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

December 15, 2011

Via Electronic Mail: Notice.Comments@irscounsel.treas.gov

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG–111283–11)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington D.C. 20044

Re: Managed Funds Association Comments on Proposed Regulation 111283-11: Swap Exclusions for Section 1256 Contracts

Ladies and Gentlemen:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the proposed regulations [REG-111283-11] published in the Internal Revenue Services' (the "Service") Internal Revenue Bulletin 2011-42, Notice of Proposed Rulemaking and Notice of Public Hearing - Swap Exclusion for Section 1256 Contracts (the "Proposed Rule"). MFA is committed to working in a constructive manner with policy makers and regulators as they develop regulatory proposals.

MFA supports the Service's goals of creating greater certainty and consistency regarding the tax treatment of similar financial instruments and preventing abusive practices designed to evade tax obligations. As discussed in more detail below, we believe the Service should provide greater certainty and consistency with respect to the definitions of "notional principal contract" and "regulated futures contract." We also encourage the Service to reconsider its proposed definition of "payment" in the Proposed Rule, which we believe could have adverse, unintended consequences for market participants that use certain types of swap contracts. Finally, we encourage the Service to focus its swap bifurcation rules on those contracts that present the greatest risk of tax

[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.

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evasion by providing clear guidance that swap contracts traded at on-market pricing will not be subject to the bifurcation rules.

Enhanced harmonization of definition of notional principal contracts

The Proposed Rule seeks to harmonize the definition of "notional principal contract" throughout the Internal Revenue Code of 1986 (the "Code") by reference to the definition provided in §1.446-3(c) of the federal income tax regulations (the "Income Tax Regulations"). In the preamble to the Proposed Rule, the Service stats that the definition of a notional principal contract in §1.446-3(c) is intended to be the operative definition for all federal income tax purposes, except where a different or more limited definition is specifically prescribed. Accordingly, the Proposed Rule includes proposed regulations under sections 512, 863, 954, and 988 of the Code to refer to the definition of a notional principal contract in §1.446-3(c). MFA supports the Service's goal of developing greater consistency in the treatment of similar financial instruments under different provisions of the Income Tax Regulations.

The Proposed Rule, however, does not amend the definition of "notional principal contract" for purposes of the trading safe harbor contained in section 864(b) of the Code and the proposed regulations under §1.864(b)-1(b)(2)(i), which refer to the more restrictive definition used in section 475(c)(2). To further the goal of developing consistent treatment under the Code and the Income Tax Regulations, we encourage the Service to expand the scope of the proposed definition of notional principal contract by providing that the definition of "notional principal contract" for purposes of section 864(b) of the Code and the rules thereunder will have the same meaning as in §1.446-3 of the Income Tax Regulations.

We recognize that the Service has not yet finalized the proposed regulations under section 864(b) (the "Proposed 864(b) Rules"),[2] and that, for procedural reasons, the Service may not be able to amend the Proposed 864(b) Rules through an amendment to the Proposed Rule. To the extent the Service determines that it cannot address the definition of "notional principal contract" for purposes of the Proposed 864(b) Rules in the final text of the notional principal regulations, we encourage the Service to provide a clear statement in the notice adopting final notional principal contract regulations that the Service intends to amend the definition of notional principal contract for purposes of section 864(b) and the regulations thereunder.

[2] As MFA has noted in previous letters to the Service, we encourage the Service to finalize rules or guidance under section 864(b) to clarify uncertainty regarding the status of certain types of investments by non-U.S. investors. See https://www.managedfunds.org/issues-policy/mfa-comment-letters/.

Definition of regulated futures contract

The legislative history of section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which amends section 1256(b)(2)(B) of the Code, provides that one of the goals of that section is to clarify that the list of swaps and agreements in section 1256 should be based on the definition of a notional principal contract under §1.446-3(c) of the Income Tax Regulations, rather than the definition of "swaps" under the Dodd-Frank Act. MFA supports the goal of limiting referencing non-tax definitions for purposes of the Income Tax Regulations, as applying non-tax definitions is often very impractical and can lead to significant uncertainty for taxpayers.

