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

November 15, 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 provide additional comments on Working Draft Directive 11-XX: Professionally Managed Funds; Trader Versus Investor Determination (the "Directive"). As discussed at our September 27, 2011 meeting with staff of the Department of Revenue (the "Department"), this letter and the attached Appendix A provide proposed revisions to the Directive to address concerns expressed by MFA members at that meeting, which were also summarized in our June 30, 2011 comment letter on the Directive.[2] We appreciate the Department's willingness to consider these additional comments and look forward to continuing to work constructively with the Department as it finalizes the Directive.

Directives 1 and 2

Whether a taxpayer is an investor or a trader for U.S. federal income tax (and, thus, Massachusetts tax) purposes is a facts and circumstances determination, and rests on basic tax principles. We agree with the Department that it would promote good tax administration to have an objective, administrable safe harbor in the professionally

[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.

[2] MFA's June 30 comment letter is available at: http://www.managedfunds.org/wp-content/uploads/2011/09/MFA.Letter.on_.Mass_.DoR_.Directive.pdf.

managed fund context to help distinguish between "investor" funds on the one hand and "trader" funds, on the other.

Over the past six weeks, we have worked extensively with members and their professional advisers to craft a three-prong safe harbor that identifies funds whose activities in the financial markets are sufficiently continuous, regular and profit-motivated to qualify them, under applicable federal tax principles, as traders. This draft safe harbor is set out in Directive 2 of the revised draft Directive, attached as Appendix A to this letter. The factors comprising the safe harbor are derived in the first instance from principles articulated in the applicable case law. As we have discussed, the case law has developed almost entirely in the context of individuals trading stocks and bonds for their own accounts. The cases thus do not consider the range of financial instruments traded by professionally managed trader funds or the breadth of the activities of the full-time professional staffs working to monitor, execute and process active trading activity. Accordingly, in developing the safe harbor, we have tried to take into account and reflect the actual activities and operations of professionally managed trading funds and their administrators. We have endeavored, in particular, to create a safe harbor that would generally be met by typical trader funds but that would *not* be met by investment funds investing for the longer term.

Though we believe the proposed safe harbor would generally be met by typical trader funds, it is important to recognize that some funds that are properly viewed under federal tax principles as trader funds may not satisfy the three-prong safe harbor because of a reason specific to their portfolio or the markets in which they trade. As such, it is important for the Department to ensure that the final Directive provides that trader funds that do not meet the safe harbor requirements can still demonstrate their status on the basis of their particular facts and circumstances. To assist the Department and funds in any facts and circumstances analysis, we have set out a non-exclusive list of characteristics of professionally managed trader funds in Directive 1.

Directive 3

We remain concerned with the approach taken in the Department's draft Directive 3 regarding apportionment of trader and non-trader activities. Relevant case law[3] 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 by applying a mechanical test that would disallow deductions for expenses associated with holdings that are integrally related to a fund's trading activities. In addition, we believe questions of apportionment, if relevant to a particular fund, would be better addressed under the more comprehensive facts and circumstances analysis of Directive 1. For these reasons, we urge the Department to delete Directive 3 in its entirety.

[3] *See, e.g.*, *King v. Commissioner*, 89 T.C. 445, 464 (1987), acq. 1988-2 C.B. 1 ("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 . . . .").

Directive 4

We agree that Directive 4, as drafted by the Department, accurately reflects the IRS's recent conclusions in Revenue Ruling 2008-39. However, we are concerned that referencing particular IRS pronouncements could cause the Directive to become out of date as federal "trade or business" law develops. Because Directive 4 accurately reflects, but does not expand on the current IRS position, we do not believe that it is necessary. Accordingly, we encourage the Department to delete Directive 4 so that the law in this area may continue to evolve to extent that federal law does so.

Conclusion

We very much appreciate the opportunity to continue working with the Department to develop standards to distinguish professionally managed funds from passive investors and, in particular, we appreciate the time the Department is spending to consider the issue. We believe the amended Directive set out in Appendix A would provide meaningful guidance to the Department's audit staff, as well as to industry participants, and that it would yield results consistent with applicable federal law. We remain eager to assist the Department in any way to complete this important project.

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

Stuart J. Kaswell,
Executive Vice President & Managing
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Professionally Managed Funds; Trader Versus Investor Determination

Introduction:
Massachusetts gross income is federal gross income with certain modifications. G.L. c. 62, § 2(d). Generally, the Massachusetts tax law adopts federal partnership taxation principles including the principle that a partner is required to include separately on her return her distributive share of the partnership's income or loss and any item of deduction or credit. G.L. c. 62, § 17(a), (b).

