MANAGED FUNDS ASSOCIATION

August 10, 2006

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Courier's Desk
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, D.C. 20044

Ladies and Gentlemen:

In accordance with Notice 2006-65,[1] this letter sets forth the views of Managed Funds Association ("MFA") concerning the possible application of section 4965[2] to tax-exempt organizations that are passive investors in private investment funds, including hedge funds.

MFA is the only U.S.-based global membership organization dedicated to serving the needs of those professionals throughout the world who specialize in the alternative investment sector of the capital markets, including hedge funds, funds of funds and managed futures funds. MFA has more than 1,000 members, including professionals from a majority of the 50 largest hedge funds, who manage a significant portion of the estimated $1.2 trillion in hedge fund assets. Hedge funds provide important benefits to the capital markets, including "liquidity, price efficiency and risk distribution."[3]

Summary of MFA's Comments

The investment fund managers represented by MFA generally do not knowingly participate in "prohibited tax shelter transactions", as that term is defined in section 4965. These fund managers should thus be able, in principle, to respond affirmatively to requests now being made by passive tax-exempt investors, for confirmation of this fact. For the reasons discussed below, however, they nevertheless have a significant interest in

[1] 2006-31 I.R.B. 102.

[2] Except where specifically indicated otherwise, all references in this letter to "sections" are references to sections of the Internal Revenue Code of 1986, as amended (the "Code") or to sections of the regulations issued under the Code.

[3] Testimony of the Honorable Randal K. Quarles, Under Secretary for Domestic Finance, U.S. Department of the Treasury, Before the Senate Committee on Banking, Housing and Urban Affairs, page 2 (July 25, 2006). ("Quarles Testimony")

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the question when a tax-exempt investor will be treated as a "party" to an investment made by the fund.

The interest of fund managers in this question arises because of the interplay of two factors. First, the term "prohibited tax shelter transaction" includes transactions that are "substantially similar" to those that have been publicly identified by the Internal Revenue Service (the "Service") as a tax avoidance transaction for purposes of section 6011 (relating to required returns and statements). The "substantially similar" test is inherently subjective and in practice has proven difficult both for the Service and for fund managers to apply with respect to common transactions, such as total return swaps, that are entered into by many investment funds in the ordinary course of business for a broad range of non-tax reasons.[4]

Second, primarily as the result of the substantial penalties imposed for failure to make required return disclosures on Form 8886 for "listed transactions", many hedge fund managers have made protective filings with respect to numerous categories of total return swaps they believe to be proper and would challenge any claim to the contrary by the Service. In these circumstances, the question when a tax-exempt organization will be treated as a "party" to an investment made by a fund in which it is a passive investor has special importance.

For the reasons set forth in this letter, MFA urges the Service and the Department of the Treasury to include in the forthcoming guidance under section 4965 a clear statement that a tax-exempt organization that is a passive investor in a hedge fund or other private investment fund will not be treated as "a party" to any transaction (including any investment) undertaken by the fund unless, based on all the facts and circumstances, the tax-exempt organization invested in the fund specifically to participate in a prohibited tax shelter transaction.

The guidance should also provide that, if the tax-exempt organization has no power to direct the fund to engage in any specific transaction or make any specific investment, the following will not be treated as evidence that the tax-exempt organization invested in the fund specifically to participate in a prohibited tax shelter transaction: (a) the receipt by the tax-exempt organization from the fund of securities law-related disclosures of the fund's investment objectives and strategies, and the conduct of customary due diligence activities, before making its investment; (b) the receipt by the tax-exempt organization from the fund of periodic reports of investment results during the course of its investment; (c) the receipt by tax-exempt organization of other information with respect to the fund or its investment therein from any source, including,

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[4] These types of transactions also have capital markets benefits. Specifically, "[h]edge funds help mitigate market-wide concentrations of risk by transferring and distributing market risk through their willingness to be counterparties in derivatives trades." Quarles Testimony at 3.

for example, tax disclosures by the fund pursuant to section 3.02 of Notice 2006-16;[5] and (d) the filing by the fund of a Form 8886 with respect to any transaction or investment by the fund.

Discussion and Analysis

Scope of Section 4965

In general outline, section 4965 imposes penalty excise taxes and reporting obligations with respect to any entity within an enumerated class of tax-exempt organizations that is or becomes a "party" to a "prohibited tax shelter transaction". Under section 4965(e)(1), the term "prohibited tax shelter transaction" includes any "listed transaction", as defined in section 6707A(c)(2), and any "prohibited reportable transaction", as defined in section 4965(e)(1)(C).

