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

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Via Electronic Filing

Internal Revenue Service
CC:PA:LPD:PR (REG–107213–18)
Room 5203
P.O. Box 7604,
Ben Franklin Station
Washington, DC 20044.

Re: MFA Comments on Proposed Regulation 107213–18, Guidance Under Section 1061

Dear Ladies and Gentleman:

Managed Funds Association ("MFA")[1] appreciates the opportunity to respond to the proposed rules to implement the changes to the tax treatment of carried interest (the "Proposed Rules") set out in Section 1061[2] of the Internal Revenue Code of 1986, as amended (the "Code"). MFA believes it is important for the rules implementing Section 1061 to appropriately distinguish between carried interest allocations and allocations on capital invested in a partnership and also avoid overly broad provisions that would subject a broader range of long-term capital gains to be recharacterized as short-term capital gains than was intended by the statute. As discussed in more detail below, we believe that certain aspects of the Proposed Rules achieve these important objectives, while other aspects should be modified to address concerns that they are overly broad in scope.

Our comments can be grouped into several categories: (1) the exception for Capital Interest Allocations; (2) transfers to related parties that are subject to Section 1061(d); (3) the Lookthrough Rule; (4) the definition of an applicable partnership interest ("API"); and (5) the scope of capital gains subject to recharacterization under Section 1061. We discuss each of these issues in more detail in the following sections of the letter, but are summarized as follows:

- **<u>Capital Interest Allocations</u>** – We agree and support the Proposed Rules treating subsequent earnings on capital that was originally an applicable partnership interest

1 MFA represents the global alternative investment industry and its investors by advocating for public policies that foster efficient, transparent, fair capital markets, and competitive tax and regulatory structures. MFA supports member business strategy and growth via proprietary access to subject matter experts, peer-to-peer networking, and best practices. MFA's more than 140 member firms collectively manage nearly $1.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, London, Brussels, and Asia, supporting a global policy environment that fosters growth in the alternative investment industry.

2 Section references in this letter refer to Code sections, unless otherwise indicated.

allocation ("API Allocation") and that was left in a partnership as Capital Interest Allocations. We believe this approach correctly distinguishes between an API Allocation and allocations that reflect returns on invested capital, consistent with the text and intent of Section 1061, and we encourage the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") to adopt those provisions. We also encourage Treasury and the IRS to modify the requirements for allocations to an API holder to be treated as Capital Interest Allocations to better account for common structures in the asset management industry that economically reflect returns on invested capital and do not present the risk of inappropriately avoiding the application of Section 1061 to APIs.

- **Transfers to Related Parties** – We believe the approach taken in the Proposed Rules to not only subject transfers of APIs to related parties to recharacterization under Section 1061, but also to cause such transfers to be immediately recognized for tax purposes, goes beyond the statutory language and intent. Accordingly, we encourage Treasury and the IRS to amend the provisions to implement Section 1061(d) to focus on recharacterization of capital gains from an API.

- **Lookthrough Rule** – We encourage Treasury and the IRS to amend the "Lookthrough Rule" to better focus the rule on transactions that would inappropriately seek to convert capital gains subject to Section 1061 to long-term capital gains, while avoiding the potential for capital gains not subject to Section 1061 to be recharacterized as short-term capital gains.

- **Definition of API** – We believe that Treasury and the IRS should modify the definition of "applicable partnership interest" to avoid an overly broad application to investment management contracts and common partnership interests that do not reflect carried interest arrangements.

- **Scope of Capital Gains Subject to Section 1061** – We agree with the Proposed Rules that qualified dividends and long-term capital gains determined under Sections 1231 and 1256 should not be subject to recharacterization under Section 1061 and encourage Treasury and the IRS to finalize those provisions in the Proposed Rules.

Capital Interest Allocations

Subsequent earnings on capital from API Allocations

Section 1061 appropriately distinguishes between gains received as carried interest allocations (API Allocations) and gains received on invested capital. The statute does not distinguish between new capital invested in a partnership by an API holder and an API holder that receives an API Allocation and chooses to leave the capital associated with that allocation in the partnership. From an economic perspective, both situations clearly reflect an investment of capital by the API holder and returns on that capital reflect a return on investment, not a carried interest allocation. This is the case with respect to API Allocations that include realized or unrealized gains. Further, treating subsequent gains on capital initially received as an API Allocation does not change the treatment of the API Allocation itself, which appropriately remains subject to Section 1061. Under the Proposed Rules, such subsequent earnings are appropriately treated as returns on invested capital and not API Allocations. We support the Proposed Rules in that regard because this approach is consistent with both the text and the intent of Section 1061 and we encourage Treasury and the IRS to adopt these aspects of the Proposed Rules.