Unfortunately, the Proposed Rule defines "regulated futures contract" under §1.1256(b)-1(b) by cross-reference to the definition of "swap" for purposes of the reporting rules under the Commodity Exchange Act, as amended by the Dodd-Frank Act (the "CEA"). MFA believes defining regulated futures contracts by cross-referencing to the Dodd-Frank Act reporting rules is inconsistent with the goal of limiting the application of non-tax definitions to the Income Tax Regulations. In addition, because the CEA has several swap reporting rules with different scopes and definitions, the cross-reference creates significant confusion as to which contracts are within the scope of Proposed Rule and unnecessarily complicates the task of taxpayers trying to determine whether a contract is a regulated futures contract under section 1256(b)(1) of the Code. Further, cross-referencing the swap reporting rules under the CEA could be redundant with §1.1256(b)-1(a), which provides that a contract that is defined as both a notional principal contract and a regulated futures contract is treated as a notional principal contract and not as a section 1256 contract.

To avoid such confusion and to better achieve the goal of defining contracts by reference to the Code and the Income Tax Regulations, we encourage the Service to delete the reference to the swap reporting rules under the CEA for purposes of defining a regulated futures contract in §1.1256(b)-1(b). We believe that the exclusion of contracts that qualify as notional principal contracts under §1.1256(b)-1(a) is a sufficiently clear and self-contained provision.

To the extent that the Service decides to continue to define "regulated futures contract" by reference to the swap reporting rules in the CEA, we believe the Service should clarify the cross-reference by specifying: (i) the relevant section of the CEA in which the term "swap" is defined for these purposes; and (ii) which CEA swap reporting rules are being referred to.

Bullet swaps

There is a well settled practice among market participants regarding the treatment of bullet swaps based on their understanding of applicable law, including prior guidance from the Service. The proposed regulations published in 2004 under §1.1234A-1(c) have

generally been widely applied by taxpayers. Those proposed regulations provided that any gain or loss arising from the settlement of obligations under a bullet swap or forward contract (including a payment pursuant to the terms of the obligations) would be treated as gain or loss from the termination of the bullet swap or forward contract. For these purposes, a bullet swap was defined as a financial instrument that: (i) is not an excluded contract as defined in §1.446-3(c)(1)(ii); (ii) provides for the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount; and (iii) provides for settlement of all the parties' obligations at or close to maturity of the contract. The definition focused heavily on the timing of the settlement payments under the contract rather than the timing of the determination of the payments under the contract. The 2004 proposed regulations did not distinguish between obligations that are floating or fixed during the term of the contract and the commentary to the proposed regulations specifically refrained from applying the 2004 proposed regulations to bullet swaps and characterized it as an expansion of scope to do so.

We are concerned that, by defining "payment" to include an amount that is fixed on one date and paid on another date under §1.446-3(c)(1)(ii), the Proposed Rule effectively changes the tax treatment of these contracts without a demonstrated policy need for the change.[3] In addition, since this portion of the Proposed Rule is presented as clarifying the interpretation of existing law, it creates significant uncertainty with respect to contracts entered into prior to the finalization of the Proposed Rule.

We believe that the current tax treatment of all bullet swaps under proposed regulation §1.1234A-1(c) is appropriate, given the economic and credit risks associated with bullet swap contracts. We believe further that the Proposed Rule would create a significantly different tax treatment for floating rate bullet swaps compared to fixed rate bullet swaps even when such difference seems unwarranted as there are relatively minor economic differences between those contracts. Accordingly, we encourage the Service to delete the language under §1.446-3(c)(1)(ii) of the Proposed Rule, which defines payment to include "an amount that is fixed on one date and paid or otherwise taken into account on a later date." To the extent that the Service determines not to make such a change, we encourage the Service to apply this change in treatment of bullet swaps and other affected contracts only on a prospective basis.

