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When and How to Form a Joint Venture in California

Often companies with distinct intangible and sometimes tangible "treasures", e.g. intellectual property, find themselves in need of capital, management, technological expertise or distribution capacity to further exploit such "treasures". To facilitate this seeming synergy, companies with untapped synergies often wonder how they could accomplish their symbiotic objectives without complicating their legal structure while effectively protecting their interests. Forming a joint venture might be a reasonable response in some situations.

When a Joint Venture Might Be Desirable

Often, joint ventures are formed:

1. When property that has an extended business of its own, e.g. intellectual property, is contributed to a new entity and the new entity is not competitive with its owner entities;
2. When a new business includes investors who contribute capital, but not participate in the new business' day-to-day management and operations; and
3. When strategic alliances, collaboration, or revenue sharing avenues are sought.

How Joint Ventures Are Often Formed

Joint ventures are formed either by:

- Forming a new business entity, a Limited Liability Company, a Corporation, a Limited Partnership or other legal entity. Or,
- Forming a contractual relationship that does not involve formation of a new legal entity. (**NOT** often recommended)

What Are *<u>Some</u>* Key Issues to Analyze Before Forming a Joint Venture?

- The parties' initial and ongoing capital commitment to the venture;
- The manner, duration and extent of capital contribution to the venture;
- The allocation of profits AND losses to the parties;
- The parties' decision making process and governance issues;
- The parties' anticipated duration and purpose of the venture;
- The parties' roles and responsibilities;
- The parties' tax considerations; and
- The parties' liabilities and indemnifications.

What Are <u>Some</u> Legal Issues to Analyze before Forming a Joint Venture?

Even though, some joint ventures are formed without forming a new business entity and by only entering into a legal agreement, it is highly advisable for a joint venture to use a business entity for the parties to implement their business objectives. There are various types of business entities in CA; however, in this article we review the two most common types: Corporations (C corporations and S Corporations) and Limited Liability Companies.

Let us analyze the rationale behind forming a business entity even in a joint venture situation and dissect pros and cons of Corporations and Limited Liability Companies in California, to some extent.

1. Limited Liability

Generally, corporate form shields members or shareholders to the extent they have contributed to the company or corporation if:

- The company is not undercapitalized, i.e. there is enough cash to pay for company's obligations;
- The company avoids commingling, i.e. the owners or shareholders use corporate funds or resources for corporate-related expenses; and
- The company has its own checking account, tax ID number i.e. its own real legal existence and corporate formalities are complied with.

2. Tax Treatment

A. Corporation

A corporation is subject to tax as a separate entity under subchapter C of the Internal Revenue Code, unless the corporation is eligible to make an election under subchapter S of the Internal Revenue Code. Net income of a C corporation is subject to both federal and state taxes at corporate tax rates. Furthermore, the shareholders report the dividends received as income and must pay federal and state income taxes on the dividends. This is called "double taxation". The corporation cannot deduct dividend payments made to shareholders as an expense.

The double taxation may be ameliorated in certain situations by the payment of salaries to shareholder-employees, by payment of fair market rent or royalties to use assets owned by a shareholder, or by payment of fair market interest on a debt owed to a shareholder.

B. Limited Liability Company

On the other hand, a limited liability company ("LLC") offers the limited liability discussed earlier and avoids the feared double taxation. LLC is a form of business organization with one or more members or owners, none of whom have individual liability for the debts and obligations of the LLC.

In addition, LLC has similar tax characteristics as a partnership with no federal or state tax due at the entity level. Furthermore, aside from filing state filings and payment of fees, there are only a few corporate formalities mandated.

The key advantage of an LLC over a corporation is that an LLC has substantially similar tax attributes as a partnership, with no federal or state income tax due at the entity level. As in a partnership, LLC members have freedom to structure management rights and financial interests in the entity in almost any configuration that the parties wish. LLCs are attractive because of their organizational and structural flexibility and the ability of members to engage actively in management without risk of liability. Further, by varying the rights of different classes of membership interests, voting control, distributions, and other attributes of LLC membership can be varied to enhance the returns and powers of one group of members in relation to another.

In California, however, an LLC must pay an annual franchise tax of $800 to the state plus an annual statutory fee of from $900 to $11,790 (subject to legislative changes), depending on the amount of the LLC's gross income derived from or attributable to California. Members of an LLC receive the same pass-through tax treatment as partners of a partnership and may agree to special allocations of profits and losses.

Salient Note:

This article *neither* supplants *nor* supplements the breadth or depth of such rarefied topic. In fact, this article *only* provides a rudimentary analysis of such esoteric subject matter.

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