Allocations in the same manner as unrelated non-service partners

For an allocation to an API holder to be treated as a Capital Interest Allocation, the Proposed Rules require the allocation to be made in the same manner as allocations to non-service partners. The Proposed Rules treat allocations to an API holder as being made in the same manner as allocations to non-service partners when allocations based on the partners' capital account balances have the same terms, the same priority, the same type and level of risk, the same rate of return, the same rights to cash or property distributions during partnership operations and on liquidation. While MFA is generally supportive of reasonable rules to ensure that an allocation to an API holder is consistent with allocations based on capital investment, we are concerned that the Proposed Rules as drafted could disqualify many partnership allocations that reflect earnings on invested capital and not carried interest from being treated as Capital Interest Allocations. We believe it is important for Treasury and the IRS to refine the Capital Interest Allocation rules to reflect a number of common situations in the asset management industry, to avoid an overly broad application of Section 1061 to capital gains earned on invested capital.

Common fact patterns include side pocket arrangements;[3] tracking and regulatory allocations; different liquidity terms for API holders and other investors; and waivers of management fees and carried interest arrangements for API holders. Although these situations can lead to different allocations among different partners, we believe that these differences should not be viewed as disqualifying what would otherwise be treated as a Capital Interest Allocation. It is not clear, however, whether these types of differences would prevent an API holder that has invested capital in a partnership from being eligible to treat allocations on that invested capital as Capital Interest Allocations. Importantly, in all of these fact patterns, the API holder is receiving allocations of gain and loss with respect to invested capital and not as a carried interest allocation.

To better address these types of common fact patterns in the asset management industry, we recommend Treasury and the IRS modify the Capital Interest Allocation rules to provide that, to the extent that the API holder shares in each of these pools of assets and the economic income rights in a similar manner to other investors, those allocations will be treated as Capital Interest Allocations. We believe this approach strikes the appropriate balance to distinguish when an API holder receives an API Allocation and when the holder receives a Capital Interest Allocation.

Capital account exception for loans

For purposes of Section 1061, under the Proposed Rules, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or

[3] Side pockets provide investment funds a mechanism to allocate gains and losses from less liquid investments to partners who were invested in a fund at the time of the side pocket investment and that want to receive allocations associated with such investments.

guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to any such other partner or the partnership). We believe that the intent of this provision was to preclude a taxpayer from disguising an API as a capital interest through use of a loan; however, we are concerned that the Proposed Rules are overly broad in this regard and would have unintended consequences.

Many asset managers have employee plans or side-by-side vehicles that provide employees a loan to invest their own, after-tax earnings in the manager's investment funds or in the investment manager itself. This is often offered to many people in the company, not just the founding or senior level members. Although these plans take many forms, the management company often makes the loan or guarantees the loan to a third-party lender. We note that the statute is silent with respect to the use of loans and guarantees to make investments.

We understand that Treasury and the IRS have concerns that certain types of loans from a partnership to a service partner in the partnership could be structured to be economically the same as granting the service partner a carried interest in the partnership. As such, we understand that Treasury and the IRS believe an anti-abuse rule regarding such loans is appropriate. There are many loans that do not raise this type of concern, however, and we believe the Proposed Rules would unnecessarily recharacterize many legitimate investments as APIs, particular given the broad definition of APIs in the Proposed Rules. We encourage Treasury and the IRS to amend the Proposed Rules to focus the exclusion from the capital interest exception only on loans from a partnership to a service partner in the partnership that are economically the same as the service provider receiving a carried interest in that partnership. Other loans from a partnership to a service partner that are not economically the same as granting a carried interest should not be subject to §1.1061–3 (c)(3)(ii)(C).

With respect to loans covered by the Proposed Rules from persons other than the partnership itself, we believe that investments financed by loans that generally are treated as such for purposes of the Code also should not be excluded from the capital interest exception. Therefore, at a minimum we recommend that, to the extent that a loan is a recourse note and the service provider is required to pay back the loan personally, regardless of whether the interest increases or decreases in value, the loan should not preclude an investment from being a capital interest for purposes of the capital interest exception.

