Managed Funds Association
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

July 31, 2017

Via Electronic Filing:

U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Managed Funds Association Comments on Review of Regulations

Dear Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] would like to provide comments in response to the Department of the Treasury's ("Treasury") request for information on its Review of Regulations[2] pursuant to President Trump's Executive Order 13777, Enforcing the Regulatory Reform Agenda (the "Regulatory Reform Executive Order").[3] We believe that existing regulations with respect to the issues discussed below create unnecessary costs and burdens for taxpayers, particularly investors in U.S. capital markets, and create unnecessary complexities and inconsistencies for taxpayers seeking to comply with the rules as well. Accordingly, we encourage Treasury and the Internal Revenue Service (the "IRS") to reconsider their regulations in light of their impact on taxpayers, particularly those taxpayers who are investors in U.S. capital markets.[4] In submitting this request, we also note the policy goal set out in President Trump's Executive Order 13789, Identifying and Reducing Tax Regulatory Burdens (the "Tax Executive Order" and, together with the Regulatory Reform Executive Order, the "Executive Orders").[5]

---

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[2] 82 FR 27217 June 14, 2017.

[3] President Trump's Executive Order 13777 is available at: https://www.whitehouse.gov/the-press-office/2017/02/24/presidential-executive-order-enforcing-regulatory-reform-agenda.

[4] MFA also submitted a comment letter in response to the Review of Regulations with comments focused on rules under Section 871(m) of the Internal Revenue Code of 1986, as amended.

[5] The Federal tax system should be simple, fair, efficient, and pro-growth. The purposes of tax regulations should be to bring clarity to the already complex Internal Revenue Code (title 26, United States Code) and to provide useful guidance to taxpayers. Contrary to these purposes, numerous tax regulations issued over the last several years have effectively increased tax burdens, impeded economic growth, and saddled American businesses with onerous fines, complicated forms, and frustration. Immediate action is necessary to reduce the

Exclude Conversion Ratio Adjustments from Withholding Taxes under Section 305(c)

We encourage Treasury and the IRS to withdraw their 2016 proposed regulation, Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock, and issue new proposed regulations providing that conversion ratio adjustments ("CRAs") on convertible securities will not be deemed a distribution subject to withholding tax. We encourage Treasury and the IRS to issue such regulations because CRAs are fundamentally and economically different than distributions to shareholders, as CRAs are designed to prevent the dilution that would otherwise occur in the value of the option embedded in the convertible debt instrument when an increased level of ordinary cash dividends are paid to shareholders.

Under Section 305(a) of the Internal Revenue Code of 1986, as amended (the "Code"), enacted in 1969, a distribution by a corporation of its stock to its shareholders with respect to their stock is not taxable except to the extent provided in Sections 305(b) or (c). Section 305(b) governs actual distributions and contains a series of exceptions to the general rule of Section 305(a). In contrast, Section 305(c) directs the issuance of regulations under which, for purposes of Sections 301 and 305, certain transactions not involving an actual distribution including "a change in conversion ratio" are to "be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change . . . .". Such a deemed distribution is, however, subject to tax as a dividend only to the extent provided in Section 305(b). For example, dividend treatment would obtain under the "disproportionate distribution" rules of Section 305(b)(2) if the result of the deemed distribution (or a series of distributions of which the deemed distribution is a part) is that some shareholders receive property such as cash and other shareholders receive an increase in their proportionate interests in the assets or earnings and profits of the distributing corporation (*e.g.*, a change in conversion ratio of stock or securities is accompanied by distribution of a cash dividend to other shareholders).

Special rules are provided to address situations in which certain changes in conversion ratios that are intended to offset dilution arising from other transactions (*e.g.*, sales of stock at prices below the conversion price) are not treated as deemed distributions. Specifically, Treasury Regulation §1.305-7(b)(1) provides in relevant part as follows:

> (b) Antidilution provisions. – (1) For purposes of applying Section 305(c) in conjunction with Section 305(b), a change in the conversion ratio or conversion price of convertible preferred stock (or securities) . . . made pursuant to a bona fide, reasonable, adjustment formula

burden existing tax regulations impose on American taxpayers and thereby to provide tax relief and useful, simplified tax guidance.

