MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 26, 2019

Via Electronic Filing

Internal Revenue Service
CC:PA:LPD:PR (REG-106089-18)
Room 5203
P.O. Box 7604,
Ben Franklin Station
Washington, DC 20044.

Re: MFA Comments on IRS Proposed Regulation 106089-18, Limitation on Deduction for Business Interest Expense

Dear Ladies and Gentleman:

Managed Funds Association ("MFA")[1] appreciates the opportunity to respond to the proposed regulations, Limitation on Deduction for Business Interest Expense (the "Proposed Regulations"), implementing section 163(j) of the Internal Revenue Code of 1986, as amended (the "Code"). The Proposed Regulations address a number of important issues regarding implementation of section 163(j);[2] however, our comment letter focuses on several issues of particular importance to private investment funds that are structured as partnerships for tax purposes.

Many private investment funds obtain various types of financing attributable to their investment and trading activities and, as a threshold matter, it is critical that investors in private investment funds are not placed at a material tax disadvantage compared to investors that use other types of asset management products to investment in capital markets (*e.g.*, separately managed accounts). We believe that Congress intended to avoid creating this type of distortion and to avoid disrupting the investment activities of investment fund partnerships when enacting section 163(j) by exempting investment interest from the general limitation in the statute. Therefore, we believe that it is important for the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") to ensure that the Proposed Regulations are consistent with this Congressional intent.

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[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 over time. 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] Section references in this letter refer to Code sections, unless otherwise indicated.

We recognize the complexity of implementing section 163(j) and believe that the Proposed Regulations appropriately implement a number of the provisions in the statute, including with respect to disallowed business interest expense carryforwards. We believe that other aspects of the Proposed Regulations should be modified or clarified, as discussed in more detail below, to better reflect the intended policy goals of section 163(j). In particular, we encourage Treasury and the IRS to:

(1) Clarify that investment interest expense of trading partnerships is properly excluded from the limitations on the deductibility of business interest expense;

(2) Provide a more tailored definition of "interest" in the Proposed Regulations;

(3) Provide for symmetrical treatment of interest expense and interest income in the proposed anti-avoidance rule; and

(4) Provide a framework that would allow tiered partnerships to aggregate interest expense and interest income on a consolidated basis, similar to the approach permitted for consolidated corporate groups.

<u>Investment Interest Expense in Trading Partnerships</u>

Section 163(j), as amended by the tax reform legislation,[3] generally limits the ability of businesses to deduct business interest. Section 163(j)(5) defines "business interest" as any interest paid or accrued on indebtedness properly allocable to a trade or business. Section 163(j)(5) also provides, however, that business interest does not include "investment interest" within the meaning of section 163(d).[4] Further, section 163(j)(4) provides that, with respect to partnerships, section 163(j) (including (j)(5) and (6)) shall be applied at the partnership level, and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership. The statute further provides that the adjusted taxable income of each partner shall be determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership.[5]

Read together, we believe these provisions create a clear statutory framework for applying section 163(j) to partnerships, including investment fund partnerships, that are engaged in a trading business. A partnership that has business interest expense is subject to section 163(j) (unless the business is otherwise exempted under the statute); however, if the partnership has investment interest expense, that interest expense is not business interest expense and is not subject to the general limitation set out in section 163(j). While the statute exempts certain businesses (*e.g.*, certain small businesses) from limitations on deducting business interest expense, it does not exclude any type of partnership that is subject to section 163(j) from the application of section 163(j)(5) and (6).

[3] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Public Law 115-97 (2017).

[4] Section163(j)(6) provides a similar exclusion from business interest income with respect to investment interest income, within the meaning of section 163(d).

[5] We note that the Proposed Regulations create specific rules with respect to the treatment of corporate partners under section 163(j). This letter does not comment on those aspects of the Proposed Regulations.

Accordingly, partnerships engaged in a trading business should not be subject to the limitations in section 163(j) with respect to their investment interest expense.

For the investment interest provisions in section 163(j)(5) the statute to have the intended practical effect, a trading partnership that has interest expense that is properly allocable to its trade or business should nonetheless have that interest excluded from the definition of business interest expense to the extent that interest is investment interest within the meaning of section 163(d). Further, any interest (expense or income) that is investment interest cannot be business interest (or the other way around) because the statute makes a binary distinction between those two types of interest.

