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

August 7, 2017

Via Electronic Filing:

Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-38)
Room 5205
P.O. Box 7604
Ben Franklin Station
Washington, DC 20224

Re: Managed Funds Association Comments on Notice 2017-38 -- Implementation of Executive Order 13789 (Identifying and Reducing Tax Regulatory Burdens)

Dear Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") in response to Notice 2017-38, Implementation of Executive Order 13789 (the "Notice"). We support the policy goal set out in President Trump's Executive Order 13789, Identifying and Reducing Tax Regulatory Burdens (the "Tax Executive Order")[2] and Treasury's review of existing regulations in light of the Tax Executive Order. Our comments in this letter are focused

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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. 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] 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.

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

on the list of rules identified in the Notice, in particular the Final and Temporary Regulations under Section 385 on the Treatment of Certain Interests in Corporations as Stock or Indebtedness (the "Final Rules"). We note that MFA also has submitted comment letters[3] in response to Treasury's request for information on its Review of Regulations.[4] While those letters address tax regulations that Treasury did not identify in response to the Tax Executive Order, we nonetheless believe that Treasury and the IRS should review and consider potential amendments to the regulations discussed in those letters along with the regulations they have identified in response to the Tax Executive Order.

With respect to the Final Rules, MFA encourages Treasury and the IRS to reconsider how the Final Rules could be more narrowly focused on the types of corporate transactions, such as inversions, that Treasury previously identified to be of primary policy concern in enacting the Final Rules. In MFA's view, such a tailored approach should (among other things) limit the scope of the final rules to transactions involving business structures where the ultimate parent entity is a corporation, or is so classified for U.S. tax purposes. Adoption of such an approach would still capture the inversion-related transactions that appeared to be the primary motivation for the Final Rules, while helping to avoid some of the adverse consequences of an overly broad scope.

Set out below are specific concerns regarding the application of the expanded group and modified expanded group rules and the proposed downward attribution rules to investment funds. Also discussed below are our views on why blocker entities used by investment funds should continue to be excluded from the scope of any amendments to the Final Rules under Section 385.[5]

<u>Expanded Group and Modified Expanded Group Rules for Investment Funds</u>

We encourage Treasury and the IRS to reconsider their decision as to the application of the expanded group (and "modified expanded group" as it applies to the bifurcation provisions) definition in the context of the business structures of investment funds and their adviser entities. For the reasons set out below, we continue to believe that, with respect to the determination of whether an expanded group or modified expanded group exists under Section 385 and the Final Rules, any vote held by an investment adviser, or a related entity to the investment adviser, should be ignored.

Private investment funds are typically structured so that the fund's investment adviser, or a related entity, owns the voting interests in the fund while investors own non-voting economic interests in the fund. Despite the adviser or related entity's ownership of the voting interests, we believe that different investment funds should not be deemed to be

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[3] MFA's comment letters in response to the Review of Regulations are available at: https://www.managedfunds.org/issues-policy/mfa-comment-letters/.

[4] 82 FR 27217 June 14, 2017.

[5] Unless otherwise indicated, any references to a "Section" or "Sections" are references to a "Section" or Sections" of the Internal Revenue Code of 1986, as amended, or the regulations issued under the Code by the Treasury and the IRS.

part of an expanded group (or a "modified expanded group" as it applies to the bifurcation provisions) simply because they are managed by the same investment adviser or the same related entity. Similarly, we do not believe that an investment fund should be deemed to be part of an expanded group (or a "modified expanded group" as it applies to the bifurcation provisions) with an investment adviser solely due to the investment adviser owning the voting interests in the fund.

Investment advisers owe fiduciary obligations to each investment fund they manage, which require the adviser to cause each fund to enter into transactions only if they are in the best interest of each investment fund. Further, different investment funds managed by the same adviser often have different investor bases. Because an adviser owes obligations to each fund separate and apart from its obligations to its other funds, it does not enter into transactions that shift tax obligations from one fund (and one set of investors) to another fund (and a different set of investors) because the transaction would lower the amount of taxes paid by all of its investment funds collectively. This is a clear distinction from a corporate structure in which a parent company may be incentivized to lower the overall amount of taxes paid across the entire structure. Transactions in the context of the business structures of investment funds and their adviser entities are therefore very different from the types of transactions in the context of corporate structures that Treasury has identified as being of primary concern in proposing these rules.

We believe that Treasury and the IRS should amend the Final Rules to avoid treating groups of investment funds as part of an expanded group, or modified expanded group under the bifurcation provisions, simply because they share a common adviser, or related entity, with voting control of the funds. Similarly, we believe that Treasury and the IRS should amend the Final Rules to avoid treating an investment adviser and an investment fund as part of an expanded group simply because the investment adviser owns the voting shares of the investment fund. Accordingly, we encourage Treasury and the IRS to amend the Final Rules under Section 385 to provide that, with respect to the determination of whether an expanded group or modified expanded group exists under Section 385, the voting interests held by an investment adviser, or a related entity to the investment adviser, should be ignored.

