**STATEMENT OF**

**DANIEL S. SHAPIRO**

**ON BEHALF OF**

**THE MANAGED FUNDS ASSOCIATION**

**BEFORE THE**

**COMMITTEE ON FINANCE**

**UNITED STATES SENATE**

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Chairman Baucus, Ranking Member Grassley and Members of the Committee, my name is Daniel S. Shapiro. I am a founding partner of the New York City law firm of Schulte Roth & Zabel LLP and am resident in the firm's London office. I have provided tax advice to private investment funds for over 30 years. I appear today on behalf of the Managed Funds Association, commonly known as MFA. MFA welcomes this opportunity to participate in the Committee's hearings on the manner in which private investment funds, their managers and their investors are taxed. In accordance with the Committee's request, this statement will focus principally on how hedge funds are structured and, in particular, on matters related to hedge funds established outside the United States by U.S.-based hedge fund managers.

MFA is the voice of the global alternative investment industry. Its members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the over $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

I

Introduction and Summary of Testimony

Hedge funds sponsored by U.S.-based managers play an important role in the U.S. capital markets and make positive contributions to the U.S. economy as a whole. These managers must, however, compete globally for talented personnel, for investment opportunities and for investors. Their ability to do so effectively is influenced by many factors, including the U.S. tax system.

Hedge funds are structured in accordance with well established principles of tax law, as set forth in the Internal Revenue Code, Treasury regulations, rulings by the Internal Revenue Service and other applicable legal authorities and this structure also promotes key Congressional tax and economic policies. This is true in the case of funds that U.S.-based hedge fund managers establish outside the United States in order to compete with non-U.S. managers for passive investors from Europe, Asia and elsewhere.

For more than 40 years, Congress has structured the tax code to encourage passive foreign investments in the U.S., both by foreign corporations and individuals. Among other things, Congress has exempted most forms of interest payments made to these passive investors from U.S. withholding tax and it has likewise exempted their capital gains from U.S. tax except to the extent they are derived from sales of U.S. real estate and certain U.S. real estate securities. Despite this advantageous treatment, most foreign investors utilize foreign corporations as the vehicle for their passive investments into the United States and U.S.-hedge fund managers would be competitively disadvantaged if they did not offer such a structure to foreign investors.

The foreign funds organized by U.S.-based hedge fund managers to attract foreign passive investors are corporations and they are subject to this same tax regime so long as they limit themselves to passive investment activities, including trading and investing in stocks, securities and commodities. These funds thus do not provide the ultimate foreign investors with more advantageous tax treatment on their U.S. investment income than they would receive if they invested directly. The foreign funds established by U.S.-based hedge fund managers simply promote the Congressional policy to encourage passive foreign investment in the United States and at the same time enable U.S.-based managers to compete for those investors.

Pension funds, university endowments and certain other U.S. tax-exempt organizations also invest in foreign hedge funds sponsored by the U.S.-based managers. These organizations invest in hedge funds to maximize the investment returns they need to carry out their public interest missions. They structure their investments in this manner because, under a quite technical tax law provision, their investment returns would be reduced by the 35 percent unrelated business income tax if they invested in a U.S. hedge fund, organized as a partnership, that used leverage to enhance its returns. In such a case, the position of the tax-exempt investor vis-à-vis the fund is no different than if it had purchased the stock of a publicly traded company on the open market.

The use of foreign corporate funds by U.S.-tax exempt organizations does not trigger this adverse tax result and its use has been sanctioned by Internal Revenue Service rulings as well as implicitly by Congress in 1996. Moreover, from a tax policy standpoint, there appears to be little basis for imposing the unrelated business income tax on passive investment income received by a pension fund or other tax-exempt organization where it has no liability for the leverage used by the fund, has no control over the fund's investments or the extent of its use of leverage, and does not incur any indebtedness to acquire or carry its investment in the fund.

