



**MANAGED FUNDS ASSOCIATION**

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**WRITTEN STATEMENT  
OF**

**RICHARD H. BAKER  
PRESIDENT AND CHIEF EXECUTIVE OFFICER**

**MANAGED FUNDS ASSOCIATION**

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**For the Hearing on**

**Foreign Bank Account Reporting and Tax Compliance**

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**BEFORE THE**

**SUBCOMMITTEE ON SELECT REVENUE MEASURES  
COMMITTEE ON WAYS & MEANS  
U.S. HOUSE OF REPRESENTATIVES**

*NOVEMBER 5, 2009*

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## **WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION**

### **Foreign Bank Account Reporting and Tax Compliance**

**November 5, 2009**

Managed Funds Association (“MFA”) is pleased to submit this written statement in connection with the House Ways & Means Subcommittee on Select Revenue Measures’ hearing, “Foreign Bank Account Reporting and Tax Compliance” held on November 5, 2009. 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 \$1.5 trillion invested in absolute return strategies.

MFA appreciates the opportunity to express its views on U.S. tax policy and specifically on foreign bank account reporting and related tax compliance issues. MFA strongly supports the efforts in Congress and the Obama administration to provide regulators with the authority needed to detect and prevent tax evasion and non-compliance with U.S. tax laws by U.S. persons holding investment assets in offshore accounts. We note that there are several legislative proposals that seek to address the issue of tax compliance, including the Obama administration’s fiscal year 2010 budget proposal, the *Stop Tax Haven Abuse Act* (H.R. 1265) and more recently the *Foreign Account Tax Compliance Act of 2009* (H.R. 3933), which is the focus of today’s hearing.

MFA believes that any legislative proposal that seeks to expand regulatory authority in this area and to establish a new tax compliance framework should be designed to uncover and stamp-out those activities that are intended to evade taxes. We strongly support regulators having the tools necessary to combat tax evasion. It is equally important, however, for U.S. businesses that manage offshore investment funds or otherwise engage in legitimate overseas investment activities to be able to continue to do so without excessive administrative burdens or adverse tax treatment that threatens the global competitiveness of U.S. businesses and markets. Legislation that does not carefully consider such activities may unduly impair investment in funds managed by U.S. advisers and place U.S. advisers at a competitive disadvantage to their foreign counterparts, particularly during this critical period in our nation’s economic recovery.

#### **LEGITIMATE OFFSHORE ACTIVITIES**

Hedge funds are among the most sophisticated institutional investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or improve their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. The growth and

diversification of hedge funds have strengthened U.S. capital markets and provided their investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. Hedge funds engage in a variety of investment strategies across many different asset classes. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

U.S. hedge fund managers engage in offshore investment activities for a number of business reasons, including to broaden their investor base internationally and to be able to raise capital from U.S. tax exempt investors. Current U.S. tax law deters pension funds and other U.S. tax exempt investors as well as non-U.S. investors from investing in domestic funds.<sup>1</sup> U.S. based managers need to manage offshore funds to meet the demands of these investors and to remain competitive with non-U.S. advisers. Thus, these transactions are quite legitimately conducted offshore and generally are not motivated by a desire to avoid disclosure or evade U.S. federal income tax.

### **MFA'S PERSPECTIVE ON THE LEGISLATIVE PROPOSALS**

MFA generally supports the objectives of those measures in the legislative proposals that seek to improve the quality of foreign information reporting. MFA believes that a more efficient reporting regime—which supplants the existing rules for Reports of Foreign Banks and Financial Accounts (TD F 90-22.1, commonly referred to as “FBAR”)—would assist hedge funds and other private investment funds in complying with regulators’ requests for information regarding offshore accounts, while reducing duplication and the costs associated with compliance.

In contrast, MFA believes that Congress should further examine and amend certain measures in the legislative proposals in order to avoid unintended and detrimental consequences for U.S. hedge fund and other private investment fund managers. For example, we believe that any measure that would treat substantially all offshore funds managed and controlled primarily in the United States as domestic corporations would impair the ability of U.S. investment managers to successfully compete with their non-

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<sup>1</sup> Section 501(a) of the Internal Revenue Code of 1986, as amended (the “Code”) provides that U.S. tax-exempt entities generally are not subject to U.S. income tax. Nonetheless, section 511 of the Code requires that these entities declare and pay taxes on “Unrelated Business Taxable Income” or “UBTI”. This section defines UBTI as any money earned from conduct unrelated to the entity’s tax-exempt purpose. This section, however, also excludes from the definition of UBTI investment income (*i.e.*, dividends, royalties, rents, capital gains and interest income) unless such income is derived from debt-financed property. Many hedge funds use some amount of debt (leverage) in connection with their trading strategies. As a result, a U.S. tax-exempt investor that invests in a domestic hedge fund would be required to treat the debt-financed income flowing through the hedge fund partnership as UBTI.

