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

April 9, 2008

Commissioner Douglas Shulman
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Eric Solomon
Assistant Secretary of Tax Policy
Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Increasing Liquidity in the U.S. Capital Markets

Dear Gentlemen:

In response to the challenging market and economic environment we now face, Managed Funds Association ("MFA")[1] and its members have been asked to consider and suggest actions concerning federal tax matters that Congress and/or the Department of the Treasury ("Treasury") and the Internal Revenue Service ("Service") could take to help alleviate the current liquidity crisis in the U.S. capital markets. MFA, on behalf of its members, has a number of suggestions and, with this letter, would request that the Treasury and Service issue guidance (through a Notice or otherwise) to confirm the application of certain provisions of the Internal Revenue Code of 1986, as amended (the "Code") to investments in "distressed debt" by non-public investment funds that are themselves non-U.S. persons or have non-U.S. persons as investors.

As discussed more fully below, and consistent with its interpretation of current law[2], MFA would suggest that such guidance confirm that the following falls within the proprietary securities trading safe harbor of section 864(b)(2) of the Code and will thus not be treated as a U.S. trade or business by such a fund: (a) the purchase of previously issued debt instruments (whether or not as part of a pool) where one or more of the debt instruments are restructured following the acquisition, whether or not such restructuring was intended by the fund at the time of the investment; and (b) restructuring negotiations, collection, servicing and similar activities

[1] MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $ 2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

[2] MFA is prepared to submit a more comprehensive memorandum of authorities if that would assist Treasury and the Service in their analyses of MFA's request.

undertaken in connection with such debt instruments on behalf of the fund by a related or unrelated party.

Reasons for the MFA Request

These are extraordinarily trying times for the U.S. capital markets, which are the primary source of credit for individual American consumers and homeowners as well as business enterprises throughout the United States. What began as a credit crisis in a specific sector of the economy has in recent months devolved into a systemic liquidity crisis. The well documented collapse of the market for collateralized mortgage obligations ("CMOs"), which was caused by rising delinquencies and defaults, has undermined the willingness of market participants to deploy risk capital and has created severe dislocations in pricing.

The collateral effects of this negative feedback loop are manifest. For example, a lack of market pricing has created uncertainty as to how assets, and more generally balance sheets, should be valued and this in turn limits the capacity of U.S. market participants to deploy risk capital for CMOs, corporate obligations, municipal debt, and so on. As a result of recent events, some U.S. banks and broker-dealers, who have traditionally been the largest source of funding for many of these asset categories, lack sufficient risk capital to participate actively in the market, and other banks and broker-dealers are simply unwilling to do so at the present time.

While there appear to be a number of sources of potential liquidity to enable the markets to function without continuing severe dislocation, there is one large source of available capital outside the U.S. that could be deployed quickly to reduce the continuing spiral of losses, write-downs and failures in the mortgage markets and the broader debt markets. At the present time, however, this pool of liquid capital is not being deployed within the U.S. debt markets as robustly as might otherwise be the case. One reason for this is the lack of published guidance confirming that the investments by non-U.S. persons in distressed debt will not create new tax burdens. MFA and its members strongly believe that non-U.S. investors would be more likely to provide significant additional liquidity for distressed debt in the current market if the Treasury and the Service would issue a Notice (or other guidance) to confirm that these types of investments are encompassed by the proprietary securities trading safe harbor of section 864(b)(2) of the Code and thus do not constitute a U.S. trade or business. Clarifying this ambiguity, would also help provide flexibility to distressed borrowers whose debt would undergo restructuring.

Overview of Current Law

Under current law, the application of the U.S. federal income tax to a non-U.S. investment fund generally depends on whether the fund is engaged in the conduct of a trade or business within the United States. If the fund is so engaged, it is subject to U.S. tax on a net income basis with respect to that portion of its income that is "effectively connected" with the conduct of that trade or business.[3] See sections 871 and 882 of the Code. In addition, in such cases, the fund could be subject to the branch profits tax imposed by section 884 of the Code. The resulting effective U.S. tax rate on such "effectively connected" income ("ECI") is sufficiently high (i.e., in excess of 50 percent) that most non-U.S. funds structure their operations to avoid *any* risk that their activities will generate ECI and they typically inform their investors that they will do so.