In this connection, MFA welcomes the introduction of H.R. 3501, which appears intended to eliminate the need for U.S. tax-exempt organizations to structure their hedge fund investments as investments in foreign funds. As discussed elsewhere in this statement, MFA believes that H.R. 3501 needs to be amended in certain respects in order to achieve its intended objectives.

Some U.S.-based managers elect to defer receipt of a portion of the payments they receive from the offshore funds they sponsor. Foreign investors frequently expect these deferral elections to be made as the resulting deferrals buttress the alignment of interests between the manager and the investors. These deferrals are taxed in the U.S. at the top income tax rate of 35 percent when they are received by the managers at the end of the deferral period and they are subject to the comprehensive tax regulatory regime enacted by Congress in 2004 to govern deferred compensation arrangements by all business enterprises. These deferral arrangements also facilitate the ability of U.S.-based managers to establish deferred compensation plans for their employees and this in turn enables these managers to compete for and retain talented personnel.

MFA is well aware that this Committee is also considering other tax policy proposals relating to hedge funds that are outside the requested scope of this statement. These proposals include the treatment of so-called "carried interests" and the application of the publicly-traded partnerships rules to public offerings of interests in hedge fund and private equity fund managers. These proposals are not unique to hedge funds. For example, many types of private investment funds provide carried interests. Moreover, many hedge fund managers already pay income tax at the top 35 percent rate on substantial portions of their carried interest income. As discussed below, MFA has significant reservations regarding these proposals and would welcome the opportunity to present its views on these issues to the Committee in greater detail as the legislative process moves forward.

## II

## Hedge Funds and Their Importance to the American Capital Markets

MFA welcomes the interest of the Committee in the hedge fund industry and is pleased to participate in the process by which the Committee will examine issues related to the manner in which these funds, their managers and investors are taxed. MFA believes that these issues are best addressed following an examination of the key characteristics that distinguish hedge funds from other private investment funds and of the important role hedge funds play in the American economy.

A. What is a “Hedge Fund”?

Hedge funds are part of what is commonly referred to as the alternative investment sector of the capital markets. This sector also includes private equity funds, venture capital funds, real estate funds, mezzanine debt funds, and structured debt funds, among others. In 1999, the President’s Working Group on Financial Markets defined a hedge fund as “a private investment pool that is professionally managed, not available to the general public and typically limited to high net worth individuals and institutional investors”.

Other private investment pools share some of these same characteristics and, in MFA’s view, hedge funds have five key characteristics, as follows:

> First, hedge funds pursue absolute returns, which are not correlated with stock market returns, and do so within defined risk parameters.
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> Second, there is no single investment strategy that is common to all hedge funds.
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> Third, there generally are no public offerings of interests in hedge funds, a fact which, in order to ensure compliance with the federal securities laws, results in substantial limitations on the ability of hedge funds and their managers to communicate with the public through public announcements of fund-specific investment results, advertisements, press interviews and open websites.
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> Fourth, to comply with applicable securities laws, hedge funds generally are directly available only to high net worth individuals and institutional investors.
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> Fifth, hedge fund managers profit principally by sharing in the returns earned by the funds themselves, and often make significant investments in the funds they manage, thus directly aligning the interests of the fund’s manager with the interests of the investors in the fund.

B. Hedge Funds and the Capital Markets

As the President's Working Group on Financial Markets and its constituent members, including the Department of the Treasury, have repeatedly stated, hedge funds provide important benefits to the U.S. capital markets and to the American economy as a whole. For example, hedge funds are an important source of liquidity, not only in the traditional markets for equity securities, but in other markets such as those for distressed debt, convertible debt, and asset-backed securities. As former Treasury Under Secretary Quarles stated in testimony presented to the Senate Banking Committee on May 16, 2006, U.S. markets are attractive to investors, both domestic and foreign, because they are among the deepest and most liquid in the world and "hedge funds are significant liquidity providers in many marketplaces".