This Directive addresses tax issues with respect to professionally managed investment funds that are not mutual funds subject to the registration and regulatory restrictions of mutual funds. Professionally managed funds for this purpose are pooled investment vehicles that are treated as partnerships for federal and Massachusetts income tax purposes and may include hedge funds, venture capital funds, private equity funds, fund of funds, long-term investment funds and managed futures funds. If a professionally managed fund is determined to be engaged in the business of trading in securities (a "trader fund"), certain fund expenses are determined to be ordinary and necessary business expenses under the Internal Revenue Code ("IRC") § 162. If the professionally managed fund is determined not to be a trader fund and instead is characterized as an "investor fund," certain expenses flow through to the partner investors as IRC § 212 expenses. Massachusetts personal income tax law does not allow a deduction for investment-related IRC § 212 expenses and does not allow a deduction for IRC §163 investment interest expenses attributable to investor funds.[1]

In general, as will be further detailed below, a professionally managed fund qualifies as a trader fund if, based on all of the facts and circumstances, the fund engages in trading activity with continuity and regularity, and the primary purpose of that trading activity is to earn income or profit. To help make this determination, this Directive will:

1) outline factors used to determine a fund's trader versus investor status, and
2) provide an administrative safe harbor test with objective standards that if met, establishes a professionally managed fund's trader fund status.

Issue 1:
What are the relevant facts and circumstances to determine trader status?

Directive 1:
A professionally managed fund will be determined to be a trader fund if:

(1) The fund engages in trading activity with continuity and regularity; and
(2) The primary purpose of the fund's trading activity is to earn income or profit.

Discussion 1:

Whether a taxpayer is engaged in a trade or business of trading in securities is determined by

[1] Massachusetts does not adopt the deductions permitted under IRC § 163 unless they are allowed under section 62 of the Code. G.L. c. 62, § 2(d); *Forte Investment Fund v. State Tax Commission*, 369 Mass. 786 (1976).

federal income tax principles. 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 whether a taxpayer is engaged in a trade or business is to be determined on a case-by-case basis.[2]

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 or profit.[3] A trader in securities is "an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield. That is, the trader's profits are derived through the very acts of trading – direct management of purchasing and selling."[4] In addition, the scope of a trade or business extends to activities and transactions that are "integrally related" to any part of the trade or business.[5]

The relative importance of particular facts in determining trader status will vary depending on the nature and circumstances of the taxpayer claiming trader status. Thus far, the case law has almost exclusively focused on individual taxpayers.[6] For individual taxpayers, who often transact in a limited range of securities and lack many of the indicia of the business operations possessed by professionally managed funds, the number of trades or other portfolio-based numerical measures can be a useful short-cut to determine whether a person is engaged in a trade or business of trading in securities rather than passively accumulating earnings.

By comparison, different trader funds may avail themselves of a broad range of trade or business activities. Professionally managed funds may enter into a variety of integrally related transactions and activities in the pursuit of trading profit and active management of risk, including, without limitation, the acquisition and disposition of long and short positions in securities and commodities, futures, forwards, swaps, options and other derivatives, and transactions under repurchase agreements and securities lending agreements and other similar transactions. The transactions used at a given time are a function of the fund's particular strategy and expertise and the particular conditions in the markets at that time. One particular numerical measure may not adequately capture the range of integrally related transactions and activities for all funds. Moreover, in addition to its trading staff, a professionally managed fund will often have additional staff and third-party services providers who are an integral part of the trading function, such as persons who research and analyze market data, process, document and reconcile trades, move and call collateral, monitor and manage risk, and ensure compliance with the many applicable laws relevant to a trading enterprise, all with continuity and regularity. As a result, there are many factors other than the number of trades and other numerical measures that indicate that a fund is engaged in trading for income or profit. The totality of facts and circumstances should be considered, and no one factor is necessarily dispositive.

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[2] *Higgins v. United States*, 312 U.S. 212, 217 (1941).
[3] *Commissioner v. Groetzinger*, 480 U.S.23, 35 (1987).
[4] *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979).
[5] See *King v. Commissioner*, 89 TC 445, 464 (1987), acq. 1988-2 C.B. 1.
[6] See, e.g., *Levin* (finding that an individual who conducted 332 transactions during the tax year and devoted virtually whole working day to stock transactions was a trader); *Fuld v. Comm'r*, 139 F.2d 465 (1943) (brother and sister who spent 6 to 8 hours per day trading and who executed over 347 and 318 transactions in years at issue were traders).

