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Investment Funds Group

Focus

Winter 2005

- The American Jobs Creation Act of 2004: Considerations for Private Equity Funds
- SEC Requires Registration of Hedge Fund Advisers
- Borrowings by Private Equity Funds: Some Key Considerations

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Paul, Weiss Investment Funds Group
The Investment Funds Group is a dedicated asset management practice that focuses on a wide variety of private and 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 investment funds.

Marco Masotti will speak at the *2005 Private Equity Fund Formation* seminar on January 26th at the Princeton Club in New York, and at the *Mutual Funds and Hedge Funds* roundtable on January 31st at Fordham University School of Law. In addition, Marco Masotti will chair and Jeffrey Samuels will speak at the *Private Equity Funds: Structures, Terms & Conditions* program on February 10th at the Association of the Bar of the City of New York.

Editors: Marco V. Masotti and Chris Jochnick

Table of Contents

The American Jobs Creation Act of 2004: Considerations for Private Equity Funds

The transfer of partnership interests may have new tax implications

Jeffrey B. Samuels and Nancy E. McGlamery

Private equity and venture capital funds may find themselves subject to substantial administrative burdens as a result of one of the provisions included in the American Jobs Creation Act of 2004, signed on October 22, 2004 (the "AJCA"). This provision relates to transfers of partnership interests where a built-in loss is reflected in the underlying partnership assets.

When a partner transfers its interest in a partnership by sale or exchange or upon the death of a partner, the acquirer generally takes a new fair market value basis in the partnership interest ("outside basis"), but the partnership's basis in its own assets ("inside basis") remains unchanged unless the partnership has made an election under Section 754 of the Internal Revenue Code of 1986 ("Code"). If the partnership has made such an election, in the event of a transfer of interests, it must adjust its inside basis in respect of the transferee partner so that the transferee partner's outside basis in its partnership interest equals its proportionate share of the partnership's inside basis. Once the election is made, these basis adjustments become mandatory for all subsequent transfers of partnership interests.

In their simplest manifestation, the rules surrounding Section 754 elections permit a purchasing partner to receive the benefit of a basis step up with respect to its share of partnership assets so as to obtain increased depreciation deductions or to reduce its share of taxable gain on a sale of appreciated partnership property. Historically, private equity and venture capital funds have not made Section 754 elections, because the recordkeeping requirements can be burdensome and because a substantial portion of the investors in such funds, such as tax-exempt and non-U.S. persons, are indifferent to basis step ups.

The AJCA provides that, unless otherwise exempted, a transfer of an interest in a partnership with a "substantial built-in loss" will give rise to a mandatory adjustment to inside basis. The built-in loss is considered "substantial" if the partnership's inside basis immediately after the transfer exceeds the fair market value of its assets by more than $250,000. Note that this $250,000 threshold is measured at the partnership level, rather than solely by reference to the built-in loss attributable to the transferred partnership interest. Accordingly, a transfer of an interest involving a much smaller distributive share of built-in loss may nevertheless trigger the provision.

Congress has indicated that venture capital funds, buyout funds, and funds of funds are intended to be exempted from the rules as so-called "eligible investment partnerships" ("EIPs"). For funds that historically have not made the Section 754 election, qualification as an EIP will permit the partnership to continue to function outside of the mandatory adjustment regime for transfers of partnership interests. However, it is expected that many such funds, including most hedge

Continued on page 4

Continued from page 3

funds, may not meet the strict criteria for EIP status. Moreover, even if a fund qualifies for the exemption provided for EIPs, under the AJCA it may still have other administrative and recordkeeping obligations with respect to certain transferee partners, and transferee partners will be prevented from claiming their share of recognized losses, up to the amount of built-in loss attributable to the transferred interest, even if such recognized losses were not built-in losses.

A partnership may elect to be treated as an EIP if all of the following requirements are met:

1. The partnership would be an investment company engaged primarily in the business of investing, reinvesting or trading in securities within the meaning of Section 3(a)(1)(A) of the Investment Company Act of 1940, but for the exemptions under sections 3(c)(1) (no more than 100 beneficial owners) or 3(c)(7)(interests held only by "qualified purchasers");

2. The partnership has never been engaged in a trade or business;

3. The partnership holds substantially all of its assets for investment;

4. 95% of the assets contributed to the partnership consist of cash or cash equivalents;

5. No contributed assets had a built-in loss at the time of contribution;

6. All partnership interests are issued by the partnership in a private placement within 24 months after the date of the first capital contribution to the partnership;

7. The partnership agreement restricts each partner's ability to cause a redemption of the partner's interest; and

8. The partnership agreement states that the partnership has a term of not more than 15 years (20 years if the partnership was in existence on June 4, 2004).

Until further guidance is issued by the IRS and Treasury, private equity and venture capital funds may wish to consider the following:

- Provision should be made in partnership agreements for the general partner to maintain control over the partnership's election of EIP status, and the partnership should require all partners to act consistently with the general partner's decision.

- The general partner should consider whether to exercise its discretionary authority to prohibit transfers when there is a "substantial built-in loss."