Whether a foreign taxpayer will be treated as engaged in a trade or business within the United States is generally determined under section 864(b) of the Code. While that provision does not contain a comprehensive definition of the term "trade or business", it does contain safe harbors for proprietary trading in securities and commodities (i.e., trading for one's own account by a non-dealer). See section 864(b)(2)(A)(ii). The definition of "securities" applicable to the safe harbor for proprietary trading in securities includes any "note, bond, indenture or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." See Reg. 1.864-2(c)(2)(i). However, the regulations under section 864(b) also indicate that a U.S. trade or business could in certain cases include enumerated financing functions, including loan origination.[4]

Many non-U.S. funds and their advisers have concluded that the proprietary securities trading safe harbor applies to investments in distressed debt. MFA believes this is the correct result, both as a matter of policy and statutory construction. Stated more specifically, MFA believes that the purchase of previously outstanding debt instruments, including distressed debt, generally is properly encompassed by the proprietary securities trading safe harbor. Nevertheless, in the absence of clear official guidance to that effect and the lack of clarity as to the scope of the

[3] If the fund is not engaged in a trade or business within the United States, it is generally subject to U.S. tax only on certain enumerated items of U.S. source income, such as dividends and some categories of interest income. U.S. tax is also imposed on certain investments in U.S. real estate.

[4] Reg. 1.864-4(c)(5) creates special rules if a foreign taxpayer is engaged in a trade or business in the U.S. and the activities of that trade or business includes one of the following: (1) receiving deposits of funds from the public; (2) making personal, mortgage, industrial or other loans to the public; (3) purchasing, selling, discounting or negotiating for the public on a regular basis notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; (4) issuing letters of credit to the public and negotiating of drafts thereunder; (5) providing trust services for the public; and (6) providing foreign exchange transactions for the public. Reg. 1.864-4(c)(5).

section 864 financing regulations, many non-U.S. funds have avoided distressed debt investments even though they too believe that these investments should be protected by the safe harbor. For example, some have questioned whether restructuring previously acquired debt could be treated as the origination of a new loan, particularly where the modifications are so substantial that a new issuance is deemed to have occurred under section 1001 of the Code. See Reg. 1001-3.

Scope of Requested Guidance

MFA believes that, given the purposes of section 864(b) of the Code, the correct view, which is supported by relevant authorities,[5] is that the purchase of previously issued debt instruments (whether or not as part of a pool) by a non-U.S. person (that is not a dealer in securities or debt instruments) is protected by the proprietary securities trading safe harbor even where (a) one or more of the debt instruments are restructured following the acquisition, including in cases where the restructuring was intended at the time of the acquisition, and (b) negotiations related to the restructuring of the debt, as well as collection, servicing, communications and similar activities, are undertaken in connection with the purchased debt instruments on behalf of the non-U.S. fund. As noted, MFA believes that the issuance of guidance confirming this interpretation could materially increase liquidity in the U.S. capital markets.

In MFA's view, it is not necessary to include a definition of "distressed debt" in the requested guidance. In any event, the guidance should apply to the restructuring of previously issued debt instruments, including mortgages, car loans, credit card receivables and other consumer and business debt, without regard to the type of debt.

The revenue consequences of this clarification should be neutral or, to the extent the incremental liquidity supports the health of our economy, positive. As we note above, without this clarification, offshore capital may remain offshore without any incremental tax revenue generated.

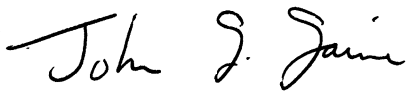
There are other issues related to these kinds of investments as to which guidance would be desirable. These include, but are not limited to, cases where additional funds are advanced as part of the restructuring as well as the question whether the fund should be treated as a "dealer" if it, for example, purchases a large portfolio of distressed loans and thereafter disposes of some portions of the portfolio in multiple transactions with different purchasers. While clarity as to these issues is also desirable, MFA urges that the requested targeted guidance not be deferred

[5] See, for example, *Whipple v. Commissioner,* 363 U.S. 193 (1963) and *Bielfeldt v. Commissioner,* 231 F.3d 1035 (7th Cir. 2000) (returns received were investment-type returns).

pending the resolution of these and other collateral issues. MFA does recommend, however, that the guidance make it clear that, where an investment involves other features not addressed in the guidance (e.g., an advancement of cash), no adverse inference will be drawn (or favorable presumption created) as to the non-application of the proprietary securities trading safe harbor by reason of such other features.

MFA would welcome the opportunity to meet with you and your colleagues to discuss the requested guidance in greater detail and respond to any questions you may have. In the interim, MFA will continue with its study to identify other areas where legislative or administrative action with respect to federal tax matters could contribute to the alleviation of the current liquidity crisis.

Respectfully submitted,



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