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 871(m) Final Rules

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.[3] One key regulatory issue that we encourage Treasury and the Internal Revenue Service (the "IRS") to reconsider is the scope and implementation of final rules issued under Section 871(m) of the Internal Revenue Code of 1986, as amended (the "Code").[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" together with Executive Order 13777, the "Executive Orders").[5] We continue to believe that the final 871(m)

[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 plans to submit an additional comment letter in response to the Review of Regulations with additional tax regulations that we believe Treasury and the IRS should reconsider in light of Executive Orders 13777 and 13789.

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

rules (the "Final Rules") are overly broad in scope and create significant complications and burdens on investors and other taxpayers that are unnecessary to achieve the primary goal of the relevant provisions of the Hiring Incentives to Restore Employment Act (the "HIRE Act"): applying appropriate withholding taxes on certain dividend equivalent payments that pose risks of inappropriate tax avoidance.

We also believe that the Final Rules are inconsistent with the President's stated policy goal in the Tax Executive Order because they are complicated, costly to implement for taxpayers, create uncertainty and risk for investors and other market participants, and adversely impact investing activity in affected markets. As a general matter, market participants need reasonable certainty when entering into transactions that they understand the non-market dynamics (*e.g.*, tax treatment) of the trade. Withholding taxes are an important factor in determining the after-tax expected return on an investment and the lack of clarity at the time of investment as to whether a transaction, or series of transactions, may be subject to withholding taxes raises significant challenges for investors in making that determination. The Final Rules do not provide the consistency and clarity needed by investors and also impose significant operational burdens on the industry, particularly with respect to buy-side investors.

Having clear and consistent rules for buy-side investors and withholding agents also is important because investors must understand the policies and practices under development by their dealer counterparties, and also must build their own implementation policies, procedures and systems in a manner that incorporate these evolving market practices. Investors need clarity on both the obligations of their dealer counterparties and the systems these counterparties will put in place to be able to efficiently respond to such obligations to determine where and when the investor may need to step in to ensure (and document) that their own withholding obligations have been met. While we appreciate that the temporary rules issued by Treasury and the IRS in January 2017 (the "Temporary Rules")[6] addressed some of the industry's concerns with respect to the Final Rules, several of the key provisions in those rules seem to apply to withholding agents, but not to buy-side investors, for example, the simplified standard for withholding agents in determining whether multiple transactions should be treated as a combined transaction for purposes of the Final Rules. As a result, the Temporary Rules leave buy-side investors with a disproportionate share of the complex compliance and administrative burdens with respect to the Final Rules, which acts as an impediment to their investment activities. In addition, the Temporary Rules do not address the full range of concerns with the Final Rules leaving significant uncertainty regarding key aspects of the Final Rules.

We also understand that the United Kingdom, Germany, Spain, France, and Italy have written to express concern regarding the applicability of the Final Rules to non-U.S. entities making payments to beneficial owners who are qualified tax treaty residents of those

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

[6] 82 FR 8144, January 24, 2017.

countries.[7] We believe the uncertainty regarding the application of the Final Rules to non-U.S. firms noted by SIFMA is another example of the complexity created by the Final Rules and another reason for Treasury and the IRS to re-consider the scope of the Final Rules.

Modify Scope of Final Rules

Given the complexities and uncertainties faced by taxpayers in administering the Final Rules, we encourage Treasury and the IRS to issue a new temporary rule for all taxpayers that modifies the scope of the Final Rules to include only delta-one derivative transactions that include a dividend equivalent payment, similar to the approach taken in the Temporary Rules. We also encourage Treasury and the IRS to extend the period during which the delta-one approach is permitted for an additional year, until January 1, 2019 while Treasury and the IRS consider the appropriate scope of the Final Rules on a permanent basis. Once again, we believe it is critical that this extension of the Temporary Rules should apply equally to buy-side taxpayers and withholding agents.