As the Section of Taxation of the American Bar Association reported to Congress during the legislative process that led to the enactment of section 4965,[6] the provision treats tax-exempt investors in a hedge fund "more harshly" than either the fund itself or the other investors. Specifically, the fund and its taxable investors may avoid the severe penalties imposed under section 6707A by making protective filings on Form 8886 and then contest any claim by the Service that the underlying transactions are in fact improper. In contrast, section 4965 appears as a practical matter to deny tax-exempt investors the same opportunity.

In MFA's view, considerations such as the foregoing appear to have prompted Congress to limit the circumstances under which a tax-exempt organization should be treated as a "party" to a transaction undertaken by an investment fund in which the organization is a passive investor. Specifically, the legislative history of section 4965 indicates that Congress intended that a tax-exempt organization that is a passive investor in an investment fund would *not* be treated as a "party" to a prohibited tax shelter transaction in which the fund engages unless the specific facts and circumstances demonstrate that the purpose of the tax-exempt entity in making the investment was specifically to participate in the prohibited tax shelter transaction. Thus, the Statement of Managers issued in connection with the Conference Report on the Tax Increase Prevention and Reconciliation Act of 2005 states:

> "In general, the conferees intend that in determining whether a tax-exempt entity is a 'party' to a prohibited tax shelter transaction all the facts and circumstances should be taken into account. Absence of a

[5] 2006-9 I.R.B. 538.

[6] Letter to the Honorable Charles E. Grassley, the Honorable Max S. Baucus, the Honorable William M. Thomas, and the Honorable Charles B. Rangel on S. 2020 (February 3, 2006).

written agreement is not determinative. *Certain indirect involvement in a prohibited tax shelter transaction would not result in an entity being considered a party to the transaction. For example, investment by a tax-exempt entity in a mutual fund that in turn invests in or participates in a prohibited tax shelter transaction does not, in general, make the tax-exempt entity a party to such transaction, absent facts or circumstances that indicate that the purpose of the tax-exempt entity's investment in the mutual fund was specifically to participate in such a transaction.* However, whether a tax-exempt entity is a party to such a transaction will be informed by whether the entity or entity manager knew or had reason to know that an investment of the entity would be used in a prohibited tax shelter transaction. Presence of such knowledge or reason to know may indicate that the purpose of the investment was to participate in the prohibited tax shelter transaction and that the tax-exempt entity is a party to the transaction."[7] (Emphasis supplied.)

Rationale for MFA Proposals

Many tax-exempt organizations, such as universities and pension trusts, invest a modest portion of their assets in private investment funds such as hedge funds. These investments enable the organization to achieve diversification and, in many cases, to enhance its yields by earning absolute returns that are not correlated to the price movements in the markets for publicly traded securities.[8] Consequently, it is quite important that section 4965 not be administered in a manner that would unnecessarily limit the ability of tax-exempt organizations to become passive investors in private investment funds.

Receipt of Information. Hedge fund investors, including tax-exempt investors, have no right whatsoever to direct the fund's manager to make any specific investment or to engage in a specific transaction and generally will not even be aware of any specific transaction or investment by the fund until after it has been made. In accordance with applicable securities laws, all hedge fund investors, including tax-exempt investors, receive an offering memorandum or similar document describing the fund's investment objectives and strategies before making their investment and they frequently conduct pre-investment due diligence activities as well. In addition, all fund investors receive periodic reports of the financial results obtained by the fund during the period covered by the report. These reports typically describe the investments held by fund, either specifically or by category.[9] Finally, tax-exempt organizations and other passive

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[7] H.R. Conf. Rep. No. 108-455, at 131.

[8] Quarles Testimony at page 3.

[9] Tax-exempt investors in mutual funds of the type described in the Statement of Managers receive comparable disclosures and reports in the form of a detailed pre-investment prospectus as well as periodic

investors frequently obtain information about a fund or its investments from other sources, including publications available to the general public, as well as tax-related disclosures from the funds themselves, such as disclosures under section 3.02 of Notice 2006-16. If the receipt of such information is treated as evidence of the required specific intent, a tax-exempt investor may have no practical choice but to avoid investing in a broad range of funds or to seek to limit the flow of information it receives. In MFA's view, neither result would be in the public interest.