In applying these provisions to a partnership engaged in "trades or businesses that are not passive activities and with respect to which certain owners of the passthrough entities do not materially participate for purposes of section 469",[6] if the interest allocable to the partnership's trade or business is investment interest, then the limitations of section 163(j) do not apply with respect to that interest. This result is consistent with section 163(d)(5)(A)(ii), which defines "property held for investment" to include any interest held by a taxpayer in activity involving the conduct of a trade or business, which is not a passive activity and with respect to which the taxpayer (in this analysis, the partnership) does not materially participate.

We believe that the text of the Proposed Regulations is consistent with this analysis, though the language in Section 6.G. of the preamble (page 67510 of the Federal Register version) creates significant uncertainty regarding the application of the Proposed Regulations to trading partnerships. In particular, we believe the above analysis is consistent with the treatment of interest expense under §1.163-8T(a)(4)(i)(C) (which is incorporated into proposed §1.163(j)-6(j)), which would treat such interest as investment interest for purposes of the Proposed Regulations. We also believe this analysis is consistent with the coordination provisions in proposed §1.163(j)-10(a)(2) and with proposed §1.163(j)-3(b)(9), which states:

> Except as otherwise provided in the section 163(j) regulations, provisions that characterize interest expense as something other than business interest expense under section 163(j), such as section 163(d), govern the treatment of that interest expense, and such interest expense will not be treated as business interest expense for any purpose under section 163(j).

Given the ambiguity regarding the application of the Proposed Regulations in light of the language in the preamble regarding certain passthrough entities engaged in non-passive trades or businesses,[7] we encourage Treasury and the IRS to make two modifications to provide greater clarity. First, we encourage Treasury and the IRS to delete the last paragraph in Section 6.G. of the preamble (page 67510 of the Federal Register version) to remove the uncertainty caused by that paragraph, which could be interpreted in a manner inconsistent with the statutory framework discussed above as well as the text of the Proposed Regulations. Second, we encourage Treasury and the IRS to include the following example in the text of the final regulations following §1.163(j)-

[6] *See,* preamble to Proposed Regulations, 83 Federal Register, 67490 (December 28, 2018) at 67510, for a discussion of these types of passthrough entities.

[7] *Id.*

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4(b)(6), which we believe will provide clarity to taxpayers regarding the application of section 163(j) to trading partnerships:

> Example.
>
> (A) Facts. T, a C corporation, and A, an individual, each own a 50 percent interest in PS1, a partnership. PS1 borrows funds from a third party (Loan 1) and uses those funds to actively trade stock and securities. The trading activity of PS1 constitutes the carrying on of a trade or business within the meaning of section 162(a), and A does not materially participate in the activities of PS1 within the meaning of section 163(d)(5)(A)(ii)(II). In the 2019 taxable year, PS1 earns trading gains and income, including interest income, of $150 and pays $100 in interest on Loan 1.
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> (B) Analysis. PS1 carries on a trade or business activity, which is not a passive activity pursuant to §1.469-1T(e)(6). Because A does not materially participate in the trade or business of PS1, A's share of PS1's interest expense and income is treated as investment interest expense and investment income for purposes of section 163(d). A's share of PS1's interest expense is not subject to the limitation under section 163(j), either at the partnership level or at the partner level, as the term "business interest" does not include interest treated as "investment interest" within the meaning of section 163(d), pursuant to section 163(j)(5) and §1.163(j)-3(b)(9). A's share of PS1's interest income is not treated as "business interest income" either at the partnership level or at the partner level, as the term "business interest income" does not include interest income treated as "investment income" within the meaning of section 163(d), pursuant to section 163(j)(6).

<u>Developing a More Tailored Definition of Interest</u>

As noted above, section 163(j)(5) defines "business interest" as any interest paid or accrued on *indebtedness* properly allocable to a trade or business. First, we are concerned that the proposed definition of "interest" in the Proposed Regulations would extend far beyond the statutory definition and would include a wide range of amounts that are not generally treated as interest under the Code. Second, we believe this proposed definition would expand the limitations in section 163(j) to amounts not intended to be covered by the statute. Lastly, we are concerned that adopting such a broad definition may create uncertainty with respect to what constitutes interest for other parts of the Code, creating unintended consequences for businesses and investors. Accordingly, we encourage Treasury and the IRS to amend the Proposed Regulations to adopt a more narrowly tailored definition of "interest" that is more consistent with the statutory language and that focuses on amounts that are generally treated as interest under the Code. We note that Treasury and the IRS would still have anti-abuse authority to address transactions that are structured to inappropriately avoid application of section 163(j).