In considering the appropriate scope for an amended set of rules under Section 871(m), we encourage Treasury and the IRS to adopt a simpler approach to the types of derivatives transactions to be covered, and one that is more narrowly tailored to the types of transactions identified as abusive by Congress.[8] One possible approach to address the concerns regarding the Final Rules in a manner more closely aligned with the HIRE Act and the policy goal set out in the Tax Executive Order would be for Treasury and the IRS to modify the scope of the Final Rules on a permanent basis to include only delta-one derivative transactions that include a dividend equivalent payment, similar to the approach taken in the Temporary Rules. We believe this approach, along with the application of a general anti-abuse rule, would target abusive transactions intended to replicate direct ownership of U.S. securities, including dividends paid to direct holders of those securities. This approach also would avoid the complications and uncertainty caused by application of the Final Rules to the trading activities of investors, particularly institutional buy-side investors that manage large portfolios. At a minimum, Treasury and the IRS should modify the Final Rules to explicitly exclude transactions that do not present the types of tax abuse underlying Section 871(m), for example, modifying the scope the Final Rules to exclude listed options and futures. This approach would accomplish the policy objectives of Section 871(m) and avoid the adverse consequences of the Final Rules' overly broad application of withholding taxes to derivatives transactions that do not pose the type of tax abuse that Section 871(m) was intended to address. We strongly encourage Treasury and the IRS to modify the Final Rules accordingly. We stand ready to work with Treasury and IRS staff in considering these suggested approaches, or other approaches, that would better achieve the policy objectives of the HIRE Act, while eliminating the complexities and uncertainties caused by the Final Rule.

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[7] See, November 14, 2016 letter from the Securities Industry and Financial Markets Association ("SIFMA") to Treasury and the IRS, available at: http://www.sifma.org/comment-letters/2016/sifma-submits-comments-to-the-treasury-and-irs-regarding-the-g5-position-letter-on-dividend-equivalent-payments/.

[8] Section 871(m)(3)(A)(i), (ii), (iii), and (iv) identifies four specific types of transactions that Congress determined should be subject to withholding taxes, cross-in transactions, cross-out transactions, derivatives for which the underlying security is not readily tradable on an established securities market, and derivatives transactions, if, in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

Set out below is a discussion of a several key aspects of the Final Rules that cause significant uncertainty and burdens on investors, which we believe demonstrate the unnecessary complexity and adverse consequences of the Final Rules. Those issues – (1) withholding taxes on phantom dividends; (2) the "in connection with" standard; (3) determine delta on a net basis; (4) Qualified Indices; and (5) derivatives on partnerships – demonstrate the need for Treasury and the IRS to modify the Final Rules in the manner discussed above, both on an immediate, temporary basis and on a permanent basis going forward. If Treasury and the IRS do not modify the scope of the Final Rules, it is critical that they provide additional guidance to address industry concerns about uncertainty, inconsistency, and overly burdensome administrative burdens resulting from implementation of the Final Rules, particularly for buy-side investors like investment funds.

Complexity and Adverse Consequences of Final Rules

Withholding Taxes on Phantom Dividends

Treas. Reg. §1.871-15(i)(2) of the Final Rules provides that a dividend equivalent payment is deemed to be made under the Rules when there is "an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction," even if the transaction does not provide for any actual payment or receipt of anything of value by the holder of the relevant derivative instrument. For example, a trader might purchase an exchange traded call option (delta 0.90) prior to an earnings release but, due to an earnings miss, the option falls out of the money and expires worthless. During the period from purchase to expiration, the underlying stock paid a dividend, creating a withholdable event. The taxpayer has sustained a full economic loss on the trade and is liable for withholding taxes on a dividend that he never received with no cash on which to pay the withholding. Moreover, calculating an implied dividend equivalent payment with respect to instruments that do not actually make payments presents significant challenges for taxpayers. We believe these issues demonstrate how the Final Rules create unnecessary complications and go far beyond the intended scope of Section 871(m) and would unfairly subject non-U.S. investors to withholding taxes on so-called "*phantom dividends*" even though an investor is not, in any real sense, receiving any payment or value as a result of the dividend that could be fairly characterized as a dividend equivalent.

"In Connection With" Standard

A second issue that we believe demonstrates the need for a fundamental reconsideration of the scope of the Final Rules is the "in connection with" standard in the Final Rules, which applies when determining whether multiple transactions should be combined into a single transaction.[9] The combination rules create significant operational complexity for market participants, particularly buy-side investors, and are likely to result in overwithholding on buy-side investors that do not appear to benefit from any of the presumptions under the Final Rules. Moreover, buy-side investors do not benefit from the simplified standards set out in the Temporary Rules, which apply only to withholding agents.

[9] The "in connection with" standard also is relevant in applying the 5% short rule discussed below.