Available at: https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-executive-order-identifying-and-reducing-tax-regulatory.

> (including, but not limited to, either so-called "market price" or "conversion price" type of formulas) which has the effect of preventing dilution of the interest of the holders of such stock (or securities) will not be considered to result in a deemed distribution of stock. An adjustment in the conversion ratio or price to compensate for cash or other property distributions to other shareholders that are taxable under Section 301. . . will not be considered as made pursuant to a bona fide adjustment formula.

The legislative history of Section 305 suggests that, in 1969, Congress enacted Section 305(c) to provide the Treasury and the IRS with a flexible to tool to combat tax motivated attempts to defeat the purposes of the exceptions to non-taxation set forth in Section 305(b), including the "disproportionate distribution" rule of Section 305(b)(2), through transactions that do not involve an actual distribution. Under the current and proposed regulations, however, Section 305(c) appears literally to reach all CRAs occasioned by a taxable distribution to other stockholders, though we believe the legislative history can and should be read to suggest that Congress did not mandate such a result in all cases. For example, the General Explanation of the Tax Reform Act of 1969, as published by the Staff of the Joint Committee on Taxation, states that "[I]t was not clear under prior law to what extent increases of this kind would be considered distributions of stock or rights to stock" and "[I]n order to eliminate uncertainty, the Act authorizes the Secretary or his delegate to prescribed regulations governing the extent to which such transactions shall be treated as taxable distributions."

Debt instrument CRAs to reflect ordinary cash dividends paid to shareholders frequently were not included in convertible debt instruments issued prior to 1969, when Section 305 was enacted, or when Treasury issued regulations thereunder in 1973 and amended those regulations in 1995. Following Congress' decision to enact legislation in 2003 to provide special tax benefits to the recipients of so-called "qualifying dividends", an increasing number of corporations commenced the payment of ordinary cash dividends on a regular basis and this produced market pressure to include CRA provisions in newly issued debt instruments that are applicable in the case of the payment of ordinary, periodic cash dividends to shareholders above a specified rate or amount. These CRA provisions were insisted upon by many potential acquirers of debt instruments in order to prevent the dilution that would otherwise occur in the value of the option embedded in the debt instrument when an increased level of ordinary cash dividends are paid to shareholders and their inclusion is often a significant factor in the ability of the issuer to market the debt instruments.

As noted above, the purpose and economic effect of many CRAs is to avoid the dilutive effect that the payment of an increased level of ordinary cash dividends to shareholders would otherwise have on the value of the option embedded in a convertible debt instrument. From an economic standpoint, the dilutive effect of such a cash dividend is not different in any material way from that produced by the transactions expressly excepted from deemed distribution treatment under the current regulations (*i.e.*, sales of stock subject to the conversion option at a price below the conversion price). Disparate treatment of economically similar transactions appears difficult to justify as a matter of tax policy.

In some cases, the option embedded in a convertible debt instrument may not, under the terms of the instrument, be exercisable at the time of the CRA and the embedded option may, for a variety of reasons, not ever be exercised. In such cases, the holder would never realize any economic income or gain and would instead continue to have no shareholder-type interest in the assets or earnings and profits of the corporate debtor. Additionally, in many cases when the underlying stock price of convertible bond issuer is low relative to the convertible instrument's strike price, a cash dividend can be punitive to the convertible bond holder. In these circumstances, the enterprise value of the corporation has decreased by the amount of the cash dividend leading to a higher required discount rate and concurrently a lower valuation of the convertible bond. In this connection, rather than an item of economic income or gain, a CRA is instead best viewed as an adjustment of the original purchase price of the debt instrument and it thus differs in principle from those situations, which are clearly taxable, where the holder receives an actual distribution as an anti-dilution remedy. It is accordingly hard to see how a CRA can be said to be an increase in the convertible securityholder's proportionate share of the issuer's earnings and profits. As such, we believe that Treasury and the IRS should issue regulations that anti-dilutive CRAs will not be deemed a distribution subject to withholding tax under Section 305 of the Code.