We also note that the proposed definition of interest does not seem to include dividend income from a regulated investment company ("RIC"), even when the underlying source of income earned by the RIC is interest income under section 163(j). We do not believe there is a policy basis to create disparate treatment between interest income earned directly (for example, interest earned on Treasury securities) and dividend income from a RIC, such as a money market fund, that is derived from the same type of underlying income. Such disparate treatment can create distortions

for investors in these markets without furthering the policy objectives of the statute or the Proposed Regulations. Accordingly, we encourage Treasury and the IRS to provide guidance that dividend income from a RIC will be treated as interest income, to the extent the underlying source of income to the RIC qualifies as interest income.

Asymmetrical Anti-Avoidance Rule

In addition to the broad definition of interest, proposed §1.163(j)-1(b)(20)(iv) adopts an anti-avoidance rule that would treat as interest expense amounts predominantly associated with the time value of money. Unlike the other provisions in the definition of interest, which apply both to interest expense and interest income, this provision applies only to interest expense. This asymmetric approach to interest expense and interest income can create unintended consequences and distortions for taxpayers. To avoid this outcome, we encourage Treasury and the IRS to adopt a symmetrical approach to the anti-avoidance rule.

Tiered Partnerships

The Proposed Regulations reserved guidance on the treatment of excess business interest expense in tiered partnerships. The preamble to the Proposed Regulations notes that section 163(j)(4) requires the interest expense limitation to be applied at the entity level for partnerships, suggesting that excess business interest expense may not be applied on a consolidated basis for partnership groups or passed through to upper-tier partnerships, except under carryforward rules. Under the statute, however, excess business interest income may be passed through to upper-tier partnerships.

The potential disparate treatment of excess business interest expense and excess business interest income in tiered partnerships can create significant distortions with unintended economic impact for tiered partnerships, including tiered investment fund partnerships. Many private investment fund partnerships involve multiple tiers to accommodate different types of investors (*e.g.*, U.S. taxable investors, non-U.S. investors, U.S. tax-exempt investors). Further, for various business reasons, such as reducing one investment fund partnership's counterparty risk, the fund's investment manager may choose to keep some cash and cash equivalent securities at a different investment fund partnership that does not directly engage in any trading activities.

For these types of tiered partnerships, we believe that the reserved regulations should permit the partnerships to elect to be part of a combined group for purposes of calculating the section 163(j) limitations (similar to the rules provided for corporations). This would permit both excess business interest expense and excess business interest income to pass through to the upper-tier partnership within the consolidated group. Permitting both interest income and interest expense to be applied on a consolidated basis would avoid creating distortions for investment fund partnerships that operate in a manner similar to consolidated corporate groups. It also would also avoid potentially punitive results for investors in such investment funds groups that decide, for legitimate business reasons, have interest expense and interest income in separate entities. We do not believe that the Proposed Regulations should force investment funds to choose between managing credit risk on behalf of their investors and managing unintended, adverse tax consequences to those investors.

We also do not believe there is a policy basis to distinguish between consolidated corporate groups and consolidated partnerships in this regard. We understand that Treasury and the IRS may have concerns about the potential for business entities to use tiered partnerships to inappropriately avoid application of section 163(j); however, we believe those concerns would best be addressed under existing anti-abuse authority, rather than creating a prohibition on consolidating excess interest expense in partnership structures. To the extent that Treasury and the IRS have questions about their ability to permit excess business interest expense to be consolidated, we would encourage Treasury to work with Congress to identify a technical amendment to the statute that would provide Treasury and the IRS with sufficient regulatory authority to issue such guidance.

Business Interest Expense Carryforward

The preamble to the Proposed Regulations notes that Treasury and the IRS considered three options to implement section 163(j)(4)(B)(ii)(I) with respect to the deductibility of a partner's excess business interest expense carryforward as it relates to a partner's share of excess taxable income. Treasury and the IRS further noted that they believe proposed §1.163(j)-6(g) is most consistent with a plain reading of the statutory language. We agree with Treasury and the IRS that the proposal is the most consistent interpretation of the statutory language.

MFA and its members would welcome an opportunity to meet with the staff from Treasury or the IRS to discuss these and any other issues in connection with implementation of the Proposed Regulations. If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other issues, please do not hesitate to contact Benjamin Allensworth at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO

/s/ Benjamin Allensworth

Benjamin Allensworth
Associate General Counsel