While we acknowledge a distinction between recourse and nonrecourse loans, we do not think that an interest funded through a nonrecourse loan should be precluded rom qualifying for the capital interest exception to the extent there is no reason to believe the loan will not be repaid or that the loan will be forgiven.[4] The Code acknowledges that employer-employee loans can be properly structured at an arm's length and be non-compensatory as long as there is adequately stated interest. Therefore, we believe the proposed regulations are overly broad by excluding investments funded by such loans. We do not believe that such loans should automatically preclude employee service providers from utilizing the capital interest exception merely because the loans were

[4] There are long-standing general Federal income tax principles and authorities that would apply to recharacterize nonrecourse loans lacking sufficient borrower risk. For example, the fact that a nonrecourse borrower commits at-risk equity capital can highlight that the borrower fully intends to repay the loan.

provided by their employer, which also provides services to the partnership. We note that Section 7872 will treat any compensatory element embedded in the loans as compensatory. Additionally, Treas. Reg. §1.83-3(a)(2) applies and will treat certain acquisitions with non-recourse debt as options rather than property.

Further, we do not think that a guarantee on a loan by itself should be treated in the same manner as a loan for this purpose, particularly in the context of recourse loans or other loans from a third-party bank. A guarantee on a loan does not make the loan from a third-party bank not a "real" loan to a service provider. They remain fully recourse loans to the service providers from the unrelated banks, and typically the bank would look to the service providers to pay back the loans in most circumstances.

<u>Requirement for unrelated, non-service partners to have a significant aggregate capital account balance</u>

The exception for Capital Interest Allocations requires that unrelated, non-service partners have a significant aggregate capital account balance (at least 5 percent) in the partnership. While we understand the rationale for the Proposed Rules to include a specified ownership percentage by unrelated, non-service partners, we are concerned about how this requirement would apply in common entities in the asset management industry, including employee investment funds and fund general partners. Because employee investment funds are typically owned entirely by related persons, it appears that allocations to the owners of the employee funds do not qualify as Capital Interest Allocations because unrelated, non-service partners do not have a significant aggregate capital account balance. This would be the case even when allocations to the owners of the employee fund fully reflect earnings on invested capital. We believe this result is inconsistent with the intent of the statute to exclude earnings on invested capital from recharacterization under Section 1061. We encourage Treasury and the IRS to modify the Capital Interest Allocation definition to avoid subjecting earnings on invested capital to Section 1061.

Further, investment fund general partners are often owned by the service partners to the fund and, therefore, may not have any unrelated, non-service partners. As a consequence, we are concerned that allocations at the general partner level may not qualify as Capital Interest Allocations. This could lead to the result that allocations from a fund partnership to its general partner, which are eligible to be treated as Capital Interest Allocations, could become subject to Section 1061 when allocations of those capital gains are made at the general partner level. We believe that this result would significantly undermine the distinction between API Allocations and Capital Interest Allocations. Accordingly, we encourage Treasury and the IRS to amend the Proposed Rules to clarify that, when a partnership receives a Capital Interest Allocation from a lower-tier partnership and makes a further allocation of those capital gains, the allocation at the upper-tier partnership will not be treated as an API Allocation solely because the upper-tier partnership does not have unrelated, non-service partners that have a significant aggregate capital account balance.

Transfers to related parties

Section 1061(d) was drafted as an anti-abuse provision to prevent taxpayers from avoiding the application of section 1061 by transferring a partnership interest to a related person. The proposed regulations go well beyond this intent to recharacterize transfers to related persons by also requiring a taxpayer to recognize gain at the time of transfer, even if the transfer is otherwise not taxable. We are concerned that this provision goes beyond the statutory language and intent of Section 1061(d) and likely will lead to the recognition of gain in many common circumstances that do not ordinarily cause recognition and that do not raise anti-abuse concerns. The following are common examples of those fact patterns:

- Transfers to family members for estate planning purposes.
- When a service partner leaves a partnership before an interest is vested, the forfeited interest is transferred back to the employer in a non-taxable event.
- It is common for a general partner entity to distribute partnership interests to the owners to hold an interest in the fund vehicle directly as a way to mitigate the liability associated with it being held in the general partner entity. These are typically done through tax free distributions under section 731.

None of these fact patterns would ordinarily result in a taxable event. They are all common fact patterns undertaken in the ordinary course of business for reasons and not tax avoidance. We recommend Treasury amend the Proposed Rules by removing the requirement to immediately recognize gain in a transaction covered by section 1061(d), if the transfer otherwise would not trigger recognition.