In addition to providing liquidity in the form of risk capital, hedge funds promote price efficiency in the capital markets, contribute to capital formation in many sectors of the economy, and frequently identify new and emerging markets. Moreover, by being active participants in off-exchange derivatives transactions, such as currency and interest rate swaps, hedge funds contribute to the deep and liquid marketplace in such instruments that enables "Main Street" American businesses, as well as banks and others, to manage many of the risks inherent in their core businesses in an efficient and cost effective manner.

Hedge funds and other private investment funds also help keep the U.S. capital markets competitive. As Treasury Under Secretary Steel stated on February 27, 2007:

> United States capital markets are the envy of the world. Our markets are deep, efficient and transparent. Creativity, innovation and entrepreneurship have long been the hallmark of U.S. markets and their benefits to our economy are clear. Private pools of capital—which include venture capital, private equity, and hedge funds—have helped make us the world's leading financial innovator. As Secretary Paulson noted in a speech last November, private pools of capital are an essential part of what keeps our capital markets the most competitive in the world."

C. Hedge Fund Investors

As noted, hedge fund investments are directly available generally only to high net worth individuals and institutional investors. These institutional investors include pension funds, university endowments and other similar institutions. Hedge funds provide these investors with the opportunity to enhance significantly their ability to carry out their missions by diversifying their portfolios, earning stable returns and protecting their capital during periods of downward price movements in the public securities markets. The investment performance hedge funds have provided to tax-exempt investors arises from the fact that hedge fund managers seek returns that are not correlated to the markets (as opposed to merely seeking to magnify market returns). Thus, while hedge funds' performance occasionally may not exceed mutual funds' performance in rising markets, they have in past years consistently provided positive and stable returns when the general markets are experiencing downturns. Thus, in the case of pension funds, for example, hedge fund investments can, in the context of a balanced and professionally managed portfolio, provide greater retirement security for millions of Americans in all walks of life, including teachers, law enforcement and fire officials, and municipal workers.

## III

## Technical Explanation of Hedge Fund Structures

As noted at the outset of this statement, hedge funds are structured in accordance with long established tax rules, as set forth in the Internal Revenue Code, Treasury regulations, Internal Revenue Service rulings, and other applicable authorities. As also noted, the typical hedge fund structure also promotes key Congressional tax policies, including those intended to encourage inbound investment into the United States.

A. Overview

A "hedge fund" with a U.S.-based manager typically consists of both a U.S.-based fund and a foreign fund, each of which has the same investment objectives. The U.S. fund is generally organized as a limited partnership and there is thus a single level of U.S. federal income tax on the fund's investment income, which is imposed at the partner level. This structure has been used, virtually without exception, by hedge funds and other private investment funds for decades. The principal investors in the U.S. fund are U.S.-based investors that are subject to the U.S. federal, state and local tax in their own right. The foreign fund is generally organized as a corporation (or as an entity that is eligible to elect to be classified as a "corporation" for U.S. tax purposes) and it is used as the vehicle for investment by those investors whose passive investment activities in the U.S. have, as discussed below, largely been exempted from tax by Congress and the foreign fund's structure simply facilitates that result.

In some cases, the U.S. fund and the foreign fund make parallel investments and in other cases (commonly referred to as "master-feeder" structures) the U.S. fund and the foreign fund (the "feeders") invest in a third fund (the "master fund") which makes the actual investments. In this structure, the master fund is typically organized as a partnership (or as an entity eligible to be taxed as a "partnership" for U.S. tax purposes).

B. U.S. Taxation of Foreign Investment

The provisions of the Internal Revenue Code governing foreign investment in the United States embody certain fundamental principles that, taken as a whole, reflect a clear Congressional intent to encourage non-U.S. persons to invest in the U.S. economy.

