



August 29, 2008

Mr. Eric Solomon  
Assistant Secretary for Tax Policy  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Commissioner Douglas H. Shulman  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

**Re: Temporary Regulation TD 9407 – Extension of Time for Filing Returns**

Dear Assistant Secretary Solomon and Commissioner Shulman:

Managed Funds Association (“MFA”)<sup>1</sup> respectfully submits this letter in response to the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service’s (the “Service”) request for comments on the provisions of Temporary Regulation TD 9407, Part 4 (IR-2008-84 (July 1, 2008)), which, among other things, revises Temp. Reg. section 1.6081-2T relating to partnership tax reporting (the “New Temporary Regulations”). In particular, MFA has set forth below its comments regarding the new due date for filing federal partnership tax returns (i.e., Form 1065 and Schedule K-1s) after tax year 2008. MFA and its members applaud the efforts of Treasury and the Service to reduce overall taxpayer burdens by releasing the New Temporary Regulations. MFA believes, however, that the new due date for issuing Schedule K-1s and for filing Form 1065 may create many unanticipated and negative consequences for partnerships. For that reason, we write to request that Treasury and the Service revert to the October 15th deadline for federal partnership tax returns to avoid jeopardizing the integrity and precision that were promoted under the tax-reporting process before the release of the New Temporary Regulations.

**Background**

Before the release of the New Temporary Regulations, Temp. Reg. section 1.6081-2T provided partnerships with a six-month automatic extension of time to issue Schedule K-1s and file Form 1065, resulting in a due date of October 15th as long as the partnership filed the appropriate form of extension request (IRS Form 8804). This extended due date was the same for individual filers and was after the extended corporate tax return due date of September 15th. The New Temporary Regulations shorten the time frame under which partnerships can issue Schedule K-1s and prepare and file Form 1065 from six months to five months (September 15th). While MFA recognizes that the previous six-month due date made it somewhat difficult for a number of

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<sup>1</sup> MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include 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.

individual taxpayers to file their respective returns<sup>2</sup>, we believe that the New Temporary Regulations will have many unanticipated and negative consequences, as described more fully below, which may adversely affect the already strained tax-reporting process for partnerships, especially alternative investment partnerships. MFA is nevertheless sympathetic to the concerns of taxpayers who must receive one or more Schedule K-1s in order to complete their returns and would be prepared to support an initiative that would extend the due date for individuals by 30 calendar days. Such an approach, which presumably would require legislation, would balance the concerns that apparently prompted Treasury and the Service to act with considerations outlined in this letter with respect to the Schedule K-1 preparation process.<sup>3</sup>

### **Reasons for MFA's Request**

As mentioned above, there may be several adverse effects of accelerating the issuance date of Schedule K-1s and filing deadline for Form 1065 as is required under the New Temporary Regulations, all of which may be increasingly burdensome for all partnerships. MFA believes that the due date for federal partnership tax returns should revert to October 15th for the following seven reasons.

(1) Alternative Investment Partnerships Already Experience Difficulty in Complying with the Former October 15th Deadline and May Be Further Burdened under the New Temporary Regulations. Investment partnerships already face significant difficulty in complying with filing deadlines required by the Internal Revenue Code of 1986, as amended (“Code”). The compressed time frame now required under the New Temporary Regulations may further burden the tax reporting process for all partnerships, but especially for alternative investment partnerships. The partnership tax return compliance process is generally a five-step process consisting of: (1) planning; (2) information gathering; (3) preparation of tax analysis and tax allocations; (4) preparation and issuance of Schedule K-1s; and (5) preparation and filing of Form 1065 and supporting schedules and forms. Significant time goes into each step of the tax return process by the taxpayer, paid tax preparer and other outside parties, such as tax counsel and tax administrators.