Proposed Downward Attribution Rules

We appreciate that the Final Rules did not include the proposed downward attribution rules, which raised concerns about the potential application of those rules under Section 318 to fund structures.[6] Under the proposed rules, indirect ownership for purposes of establishing an expanded group under Section 385 would have meant applying the attribution rules of Section 318, as modified by Section 304(c)(3). The proposed attribution rules also included upward attribution (Section 318(a)(2)), which attributes stock held by subsidiary entities to their owners, and downward attribution (Section 318(a)(3)), which

[6] We note that others also raised this concern with the proposed rules, including the report of the Tax Section of the New York State Bar Association (the "NYSBA Report"), submitted on June 29, 2016 (see, for example, pages 41 through 43 of the NYSBA Report).

attributes stock held by owners to their subsidiary entities.

Of particular concern is that the proposed downward attribution rules generally would be more expansive in application than the upward attribution rules. Whereas the upward attribution rules attribute stock owned by a subsidiary to a parent in an amount proportionate to the parent's ownership interest in the subsidiary, the proposed downward attribution rules could attribute 100% of the stock owned by a parent to a subsidiary. Under the proposed downward attribution rules in Section 318(a)(3), as modified by Section 304(c)(3), a subsidiary corporation would be treated as owning a share of stock held by the parent corporation in an amount that is proportionate to the parent's ownership interest in the subsidiary, if the parent's ownership is more than 5% but less than 50%. Under those proposed rules, however, if the parent's ownership interest in its corporate subsidiary is 50% or more, then all of the stock held by the parent would be attributed to the subsidiary. In addition, a partnership would be treated as owning all of the stock owned by its partners, regardless of the ownership percentage of the partners.

We continue to believe that the application of the proposed downward attribution in the context of an expanded group would affect transactions beyond the intended policy goal of the Final Rules.

> *Example*. P1 is a corporation that is the common parent of a consolidated group. P1 owns a small 1% interest in Fund A, a partnership for US tax purposes. Fund A owns 80% of the value of Portfolio Company A. S1, a wholly-owned affiliate of P1 engaged in a lending business, makes a loan to Portfolio Company A in the ordinary course of its lending business.

Under the proposed downward attribution rules, Fund A would be treated as owning all of the stock owned by its partners, including P1. Consequently, Fund A would be treated as owning all of P1's subsidiaries, including S1. Because Fund A would be treated as owning 100% of P1's subsidiaries, including S1, each of P1's subsidiaries also would be treated as owning all of the stock owned by Fund A, including the stock in Portfolio Company A, thereby making Portfolio Company A and S1 members of the same expanded group. Similar concerns would arise in the context of investment fund partnerships that have multiple tiers of corporate entities used for certain types of investors or to make certain investments.

We believe that expansive scope of the proposed downward attribution rules, particularly in the context of partnerships like investment funds, would expand the scope of the Final Rules to transactions and structures beyond the stated policy goals of the Rules. Small partners in a partnership are not the types of related parties with enhanced incentives to engage in transactions that result in excessive indebtedness identified by Treasury and the IRS as the type of relationship intended to be addressed by the Final Rules.[7]

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[7] See proposing release, 81 FR 20911, at 20914 (April 8, 2016).

Accordingly, we encourage Treasury and the IRS to formally withdraw the proposed downward attribution rules that the Final Rules reserved for potential rulemaking. To the extent Treasury and the IRS determine in the future to adopt downward attribution rules, we recommend that Treasury and the IRS amend the proposed downward attribution rules to apply only when 80% of an entity is owned by a parent company.[8] This amendment would ensure that the downward attribution rules apply only when the subsidiary to which stock ownership is attributed is closely related to its parent.

Blocker Entities

Finally, we note that Treasury and the IRS chose to reserve for further consideration whether to issue rules under Section 385 with respect to whether indebtedness used by investment funds and so-called blocker entities raise similar policy concerns as those underlying the Final Rules. We continue to believe that policy questions, if any, associated with the use of blocker entities should be addressed outside of the context of the Final Rules and outside of Section 385. Private investment funds, such as hedge funds, use these structures principally to avoid creating adverse tax consequences for investors that choose to invest through pooled investment funds rather than invest directly. Accordingly, the use of the levered blocker structure is intended to preserve the result that taxation on the funds' income occurs at the level of the investor rather than at or below the fund level.

Further, many private investment funds are ultimately owned by a large number of investors. Private investment funds provide investors the ability to pool capital with other investors for the purpose of having an asset manager make investment decisions. Although the private investment fund itself may own 100% of the blocker entity, on a look-through basis, each ultimate investor in the investment fund typically owns an interest in the blocker entity that is significantly less than the 50% and 80% thresholds that apply under the expanded group or modified expanded group rules.

In addition, transactions involving these blocker entities typically are already subject to "earnings-stripping" limitations under Section 163(j). As such, we believe that these structures do not raise the same policy concerns as those underlying the Final Rules. Because blocker entities used by private investment funds, such as hedge funds, do not implicate the same types of policy concerns and transactions involving such entities are already subject to existing rules regarding earnings-stripping, we believe that any policy considerations regarding blocker entities should be made outside of the scope of the Final Rules. Accordingly, we encourage Treasury and the IRS to withdraw their statements in the adopting release of the Final Rules that provided for potential amendments to the Final Rules related to the use of blocker entities by private investment funds.

[8] We note that this is similar to the recommendation made in the NYSBA Report.

MFA appreciates the willingness of Treasury and the IRS to consider the issues discussed with respect to its review of the Final Rules in light of the policy goals set out in the Tax Executive Order. If you have any questions regarding any of MFA's comments, or if we can provide further information with respect to the issues raised in our letter, 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