The following non-exclusive list of factors is representative of the kinds of facts that, individually or collectively, support a finding that a professionally managed fund is engaged in trading activity with continuity and regularity for the primary purpose of earning income or profit:

- The regular conduct of substantial operations in connection with its trading, which may include research, valuation, accounting, trade processing and reconciliation, reporting, cash management, the posting of collateral, clearing, compliance and/or risk management.
- The establishment and use of prime brokerage and/or custodial accounts, credit facilities, or other financial arrangements commonly associated with professionally managed trader funds.
- The use of an administrative staff or a third-party administrator to record, process, document, value, post/demand collateral for, reconcile and report transactions.
- The existence of a full-time trading staff and support personnel, which continually monitors the fund's portfolio and the markets, permitting the fund to be ready and available to trade every trading day in response to developments in the markets.
- The licensing and regular use of third-party market data, market research and trading and research platforms and portals (such as products from Bloomberg LP, Reuters, Markit, etc.).
- The frequency and volume of transactions.
- The use of leverage and hedging or other profit making and risk management techniques.

Issue 2:

Are there objective standards through which a professionally managed fund may establish trader status?

Directive 2:

As an administrative safe harbor, the Department will consider a fund to be a trader fund if it can satisfy the requirements of each of the three categories listed below. For purposes of the below safe harbor tests, transactions that are entered into to generate returns and actively manage risk should be taken into account. For example, as applicable, initiations and covers of short positions, purchases, sales, settlements, terminations and other dispositions of securities and other assets (including the economic equivalent thereof using derivatives), transactions under repurchase agreements and securities lending agreements and other cash management transactions should be taken into account to the extent they are used by the fund's trading professionals to pursue profit and actively manage risk consistent with the fund's strategy.

SAFE HARBOR TESTS: Must Meet All 3 Categories

Category A: Trading activity is continuous and regular. (Must satisfy 2.)

- Number of transactions per year:
  - Must exceed 500.
- Number of transaction days per year:

    - Must transact at least 70% of all days on which the relevant markets (*e.g.*, the stock markets, bond markets) are open.
- Full-time trading staff and support personnel that continually monitors and evaluates the fund's transactions and the relevant markets, thereby permitting the fund to be ready and available to trade every trading day.

Category B: Primary purpose of trading activity is to earn income or profit. (Must satisfy 1.)

- Portfolio Turnover:
    - At least 1.0X
    - To calculate:
        - Divide lesser of amount, on an absolute value basis, of purchases/acquisitions/opens or sales/dispositions/terminations of securities or other positions (including the economic equivalent thereof using derivatives), for a period by the average net asset value of the fund for that period.
- Nature of income:
    - Majority of gross income and loss, on an absolute value basis, is not long-term capital gains and losses. §1256 contracts treated as all short-term.
- Holding period:
    - At least 2/3rds of realized transactions held less than one year.

Category C: Consistency in reporting. (Must satisfy.)

- The fund's tax disclosure and federal income tax filings do not reflect an intent that is inconsistent with trader status.

Discussion 2:

As noted earlier in this Directive, there is no one standard or particular set of standards set forth in the Code or case law to guide taxpayers or tax administrators in the determination of a fund's trader versus investor status. Some courts have attempted to identify quantitative standards to serve as indicia of a taxpayer's trading activity. However, these cases have almost exclusively centered on one or more individuals with a limited range of market activity and minimal or no trading-related business operations. As a result, the quantitative measures identified in these cases often do not capture the broader range of trading-related business activity of a professionally managed fund.

In an effort to provide administrable guidance for both taxpayers and tax administrators, Directive 2 attempts to identify objective standards to serve as a safe harbor appropriate for professionally managed funds.

A fund that does not meet one or more categories of the safe harbor test may still qualify as a trader fund, based on the relevant facts and circumstances, as further set forth under Directive 1. In such cases, the application of the facts and circumstances test may take into consideration particular reasons why a fund does not meet the safe harbor test, such as unusual market

conditions or unusual portfolio situations. For example, certain events external to a fund may impact its trading strategy at a particular time, such as disruptions in one or more financial markets that result in increased costs to borrow and/or wide bid/ask spreads, which may limit trading opportunities for a particular fund. Circumstances internal to a fund may also impact its ability to meet the safe harbor. For example, certain tax rules, such as wash sales, straddles, original issue discount and similar rules that impact timing and character of income recognition may produce tax results that do not fully reflect the economic trading activity of the fund and skew the results under one or more of the safe harbor tests.