Form 8886 Filings. Fund managers are now receiving requests from prospective and current tax-exempt investors for confirmation that the fund has not and will not engage in a "prohibited tax shelter transaction". MFA's members generally do not knowingly make investments that would be so classified and thus, in principle, should be able to respond affirmatively to such requests. Where, however, the fund has, by reason of the substantial penalties involved, made protective filings on Form 8886 with respect to one or more of its investments (e.g., many types of total return swaps), the application of section 4965 currently is problematic even where the fund believes the investments are entirely proper and intends to contest any claim by the Service to the contrary (and in most cases does not even expect such a claim to be made).

Under section 6707A(c)(2) and Treas. Reg. §1.6011-4(b)(2) the term "listed transaction" (one of the operative terms in section 4965) is defined to include any transaction that is the same or "substantially similar" to a transaction that is specifically identified by the Service in published guidance as a tax avoidance transaction for purposes of section 6011 (relating to required returns and statements). The severity of the penalties imposed for failure to file Form 8886 has created a strong bias toward disclosure among taxpayers and has prompted many fund managers to make protective filings rather than attempt to determine when a particular transaction might be encompassed by the inherently subjective "substantially similar" test. This is illustrated by Notice 2006-16, discussed below, in which the Service acknowledged that investment funds enter into common transactions such as total return swaps for bona fide non-tax purposes and yet made protective filings with respect to a broad range of those swaps following the 2002 designation by the Service of one specific, atypical, swaps transaction as a "listed transaction".

While the experience of the Service and taxpayers with respect to the treatment of certain types of total return swaps as "listed transactions" hopefully will prove to be the exception rather than the rule, the severity of the penalties imposed under section 6707A is such that fund managers and other taxpayers will likely continue to find it prudent to make protective Form 8886 filings, particularly where the subjective "substantially

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reports on investments made by the fund and income earned. As a result, Congress must be presumed to have concluded that mere knowledge of a fund's investment objectives, investments made, and income earned was not in and of itself sufficient to warrant treatment of a tax-exempt investor as "a party" to each transaction in which the fund engages.

similar" criterion is involved. For these reasons, and to ensure that the bias toward disclosures on Form 8886 will not be undermined, MFA believes that the fact a fund files Forms 8886 with respect to one or more of its investments should be disregarded in determining whether a tax-exempt investor in the fund made its investment in the fund "specifically to participate" in a prohibited tax shelter transaction.

Lessons of the Total Return Swaps Experience for Section 4965

MFA believes that the decisions made by the Service and the Department of the Treasury as to the application of section 4965 to passive investors in private investment funds should be informed by the experiences of the Service and taxpayers following the issuance of Notice 2002-35,[10] in which the Service designated as a "listed transaction" a transaction involving a notional principal contract (an "NPC") that provided for contingent non-periodic payments and a deferred final non-periodic payment. The final payment had both a non-contingent component and a (smaller) contingent component and this feature apparently was relied upon by the taxpayer to deduct the periodic non-contingent payments, while not accruing income with respect to the deferred non-periodic payment even though the deferred payment would largely offset the amounts deducted by the taxpayer during the term of the swap. As the result of the action of the Service, both the specific and quite rare total return swap described in Notice 2002-35 *and* all other total return swaps that are "substantially similar" to that transaction constitute "listed transactions".

Many of MFA's member funds enter into swaps and other NPC transactions on a regular basis in the ordinary course of business for a broad range of non-tax reasons, such as to hedge other investments or to increase portfolio yields. These transactions include total return equity swaps and credit default swaps. In the typical case, the NPCs on which these transactions are based provide for both periodic payments and a deferred non-periodic contingent payment (with no non-contingent component).[11] In the view of almost all tax advisers, these types of "plain vanilla" swaps transactions should not be treated as "substantially similar" to the transaction described in Notice 2002-35.

Nevertheless, given the substantial penalties for failure to make the filings required with respect to "listed transactions", many funds followed the recommendations

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[10] 2002-1 C.B. 992.

[11] For example, in a "plain vanilla" total return equity swap, a taxpayer will make periodic payments to the counterparty during the term of the swap and receive (or make) a deferred non-periodic payment that is wholly contingent (e.g., one that is based on the change in the value of the reference stock during the term of the swap). Similarly, in the case of a plain vanilla credit default swap (a "CDS"), the protection buyer will either make lump sum or periodic payments until the first to occur of the end of the term of the swap or the occurrence of a defined credit event. If such a credit event occurs, the protection buyer will often receive a contingent payment from the protection seller. See Notice 2002-52, 2002-2 C.B. 87.

of their professional advisers and made *protective filings* on Form 8886 with respect to a broad range of "plain vanilla" total return equity swaps and credit default swaps.

