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

July 20, 2011

Via Electronic Mail:

Mr. Kevin W. Brown
General Counsel
Massachusetts Department of Revenue
100 Cambridge Street
Boston, Massachusetts 02114

Re: Draft Directive on Professionally Managed Funds

Dear Mr. Brown:

Managed Funds Association ("MFA")[1] welcomes the opportunity to comment on Working Draft Directive 11-XX: Professionally Managed Funds; Trader Versus Investor Determination (the "Directive") that was published by the Department of Revenue (the "Department") on May 23, 2011. As we discussed on our telephone call with Department staff on June 28, 2011, we respectfully request that the draft Directive be revised to more clearly distinguish professionally managed funds from passive investors for purposes of determining when funds are engaged in the trade or business of trading securities.

As you know, about a year ago MFA and its members first asked the Department to develop guidance to distinguish professionally managed securities trading funds from passive investors. The U.S. Supreme Court has articulated the key principles in this area, and the lower courts have applied these principles by focusing on a variety of facts and circumstances. We observed that because lower courts have predominantly applied the principles to individual investors, they have tended to highlight the number of trades and the holding period of positions because, for individual investors, these factors often are the most useful benchmark (and reinforce the lack of other indicia of a trade or business). We also explained why, given the unique features of professionally managed funds, a

[1] 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 $2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

focus on the number of trades and the holding period of positions misdirects the analysis away from better indicia of trading activity.

We appreciate the Department's willingness to publish a draft Directive to help determine whether a trade or business exists for professionally managed funds. And, while we recognize and support the Department's goal of developing administrable standards, we are concerned that the Directive as drafted (which unduly emphasizes the number of trades and the holding period of positions) will not help either professionally managed funds or the Department's auditors fairly apply the tax rules. We are further concerned that under the Directive as drafted, Massachusetts-based managers and funds will be at a competitive disadvantage compared to industry participants in other states.

We believe the changes that we suggest below would better align the Directive with the principles of existing case law (which have yet to be extended to professionally managed funds) and provide meaningful, adequate guidance to both the industry and the Department's audit staff.

In general, we believe the Directive should develop a non-exclusive list of factors that the Department can use to determine whether a professionally managed fund's trading activity is conducted with the requisite continuity and regularity to constitute a trade or business.[2] We note that the Department followed this approach in Directive 03-3: Factors For Determining When Gambling is a Trade or Business (the "Gambling Directive"), which established a list of non-exclusive factors for the Department to consider when determining whether someone is engaged in the business of gambling.

In our view, the Directive's safe harbor based on the holding period of securities not only could be interpreted as establishing a de facto "bright line" test that is based on a single factor, contrary to the legal authority, but relies on a factor that is a weak indicator of a professionally managed fund's securities-trading activities. For these reasons, we urge the Department to delete the proposed safe harbor. We also urge the Department to delete the apportionment test set out in the third part of the Directive because it wrongly looks to the holding period of assets rather than to whether particular holdings or activities are integrally connected with the taxpayer's trade or business.

We agree that the Department's fourth directive accurately reflects the IRS's recent conclusions in Revenue Ruling 2008-39. Accordingly, we encourage the Department to adopt directive 4 as proposed.

[2] As noted in the Directive, in *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the U.S. Supreme Court articulated the standard that to be engaged in a trade or business, a taxpayer must be involved in an activity with continuity and regularity for the primary purpose of income or profit.

Directive 1

We agree that the Department should publish a list of non-exclusive factors to use to determine whether a professionally managed fund is engaged in the business of trading securities. To clarify the appropriate application of directive 1, we urge the Department to amend the Directive in the following ways.

1. The Directive should Include a Statement of Relevant Legal Principles.

First, we urge the Department to preface any list of factors with a summary of the legal principles that apply to professionally managed funds engaged in the trade or business of trading securities. We are concerned that the draft Directive focuses on cases in which the lower courts have applied numerical short-cuts to the particular circumstances of individual investors. To clarify the appropriate application of directive 1, we urge the Department to state explicitly in the Directive that whether a fund is engaged in the trade or business of being a trader in securities must be determined based on all relevant facts and circumstances, some of which will be listed in the Directive. In addition, we believe the Department should explicitly state that a professionally managed fund need not satisfy all factors. Accordingly, we urge the Department to insert a statement similar to the following:

> "Whether a taxpayer is engaged in a trade or business of trading in securities is determined by federal income tax principles. Under Section 702(b) of the Internal Revenue Code, the character of any investment-related income or deductions of a partner in a partnership is determined at the partnership level. Consequently, a Massachusetts taxpayer that is a partner in a partnership may deduct the expenses arising from the trade or business of that partnership."
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> "The U.S. Supreme Court has recognized that determining whether a taxpayer's trading activities rise to the level of carrying on a trade or business turns on a facts and circumstances inquiry and that the question whether a taxpayer is engaged in a trade or business is to be determined on a case-by-case basis. *Higgins v. United States*, 312 U.S. 212, 217 (1941)."
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> "To be in a trade or business, a taxpayer must be involved in activities with continuity and regularity, and the primary purpose for engaging in the activities must be for income and profit. *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987). Factors to be considered in determining whether a taxpayer is a trader or an investor include the taxpayer's intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions. *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). The frequency of transactions, volume of trades, the use of leverage, swaps and other derivatives, and other objectively demonstrable factors may, individually or collectively, indicate the continuity and regularity of effort required of a trader in securities as distinct from a passive investor. The relative

importance of particular facts in determining trader status will vary depending on the nature and circumstances of the taxpayer claiming trader status. For individual taxpayers, who lack other indicia of business operations possessed by professionally managed funds, the lower courts have often focused on the number of trades or other numerical measures as a short-hand way to determine whether a person was engaged in a trade or business or, instead, was passively accumulating earnings.[3] For a professionally managed fund, other factors will often predominate. No one factor is necessarily dispositive."

2. The Directive should Include a List of Non-Exclusive Factors that Recognizes the Unique Nature of Professionally Managed Funds.

In addition to identifying the basic legal principles relevant to trade or business determinations (*e.g.*, those set forth in *Higgins* and *Groetzinger*), we also urge the Department to amend the list of factors in directive 1. We believe the revised list of factors discussed below better distinguish professionally managed funds that are engaged in the business of trading securities from other types of managed funds that are not engaged in the business of trading securities, such as private equity or venture capital funds.[4] We suggest that the final Directive contain the following factors, each of which bears relevantly on whether a professionally managed fund is a trader:

- **The fund is an entity organized to buy and sell investments opportunistically.** A trader in securities will often be subject to market forces and other factors that dictate the actual timing of a transaction, but it stands ready to act as the opportunity arises. We believe that opportunistic reaction to market forces reflects, in the context of a professionally managed fund, the case law dealing with individual traders who looked to exploit swings in daily market movements.[5] Likewise, professionally managed funds with trading desks and operations that opportunistically monitor and react to markets on a real time basis display the requisite continuity and regularity.
- **The fund is an entity organized and operated to engage in securities trading and related activities and is engaged in such activities with continuity and**

[3] *See, e.g.*, *Fuld v. Commissioner*, 139 F.2d 465, 468 (2d Cir. 1943) (observing that the taxpayer "had no other business and her speculative activities were very substantial both in time consumed and the amount and number of securities traded in"); *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979) (taxpayer who conducted 332 transactions during the year and "devoted virtually his whole working day to his stock transactions" was engaged in the trade or business of trading).

[4] We are not commenting on whether such other funds may be determined to be in other types of trades or businesses.

[5] In *Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955), the court observed that, "[i]n a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis."

regularity. We agree with the Department that "continuity and regularity" are requirements to be engaged in a trade or business.[6] As discussed further below, because a sophisticated trader fund may employ many hedging and other strategies to achieve its goals, the proper focus for determining the continuity and regularity of its trading activities is the totality of those activities, not merely the frequency of trades.

- **The fund does not pursue, as a primary strategy, a long-term buy-and-hold investment strategy for capital appreciation and income without regard to short-term developments that would influence the price of the securities on the daily market.** We believe that the inclusion of "as a primary strategy" is necessary to avoid the implication that a trader fund could not have any long-term investments in its portfolio. While we agree that a trader fund should not primarily engage in a long-term buy-and-hold strategy, we believe that the language in the draft Directive is overly broad and would unduly restrict the activities of a trader fund.
- **The fund relies on a trading function that is staffed while the markets are open. The fund's trading functions are supported by several substantial operations, which may include research, valuation, accounting, reporting, cash management, compliance and risk management systems.** Auditors should understand that a trader fund is engaged in analyzing and exploiting the securities market. Its professionally managed energies are directed toward that end, not (as in a private equity fund, for example) at analysis and management of the businesses underlying its investments.
- **In connection with its activities described above, the fund establishes prime brokerage and custodian accounts, credit facilities, or other financial arrangements commonly associated with professionally managed funds.** Because trader funds are not buy-and-hold investors, but strive on a continuous basis to manipulate portfolio holdings in order to maximize yield,[7] they require prime brokerage and other specialized financial services, including securities lending, financing, clearance and settlement, and cash management services.
- **The fund has unrelated third party investors.** While a trader fund need not necessarily have third party investors, the existence of third party investors is so common a feature of trader funds that it should be listed as one of several relevant indicia of trader status.
- **The fund takes federal income tax return positions that are consistent with the status of a securities trader.** We believe this factor should replace the last factor in the draft Directive, that a fund "has not indicated (in investor documents,

[6] *See Groetzinger*, 480 U.S. at 35.