- Funds that otherwise should qualify as EIPs might consider the use of "feeder" partnerships to address the 24 month commitment period, 95% cash and 15 year term requirements. Each feeder partnership would qualify as an EIP, but by co-investing, these feeder partnerships could effectively extend the commitment period beyond two years. Note, however, that there is as of yet no guidance on this kind of approach and no assurance that it will be effective to attain EIP status.

In the absence of future guidance, a fund that invests in an LLC or partnership engaged in a trade or business may itself be deemed so engaged. Accordingly, funds that otherwise would qualify as EIPs may wish to consider the use of "blocker" corporations to avoid the risk of investing in partnerships engaged in a trade or business. However, while a corporate blocker should prevent imputation of a trade or business to the fund, the taxation at the corporate level will create tax leakage.

SEC Requires Registration of Hedge Fund Advisers

Advisers to private funds that allow redemptions within two years must register

Marco V. Masotti, A. Chandler Bass and Jennifer N. Visconti

On October 26, 2004, the Securities and Exchange Commission (the "SEC") approved new Rule 203(b)(3)-2 and amendments to existing rules (collectively, the "Rule") to the Investment Advisers Act of 1940 (the "Advisers Act") requiring the registration of most advisers to hedge funds. The Rule applies to investment advisers managing at least $30 million for U.S. investors and with 15 or more clients, excluding "knowledgeable employees" and "insiders" (advisers who have at least $25 million in assets under management may register at their discretion).

The Rule requires that advisers to "private funds" count the number of investors in each private fund as a single client for purposes of determining whether the adviser is subject to registration with the SEC. A "private fund" is defined as any entity that: (i) would be an "investment company" under the Investment Company Act of 1940 (the "Act") but is exempted by either Section 3(c)(1) or 3(c)(7) of the Act; (ii) permits its owners to redeem any portion of their ownership interests within two years of purchase; and (iii) offers interests based on its adviser's expertise. The SEC's Division of Investment Management has indicated that it will monitor the imposition of two year lock-up periods by funds to ensure that this exemption is not misused to avoid registration.

There are certain limited exceptions to registration under the Rule. For example, offshore advisers to publicly offered offshore mutual funds or closed-end funds are exempt from the registration requirements, regardless of the number of U.S. investors in such funds. In addition, commodity trading advisers that are registered with the Commodity Futures Trading Commission are not required to register under the Rule so long as their business does not consist primarily of acting as investment advisers.

Certain changes were made to the Rule in response to comments submitted during the comment period. For example, the proposed rule allowed an exception to the two-year lock-up under the definition of "private fund" for "extraordinary *and unforeseeable*" events. However, under the Rule, an entity will not be considered to be a "private fund" if its owners redeem their interests within two years of purchase due to "extraordinary" events. This revision allows advisers to private equity and venture capital funds, to permit investors to withdraw due to foreseeable events, such as legal and regulatory circumstances, as well as pursuant to certain contractual provisions such as "key man" provisions, without becoming subject to registration. The Rule also allows an exemption to the two-year rule for interests acquired through reinvestments of distributions by the fund of capital gains or income.

Registered investment advisers may only charge performance fees to a "qualified client," *i.e.*, a natural person or entity: (i) with at least $750,000 in assets under management with the adviser;

Continued on page 6

Continued from page 5

(ii) with a net worth of at least $1.5 million; or (iii) that is a "qualified purchaser" under 2(a)(51) of the Act. An important "grandfathering" exception to this rule allows newly-registered advisers to maintain their existing fee structure with respect to investors who are clients prior to February 10, 2005, whether or not such investors are "qualified clients."

Domestic and foreign investment advisers are treated differently under the Rule. Offshore advisers (*i.e.*, those with a principal office and place of business outside the U.S.) are only required to count clients that are U.S. residents for purposes of the 15-client rule, while domestic advisers must count all clients for such purpose. An investor formed under the laws of the United States is deemed to be a U.S. investor. The residency status of an investor is determined at the time that such investor makes his or her investment. Accordingly, if an investor moves after making an investment in the fund, such investor's residency status under the Rule does not change. A non-U.S. adviser that provides advisory services to 15 or more U.S. clients is subject to the same registration requirement as if it were a domestic adviser. However, a non-U.S. adviser to offshore private funds that is subject to the registration requirement because such funds have 15 or more U.S. investors is subject to less rigorous regulation. Such an adviser much register with the SEC and maintain the required books and records, but it is not required to adopt a code of ethics or comply with the compliance rule, proxy voting rule or custody rule.

Rule 204-2 of the Advisers Act requires registered advisers to maintain books and records supporting performance information contained in advertisements and materials sent to ten or more persons. To accommodate advisers required to register under the Rule, the SEC has amended Rule 204-2 to permit such advisers to market their performance history even without sufficient records, provided that they (i) begin to maintain adequate records starting as of February 10, 2005, and (ii) retain whatever relevant records they possess prior to such date.