Facilitate Foreign Investment in U.S. Capital Markets

We encourage Treasury to provide additional guidance to non-U.S. investors with respect to the application of Section 864(b)(2) of the Code, which provides U.S. companies with greater access to capital markets financing to supplement and complement traditional bank financing options by providing a safe harbor from U.S. taxes for non-U.S. investors for their securities and commodities trading activities. We also have encouraged Congress to expand the scope of Section 864(b) as part of its broader tax reform efforts, but technical guidance from Treasury as to the application of Section 864(b) as currently enacted also would help facilitate increased investment activity in the U.S. by non-U.S. investors.

Significant changes in capital markets since it was added to the Code in 1966 and a lack of guidance by the Treasury in response to those changes have led to underinvestment by non-U.S. investors in U.S. capital markets, to the detriment of U.S. companies and the economy. Specifically, non-U.S. investors do not make investments unless they have a high level of confidence that their specific investment activity is within the scope of the Section 864(b) safe harbor. Given the lack of guidance from Treasury, many firms have chosen to limit the scope of their investment activity in the United States. This underinvestment is hurting U.S. capital markets and small and medium-sized businesses that depend upon capital markets as one source of financing to grow their businesses and create jobs.

In general, to the extent non-U.S. persons engage in a "trade or business" in the United States, they will be subject to U.S. tax on income that is effectively connected with that trade or business. In order to promote foreign investment in U.S. companies, Section 864(b)(2) of the Code provides a safe harbor from that general rule for non-U.S. taxpayers that trade securities or commodities for their own account.

This issue is particularly relevant to offshore private investment funds because U.S. tax exempt investors and non-U.S. investors will seek assurances from an investment fund that it will not make investments that fall outside of the Section 864(b) safe harbor. In order to avoid negative tax consequences, investment funds, along with other non-U.S. investors, typically avoid making investments in the United States unless they have a high level of confidence that the investment is within the safe harbor. Treasury has not provided guidance with respect to whether many types of investments fall within the safe harbor. As such, in the absence of regulatory guidance, many non-U.S. investors often choose not to make certain investments, even if their tax advisors agree that the investment should be within the scope of the safe harbor.

We believe the uncertainty and complexity resulting from the lack of guidance on the existing safe harbor is inconsistent with the policy goals set out in the Executive Orders. Technical guidance from Treasury under Section 864(b) to address these issues, on the other hand, will promote non-U.S. investment in U.S. capital markets, which we believe is consistent with the policy goals set out in the Executive Orders. Additional investment in U.S. companies and in U.S. capital markets will reduce the costs of capital markets financing for U.S. businesses and will help ensure that businesses that may be underserved by U.S. banks for regulatory and capacity reasons will have access to alternative sources of financing.

Create Safe Harbor from Publicly Traded Partnership Rules for Private Investment Funds

We believe that Treasury and the IRS should consider revising the current regulations implementing the publicly traded partnership ("PTP") provisions in Section 7704 of the Code and the related safe harbors as they apply to privately offered investment funds that are structured as partnerships. We believe the current regulations, and limited safe harbors, unnecessarily limit the liquidity that private investment partnerships provide to their investors, beyond the liquidity limitations that investment funds would otherwise place on their investors in light of the private offering provisions of the federal securities laws and sound business and risk management practices. We encourage Treasury and the IRS to amend the PTP framework for privately offered investment funds in a manner that would promote investor liquidity while continuing to accomplish the policy goals of Section 7704 of the Code.