For domestic alternative investment funds—which are generally limited partnerships—this process generally starts in the prior year with year-end and on-going planning and ends very close to October 15th of the current year with the issuance of Schedule K-1s and the filing of the Form

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<sup>2</sup> The American Institute of Certified Public Accountants (the “AICPA”) sent a letter to the Service dated January 24, 2008 (the “AICPA’s Proposal”), requesting that the Service change the due date for the filing of federal partnership tax returns to September 15th. In the AICPA’s Proposal, the AICPA asserted that the October 15th Form 1065/Schedule K-1 due date created a dilemma for “a significant percentage [of taxpayers who are] presently burdened by the late receipt of Schedules(sic) K-1.” While MFA recognizes this concern, we believe that the New Temporary Regulations will not alleviate the concerns raised by the AICPA, but instead will create a strain on the tax-reporting process for all taxpayers, especially alternative investment partnerships. The strain on the tax-reporting process may result from increased filing activity. Under the New Temporary Regulations, individual partners will receive their Schedule K-1s by September 15th, but these schedules may not be as precise at the time they are delivered to partners. As a result, individual partners may have to file amended returns once more precise information becomes available. This point is discussed more fully below in sections 2 and 3 of this letter.

<sup>3</sup> While MFA and its members have given consideration as to whether legislative relief would provide the most ultimate resolution to our request, we have concluded that a regulatory change would quickly address the concerns that are posed by the New Temporary Regulations.

1065. This process is further affected by the following other factors, which create additional difficulties for alternative investment partnerships in complying with the former October 15th deadline: (1) the number of partnership tax filings have considerably increased over the years as investments in alternative investment funds are increasingly made in partnership form; (2) investment diversity/complexity; (3) globalization/international expansion; (4) increasing tax reporting obligations at state and local levels; (5) resource constraints; and (6) technology constraints. Thus, these additional considerations and the unique nature of the alternative investment partnership tax reporting process make it extremely difficult to file accurate and timely tax returns.

A typical component of the tax analysis and allocations step for alternative investment funds is to undergo a formal audit of their financial statements. Such an audit is often required pursuant to a fund's partnership agreement. The timing of a fund's audit completion, which takes place generally in April and May, adds an additional layer of reporting difficulty for all parties. In order to finalize taxable income, and all corresponding analysis, it is preferred that the audit be complete before Schedule K-1s are issued. These audits take significant time and resources. Many alternative investment fund partnerships have special allocations for which a considerable time must be spent during the audit to ensure that the partners of these entities are properly allocated their correct shares of both book and taxable income. Underlying these special allocations are significant levels of tax analysis.

The significant portfolio trading activity of many alternative investment funds adds another layer of complexity to the tax return process. For example, the typical alternative investment fund often performs the following tax analysis and calculations: unrelated business income tax; original issue discount, market discount; Code section 754 basis calculations and adjustments; Code section 1256 contracts; notional principal contracts; wash sales; straddles; interest and carrying costs associated with straddles; payments in lieu of dividends; qualified dividend income calculations; constructive sales; and several other tax items.

Moreover, a number of alternative investment funds are dependent on receiving information from other entities before they can issue their own Schedule K-1s and prepare Form 1065s. Some alternative investment funds, such as those funds that engage in private equity activities and special opportunity funds, must wait for corporate earnings and profits to be computed before they can finalize dividend distributions and include Subpart F income. Other alternative investment funds must wait for their ratable share of passive foreign investment company earnings, while many others must wait for information from underlying partnerships, as discussed below.

Once these calculations have been completed, information necessary for the completion of tax returns has been compiled and adequate attention is given to the relevant complex tax issues, the tax item calculations must be specifically allocated in accordance with the partnership agreement and the tax rules and regulations. The final step in the process comes when paid tax preparers complete Form 1065.

The alternative investment fund tax return preparation process becomes exponentially more difficult when the alternative investment partnership is a partner to other partnerships, i.e., a "fund of hedge funds" or other investment partnership. Funds of hedge funds and other investment partnerships must compile all Schedule K-1s coming from their hedge fund investments, aggregate them and perform separate and distinct tax analyses and allocations to their respective partners

further extending the Schedule K-1 release date. In light of all of the complexities of the alternative investment fund tax return preparation process, it is apparent that a change to the due date for Form 1065 and Schedule K-1s in accordance with the New Temporary Regulations will cause additional significant burdens because of the condensed time frame in which alternative investment funds must complete the process.