Notice 2006-16 was issued by the Service to reduce the number of these protective filings. To accomplish this objective, the Service modified Notice 2002-35 to exclude from the "substantially similar" classification an NPC that requires a counterparty to make a contingent non-periodic payment (whether or not the non-periodic payment has non-contingent as well as contingent components) if the taxpayer (a) uses a method of accounting that takes the contingent non-periodic payment into account over the life of the contract under a reasonable amortization method; (b) properly accounts for the NPC under section 475; (c) properly accounts for the NPC under Treas. Reg. §1.446-4; (d) properly accounts for the NPC as a hedge described in Treas. Reg. §1.988-5(a) in connection with a qualified hedging transaction; or (e) properly accounts for the NPC under Treas. Reg. §1.988-2(e).

While the issuance of Notice 2006-16 was a welcome development, it did not provide substantive guidance and clarity as to how taxpayers were to identify which of the many transactions not covered by the safe harbor might be viewed by the Service as "substantially similar" to the transaction described in Notice 2002-35. Indeed, after acknowledging that protective filings have been made for common transactions, such as total return swaps that are entered into for bona fide non-tax purposes, the Service stated:

> "This Notice is intended to narrow the scope of reportable transactions *that might be perceived* to be substantially similar to the transaction described in Notice 2002-35, and is intended to reduce the number of [protective] Form 8886 filings. This Notice should not be construed as expanding the scope or potential application of Notice 2002-35. *Specifically, no inference is intended regarding whether transactions not described in Section 3.01[of the Notice] are or are not to be reported under Notice 2002-35.*" (Emphasis added.)

In short, Notice 2006-16 has reduced but not eliminated the uncertainties surrounding the question whether a particular NPC transaction is or is not "substantially similar" to the NPC transaction described in Notice 2002-35. As a result, it is inevitable that many investment funds will continue to make protective filings with respect to one or more classes of total return swaps in order to avoid any risk that penalties might be imposed under section 6707A even though they fully intend to contest any claim that the underlying transactions are improper. If such filings are not disregarded for purposes of section 4965, both the fund and its current and prospective tax-exempt investors will be placed in what frequently will be an untenable position. In this connection, MFA believes that, if a tax-exempt organization is the type of passive investor entitled to receive disclosures under section 3.02 of Notice 2006-16, it is presumptively not a "party" to the underlying transaction entered into by the fund.

MFA Proposals

The experience of taxpayers, including MFA and its members, with respect to total return swaps illustrates why the Service and the Department of the Treasury should, in accordance with Congressional intent, provide certainty with respect to the application of section 4965 to tax-exempt organizations that are passive investors in hedge funds and other investment funds.

Specifically, a tax-exempt organization that is a passive investor in a hedge fund or other private investment fund should not be treated as "a party" to any transaction (including any investment) undertaken by the fund unless, based on all the facts and circumstances, the tax-exempt organization invested in the fund specifically to participate in a prohibited tax shelter transaction.

Where the tax-exempt organization has no power to direct the fund to engage in any specific transaction or make any specific investment, the following should not be treated as evidence that the tax-exempt organization invested in the fund specifically to participate in a prohibited tax shelter transaction:

> (a) the receipt by the tax-exempt organization from the fund of securities-law related disclosures of the fund's investment objectives and strategies, and the conduct of customary due diligence activities, before making its investment;
>
> (b) the receipt by the tax-exempt organization from the fund of periodic reports of investment results during the course of its investment;
>
> (c) the receipt by the tax-exempt organization of other information with respect to the fund or its investment therein from any source, including, for example, disclosures pursuant to section 3.02 of Notice 2006-16; and
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> (d) the filing by the fund of a Form 8886 with respect to any transaction or investment by the fund.

In addition, in order to ensure that Notice 2006-16 will serve its intended purpose, the forthcoming guidance should confirm that both a fund manager and its tax-exempt investors may rely on pronouncements such as Notice 2006-16 in determining that the fund has not engaged in a prohibited tax shelter transaction and that the excise tax imposed by section 4965 does not apply. As discussed above, if a tax-exempt organization is the type of passive investor entitled to receive disclosures under section 3.02 of Notice 2006-16, it is presumptively not a "party" to the underlying transaction.

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MFA stands ready to respond to any questions you may have with respect to this letter and specifically requests the opportunity to meet with representatives of the Service and the Department of the Treasury to discuss these important issues.

Respectfully submitted,

John G. Gaine, President