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Investment Funds Group

Focus

Summer/Fall 2005

- Proposed Tax Rules on Compensatory Partnership Interests
- E-mail Retention and Production Obligations under the Advisers Act
- Anti-Money Laundering – An Update

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

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Personal Representation

Paul, Weiss Investment Funds Group
The Investment Funds Group is a dedicated asset management practice that focuses on a wide variety of private investment funds. The Group participates in the organization, fund raising and maintenance of private investment funds of every type, including buyout funds, venture capital funds, distressed funds, mezzanine funds, sponsorship funds, infrastructure funds, co-investment funds, funds of funds and hedge funds. The Group is involved in acquiring, merging and advising investment management businesses. In addition, the Group represents a diverse group of domestic and foreign investors in connection with their investments in private investment funds.

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Upcoming Events

Marco Masotti will moderate a panel discussion at the *12th Annual Private Equity Analyst Conference* focused on Document Retention and Disaster Recovery Plans for private equity firms on September 20, 2005 at the Waldorf Astoria in New York. In addition, Marco will speak at the *Private Equity Business Operations Forum* on October 17-18, 2005 at the Harvard Club in New York.

Proposed Tax Rules on Compensatory Partnership Interests

Stephanie R. McCavitt

On May 20, 2005, the IRS issued proposed rules relating to the tax treatment of the receipt of partnership equity interests (including profits interests and compensatory options) in connection with the performance of services. The proposed rules, which are set forth in proposed regulations and in a proposed Revenue Procedure, will not be effective until they are published in final form. If the proposed regulations are adopted in their current form, they will have a significant impact on the "carried interest" arrangements common in most private equity funds, hedge funds, real estate funds, and other compensatory arrangements common in venture capital. This is the first time that the IRS has specifically addressed the tax consequences of compensatory partnership interests in such a comprehensive manner.

The proposed rules treat compensatory partnership interests as property for Section 83 purposes. Therefore, under the proposed rules, a service provider will have compensation income at the time a compensatory partnership interest is received equal to the fair market value of the interest less any amount paid for the interest—even if the interest represents only a "pure profits interest." A service provider who receives a substantially nonvested compensatory partnership interest will not be taxed (and will not be treated as a partner) until the interest becomes substantially vested, unless a Section 83(b) election is made. The Section 83(b) election should preserve the character of the "carried interest" profits that are allocable to an electing service provider's partnership equity interest. The amount the service provider must include in income in connection with the Section 83(b) election is also generally equal to the fair market value of the interest less any amount paid for the interest.

Recognizing that fair market value is often difficult to determine, the proposed rules provide for a "Safe Harbor Election" that may be made by the partnership and its partners to value the partnership interests at "liquidation value." If the service provider would not receive any distribution if the partnership assets were sold at fair market value and the partnership was liquidated immediately after the grant of the interest, the Safe Harbor Election should ensure that the issuance of the partnership equity interest will not result in any income recognition to the recipient. To be eligible to make a Safe Harbor Election, however, the partnership agreement (or separate document executed by each partner) must contain specific language authorizing the making of such election and all partners must agree to comply with certain Safe Harbor Election requirements. The Safe Harbor Election requirements set forth in the proposed rules are not easy to satisfy, as some of them are unfavorable, and they are administratively burdensome especially for partnerships that are already in existence. It is unclear how the proposed rules would apply to partnership equity arrangements that exist today, as many of those arrangements may not satisfy

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the Safe Harbor Election requirements. If a partnership and its partners do not qualify for or do not make the Safe Harbor Election, the partnership potentially will be required to value partnership equity interests each time an interest is granted or vests.

In addition, if a service provider makes a Section 83(b) election and later forfeits the partnership interest, under the proposed rules, certain forfeiture allocations are required to be made in order to offset prior distributions and allocations of partnership items. It is unclear how these rules will ultimately apply and what will be required in the event that a partnership does not have enough actual tax items to make such allocations.

The proposed rules also provide that a partnership will not recognize gain or loss as a result of the transfer of an equity interest in such partnership to a service provider. If a new partner recognizes income upon the receipt of a compensatory partnership interest, the partnership will have a corresponding compensation deduction in the same year. The proposed rule expressly provides, however, that the deduction cannot be allocated to the service provider.

Note that these proposed rules expressly do not apply to transactions involving the transfer of an interest in a partnership in exchange for services rendered to a related partnership—a common practice in the investment funds industry. For example, the proposed rules do not apply to a situation in which services are rendered to the management company of an investment fund but a profits interest is issued by a different affiliated partnership that is the general partner of such investment fund. However, the IRS has asked for comments on the income tax consequences of compensatory transactions involving tiered and related partnership arrangements, indicating that the IRS intends to deal with such structures in the future or expand the scope of the proposed regulations.

