MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
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FINANCIAL PRODUCTS

We believe that a discussion on the tax treatment of financial products is an important component of overall tax reform. In that regard, we appreciate the opportunity to provide feedback to the Committee regarding taxation of financial products.

We generally support the goal of creating clear, consistent, and simple rules regarding the tax treatment of financial products, including derivatives.

MFA Comments on Key Issues Related to Taxation of Financial Products (Section references to Former Chairman Dave Camp's "The Tax Reform Act of 2014" (HR 1) unless specifically noted)

Mark-to-market of derivatives (Section 3401)

Similar to Mr. Camp's 2013 discussion draft on financial products, Section 3401 of the Tax Reform proposal would require derivatives transactions to be marked to market at the end of each tax year and to treat any gains or losses on the derivative as ordinary income or loss. Also similar to the 2013 discussion draft, the definition of derivative continues to be very broad, though it has been narrowed to a degree, compared to the 2013 draft. For example, the definition of derivatives continues to include short sales. It does not include derivatives used for properly identified hedges, transactions requiring physically delivered commodities, and certain transactions that are commercial (not financial) or non-speculative in nature.

While some funds elect mark-to-market treatment of their derivatives investments, we are concerned with a mandatory requirement to mark-to-market financial derivatives at the end of each tax year, and treating the changes in value – which are "paper" rather than economic gains – as ordinary income/loss, raises important questions with respect to liquidity, volatility, valuation, and fairness. We are further concerned that the proposal could have unintended consequences for markets and investors.

- Liquidity & Volatility: Requiring taxes to be paid before economic income has been realized risks forcing taxpayers to sell positions for the sole purpose of paying these new mark-to-market taxes. This could exacerbate price volatility generally, while for less liquid positions, there might not even be a reasonable opportunity to access the needed liquidity without incurring significant economic dislocation (potentially leading to year-end fire sales). New mark-to-market taxes could also lead to volatility in fiscal receipts by linking tax revenues (and potential refunds) to market performance and have unintended pro-cyclical consequences.

- Valuation: The fair market value of an investment should not be determined without accounting for the true costs of liquidating the position (*e.g.,* block discount or marketability discounts). Meanwhile, determinations of the fair market value for non-publicly (or thinly) traded investments may not provide a sufficiently consistent and reliable basis for taxation.

- Fairness: Investors may be forced to pay taxes on "paper" gains over the course of a number of years, but subsequently, if they ultimately realize an economic loss, find themselves unable to recoup the prior taxes paid. Further, it is inconsistent to apply a mark-to-market regime to derivatives, but not to stocks, bonds and other investment assets. Such treatment would, for certain derivatives, treat economically similar investments differently for tax purposes.

- Effects on investment: The disparate treatment of derivatives and other types of investment assets is particularly problematic for certain types of investments, which can require the use of derivatives (such as U.S. firms investing in Chinese securities) to gain economic exposure. Further, derivatives are often used for investment purposes because they provide an efficient way to gain exposure (examples include: (1) investment in foreign equities where direct investment may entail significant transaction costs and other types of risks, which can be mitigated by having a U.S. financial institution as the derivative counterparty; (2) exposure to market indices; or (3) exposure to illiquid or thinly traded assets). The differences in timing and character for economically similar investments can present difficulties for those managing an investment portfolio that is composed of a mix of derivatives and other investments.

To the extent that Congress decides to adopt a mark-to-market framework, we believe it is critical to ensure that ordinary losses are "above the line" to avoid discriminatory treatment of losses as compared to gains. Further, instead of a mandatory deemed annual sale, taxpayers should be permitted to use their actual holding periods for purposes of determining their tax liability.

FIFO cost basis reporting for securities (Section 3421)

Section 3421 provides that taxpayers who sell a portion of their holdings in substantially identical stock generally would be required to determine their taxable gain or loss on a "first-in, first-out" basis. This provision eliminates the ability of fund managers to sell securities in a tax efficient manner by identifying the particular securities sold. This provision is a change to the provision in the financial products discussion draft, which would have required taxpayers to determine their gain or loss on an average cost basis for all substantially similar securities. While Section 3421's requirement to determine gain or loss on a FIFO basis may reduce the administrative concerns with the average cost basis proposal, it will still reduce the ability of managers to manage the trading activity of their funds in a tax efficient way. Further, a fixed FIFO cost basis approach could impose additional administrative burdens for funds that hold substantially identical stock at different broker-dealers and could cause many funds, administrators, and brokers to have to change their cost basis reporting to follow the prescribed method.

Capital Gains (Section 1002)

Section 1002 eliminates the different rate for long-term capital gains for non-corporate taxpayers, subjecting net long-term capital gains to the same rates (but not the same characterization) as ordinary income, including the 10% surtax for high-income taxpayers described in MFA's white paper on taxation of pass-through entities. The proposal does, however, permit taxpayers to take an above-the-line deduction equal to 40% of the net capital gain. The proposal does not change the 3.8% tax on net investment income.

Using "collars" to avoid paying capital gains taxes

The Senate Finance Committee Democratic staff paper released March 3, 2015 requests regulatory guidance under the existing statute. We understand that funds typically use collars within the bands described in the Congressional Committee Reports, as well as suggested parameters described in bar reports and comment letters (which are significantly larger than the band described in the staff paper). To the extent that Congress or Treasury determine that additional regulation is necessary, we believe those regulations should be consistent with the guidelines set out in the existing literature, such as, for example, IRS Revenue Ruling 2003-7.

Using wash sales to time the recognition of capital income

We understand that certain practices take advantage of perceived gaps in the statutory language, while others are designed around the regulatory "substantial overlap" rules under Section 246 of the Internal Revenue Code (the "Code"), under which a derivative based on an index or portfolio comprised of at least 20 positions will not be disaggregated. We believe that any legislation or regulation should be narrowly tailored to address concerns about abusive situations, without expanding the wash sale loss disallowance to new areas.

Using derivatives to avoid constructive ownership rules for partnership interests

This proposal from the Senate Finance Committee Democratic staff relates to an existing statutory rule for which they request regulatory guidance. We understand that funds generally take positions which are consistent with what reasonable regulations will provide. We believe that any guidance remains consistent with the existing statute.

Scope of investing activities under Section 864(b) of the Code

MFA supports statutory or regulatory changes to address significant ambiguities as to whether certain activities by otherwise passive non-U.S. investors, including but not limited to activities involving the acquisition of loans and other debt securities, issuing guarantees, and engaging in reverse repos with excess cash, would be treated as the conduct of a trade or business within the United States. We believe that ensuring a wide range of investing activities are included within the scope of Section 864(b) would generate significant value for U.S capital markets by encouraging additional investment in U.S. markets by non-U.S. investors.

Application of Section 305(c) of the Code to conversion ratio adjustments on convertible bonds

Based on our review of the legislative history to Section 305, we believe the general intent of the statute was to apply taxes to shareholders who increased their proportionate interest in the corporation, for example by receiving stock dividends in lieu of a cash dividend. Given the legislative history to Section 305(c), we believe Congress should amend Section 305(c) to not apply to ratio adjustments that are designed to protect convertible bond holders against erosion in the value of embedded call options in a convertible bond that occurs when an issuer pays a dividend to equity holders, rather than increase the convertible bond holder's proportionate interest in the corporation.