Under current law, in general, a partnership (or an entity classified as a partnership for federal income tax purposes) is not subject to federal income tax. The partners of the partnership are instead subject to tax on each partner's share of the partnership's income. However, Section 7704 of the Code provides that a partnership that is classified as a PTP will instead be taxable as a corporation, and subject to federal corporate income taxation. A partnership that is a PTP will nevertheless remain taxable as a partnership if 90% or more of the partnership's annual gross income is "qualifying income" under Section 7704(d).

Under the federal securities laws, private investment partnerships are sold through non-public offerings to sophisticated investors. Partnership interests in those funds generally are sold and redeemed directly by the investment partnership and the partnership interests generally are not traded on established securities markets. Investors in private investment partnerships are subject to limitations on their ability to redeem their interests and typically are subject to advance notice requirements before they can redeem as well. Private investment partnerships provide limited liquidity to investors, both to ensure that they comply with the non-public offering requirements in the federal securities laws and to promote sound risk management in light of the nature of the investment partnership's investment strategy and portfolio of assets.

Uncertainty with respect to whether a private investment partnership's interests are readily tradable on a secondary market, however, often creates additional, unnecessary constraints on the liquidity terms private investment partnerships provide to their investors as the investment partnerships seek to avoid potentially being deemed a PTP. We do not believe these additional liquidity restrictions are necessary to accomplish the policy goals of Section 7704 and that the additional restrictions harm investors who seek to invest in these private investment partnerships. We believe this impairment of capital investment is inconsistent with the policy goals set out in the Executive Orders.

Accordingly, we encourage Treasury and the IRS to revise their rules under Section 7704 of the Code to create a more flexible framework for private investment partnerships to offer liquidity to investors in a manner that does not create a public market for the interests in the investment partnership. We would welcome the opportunity to work with Treasury and the IRS in considering amendments to existing regulations and safe harbors, or potentially creating new safe harbors to accomplish this goal.

Amend Treasury regulations on notional principal contracts to address asymmetrical tax treatment and complexities for investors

We encourage Treasury and the IRS to reconsider the current tax regulatory framework for notional principal contracts ("NPCs"), which creates character and timing issues and asymmetrical tax treatment for taxpayers with respect to gains and losses on NPCs, particularly with respect to investment funds whose investment and trading activities do not give rise to a determination that the investment fund is engaged in a trade or business. This asymmetrical treatment creates unnecessary complexities and costs for investors and impairs investors' ability to use NPCs to efficiently hedge risks or allocate capital as part of their investment portfolios.

Under existing Treasury and IRS regulations, investors generally pay ordinary income tax on payments, other than termination payments, received in connection with an NPC, at the time when those payments are received or deemed received. With respect to investor payments made in connection with an NPC, however, those payments generally are treated as expenses incurred for the production of income under Section 212 of the Code and, as such, are subject to the two percent threshold for miscellaneous itemized deductions. As a practical matter, many investors do not have miscellaneous itemized deductions that exceed the two percent floor. As a result of the tax treatment of NPCs, investors face the asymmetrical result that they owe ordinary income on payments they receive under an NPC, but they are unable to deduct losses due to payments they make under an NPC. This asymmetry can impose significant costs on investors and creates an unfair result from a tax policy perspective.

In light of these concerns, we encourage Treasury and the IRS to reconsider the appropriate regulatory framework for NPCs. We stand ready to work with regulators in developing a regulatory framework that appropriately addresses tax policy considerations with respect to the trading of derivative financial instruments that also reduces the unnecessary costs and complexities investors currently face under the existing regulatory framework.

Conclusion

As Treasury and the IRS consider the policy goals set out in the Executive Orders, we encourage you to consider reviewing and revising the existing tax regulations with respect to the above issues. We believe that revised regulations can promote investment in U.S. companies and the U.S. capital markets while still accomplishing the relevant policy objectives underlying the existing regulations. If you have any questions regarding any of the issues discussed in this letter, or if we can provide further information with respect to any of those issues, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice-President and Managing Director, General Counsel