It is not clear whether and how investment fund managers and others should modify their practices with respect to the grant of partnership equity interests to service providers prior to the proposed rules becoming final. Since the proposed regulations would, as written today, apply to post-effective date grants of interests by existing partnerships, in order to prepare for future compliance with the final version of the proposed rules, investment fund managers may want to consider including a provision in new partnership agreements calling for all partners to consent to, and to provide any required information in connection with, any tax elections, forfeiture allocations, or other matters that are necessary or desirable under the final rules. Investment fund managers should consult with their tax advisors in connection with the future issuance of partnership equity interests.

E-mail Retention and Production Obligations under the Advisers Act

Marco V. Masotti and Adam V. Nguyen

Rule 204-2 under the Investment Advisers Act of 1940 (the "Advisers Act") specifies that the records, communications and information that advisers are required to maintain. Over the past few years, the SEC, through its inspection and enforcement process, has informally applied Rule 204-2 to e-mail correspondence. This informal application has created ambiguities over the SEC's expectations of advisers' obligations to retain and produce e-mail correspondence. While the SEC appears to be preparing written guidance on this issue, advisers continue to incur substantial costs in connection with complying with inspection requests and continue to confront a host of difficult compliance issues. At least two issues require special attention:

E-mail Retention. There is uncertainty among advisers as to how to comply with e-mail retention requirements or in fact, what exactly those requirements are. Although the SEC has acknowledged that advisers do not need to save e-mail correspondence that does not contain information required to be retained under Rule 204-2, the SEC also has indicated that advisers must implement procedures reasonably designed to ensure that all required information is retained in connection with any routine deletion of e-mail correspondence. Consequently, many advisers feel compelled to keep all e-mail communications for five years, for fear that SEC inspectors will either deem the advisers' procedures unreasonable or insist on absolute certainty that required records have not been deleted.

Moreover, Rule 204-2(a)(7) of the Advisers Act, which requires the retention of certain types of written communications, creates further uncertainty with respect to this issue. Many advisers have long interpreted Rule 204-2(a)(7) to apply only to communications between an investment advisory firm and third parties, and not to internal firm communications. However, the staff in the Office of Compliance Inspections and Examinations at times has applied Rule 204-2(a)(7) to communications among a firm's employees.

E-mail Production. The scope of e-mail production in response to SEC inspection requests is another area of concern. Currently, SEC examiners routinely request that an adviser promptly produce all firm e-mail, or all e-mail sent or received by certain individuals, in an electronically searchable format. The SEC has construed the general authority of Section 204 of the Advisers Act to authorize it to review *any* record of an adviser (unless privileged), including records not required to be retained under Rule 204-2. However, an adviser may not be able to comply with such a broad inspection request if it has not saved e-mail correspondence that did not include information required to be retained under Rule 204-2.

Moreover, it remains unclear whether the SEC has the authority to require the production of *all* records (regardless of whether such records must be retained pursuant to Rule 204-2) in an electronically searchable format. For example, Rule 204-2(g), which provides that required records maintained electronically must be arranged in a way that permits easy access and location, does not apply to records that are not required to be retained under Rule 204-2.

In a May 11, 2005 letter to the SEC, the Committee on Investment Management Regulation of The Association of the Bar of the City of New York requested that the SEC issue rules to clarify advisers' e-mail retention and production obligations. With regard to e-mail retention, the Committee recommended that the burden of maintaining all of a firm's e-mail correspondence for five years could be eased by a formal statement from the SEC that reasonable procedures will satisfy an adviser's retention obligations with respect to e-mail correspondence and by providing guidance on the types of procedures the SEC would view as reasonable. The Committee suggested that, given the financial burden of reviewing each e-mail prior to deletion, the SEC should clarify that reasonable procedures need not include individual review and that reasonable retention procedures should permit the deletion of "junk" e-mail. Moreover, because Rule 204-2(a)(7) addresses only communications between an adviser and third parties, and not internal firm correspondence, the Committee urged the SEC to affirm the long-standing industry interpretation that the rule applies only to communications with third parties.

With regard to e-mail production, the Committee suggested that if the SEC believes that Rule 204-2 is not sufficiently broad in its scope, the SEC should promulgate new rules to include e-mail correspondence and other information that currently is not required to be retained (and therefore, not required to be produced) under the rule. Due to the considerable expense of converting electronic records into a searchable format from a non-searchable format, the Committee recommended that advisers may, until required to do otherwise by the rule, produce non-required electronic records in any format or medium.

Anti-Money Laundering – An Update

Marco V. Masotti and Amran Hussein

On October 26, 2001, anti-terrorism legislation known as the Uniting and Strengthening America Act by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot) Act of 2001 (the "Act") was passed into law resulting in significant amendments to the anti-money laundering provisions of the Bank Secrecy Act. Of particular significance is Section 352 of the Act, which requires that every *financial institution* establish an anti-money laundering program (an "AML Program") that includes, at a minimum, the following four elements:

- the development of internal policies, procedures and controls;
- the designation of an anti-money laundering compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the AML Program.