Of particular concern is that the ordering rules set forth in Treas. Reg. §1.871-15(n)(6) require parties to combine transactions "in the manner that results in the most transactions with a delta of 0.80 or higher with respect to the referenced underlying." A literal application of this provision with respect to an investor that trades 50 option trades on a single name in a single day could lead to both parties having to test the more than 1 *quadrillion* unique combinations that could theoretically be formed.[10]

With no clear standards, market participants will end up with widely differing results with respect to similar trades. More fundamentally, we are concerned that the combination rules are vastly over inclusive with respect to the scope of transactions subject to withholding taxes under the Final Rules. While Treasury and the IRS have acknowledged the challenges posed by the combination rules, they have not provided meaningful guidance, in particular for buy-side investors, to make those rules work in practice, despite numerous comments from the industry on potential ways to reduce some of the uncertainty and administrative difficulties implementing those rules.[11] The complexity of the combination rules and the challenges in providing meaningful guidance to the industry to facilitate compliance with those rules demonstrates the need for a different approach to implement withholding taxes on dividend equivalent payments under Section 871(m).

Determining Delta on a Net Basis

The Final Rules require market participants to combine long transactions entered in connection with each other, but do not permit market participants to net long and short positions entered into in connection with each other. Market participants entering into long and short positions in connection with each other are not seeking to create a synthetic long position that closely resemble owning the underlying security, nor are they entering into multiple transactions for purposes of avoiding application of the general delta threshold. Rather, these kinds of option strategies are most often utilized to isolate and profit from specific price movements in the underlying stocks.

The preamble to the Final Rules acknowledges that the inability to combine long and short positions fails to "reflect the economics of the transactions" and does not appear to contain a policy rationale for not permitting such combinations. Instead, the preamble notes that none of the commenters suggesting such combinations proposed an administrable approach that would reliably combine long and short positions, though many commenters have suggested approaches for Treasury and the IRS to consider. The acknowledged fact that this aspect of the Final Rules imposes withholding tax liability that does not reflect the economics of the impacted transactions is another example of how the scope and impact of the Final Rules goes far beyond the intended scope of Section 871(m).

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[10] Using the formula n! / (r!(n - r)!) where *n* equals 50 and *r* equals the number of transactions to be combined, adding together the totals for each number of transactions *r*.

[11] *See, e.g.*, MFA's March 2014 comment letter on the re-proposed 871(m) rules, available at: https://www.managedfunds.org/wp-content/uploads/2014/03/MFA-Comment-Letter-on-Re-Proposed-871m-Rules.pdf.

Qualified Indices

We appreciate that the Final Rules include a safe harbor from withholding taxes for dividends on qualified indices, given the lack of tax abuse concerns with such transactions. We believe that this exception is consistent with the anti-abuse policy underlying Section 871(m). We are concerned, however, that the qualified index safe harbor currently is difficult to implement in practice and may be implemented inconsistently by investors and withholding agents. We also are concerned that certain indices may be deemed not to meet the definition of a "qualified index" even when such indices do not present the tax abuse risks the Final Rules seek to address.

For example, the relative weightings of the top stocks in the Nasdaq 100 create a significant risk of that index failing the test for a qualified index. As shown in the tables below, the weighting of the top 6 equities in that index[12] came close to 40% on December 30, 2016 and exceeded 40% on July 24, 2017 (even excluding the second Alphabet Inc stock would have left the top 5 stocks close to 40% on July 24). Given how close to the threshold the Nasdaq 100 has been on various trading days, there is substantial risk of a single day's price movements preventing that index from being a qualified index for the next year, even though it does not present the tax abuse risks that Section 871(m) was intended to address. This is an example of how the Final Rules can cause significant market disruption in heavily traded indices as an unintended consequence.

12/30/2016				
Ticker	Name	Weight (%)	Shares	Price
NDX Index				
AAPL UW Equity	Apple Inc	10.95	5332.313	115.82
MSFT UW Equity	Microsoft Corp	8.57	7775.350501	62.14
AMZN UW Equity	Amazon.com Inc	6.32	475.166527	749.87
FB UW Equity	Facebook Inc	4.77	2340.824544	115.05
GOOG UW Equity	Alphabet Inc	4.72	345.090748	771.82
GOOGL UW Equity	Alphabet Inc	4.16	296.087212	792.45
		39.49		