Advisers who believe they will be required to register with the SEC should begin now to consider what steps must be taken to comply with the SEC's regulatory regime, including gathering the information necessary to complete their Form ADV, developing a compliance manual (including proprietary trading guidelines), establishing a code of ethics and designating a chief compliance officer. Form ADVs may take as much as 45 days from the date of filing to become effective, so advisers should file their ADVs by mid-December 2005.

Borrowings by Private Equity Funds: Some Key Considerations

Valerie E. Radwaner and Robert M. Hirsh

Borrowings by private equity funds are increasingly common in today's leveraged finance market. The organizational documents of funds often impose restrictions on their ability to incur indebtedness or to issue guarantees. Fund advisers need to be mindful of these restrictions and need to ensure the necessary flexibility in the organizational documents to support future borrowings.

General Authority. The general grant of authority to the general partner often explicitly permits the general partner to enter into (or cause the fund to enter into) borrowings and/or guarantees. However, even if broadly permitted, the availability to borrow or provide guarantees and the ability to provide loan or guarantee covenants may be restricted by (i) limitations on the purpose, amount or duration of such loan or guarantee, (ii) practical limitations on the ability of the fund to repay from capital contributions or investment proceeds, and (iii) tax covenants that may, in effect, eliminate the ability to borrow or guarantee. These types of limitations may appear in the partnership agreement, but often arise in (or are modified by) side letters entered into with individual investors who are particularly sensitive to borrowings and guarantees (typically for tax reasons).

Purpose/Amount. The fund agreement may set forth limits on the maximum aggregate amount of borrowings and/or guarantees. These limits are typically expressed as a percentage of capital commitments, which may be based on either an occurrence test or on amounts outstanding from time to time. Funds may also have restrictions on the use of proceeds of any borrowing; for example, interim financing may be permitted to cover expenses or to consummate a portfolio investment in advance of receiving capital contributions. Time limits may also be imposed on any borrowings.

Sources of Repayment. If capital contributions are to be a source of repayment of borrowings or securing a guarantee, the fund's capital call provisions must be examined to confirm that they permit the fund to satisfy these obligations and service any interest expense. For example, diversity restrictions may limit the amount of capital allocable to the investment supported by the borrowing or guarantee. Borrowings may also be limited to an initial "investment period"; with further capital calls possibly permitted only in support of "follow-on investments." In addition to, or in place of, capital contributions, funds may allow investment dispositions to be applied to borrowings.

Tax Issues. Income not otherwise classified as UBTI may nevertheless be treated as UBTI if derived from property that is "debt-financed." A fund's incurrence of debt to make an investment will ordinarily generate UBTI for a tax-exempt investor, with special exceptions for debt-financed income of pension funds and educational endowments. Most funds offer their tax-exempt investors some protection against this risk. Funds will frequently covenant to use "best" or "reasonable efforts" to avoid UBTI - a covenant that may restrict the ability of a fund to borrow or offer guarantees. Funds may also offer tax-exempt investors the ability to contribute an amount equal to their proportionate share of any indebtedness used to make an investment such that no indebtedness is allocable to such investor. In effect, these investors fund their *pro rata* share of the loan with accelerated contributions of equity capital. Additionally, in anticipation of the fund's incurrence of debt, a fund may offer its tax-exempt investors the opportunity to invest through an alternative investment vehicle in the form of a corporate tax blocker.

Investment Funds Group Offices

New York
1285 Avenue of the Americas
New York, NY 10019-6064
212-373-3000
212-757-3990 (Fax)

U.S. contacts

Robert M. Hirsh
212-373-3108
212-373-2182 (Fax)
rhirsh@paulweiss.com

Yvonne Y. F. Chan
212-373-3255
212-373-2322 (Fax)
ychan@paulweiss.com

Marco V. Masotti
212-373-3034
212-373-2077 (Fax)
mmasotti@paulweiss.com

London
Alder Castle
10 Noble Street
London EC2V 7JU
United Kingdom
(44-20) 7367-1600
(44-20) 7367-1650 (Fax)

Europe contacts

Mark S. Bergman
(44-20) 7367-1601
(44-20) 7367-1651 (Fax)
mbergman@paulweiss.com

David K. Lakhdhir
(44-20) 7367-1602
(44-20) 7367-1652 (Fax)
dlakhdhir@paulweiss.com

Hong Kong
12th Floor
Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933
(852) 2536-9622 (Fax)

China/Hong Kong contact

John E. Lange
(852) 2846-0333
(852) 2840-4333 (Fax)
jlange@paulweiss.com

Tokyo
Fukoku Seimei Building
2-2 Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
(81-3) 3597-8101
(81-3) 3597-8120 (Fax)

Japan contacts

Russell E. Colwell
(81-3) 3597-6301
(81-3) 3597-8120 (Fax)
rcolwell@paulweiss.com

Lisa Yano
(81-3) 3597-6302
(81-3) 3597-8120 (Fax)
lyano@paulweiss.com

New York
Washington, D.C.
London
Beijing
Hong Kong
Tokyo

www.paulweiss.com

Please contact funds@paulweiss.com to be added to our mailing list or for further information.