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

March 5, 2013

Via Electronic Filing:

Internal Revenue Service
CC:PA:LPD:PR (REG–130507–11),
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington D.C. 20044

Re: MFA Comments on IRS REG-130507-11, Net Investment Income Tax

Dear Sir or Madam:

Managed Funds Association ("MFA")[1] appreciates the opportunity to respond to the Internal Revenue Service's ("IRS") proposed regulation 130507-11, Net Investment Income Tax (the "Proposed Regulation"). MFA and its members believe that the final regulations to implement the net investment income ("NII") tax provisions of section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (which added section 1411 to the Internal Revenue Code) must be done in a manner that avoids unintended consequences, such as limiting the ability of taxpayers to net against relevant income applicable expenses, losses, and deductions. Limiting the ability of taxpayers to include these appropriate items when they calculate their NII will lead to taxpayers incurring tax liability on investment income beyond the taxpayer's real net gains or losses on relevant categories of income.

As discussed in more detail below, we encourage the IRS to amend the Proposed Regulation to:

- Better ensure that gains and losses derived from the trade or business of trading in securities or commodities can be netted against each other;

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

- Permit net operating loss carryforwards with respect to eligible items, subject to appropriate tracking;
- Ensure that capital gains and losses can be fully netted against each other;
- Permit up to $3,000 in capital losses to be deducted from Category 1(as defined below) income;
- Permit the election with respect to the treatment of controlled foreign corporations ("CFCs") and passive foreign investment corporations that are qualified electing funds ("electing PFICs") to be made at the partnership level, or allow the election to be made on individual CFCs/PFICs; and
- Permit taxpayers to deduct foreign taxes in calculating their NII.

We believe each of these suggested amendments will better achieve the statutory objective of taxing ***net*** investment income by ensuring appropriate netting of expenses, losses and deductions against investment income subject to the NII tax.

Clarify that net gains and losses derived from the trade or business of trading are applicable in determining Category 2 income

Under §1.1411-4(a)(1) of the Proposed Regulations, NII is divided into three categories: (i) gross income from interest, dividends, annuities, royalties, and rents, (unless derived in a trade or business described to which the tax does not apply) ("Category 1 income"); (ii) other gross income from trades or businesses described in §1.1411-5 ("Category 2 income"); and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property (unless the property was held in a trade or business to the tax does not apply) minus certain allowable deductions ("Category 3 income"). Category 2 income includes income from passive activities and income from trading in securities or commodities ("§1.1411-5 activities"). The Proposed Regulations further provide that gains from the disposition of property used in §1.1411-5 activities are themselves treated as Category 2 income and will not benefit from the concept of "net gain" that applies to Category 3 income. Further, §1.1411-4(f)(4) provides that losses are deductible only in determining net gain, which appears to apply to Category 3 income, but not Category 2 income.

The approach of taxing all Category 2 income on a gross basis would effectively lead to taxpayers, including investors in investment funds engaged in the business of trading, paying NII tax on gross investment income earned in connection with the trade or business, rather than NII, as intended by the statute. This also results in a disparity in the treatment of investors in investor funds, which would be permitted to net gains and losses (because their gain and loss is Category 3 income), while investors in trader funds would not be permitted similar treatment (because their gain and loss is Category 2 income).

We understand that the limitation in §1.1411-4(f)(4) likely was not intended to create this result. We encourage the IRS to revise its final rules to make clear that gains and losses from trading in securities or commodities can be netted together for purposes of determining Category 2 income.

Permit net operating loss carry-forward to the extent comprised of deductible items

We are concerned with the determination made in the Proposed Regulations that NII does not take into account a taxpayer's net operating loss ("NOL"). Not allowing a taxpayer to adjust their NII to account for a properly allocable NOL will lead to overtaxation for many taxpayers, as they would be required to pay the NII tax on investment income beyond the net amount of such income actually earned. This result unfairly imposes a tax liability beyond that intended by the statute.

The Proposed Regulation notes that some of the deductions included in the computation of an NOL may be deductions described in §1.1411-4(f); however, the IRS nonetheless determined not to allow an NOL adjustment because the character of items comprising an NOL is generally not tracked once the item becomes part of an NOL. The IRS further states that rules allowing a deduction properly allocable to income or gain subject to Section 1411 would be unduly complex and not administrable.