7/24/2017				
Ticker	Name	Weight (%)	Shares	Price
NDX Index				
AAPL UW Equity	Apple Inc	11.659836	5213.84	151.98
MSFT UW Equity	Microsoft Corp	8.326055	7720.514731	73.29
AMZN UW Equity	Amazon.com Inc	7.309692	477.975499	1039.3101
FB UW Equity	Facebook Inc	5.75087	2364.782615	165.27
GOOG UW Equity	Alphabet Inc	4.963395	346.96711	972.17
GOOGL UW Equity	Alphabet Inc	4.342634	297.628801	991.585
		42.352482		

Another area of uncertainty is the application of the safe harbor for *de minimis* short positions of component securities of a qualifying index in Treas. Reg. §1.871-15(l)(6)(ii). It is unclear how market participants should calculate the value of the component short position for purposes of determining whether the safe harbor applies. We understand that market participants use multiple methodologies to calculate the value of the short component, creating uncertainty and inconsistency in application of the safe harbor. It also is unclear how to determine whether and to what extent a short position should be treated as entered into "in connection with" the long position on the index for purposes of potentially disqualifying a derivative that references an otherwise qualified index.

We also believe that applying withholding taxes to the entire long position on an index that would be a qualifying index but for a short position on more than five percent of the index components is unduly punitive and unnecessary to achieve the policy objectives of

[12] We note that there is uncertainty regarding whether to include both Alphabet Inc. stocks when determining whether the index exceeds the thresholds set out in the rules. We understand that at least some practitioners take a conservative view that both stocks should be included when making the calculation.

the Final Rules. However, Treasury and the IRS have not provided any alternative methodology that would permit a more proportionate approach.

For example, if an investor is long S&P 500 Index ("SPX") futures and short SPX futures, then the investor can rely on the qualified index safe harbor because the investor is short "the" entire index. Similarly, if an investor uses an index convergence strategy, it can be long Dow Jones Industrial Average ("DJI") futures, and short SPX futures, and the investor should be able to rely on the safe harbor because the taxpayer is implicitly short DJI futures in its entirety (*i.e.*, all Dow stocks are in S&P500). However, if the investor is long SPX futures and short DJI futures, then this will result in the SPX futures being subject to withholding because the safe harbors in Treas. Reg. §1.871-15(l)(6)(i) and (ii) would not apply. This type of transactions does not seem to present the tax abuse concerns that the HIRE Act was intended to address, but rather an example of the overlying broad impact of the Final Rules.

Partnerships

Finally, market participants face significant uncertainty with respect to how they should calculate withholding amounts on dividend equivalent payments arising on derivatives referencing partnerships, such as publicly traded master limited partnerships. The amount of the partnership distributive share of income that is a dividend is not known until the Schedule K-1 is furnished, which generally is after March 15 of the following year. It is unclear whether withholding under the Final Rules can be made on an estimated dividend yield of a covered partnership and, if so, what market participants can rely on in making such an estimate (*e.g.*, the prior year K-1s). It also is unclear how and to what extent amounts reflected on a Schedule K-1 drive the dividend equivalent payments in respect of particular derivatives and whether a true-up payment must be made even if the actual dividend allocation amounts are known. We note that MFA members are already experiencing inconsistent application by withholding agents, and it is unclear that these methodologies will accurately reflect the actual dividend equivalent payment, if any. These complexities and uncertainties impose significant burdens on investors who must monitor and track all of this information, even when there are relatively small amount of dividend equivalent payments made (many master limited partnerships, for example, have minimal dividends as part of their income mix).

Conclusion

MFA appreciates the opportunity to provide these comments on the Final Rules. We believe the above issues demonstrate the complexities and burdens associated with the Final Rules as adopted, even with the guidance provided in the Temporary Rules, and provide strong evidence of the need to modify the approach taken to implement Section 871(m).

As Treasury and the IRS consider the policy goals set out in the Executive Orders, we strongly encourage you to consider issuing a new temporary rule for all taxpayers that modifies the scope of the Final Rules to include only delta-one derivative transactions that include a dividend equivalent payment, similar to the approach taken in the Temporary

Rules. We also encourage Treasury and the IRS to extend the period during which the delta-one approach is permitted for an additional year, until January 1, 2019 while Treasury and the IRS consider the appropriate scope of the Final Rules on a permanent basis. We further encourage Treasury and the IRS to consider such an approach, or other similar approach that is more narrowly tailored to the types of abusive transactions Congress identified in enacting Section 871(m), in modifying the scope of the Final Rules on a permanent basis.

If you have any questions regarding any of the issues discussed above, or if we can provide further information with respect to the Final Rules, 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