Current tax law distinguishes between those non-resident aliens and foreign corporations that are not engaged in a trade or business in the United States ("passive foreign investors") and those that are so engaged. In general, passive foreign investors are subject to U.S. tax only on their U.S. source dividends, certain interest, rents and royalties (collectively, "fixed or determinable, annual or periodical" gains, profits and income). This tax is generally collected via withholding at a flat 30 percent rate. Significantly, many types of interest payments made by U.S. payors, including the United States government, to passive foreign investors are not subject to U.S. withholding tax at all (e.g., under the so-called "portfolio interest" exemption). Finally, passive foreign investors are not subject to tax on their U.S. capital gains except in the case of gains from certain investments in U.S. real property and U.S. real property interests.

In contrast, non-resident aliens and foreign corporations that are engaged in a trade or business in the United States, and are thus not merely passive investors in the U.S. economy, are subject to U.S. tax on a net income basis, generally at a 35 percent rate. This tax generally is imposed with respect to all income, both U.S. source and foreign source, that is "effectively connected" with the U.S. trade or business. In addition, in such cases, a so-called "branch profits tax" is imposed on the repatriation of such "effectively connected income" and this may result in a combined effective tax rate that is substantially in excess of 50 percent.

As a result of these differences in the way foreign investors are taxed, passive foreign investors remain vigilant to ensure that their activities do not inadvertently fall within those categories of activities that may be treated as a U.S. trade or business. To ensure the steady flow of foreign investment funds into the United States, Congress acted as long ago as the Foreign Investors Tax Act of 1966 to provide certainty to passive foreign investors whose activities within the U.S. capital markets consist principally of trading or investing in stock, securities and commodities. Specifically, Congress enacted statutory safe harbors providing that the proprietary trading of, and investing in, stocks, securities and commodities will not be treated as engaging in the conduct of a trade or business within the United States. As the Committee is well aware, for many years the proprietary trading safe harbor for stocks and securities was available to foreign corporations (including most foreign hedge funds) only if the foreign corporation maintained its "principal office" outside the United States. In 1997, Congress amended the law to eliminate this requirement in order to stimulate foreign funds and others to increase the number of employees and service providers based in the United States. Most if not all foreign hedge funds structure their activities to fall within these two proprietary trading safe harbors.

C. Taxation of Foreign Funds and Non U.S. Investors in Foreign Funds

As noted, foreign hedge funds sponsored by U.S.-based managers are generally organized as corporations or as entities that can elect, under Treasury regulations, to be taxed as corporations for U.S. tax purposes, and are located in a tax-neutral jurisdiction to avoid double taxation of the foreign investors. The corporate structure is used to enable the foreign fund to attract investors from the U.K., Europe, Asia and elsewhere. These investors insist upon such a structure principally to ensure that their other assets (i.e., the assets they do not invest in the fund) will not be subjected to U.S. tax should the foreign fund inadvertently engage in activities that are found to constitute the conduct of a trade or business within the United States. Absent such a structure, U.S.-based fund managers would not be able to compete with fund managers based in the U.K., Europe, Asia and elsewhere for non-U.S. investors who wish to invest in the U.S. on a passive basis.

This structure does not create new U.S. income tax benefits for foreign passive investors that they could not obtain if they were direct investors in the United States because the foreign fund is subject to U.S. withholding taxes on the dividends, certain interest, rents and royalties it receives to the same extent as any other passive foreign investor. Moreover, while the foreign fund is exempt from U.S. tax on its capital gains (except those attributable to the disposition of U.S. real property interests), that exemption is available to all passive foreign investors. Despite this advantageous treatment of passive foreign investors, most foreign investors utilize foreign corporations as the vehicle for their passive investments in the United States and they would be unlikely to invest with U.S.-based hedge fund managers if those managers did not provide such a structure. In short, the use of a foreign fund enables U.S.-based managers to compete for passive foreign investors.