When the Act was initially adopted, it was unclear whether private investment funds and investment advisers would be subject to Section 352. However, since the Act's adoption, pursuant to the broad authority granted to it under the Act, the U.S. Secretary of Treasury ("Treasury") has proposed rules which, if enacted, would require certain private investment funds and investment advisers to comply with the anti-money laundering requirements of Section 352.

Proposed Rule for Unregistered Investment Companies. On September 26, 2002, Treasury proposed a new rule (the "Proposed Funds Rule") which, if adopted, would subject certain U.S.-based private investment funds to Section 352 of the Act. The comment period for the Proposed Funds Rule ended on November 25, 2002. Although there have been continuing rumors about its adoption, a final rule has not yet been enacted.

The Proposed Funds Rule provides that for purposes of the Act the term "investment company" would include "unregistered investment companies." Under the Proposed Funds Rule, an "unregistered investment company" is an issuer of securities that meets the following four requirements:

(1) *Type of Entity* - An issuer that is: (a) a 3(c)(1) and 3(c)(7) fund; (b) a commodity pool; or (c) investing primarily in real estate and/or interests therein.

(2) *Redemption Rights* - An issuer that permits an owner to redeem its ownership interest within two years of purchase.

(3) *Minimum Assets* - An issuer that has total assets (including received subscriptions) as of the end of the most recently completed calendar quarter of at least $1 million.

(4) *U.S. Jurisdictional Limitation* - An issuer that (a) is organized in the U.S., (b) is organized, operated or sponsored by a U.S. person, or (c) sells ownership interests to a U.S. person.

Most U.S.-based hedge funds would be covered by the foregoing definition, unless the hedge fund had a lock-up period longer than two years. However, most U.S.-based private equity and venture capital funds would not be covered by the definition because, unlike hedge funds, such funds generally do not allow investors to redeem their interests prior to the end of the life of the fund.

Proposed Rule for Investment Advisers. On April 8, 2003, Treasury proposed another new rule (the "Proposed Advisers Rule") which, if enacted, would subject certain U.S.-based investment advisers to Section 352 of the Act. The comment period for the Proposed Advisers Rule ended on July 7, 2003. Again, although there have been continuing rumors about its adoption, a final rule has not yet been enacted. The Proposed Advisers Rule provides that for purposes of Section 352, the term "investment adviser" would include the following two types of investment advisers:

(1) *Registered* - Investment advisers with discretionary or non-discretionary authority over assets that (a) have a principal office and place of business in the United States, (b) are registered with the SEC, and (c) report to the SEC that they have assets under management.

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(2) *Unregistered* - Investment advisers that (a) have a principal office and place of business in the United States, and (b) are not registered with the SEC, but have $30 million or more of assets under management and are relying on the registration exemption for advisers with fewer than 15 clients that do not hold themselves out generally to the public as investment advisers.

The Proposed Advisers Rule also sets forth specific instructions concerning when a particular investment fund should be included or excluded from an investment adviser's AML Program. For example, the Proposed Advisers Rule would permit investment advisers covered by the proposal to exclude from their AML Programs any of their investment funds that are already subject to an AML Program requirement (which may include hedge funds covered by the Proposed Funds Rule).

If the Proposed Funds Rule is adopted, U.S.-based private investment funds that are covered by the "unregistered investment companies" definition will be required to establish AML Programs that meet the requirements set forth in the final rule. Similarly, if the Proposed Advisers Rule is adopted, most U.S.-based registered and unregistered investment advisers will be subject to Section 352 and therefore will be required to establish AML Programs that meet the requirements set forth in the final rule.

In the absence of concrete guidance from Treasury, many private investment funds and investment advisers have taken it upon themselves to engage in cautionary measures and have enacted AML Programs that comply with Treasury's proposed rules.

In Focus

Japanese Tax Law

As a result of the 2005 Japanese Tax Reform Proposal (the "Proposal"), capital gains from Japanese equity investments realized by some non-Japanese investors through offshore investment partnerships generally will be subject to a 30 percent Japanese corporation tax. Under current rules, such capital gains generally are not taxable to non-Japanese investors absent a permanent establishment in Japan. Capital gains from the "sale of a business" are subject to Japanese tax regardless of the existence of a permanent establishment. The "sale of a business" occurs when an investor sells at least 5 percent of the equity of a Japanese corporation in which the investor has owned at least 25 percent of the corporation. This rule is currently applied separately to each investor in an investment partnership and, therefore, rarely results in the imposition of tax. Under the Proposal, the 25 percent/5 percent rule would be applied at the investment partnership level. As a result, capital gains realized by an investment partnership from the "sale of a business" allocable to non-Japanese investors will subject such investors to Japanese tax and filing requirements. However, U.S. investors will be protected from the proposed capital gains tax pursuant to the income tax treaty between the United States and Japan, except that gains from the sale of shares of real estate holdings will not qualify for treaty benefits.

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