Treatment of credit default swaps with single upfront payments

Under §1.446-3(c)(1)(i) of the Proposed Rule, a notional principal contract is defined as "a financial instrument that requires one party to make two or more payments to the counterparty at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." §1.446-3(c)(1)(iii) of the Proposed Rule added credit default swaps

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[3] We note that under the Proposed Rule, the new definition of "payment" may also change the generally accepted tax treatment of certain other types of contracts, such as prepaid forward contracts and exchange-traded notes.

("CDSs") to the list of contracts included as notional principal contracts. Under §1.446-3(c)(1)(iv), options and guarantees are excluded from the definition of notional principal contracts.

To the extent the Service does not amend its definition of "payment" as discussed above in the discussion related to bullet swaps, we believe the Service should clarify whether a credit default swap that has only an upfront payment of the premium is a notional principal contract or an option. This clarification is necessary because, while Proposed Rule will still exclude options and guarantees from the definition of notional principal contracts, the Proposed Rule also provides that CDS contracts are notional principal contracts.

This distinction creates uncertainty as to whether certain types of CDS contracts (*i.e*., those with only upfront payment of the premium) should be treated as options or notional principal contracts. We believe that a CDS contract with only an upfront payment of the premium should not be a notional principal contract as it would not require a party to make two or more payments to the counterparty. Accordingly, we encourage the Service to clarify that such a contract should be treated as an option and not be deemed a notional principal contract under §1.446-3(c) of the Income Tax Regulations.

With respect to any CDS contract that is a notional principal contract, rather than an option or a guarantee, there is uncertainty as to whether a credit event payment under the CDS contract should be treated as a non-periodic payment under §1.446-3(f) or an early termination payment under §1.446-3(h). Because credit event payments extinguish all or a proportionate part of the remaining rights and obligations of any party under the CDS contract, we believe that such payments are appropriately viewed as termination payments, eligible for tax treatment as capital gains or losses. We encourage the Service to clarify in its final rule that credit event payments which extinguish all relevant obligations under a swap contract should be treated as termination payments.

Treatment of contracts with significant upfront payments

The tax treatment of significant upfront payments is governed by §1.446-3(g)(4) of the Income Tax Regulations. Under those regulations, if a notional principal contract has a significant upfront payment, then market participants need to bifurcate the swap into a loan and a deemed on-market swap. The primary policy reason for requiring bifurcation of certain notional principal contracts is to avoid abusive practices designed to evade unfavorable tax treatment by embedding loans into swaps. The assumption underlying these rules is that embedding a loan within a swap would cause the pricing of the swap to be traded at off-market pricing.

We are concerned that the rules regarding significant upfront payments could unintentionally require the bifurcation of many exchange-traded and centrally cleared swap contracts, which could undermine the goal of the Dodd-Frank Act to have many

swap contracts exchange traded or centrally cleared. Exchange-traded swaps are expected to cause taxpayers to receive or make upfront payments when they enter into those contracts. Such upfront payments may be significant even though the swaps would be based on arm's length pricing and would not reflect any intent from the parties to embed a loan within a swap. Avoiding an unintentionally broad application of the bifurcation rule of §1.446-3(g)(4) is particularly important for many hedge funds, as bifurcation create many potential collateral tax issues for such funds.

If a hedge fund has to bifurcate the payments on a swap because it is deemed to have made a significant upfront payment (thereby treating the upfront payment as a loan), it potentially raises questions as to: (i) whether an offshore fund or foreign investors could be deemed to be engaged in a U.S. trade or business due to loan origination activities; or (ii) whether such activity could be regarded as closely related to the activities of trading on your own account under the trading safe harbor of section 864(b) of the Code and the regulations thereunder. Funds could have similar issues under the controlled foreign corporation rules and the sovereign wealth fund rules. Further, tax-exempt investors could have unrelated business income tax issues if they are deemed to receive a significant upfront swap payment treated as a loan.