Lookthrough Rule for tiered partnerships

The Lookthrough Rule applies if: (1) an API holder disposes of an API; (2) the holding period of the API was more than three years; and (3) 80 percent or more of the assets of the partnership in which the API is held are assets that would have a less than 3 year holding period (i.e., the Substantially All Test is met). There are rules for Direct and Indirect transfers, but the rules appear to look to the lowest-tier API (e.g., typically the carried interest in the fund itself) to determine whether the Substantially All test is met.

The Lookthrough Rule could lead to applying Section 1061 in circumstances when a fund complex sets up a new entity, turning what would otherwise be holding periods of more than 3 years into a holding period of less than 3 years simply because a new entity is added to the structure. To the extent an owner in the general partner entity sells its interest in the general partner, it would be the sale of a directly held API, as well as the sale of indirectly held APIs (the fund carried interests issued to the general partner entity). Assume, for example, an asset manager forms one general partner entity to hold APIs in multiple fund structures instead of using a different general partner entity for each API. In this scenario, the gain attributable to the API in the new fund could subject a portion of the gain on the sale of the general partner entity to recharacterization even though the general partner entity itself was held greater than 3 years. Given this result, Treasury and the IRS should clarify that the modification of a partnership agreement does not itself create a new holding period for the API.

The Lookthrough Rule also could raise concerns about going concern value in lower-tier entities becoming subject to ordinary income rates if the upper-tier partnership interest is sold. Because the Lookthrough Rule applies by taking a percentage of the assets under a hypothetical liquidation that would be less than 3 year property and applying that percentage to the entire gain recognized on the sale of the interest, the portion of the enterprise value or goodwill associated with such interest is taxed based on the same percentage. The intent of the Lookthrough Rule was to assure taxpayers did not use partnerships to convert what would have otherwise been gain on the sale of less than 3 year assets into gain from the sale of a 3 year asset. Because goodwill is based on the established reputation of the business, regardless of what the strategy of that business is or of the holding period of the underlying assets, we do not think they should have an impact on the character of the gain or loss associated with the portion attributable to goodwill. We therefore recommend that gain associated with goodwill or enterprise value maintain the holding period of the partnership interest itself, as opposed to the underlying assets, and the Lookthrough Rule only apply to the gain associated with the hypothetical liquidation of the underlying assets.

Definition of applicable partnership interest

The definition of an API in the Proposed Rules provides, "an interest in a partnership also includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations)." This definition would seem to include investment management contracts that provide for a fee based on the assets of a fund partnership and not a carried interest or other performance allocation. We believe this definition is overly broad by including management contracts that do not provide for carried interest allocations. To the extent the management contract is included in the definition of an API, it creates a risk that the sale of the management company (and the indirect sale of the management contract) is subject to Section 1061. This could result in the enterprise value of the management company being taxed at ordinary income rates. To better tailor the definition of an API to carried interest or economically similar arrangements, we encourage Treasury and the IRS to amend the definition of "applicable partnership interest" to exclude financial instruments or contracts that merely reference the value of partnership assets or that provide for fee income that is subject to ordinary income tax treatment.

We also encourage Treasury and the IRS to modify the proposed API definition in the context of partners holding a partnership interest while providing services to the partnership. Under Section 1061(c)(1), an API is defined as an interest in a partnership's profits that is transferred or held "in connection with the performance of substantial services." The Proposed Rules presume that services are substantial with respect to a partnership interest transferred in connection with those services. We are concerned that the Proposed Rules could have the effect of treating most, if not all, partnership interests transferred to or held by a partner who provides services to the partnership as an API. We believe this would be an overly broad result, given that the statute does not treat all partnership interests held by a partner who provides services as an API, only those partnership interests that are transferred or held "in connection with the performance of substantial services." We believe it is important for the final rules to recognize the statutory language limiting the circumstances in which a service partner will be treated as holding an API.

We encourage Treasury and the IRS to remove the presumption that a partner who provides services is presumed to provide substantial services for purposes of Section 1061. We further encourage Treasury and the IRS to provide non-exclusive safe harbors that service partners could rely on to determine that partnership interests they hold or have been transferred are not "in connection with the performance of substantial services."

Treatment of qualified dividend, section 1231 and section 1256 capital gains

The proposed rule treats qualified dividends and long-term capital gains determined under sections 1231 and 1256 as not subject to recharacterization under section 1061. MFA supports that aspect of the Proposed Rules, which we believe is consistent with the construction of the statute. Accordingly, we encourage Treasury and the IRS to adopt those provisions as proposed.

MFA and its members appreciate the opportunity to provide comments to Treasury and the IRS regarding the implementation of Section 1061. 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 the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Mark D. Epley

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