclined to require equal input on many matters and unanimity before certain decisions are taken. This can often be a mistake because the unanimity requirement can risk paralyzing the enterprise through deadlock if the parties disagree on an important issue. Therefore, structuring decision-making in such a way as to avoid deadlock, or providing appropriate mechanisms for resolving deadlock (*e.g.*, mandatory mediation and binding arbitration), are critical. Buy-sell mechanisms often employed in closely held or family-held businesses or mandatory dissolution procedures may be also used and should be agreed to in advance. Further, the joint venturers may explore implementing simple (or, if appropriate, elaborate) put or call rights if certain predetermined events occur. Put and call rights are often used in situations where a competitor of one of the co-venturers takes control of the other co-venturer. These mechanisms must, of course, pass anti-competition or antitrust scrutiny and will require careful consideration at the time of formation of the joint venture.

**Joint ventures are wonderfully flexible devices that can be used to achieve a number of business goals, but that flexibility comes at the expense of complexity.**

In situations where an exit is contemplated from the beginning of the venture, the co-venturers may consider implementing typical venture capital and private equity mechanisms to allow them to benefit from a successful exit. These mechanisms include registration rights, standard drag-along and tag-along rights, as well as redemption rights. Registration rights provide liquidity to joint venturers by allowing them to require the joint venture entity to register the venturers' equity securities for sale to the public, either as part of an offering already contemplated by the joint venture entity (*i.e.*, piggyback rights) or in a separate offering initiated at a joint venturer's request (*i.e.*, demand rights). A drag-along right in the joint venture context generally requires one of the joint venturers to vote their equity securities in favor of a certain transaction or action. A co-sale right in the joint venture context provides some protection against a co-venturer selling its interest in the joint venture entity to a third party by giving the other co-venturer the right to sell a portion of its own stock as part of any such sale. In certain circumstances, co-venturers may find it appropriate to implement redemption rights. A co-venturer's equity holdings may be redeemable, either at the option of the joint venture entity or the co-venturer or mandatorily on a certain date, perhaps at some premium over the initial purchase price of the equity in the joint venture entity.

## CONCLUSION

This article has highlighted the rationales for pursuing an international joint venture and explored some of the legal and tax issues affecting their formation, operation, and termination. Joint ventures are wonderfully flexible devices that can be used to achieve a number of business goals, but that flexibility comes at the expense of complexity. Joint ventures are famously difficult to negotiate, conclude, and implement successfully. One size does not fit all, and advisors who expect to follow a cookie-cutter formula in drafting a joint venture agreement will be disappointed. To be sure, joint venture templates exist, but counsel must be prepared to deviate significantly from "standard" forms in light of the innumerable variables that can dictate business and legal choices.

Moreover, it is imperative that the parties and their advisors recognize that a joint venture has no "closing," and that the execution of the definitive agreement is only the beginning of the parties' association. A joint venture is really about building a lasting business relationship and, like any good relationship, a successful joint venture requires consistent effort, flexibility, and understanding. An early realization of these requirements should promote a sense of cooperation and respect between the parties as they negotiate their business deal and then execute on their shared vision.