Section 864 of the Code does not subject non-U.S. investors to U.S. income tax unless such investor conducts a trade or business within the United States. In that case, section 864 of the Code requires that non-U.S. investors file a U.S. tax return and pay taxes on the same terms as a U.S. individual or corporation. If a foreign investor invests in a domestic hedge fund, he or she is typically treated as engaged in a U.S. trade or business.

U.S. counterparts in attracting investments from U.S. tax exempt investors and non-U.S. investors. By treating offshore funds as domestic corporations, these funds would be subject to U.S. corporate tax at rates up to 35 percent (39.6 percent in 2010), regardless of the source, character (*i.e.*, ordinary or capital gain) or nature (*i.e.*, related to a business or mere investment) of the income they generate. These taxes would significantly reduce the return on investment for pension funds and other fund investors. The lower return on investment ultimately would drive pension funds (which have a fiduciary duty to their pensioners) and non-U.S. investors (who generally are not currently subject to U.S. federal income taxes to the extent they invest in a non-U.S. fund, even when that fund invests in U.S. securities) to invest in funds managed by non-U.S. investment managers (*e.g.*, Canadian, European and Asian fund managers). In effect, this type of measure would only penalize U.S. private investment fund managers who lawfully manage funds for U.S. tax exempt investors and non-U.S. investors. It is questionable whether such a provision would even raise revenue, as most affected investors would likely invest in funds managed by non-U.S. advisers.

It is noteworthy that, if such measures were to be enacted into law, U.S. investment managers might relocate their management companies outside of the United States in order to successfully compete with their non-U.S. counterparts. Additionally, the relocation of an entire industry could cause many more U.S. jobs to be lost. At a time when the U.S. economy and job market are struggling, tax measures that seek to domesticate offshore funds for U.S. federal income tax purposes appear to establish an unnecessary impediment to investment activities and job creation in the United States. Given these harmful and unintended consequences, we commend House Ways & Means Committee Chairman Charles Rangel for introducing a legislative proposal that addresses the concerns of tax evasion by U.S. persons without including such a measure. Indeed, such a provision could result in U.S. job losses as a consequence of investors migrating to non-U.S. advisers.

Other measures in the legislative proposals appear overly broad and, in attempting to halt the use of a specific financial product, would inadvertently constrain the use of a much broader range of financial products. In particular, some of the legislative proposals seek to expand the definition of the term “dividend” for U.S. withholding and sourcing purposes to include dividend equivalents (*i.e.*, payments pursuant to notional principal contracts contingent upon or reference to the payment of a dividend) and other similar payments. It is our understanding that these measures are intended to target investors who enter into certain equity derivative products solely to avoid U.S. withholding tax. While we agree that such equity derivatives entered solely for tax avoidance purposes should be the subject of withholding, it is our view that the language in the legislative proposals is written too broadly and would also cover equity derivatives that are entered into for legitimate business reasons. As a consequence, we believe these proposals would unnecessarily require an intermediary to withhold funds in connection with all equity derivative transactions. One significant business reason why market participants enter into equity derivatives is for hedging purposes, including hedging positions taken in U.S. equity markets. In effect, these legislative proposals could reduce the cost benefit of equity derivatives and ultimately the liquidity in U.S. and non-U.S. equity markets as a

result of investors not having access to financial products that allow them to hedge their risks. We look forward to working with Chairman Rangel, the Subcommittee and other policy makers to target abusive equity swaps while permitting market participants to continue trading legitimate equity swaps. MFA plans to submit substantive comments to this measure and other aspects of the Chairman's proposal that are consistent with the purposes of the legislation.

### **CONCLUSION**

MFA strongly supports legislation that seeks to provide regulators with the necessary tools to detect and prevent tax evasion by U.S. persons engaged in offshore activities. MFA members are willing to comply with any new compliance framework that provides regulators with the appropriate amount of information to enforce U.S. federal tax law. However, it is important that such framework does not impose excessive or duplicative administrative burdens on hedge funds and other private investment funds. As stated above, MFA looks forward to being a constructive participant in working with the Subcommittee and other policy makers to achieve the intended objectives of the legislation.

MFA appreciates the opportunity to submit this statement to the Subcommittee. We would welcome the opportunity to elaborate on these points, or answer any questions that Subcommittee members or staff may have regarding our views.