Losses arising from items properly attributable to NII should be allowed to be carried forward. Disallowing these losses will lead to taxpayers being subject to additional tax beyond the scope of the legislation as they would not be permitted to net their relevant gains and losses. As a consequence, taxpayers would be subject to overtaxation of their investment income. To ensure appropriate tracking of items within an NOL that are appropriately deductible for NII purposes, the IRS could adopt a new schedule to Form 1040 that would allow taxpayers to identify the character of specific items comprising an NOL to provide a mechanism to track those items going forward. This approach would be analogous to current rules regarding tracking of passive activity losses.

Ensure appropriate netting of capital gains and losses

A further issue that arises with respect to the different categorization of NII is the potential for mismatched treatment of capital gains and losses. To the extent a taxpayer has capital gains and losses characterized as Category 3 income, those gains and losses will be netted against each other (though Category 3 income cannot be an amount less than zero). Assuming the IRS clarifies the issue discussed above with respect to gains and losses that are within Category 2, those capital gains and losses also will be netted against each other. A taxpayer that has Category 2 capital gains and Category 3 capital losses, however, does not appear to be able to net those capital gains and losses. The taxpayer in this situation would, however, net those capital gains and losses for regular tax purposes and, thus, would not have a loss carryforward for NII purposes.

To avoid this anomalous result, we encourage the IRS to amend the categories to permit taxpayers to include all capital gains and losses that would otherwise be included in Category 2 in Category 3. Alternatively, if the IRS does not change the categorization of capital gains and losses, we urge the IRS to make clear that a taxpayer will be permitted to net capital gains and losses across Categories 2 and 3.

Permit netting of Category 1 income with Category 3 losses

Under the Proposed Regulation, Category 3 income is comprised of net gain attributable to the disposition of property other than property held in a trade or business not described in §1.1411-

5. This is consistent with the statutory definition of NII and appears to preclude the possibility that Category 3 could be a net loss. While we understand that the IRS cannot change the statutory definition of NII, we encourage the IRS to amend the Proposed Regulations to permit taxpayers to treat capital losses that would be permitted to be netted against other Category 3 gain as an eligible deduction (up to the $3,000 limit applicable under regular tax rules) against any Category 1 income when calculating their NII. We believe this approach better reflects the extent to which a taxpayer has a real economic gain or loss on relevant income and does so in a manner consistent with regular tax principles.

Allow CFC/PFIC elections at the partnership level or allow elections on individual CFCs/PFICs on an entity-by-entity basis

Under the Proposed Regulations, income from investments in CFCs and electing PFICs generally is not treated as a dividend and, therefore, is not included as Category 1 income for purposes of the NII tax. Under regular tax rules, however, investors in investment funds generally are required to include as income profits from such CFCs and electing PFICs, even in the absence of a distribution. This creates a difference in treatment between income subject to income tax and income subject to the NII and will create administrative difficulties for taxpayers as they will have to maintain two sets of records accounting for the difference in tax treatment under regular tax rules and the NII tax rules.

To relieve the administrative burden on taxpayers, the Proposed Regulations permit taxpayers to make an election to treat earnings from CFCs and electing PFICs as current NII for purposes of the NII tax. The Proposed Regulations require that a taxpayer making such an election do so irrevocably and with respect to all CFCs and electing PFICs in which the taxpayer invests.

This requirement presents a significant problem for investment funds as the election would be made at the individual investor level. As such, an investment fund will have to maintain two sets of records with respect to all of its investments in CFCs and electing PFICs, unless the investment fund can confirm that all of its direct and indirect investors have made the necessary election. In order to make the election more feasible for investment funds and other partnerships, we encourage the IRS to modify the Proposed Regulations to allow the election regarding the NII tax treatment of CFCs and electing PFICs to be made at the partnership level on behalf of underlying investors. Alternatively, we encourage the IRS to permit taxpayers to make the election with respect to a CFC/PFIC on an entity-by-entity basis. This alternative approach would make it more likely that an investment fund or other partnership could require all of its investors to make the election as the election would only pertain to the investor's indirect investments in CFCs/PFICs through its investment in the fund.

Permit taxpayers to deduct foreign taxes against NII

The Proposed Regulations do not address the issue of whether taxpayers may use tax credits, including foreign tax credits, to pay any NII tax liability otherwise owed. We understand that IRS staff has indicated that they do not believe that foreign tax credits may be used to pay the NII tax. Since the foreign tax incurred is a legitimate expense incurred in generating the income subject to the NII tax, we believe that the rules should permit any excess foreign tax credits to be deemed an allocable expense under §1.1411-4(f) at the election of the taxpayer.

We would be very happy to discuss our comments or any of the issues raised in the Proposed Regulations with the IRS. If the IRS has any comments or questions, please do not hesitate to contact Benjamin Allensworth or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President & Managing Director, General Counsel