[7] *Cf. Mayer v. United States*, 32 Fed. Cl. 149, 156 (1994) ("a trader is an 'active investor' who does not 'passively accumulate earnings, nor merely oversee his accounts,' but who 'manipulates his holdings in an attempt to produce the best possible yield.'") (quoting *Levin*, 597 F.2d at 765).

> federal tax documents, or otherwise) an intent or expectation of treatment other than as a trader in securities for federal income tax or other purposes." As modified, we believe this factor places the proper emphasis on actual fund operations, instead of expected operations, and remains a useful factor for funds and audit staff to consider.

We believe the Department should delete the third proposed factor, that a fund "has demonstrated that its primary object is the achievement of short-term income or profit." As discussed above, in the case law concerning individual taxpayers, the number of trades and holding period of positions have been used in part to determine whether profit was achieved through active and strategic response to market changes rather than through passive oversight of the portfolio. For a typical individual investor, the number of trades and holding period of positions are more relevant than for a professionally managed fund.

For example, a professionally managed fund might acquire a large equity position in a company within a particular market sector and seek to limit its sector-specific risk by acquiring long equity positions in one or more companies from sectors viewed as having an inverse correlation to the original sector (or to the particular company). In addition, the fund might also acquire short positions, via swaps, options or other derivatives, in sector-related positions, currencies and/or commodities. As the markets change, the fund will adjust each of its positions to reduce risk and maximize the profit for its investors. The net exposure may even change from "net long" to "net short." Components of the net position may be continuously adjusted; however, particular securities within the position may be held for longer periods of time.

There are a number of reasons for this. Rather than selling the security outright (perhaps to reduce trading costs or to avoid tipping its hand to the market), the fund may use an offsetting derivative position to reduce its exposure without an actual sale. The security also may become a component of a new trading position. In addition, especially if the fund is large, the fund might take a period of time to build a particular position, and similarly to undo that position, as it waits for interim price movements on the way up and on the way down, all in a manner designed to ensure that the fund does not also move the market itself through its own purchases and sales.

Thus, a fund with significant, regular and continuous trading activity that would not view itself as holding any one component primarily for long-term investment purposes – and may not even view itself as "invested" at all in a particular component due to the offsetting positions – is likely to have a portfolio that produces a range of holding periods and income types.

We also believe that the Department should delete the fifth factor in the draft Directive, that a fund "does not impose a redemption restriction on its investors of longer than one year." Professionally managed funds impose restrictions on redemptions for a

variety of reasons. As such, the redemption provisions of a fund are not relevant to the determination of the trading activities of that fund.

Directive 2

We understand the Department's desire to create administrable standards for its audit staff. In our view, the factors discussed above provided the necessary audit guidance to distinguish professionally managed funds from passive investors. In any case, however, a safe harbor that focuses on a single possible indicia of trader activity is not appropriate. Moreover, the proposed safe harbor focuses on a measure of trading activity far more relevant to individuals (where asset holding periods may be one of only a few clear bases for distinguishing between trading and investing) than to professionally managed funds, and it fails to account for other integral trading activities at professionally managed funds such as the use of leverage, hedging activities and cash and cash equivalents. For these reasons, we urge the Department to remove directive 2 from any final Directive.

Directive 3

We are also concerned with the approach taken in directive 3 with respect to the apportionment of expenses associated with business activities. We believe an apportionment of expenses based on the holding period of assets is inconsistent with and unsupported by relevant case law. Relevant case law[8] provides that expenses associated with activities that are integrally related to the taxpayer's trade or business may be deducted by a taxpayer as trade or business expenses. The approach taken in directive 3 would fundamentally alter this approach and disallow deductions for expenses associated with longer term holdings, even if those holdings are integrally related to a fund's trading activities. Because this result is inconsistent with the relevant standard established by case law, we urge the Department to delete directive 3 in its entirety.

Directive 4

We believe that directive 4 accurately reflects the IRS's recent conclusions in Revenue Ruling 2008-39. Accordingly, we encourage the Department to adopt directive 4 as proposed.

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[8] *See, e.g.*, *King v. Commissioner*, 89 T.C. 445, 464 (1987) ("This case is not factually similar to *Higgins* in that the transaction here in issue was integrally related to transactions which were indisputably part of petitioner's trade or business . . . .").

Conclusion

We appreciate the opportunity to continue working with the Department to develop standards to distinguish professionally managed funds from passive investors. We believe the amendments to the Directive suggested above would provide meaningful guidance to industry participants and to the Department's audit staff. We remain eager to work with the Department to develop additional details to be included in a revised Directive. In that regard, we request an opportunity to meet with the Department at your convenience.

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 Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

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