D. U.S. Tax-Exempt Investors in Offshore Funds

Pension funds, university endowments and most other U.S. tax-exempt organizations are generally exempt from U.S. tax on their passive investment income, but they are typically subject to the unrelated business income tax ("UBIT"). This tax is generally imposed at the regular corporate income tax rate of 35 percent.

UBIT was originally enacted in 1950 to prevent tax-exempt organizations from exploiting their tax exempt status by acquiring an unrelated operating business and enabling that business to compete unfairly with taxable enterprises. The UBIT base was thereafter expanded by Congress to include so-called "debt financed income". The legislative history of the debt-financed income amendment suggests that Congress was principally concerned with abuses of the original legislation through techniques such as leveraged acquisitions of operating business assets. Nevertheless, the statutory definition of "debt financed income" has a much broader reach and includes such items as dividends on stock of a publicly traded company if the stock was purchased through a margin account.

As the Committee is well aware, hedge funds frequently employ leverage as an integral part of their investment strategies to enhance returns to investors. The amount of leverage used by an individual manager of a hedge fund varies widely, depending on, among other things, the particular manager's investment strategy, view of the market and the current cost of borrowing. Under the current UBIT rules, if a tax-exempt organization invests in a U.S. hedge fund organized as a partnership, a portion of the fund's leverage would be imputed to the tax-exempt organization in its capacity as a limited partner (passive investor) in the fund. The imputed leverage would expose the tax-exempt organization to liability for UBIT on its investment returns from the fund even if, as is almost universally the case, the tax-exempt organization had no liability for the fund's debts, had no control over the fund's investments and did not incur any indebtedness to acquire or carry its investment in the fund.

As a result of the application of UBIT to investments in U.S. hedge funds that use leverage, tax-exempt organizations have for some years made their hedge fund investments through the foreign fund (a corporation, for the reasons discussed above). Under current law, none of the leverage used by the foreign fund is imputed to the tax-exempt shareholder (passive investor). Thus, gains realized by the tax-exempt shareholder on a complete or partial redemption of its interest in the foreign fund are not subject to UBIT.

Both Congress and the Internal Revenue Service have sanctioned the use of these structures by tax-exempt organizations for investments in foreign funds. Specifically, while the passive foreign investment company ("PFIC") rules enacted in 1986 apply onerous tax rules to most U.S. taxpayers investing in a foreign hedge fund, the implementing regulations exempt, in accordance with Congressional intent, U.S. tax-exempt organizations from the PFIC rules. In 1996, Congress considered proposals to apply a "look through" rule under which dividend income received by a U.S. tax-exempt organization from a controlled foreign corporation would be subject to UBIT to the same extent the underlying income would be taxed under UBIT if earned directly by the tax-exempt organization. Congress flatly rejected such an approach except in those limited cases where the foreign corporation was actively engaged in an insurance business and thus presented the potential for the very type of unfair competition at which the original UBIT provisions were aimed.

Moreover, in its general explanation of the 1996 legislation, the staff of the Joint Committee on Taxation stated that Congress believed that the prior IRS rulings declining to impose such a look through rule were correct and, since the 1996 legislation, the IRS has issued an additional series of "no look through" rulings, including rulings to U.S. tax-exempt organizations with respect to investments in foreign funds.

Current practice is not merely a technically correct application of the current tax code. It is also consistent with the underlying purposes of UBIT. When a tax-exempt organization invests in a foreign hedge fund, it does not incur any debt to finance the investment (or else UBIT would apply to that extent), it has no liability for any of the debt incurred by the fund, and it has no control over either the investments made by the fund or the extent of leverage employed by the fund in doing so. In short, the tax-exempt organization receives only passive investment income and its position vis-à-vis the foreign fund is no different than if it had purchased shares of corporate stock (and many corporations use often substantial leverage in connection with their business operations).

As the Committee is aware, many tax-exempt organizations, especially universities across the country, have been able to achieve significant growth in their endowment funds by investing in a wide variety of hedge funds. A significant percentage of those investments have been made, either directly or through funds of funds in foreign hedge funds, many of which use substantial leverage. If the universities, and other tax-exempt organizations such as pension funds that have also been increasing their allocations to hedge funds, were to be made subject to UBIT on those investments merely because the managers of the foreign funds decided to seek enhanced returns through leverage, their rates of return would be very materially diminished. The potential for such marked adverse effects of a change in the current tax rules should therefore be given the most careful consideration.

In light of the foregoing, MFA welcomes the introduction of H.R. 3501. This legislation would amend the UBIT provisions of the Internal Revenue Code relating to debt-financed income and appears intended to eliminate the need for U.S. tax-exempt organizations to structure their hedge fund investments as investments in the foreign funds sponsored by U.S. managers. H.R. 3501, would accomplish this objective by creating a statutory safe harbor under which indebtedness of a U.S. fund would not be attributed tax-exempt investors in the fund if certain requirements are satisfied.

MFA believes that, if H.R. 3501 is to achieve its apparent objective, it needs to be amended in certain respects. Let me illustrate. First, the safe harbor would apply only if the U.S. fund is organized as a limited partnership. In fact, some funds are organized differently (e.g., as limited liability companies). Second, the safe harbor would apply only to indebtedness incurred by the fund with respect to qualified securities and commodities. In fact, while most hedge funds invest principally in securities and commodities, many funds make other leveraged investments some of which may not fall within this definition. Third, the safe harbor would incorporate the so-called “fractions rule”, which was enacted in committee legislation to permit pension funds and certain educational institutions to participate in leveraged real estate partnerships. This rule, which is quite complex to apply, was enacted to restrict shifting of tax benefits (such as depreciation) when a tax-exempt entity invests in a real estate partnership. This potential does not, in MFA’s view, exist to any significant degree in the case of hedge funds. MFA therefore believes that, in lieu of expanding the reach of the fractions rule, it may be more desirable for the Congress to consider granting the Treasury and the Internal Revenue Service regulatory authority to address arrangements that inappropriately shift tax benefits from tax-exempt to taxable investors in the fund. MFA would be pleased to work with the Committee on these and related technical issues.

E. Payments to U.S. Managers

Hedge fund managers frequently receive both fixed payments (based on a percentage of the value of assets under management) and incentive payments (based on investment performance) from the foreign funds they sponsor. These payments are subject to U.S. tax as ordinary income when received. In some instances, the manager may elect to defer the payment of a portion of these amounts to a subsequent taxable year. In those cases, the deferrals, together with any actual or notional earnings thereon, are subject to U.S. tax as ordinary income when received at the end of the relevant deferral period and are taxed at the top 35 percent tax rate.

Foreign investors frequently expect the election of such deferrals to be made by the manager since the deferrals buttress the continuing alignment of interests between the manager and the investors. As noted above, the onerous PFIC rules make it very burdensome for the manager to invest directly in a foreign fund, as they frequently do in U.S. funds.

Moreover, the deferred amounts remain as general assets of the foreign fund and are subject to risk of loss in the event of future adverse investment performance or if the foreign fund becomes insolvent and is unable to meet the claims of creditors. Thus, as to its elective deferrals, the manager is simply a general unsecured creditor of the fund. In this sense, these deferrals differ from tax-qualified arrangements such as traditional pension plans and section 401(k) plans. Those plans are funded and the amounts set aside in the trusts or other funding vehicles can be used only to pay benefits and are not subject to claims of the employer's creditors.

These elective deferrals by fund managers generally are subject to the rigorous regulatory regime for nonqualified deferred compensation arrangements enacted by Congress in 2004, as are any deferred compensation plans maintained by the manager for its employees and other service providers. Some hedge fund managers use plans in this latter category to attract and retain key personnel through deferred compensation arrangements that are linked to the manager's elective deferrals with the foreign funds it sponsors. Careful thought should be given to these issues prior to the enactment of tax policy changes that would limit their ability to do so.

As set forth in section 409A of the Internal Revenue Code, the 2004 legislation imposes strict rules governing deferral elections, the circumstances under which deferred amounts can be paid, and the limited conditions under which payment of deferred amounts can be accelerated. Final regulations under section 409A were issued by the Department of the Treasury and the Internal Revenue Service earlier this year. Those regulations confirm that section 409A does in fact generally apply to deferral arrangements involving hedge fund managers and that, accordingly, plans involving hedge fund managers are subject to the same rules that apply to all other taxpayers. MFA has cooperated fully with the Treasury and the Internal Revenue Service to ensure the proper and timely implementation of section 409A and it will continue to do so.

## IV

## Concluding Observations

MFA is well aware that the tax treatment of foreign funds is but one of a series of tax policy proposals concerning hedge funds and other alternative investment funds that are under active consideration by this Committee and others. These include H.R. 2834, which would alter the tax treatment of income attributable to so-called carried interests and S. 1624, which would limit the ability of investment advisory firms to engage in public offerings of equity interests while maintaining their “partnership” tax status. These and other similar proposals would reverse long standing tax policies related to partnerships and could have potentially significant and disparate effects on the way in which capital is raised and deployed in major segments of the economy, with consequent effects on economic development and job creation. MFA believes that Congress should carefully consider the potential macroeconomic effects in deciding whether to enact such tax law changes.

Similarly, MFA believes that Congress should carefully consider the impact of the pending proposals on the continuing erosion of the traditional position of the United States as the world’s leading financial center and source of financial innovation. This process is already underway as other countries seek to exploit their natural advantages, including location, and the capital markets continue to be increasingly global in nature. U.S.-based hedge fund managers are important to the competitive position of the U.S. in the financial services sector. These managers compete globally for investors, key personnel and investment opportunities. Tax legislation that compromises their ability to compete effectively in any of these areas could have adverse effects on the competitive position of the U.S. as a global financial center.

As noted above, these proposals are not unique to hedge funds. For example, many types of private investment funds provide carried interests. Moreover, many hedge fund managers already pay income tax at the top 35 percent rate on substantial portions of the income attributable to carried interests in the U.S. funds they sponsor as a large percentage of such income is attributable to trading profits from stocks and securities held for less than a year. H.R. 2834 does not, however, merely raise the rate of tax on income from carried interests. It also recharacterizes such income as compensation for services. As other testimony presented to this Committee in connection with this hearing suggests, such recharacterization of what would otherwise be short or long term capital gains in this context appears to be largely unprecedented. Moreover, it could have significant adverse collateral effects under other provisions of the Internal Revenue Code and under state and local tax laws.

MFA also has significant policy concerns with S. 1624, which would limit the ability of investment fund management companies from engaging in public offerings unless they forfeited their “partnership” tax status. MFA questions whether there is a compelling tax policy rationale for S. 1624. For example, the assets of these companies have almost always been held by partnerships and MFA thus doubts that public offerings by such companies should be characterized as increasing the potential for erosion of the corporate tax base. Moreover, MFA questions whether investment managers should be subject to a different tax regime than publicly traded partnerships organized in other sectors, such as oil and gas, commodities, substitute fuels, etc. MFA also believes that Congress should give careful consideration to the fact that fund managers that have engaged, or in the future may do so, in public offerings are important participants in the U.S. capital markets and that public offerings by such firms will both increase transparency due to the disclosure requirements of the federal securities laws and facilitate succession arrangements designed to enhance the stability of these firms.

MFA would welcome the opportunity to present its views on H.R. 2834, S. 1624 and similar proposals to the Committee in greater detail.

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MFA appreciates this opportunity to present its views to the Committee on hedge fund structures and will continue to work with the Committee and others concerned as the legislative process moves forward.