(2) The Quality, Integrity and Precision of Tax Analysis in Preparation of Form 1065 and Schedule K-1s May Unintentionally Be Compromised. It is noteworthy that the former filing deadline of October 15th imposed a significant burden on the operations groups that support alternative investment funds. The condensed time frame in which all tax reporting must be completed under the New Temporary Regulations may unduly burden alternative investment funds, and may potentially jeopardize the quality, integrity and precision of the tax analysis that alternative investment funds engage in during their preparation of Schedule K-1s and Form 1065.

In general, additional administrative burdens to the tax reporting process can significantly and adversely affect both partnership and investor reporting for alternative investment funds. An example of the effect of additional administrative burdens was seen most recently after the enactment of Code section 6694, which dramatically slowed down the process of filing tax returns as many paid tax preparers found themselves spending considerable amounts of time determining tax positions at the expense of completing more precise returns.<sup>4</sup> As a result, many paid tax preparers were not equipped to release more precise Schedule K-1s on behalf of their clients during peak times because of a shortage of resources, including manpower.

(3) “Less Polished” Inputs May Be Used to Avoid Penalties. In addition to potentially compromising in the quality of tax analysis, accelerating the partnership filing deadline may have the effect of causing unintentional inaccuracies in reporting to avoid penalties. This is because the New Temporary Regulations may require the use of less polished information in order to avoid penalties for late filing. Most taxpayers file tax returns on a "best efforts" basis in order to minimize penalties. Under this approach, the environment may become one where amended Schedule K-1s may need to be issued and amended Form 1065s may need to be filed. An increase in the number of amended tax returns may not only be costly and inefficient for taxpayers, but will go against the purpose of the New Temporary Regulations, which is to facilitate the timely and accurate reporting for individual taxpayers. Amended Schedule K-1s may lead to amended Form 1040s, leading to further costs and inefficiencies for individual taxpayers. In some cases, taxpayers may be unable to file timely due to the earlier deadline, thereby subjecting them to penalties.

Moreover, the increase in filing activity may not only affect partnership and individual taxpayers. Indeed, the increased filing of amended Form 1065s by partnerships and Form 1040s by individual partners may create a significant administrative burden on the resources of the Service to process additional tax returns.

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<sup>4</sup> MFA is referring to the amendment to Code section 6694, which changed the tax return reporting standard applicable to preparers for undisclosed positions was raised from the “realistic possibility” standard to a “reasonable belief that the position would more likely than not be sustained on its merits” standard. The amendment also changed the preparer standard for disclosed positions were raised from "not frivolous" to "reasonable basis." Further, Code section 6694 was amended to (1) apply the preparer penalty and related standards to all tax returns, not just income tax returns; and (2) increase the amount of the penalties.

(4) Foreign Reporting May Be Adversely Affected. The New Temporary Regulations will also require that foreign tax professionals hasten their reporting. Foreign information such as foreign financial statements, trial balances, additional supporting documentation and details underlying foreign informational filings (such as Forms 8621, 8858, 8865, 5471, 5472) may not arrive in time for the new September 15th deadline. Assuming alternative investment funds receive this financial information before September 15th, alternative investment funds may face significant difficulties in producing Form 1065s by the accelerated deadline. Without adequate time to compile and analyze the additional information required, partnerships and investors of alternative investment funds may unfairly face considerable penalties for inaccuracies or incompleteness.

(5) State and Local Level Filings May Be Adversely Affected. Beyond the adverse effect on foreign reporting requirements, significant inefficiencies and costs may arise at the state and local level, as well. Numerous states require that partnerships issue their partners state-equivalent Schedule K-1s. For example, for the 2007 tax year, New York State created state Schedule K-1 forms (one for corporate partners and another for individual, fiduciary and flow-through partners) that not only incorporate all of the information contained in the federal Schedule K-1 form, but also required substantial detail and analysis related to the partnership's New York State business and investment activities.

State filing obligations require additional time to prepare, review and distribute state-equivalent Schedule K-1s. The time demand to prepare, review and distribute state Schedule K-1s may be even more consuming than that required for federal Schedule K-1s given the number of states and the fact that each state has different rules and forms. For the reasons discussed below, in order to meet the filing obligations at the state level, it may be necessary to have the federal tax return completed several weeks or months in advance of the September 15th due date under the New Temporary Regulations.

Moreover, it is extremely common for state and local filing deadlines to mirror federal filing deadlines. Therefore, it is quite possible that as a result of the change to the federal due date, there may be a corresponding change to many state and local due dates. In that event, not only will taxpayers and their paid tax preparers struggle to file complete and accurate federal returns by a revised due date, but the filing obligations at the state and local level will be extremely difficult to meet under the accelerated deadline. The demand to complete federal and state filings in a shorter time period may unintentionally affect the quality of the information reported to federal and state authorities.

(6) Despite What Others May Suggest, the New Temporary Regulations Should Not Affect Corporate Filings. While the AICPA and others have suggested that the change in due date caused by the New Temporary Regulations will benefit both individual and corporate partners, MFA believes that, in practice, the New Temporary Regulations are not likely to facilitate more timely or accurate filings of corporate tax returns on a broad-scale basis. Items of taxable income specifically allocated to C-corporations must be finalized by mid-August so that entities can consolidate their electronic filings and state tax returns in advance of the September 15th deadline. For many large corporate taxpayers, the percentage of taxable income coming from flow-through investments is relatively immaterial when compared with the total activity of these corporations. In order to provide for the most accurate income reporting, corporate partners typically use Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request*, along with best estimates of flow-through

activity for return reporting purposes. This process can take place before the delivery of Schedule K-1s. Instead of "truing-up" inaccuracies between the actual and estimated Schedule K-1 in the following year, large corporate taxpayers commonly incorporate any difference into audit adjustments. These adjustments accumulate over an audit period and the total adjustment is reflected on a Schedule M-1 that is amortized for tax purposes.

(7) Paid Tax Preparers May Be Adversely Affected. Paid tax preparers could also be adversely affected by the New Temporary Regulations. Previously, paid tax preparers would stagger corporate and partnership tax preparation, with corporate work getting first priority given the earlier deadline. Under these established deadlines, paid tax preparers generally spread out work evenly throughout the year, so that they have the ability to complete all filings with proper review. Under the New Temporary Regulations, these deadlines will be simultaneous, and as a result, will further strain resources, making it necessary for tax preparers to expend significant costs in order to meet filing obligations for both corporate and partnership work at the same time, and may have the net effect of reducing the quality, as well as increasing the cost of, tax return preparation.

#### **MFA's Recommendation**

MFA respectfully requests that Treasury and the Service revert to the October 15th filing deadline for Form 1065s and Schedule K-1s. As we have outlined above, the New Temporary Regulations will create significant additional burdens for alternative investment partnerships, which will far outweigh the perceived benefits cited by others who have provided comments as cited in the New Temporary Regulations. Substantial time and resources are needed to analyze and report accurate information for federal, state, local and international purposes. The New Temporary Regulations will make accurate reporting exceedingly difficult for alternative investment partnerships because of the shortened timeframe in which the tax reporting process must be completed.

As noted at the outset of this letter, MFA is not unsympathetic to the considerations that prompted the Treasury and the Service to issue the New Temporary Regulations and would support an alternative approach that would balance both those considerations and those outlined in this letter.

MFA appreciates your consideration of our request. In addition, we welcome the opportunity to meet with you and your colleagues to discuss this issue in greater detail. If you have any questions, please feel free to contact my colleague, Carl Kennedy, Legal Counsel, at 202.367.1140 or at [carl@managedfunds.org](mailto:carl@managedfunds.org).

Respectfully submitted,



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