We support the Service's efforts to eliminate abusive tax practices. Given the significant, adverse collateral consequences that could result from funds having to bifurcate payments under their swaps contracts, however, we encourage the Service to narrow the scope of §1.446-3(g)(4) to address the underlying policy goal of preventing tax evasion through abusive practices, while avoiding the unintended consequences that could result from an overly broad application of the bifurcation provisions. As a policy matter, we believe that §1.446-3(g)(4) should exclude from the bifurcation rule any notional principal contract with a significant upfront payment that reflects on-market pricing.

We believe that contracts traded at on-market pricing, whether traded on an exchange or over the counter, do not present the risk of abusive practices that the bifurcation rules were designed to prevent. Because exchange-traded swap contracts and centrally cleared swap contracts will, by definition, be traded at on-market pricing, we encourage the Service to explicitly exclude such contracts from the bifurcation rules. Further, we encourage the Service to issue guidance in adopting final rules that over the counter swap contracts traded at on-market pricing will not be subject to bifurcation. For purposes of such guidance we believe that swaps for which a taxpayer (i) immediately posts an amount equal to the upfront payment as collateral; or (ii) posts variation margin should be deemed to be traded at on-market pricing. We believe that such an exclusion and such a presumption would be consistent with the intent of §1.446-3(g)(4) to recharacterize only a contract that was not traded at on-market pricing because of an embedded a loan within the contract.

We also have two specific concerns with respect to the determination whether a market participant has a significant upfront payment that requires bifurcation under

§1.446-3(g)(4). To the extent that the Service does not exclude contracts traded at on-market pricing from the bifurcation rules, we believe it would be important for the Service to address the two issues discussed below.

First, the Income Tax Regulations leave significant uncertainty as to what percentage of the present value of the total amount of fixed payments due under a notional principal contract causes an upfront payment to be significant. Two examples provided by the Income Tax Regulations under §1.446-3(g)(6) create significant uncertainty about the treatment of upfront payments. One example provides that 9.09% is not significant, whereas another example provides that 66.67% is significant. With the Dodd-Frank Act and related rules requiring many swaps to be exchange-traded or centrally cleared going forward, many of those swaps will have upfront payments, and we are concerned that many of those swaps will end up in this broad grey area if the Service does not exclude them from the bifurcation rules as discussed above. This uncertainty and the potential for adverse tax consequences for funds that trade exchange listed and centrally cleared swaps with upfront payments could reduce the desirability of exchange trading and central clearing, contrary to the Dodd-Frank Act's goal of promoting exchange trading and central clearing of swaps.

Our second concern is that, based on the examples in §1.446-3(g)(6) of the Income Tax Regulations, the determination is made by comparing the upfront payment to the present value of the "total amount of fixed payments" due under the swap contract. If there are no fixed payment (*e.g.*, a basis swap – all payments are contingent/variable) or the only fixed payment is the upfront payment, then the Proposed Rule would seem to automatically deem the upfront payment to be significant. As a result, even relatively small upfront payments could be deemed significant for certain types of swap contracts, even if the upfront payment would likely not have been deemed significant if there were any fixed payment down the road on the swap (*e.g.*, a fixed for floating interest rate or a CDS with periodic fixed payments). We believe this could result in market participants having to bifurcate a large percentage of their swaps contracts, including many contracts that we believe should be outside of the scope of contracts requiring bifurcation. We encourage the Service to provide guidance that would allow taxpayers to take into account non-fixed payments based on their present value as if they were deemed fixed in accordance with the prices or rates as of the date the contract is entered into.

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Conclusion

MFA appreciates the opportunity to provide comments on the Proposed Rule. MFA supports the Service's goals of creating greater certainty and clarity regarding the tax treatment of financial instruments and preventing abusive practices designed to evade tax obligations. We encourage the Service to amend the Proposed Rule as discussed above to provide greater certainty to market participants and to avoid unintended consequences from certain overly broad provisions in the Proposed Rule.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these issues, please do not hesitate to contact Stuart Kaswell or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO