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

June 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 provide additional comments[2] in response 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").[3] This letter focuses on the eleven-step computation to allocate excess items to partners in partnerships that receive an allocation of taxable income greater than their allocation of "excess taxable income" ("ETI"). We are concerned that many partners that receive special allocations will receive allocations of ETI that are not consistent with the economic arrangement set out in partnership agreements.

We believe these economic distortions are unintended consequences but nonetheless may arise in several common circumstances. This issue may arise for partners that own direct or indirect equity investments in operating businesses conducted in partnership form. These unintended consequences also may arise in the context of trader funds that hold side-pocket investments or use

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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] This letter supplements MFA's February 26, 2019 comment letter on other aspects of the Proposed Regulations, available at: https://www.managedfunds.org/wp-content/uploads/2019/02/MFA-comment-letter-on-163j-proposed-rules.pdf. As discussed in the February letter, MFA continues to believe that interest expense incurred by an investment partnership, including investment partnerships engaged in the trade or business of trading securities, in connection with its investment or trading activities should be treated as investment interest and not business interest.

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

monthly allocations (to the extent such funds are deemed to have business interest expense rather than investment interest expense) as well as in any partnership that uses tracking or gross item allocations. We illustrate the concerns in this letter by focusing on the simple fact pattern of an operating partnership that allocates gross income to a preferred partner.

MFA believes the refinements to the eleven-step computation in Proposed Regulation § 1.163(j)-6 discussed in this letter would avoid the unintended and punitive consequences for investors in those businesses when the investors are entitled to special allocations of income. As described in more detail below, MFA believes that those adverse and undesirable effects can be avoided in a manner consistent with the policy objectives set out in the preamble to the Proposed Regulations by allowing partnerships the flexibility to allocate positive remedial ETI to partners who receive an allocation of income in excess of their allocation of regular ETI. Under this proposal, an offsetting and equal amount of negative remedial ETI would be allocated to the other partners.

Adverse Consequences of the Eleven-Step Computation

Investors in operating businesses conducted through partnerships often receive special allocations of income that exceed their allocation of nonseparately stated taxable income. Such allocations often will occur when an investor makes a preferred equity investment in a partnership. In a typical preferred equity structure, the preferred investor receives a priority allocation of gross income in an amount equal to its preferred return. Many investment funds have made those types of investments and have financed those investments with debt at the partner-level. The ability to allocate gross items permits a partnership to pay a preferred return even when the partnership does not have net income sufficient to support the preferred return. Allocation of gross income to preferred interest holders provides operating partnerships with a critical source of financing that may otherwise be unavailable. The flexibility afforded by special allocations is a defining feature of the partnership form and the MFA believes that the limitations imposed by the Proposed Regulations and described in this letter are fundamentally inconsistent with the principles of subchapter K and unnecessary to achieve the intended policy objectives of the Proposed Regulations.

Under section 163(j)(4)(A)(ii)(C), a partnership allocates to a partner ETI to the extent the partnership had excess capacity under the section 163(j) limitation. Under the 11-step computation in the Proposed Regulations, an allocation of ETI among partners in a partnership that makes only pro-rata allocations of partnership items would generally allow the partners to benefit from an allocation of ETI in proportion to the taxable income allocated from the partnership and in an amount commensurate with the amount of "adjusted taxable income" ("ATI") the partners would have had if they earned directly the income allocated to them from the partnership. That same result does not occur if the partnership specially allocates income to the partners.

Consider the example of a partnership with no business interest expense that has one preferred partner (A) and one common partner (B). Partner A is entitled to an annual preferred return of $100 (cash distributions) and a corresponding priority allocation of gross income in the same amount. Partner A borrowed a portion of the capital it invested in the partnership and has $30 of business interest expense allocable to that borrowing. Assume that in 2019 the partnership has $0 business interest income, $0 business interest expense, a net taxable loss of $30, comprised of $100 of gross income and $130 of gross deductions ($50 of which is depreciation). The partnership

allocates $100 of gross income to partner A and $130 of gross deductions to partner B. After adding back $50 of depreciation deduction pursuant to section 163(j)(8)(A)(v), the partnership has ATI of $20, resulting in $20 of ETI. Under the 11-step computation, partner A would be allocated $20 of ETI, which would allow partner A to deduct $6 of its $30 of business interest expense.

Partner A, however, received an allocation of $100 of gross income. Had the allocation of ETI equaled the amount of gross income allocated to partner A, partner A would have been able to deduct $30 of business interest expense, resulting in $70 of net taxable income attributable to its investment in the partnership. Instead, under the Proposed Regulations, partner A will have net taxable income of $94, because it can deduct only $6 of partner-level interest. The additional $24 of taxable income is solely a result of receiving from the partnership an allocation of ETI that is significantly less than its allocation of taxable income.

Assume, in addition to the above, that partner B has a sole proprietorship with ATI of $80 and business interest expense of $24. Under the Proposed Regulations, partner B's section 163(j) limitation is computed without regard to the partnership's allocation of $130 loss to partner B. The facts of the example and the tax treatment under the Proposed Regulations are summarized in Table 1.

Table 1

Example Under Proposed Regs	**A**	**B**
Allocation from Partnership	100	(130)
Partner-Level Income/Loss (ATI)	-	80
Total Income/Loss Before Interest Expense	**100**	**(50)**
Interest Expense Allowed	6	24
Taxable Income/Loss After Interest Expense	**94**	**(74)**
Disallowed Interest Expense	*24*	*-*

Proposed Solution

MFA believes that the distortion and punitive consequences shown above can be addressed in a manner similar to the treatment of book/tax disparities under the remedial method in Treas. Reg. § 1.704-3(d). When a partner contributes property to a partnership, the "ceiling rule" can cause a noncontributing partner's allocation of tax items to be less than its allocation of corresponding book items. If the partnership elects the remedial method, Treas. Reg. § 1.704-3(d) allows the partnership to "create[] a remedial item of income, gain, loss, or deduction equal to the full amount of the [book/tax] difference" and allocate that amount to the noncontributing partner. The partnership also simultaneously creates an offsetting remedial item in an equal amount, which is allocated the contributing partner.

Under MFA's proposed solution to the section 163(j) issue noted above, if a partner receives an allocation of taxable income in excess of such partner's allocation of ETI, the partnership could elect to create positive remedial ETI in the amount of the excess and allocate such positive remedial ETI to the affected partner (partner A in the example discussed above). At the same time, the partnership would create an offsetting negative remedial ETI in an equal amount that would be allocated to the other partners (partner B in the example discussed above).

Whereas the positive remedial ETI allocations would increase a partner's own ATI, the negative remedial ETI allocations would decrease a partner's ATI. That would allow a partner with allocated taxable income in excess of allocated ETI from the partnership to have ATI attributable to the partnership commensurate with the amount the partner would have had if it had earned directly the income that was allocated to it from the partnership. Moreover, the offsetting negative remedial ETI allocation would result in the partnership allocating the same net amount of ETI to the partners in the aggregate had the remedial allocation election not been made.

Under the remedial allocation approach, partner A in the example above would receive an allocation of $80 of positive remedial ETI, providing partner A with total ATI of $100 attributable to the partnership – the same amount as its allocation of taxable income from the partnership. That would allow partner A to deduct $30 of business interest expense at its level, $6 as a result of the regular ETI allocation and $24 as a result of the positive remedial ETI allocation. Partner B, conversely, would receive $80 of negative remedial ETI allocation. That would result in partner B being unable to deduct the $24 of business interest expense from its sole proprietorship, as illustrated in Table 2. Thus, under the remedial allocation approach, the section 163(j) regulations would acknowledge and appropriately account for the actual economic arrangement among partners in partnerships such as the one described here.

Table 2

Example Under MFA Proposal	**A**	**B**
Allocation from Partnership	100	(130)
Partner-Level Income/Loss (ATI)	-	80
Regular ETI from Partnership	20	-
Remedial ETI from Partnership	80	(80)
Section 163(j) Limitation	**30**	**-**
Total Income/Loss Before Interest Expense	**100**	**(50)**
Interest Expense Allowed	30	-
Taxable Income/Loss After Interest Expense	**70**	**(50)**
Disallowed Interest Expense	*-*	*24*

Accordingly, MFA recommends that, similar to Treasury's exercise of regulatory authority to allow partnerships to create and allocate offsetting items under the remedial method in Treas. Reg. § 1.704-3(d), Treasury use its regulatory authority to create and allocate similar remedial ETI to prevent the distortions caused by a partner receiving allocations of taxable income from a partnership in excess of its ETI. MFA believes this change would be consistent with the policy behind section 163(j), as it would not affect the net amount of interest that could be deducted by the partners in the aggregate and would allow partnerships the flexibility to address distortions caused by a partner having less ATI than it would have had if it had earned directly the income that was allocated to it from a partnership. We also believe this approach to allocating ETI is consistent with the five principles set out in Section 6.D.i. of the preamble to the Proposed Regulations[4]

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

[4] 83 Federal Register 67490, at 67505 (December 28, 2018).

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/ Mark D. Epley

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