| asset management group

**Submitted electronically via http://www.regulations.gov**

Internal Revenue Service
via Federal e-Rulemaking Portal

**Re: Section 385 Proposed Regulations – Treatment of Certain Interests in Corporations as Stock of Indebtedness [REG-108060-15]**

Dear Sir or Madam:

The Asset Management Group of the Securities Industry and Financial Market Association ("SIFMA AMG")[1] appreciates this opportunity to provide comments to the Internal Revenue Service ("IRS") and the Department of Treasury ("Treasury") regarding proposed regulations under section 385 of the Internal Revenue Code ("Proposed Regulations"). SIFMA AMG appreciates the IRS and Treasury's efforts to limit the benefits of post-inversion tax avoidance transactions and discourage strategies that avoid U.S. tax by "stripping" U.S.-source earnings through intercompany debt. However, we believe the Proposed Regulations are too broad and reach beyond the IRS and Treasury's objectives, resulting in unintended consequences for the financial sector and investors.

The Securities Industry and Financial Market Association's Federal Tax Committee ("SIFMA") submitted a separate comment letter dated July 6, 2016, on the Proposed Regulations ("Federal Tax Committee Letter"), and as described below, SIFMA AMG wishes to express its support for the considerations and recommendations in the Federal Tax Committee Letter. Further, we would like to highlight those issues of particular importance to the asset management industry.

While the asset management industry shares some overlapping concerns with the financial sector, the particular characteristics of an asset management group[2] warrant additional consideration. An asset management group makes investments on behalf of client investors. In

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[1] SIFMA AMG is the voice for the buy side within the securities industry and broader financial markets, which serves millions of individuals and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. SIFMA AMG's members represent U.S. asset management firms whose combined assets under management exceed $34 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http:// www.sifma.org/amg.

[2] "Asset management group" is defined in this context as an asset management company doing business in the U.S. with an array of investments and/or affiliates, as well as investors, located throughout non-U.S. (i.e., foreign) jurisdictions.

this role, the asset manager advises on the commercial and market risks related to the investment. In doing so, asset managers must be mindful of foreign regulatory regimes that impose various requirements on investment advisers and investment vehicles. These risks and requirements influence the asset manager's decisions in structuring and timing certain intercompany transactions including, for example, debt issued from the manager to one of its affiliates in order to satisfy cash requirements for purposes of foreign regulatory capital requirements. Intercompany debt is issued to facilitate the asset manager's advisory role and not for the purpose of avoiding U.S. tax by "stripping" U.S.-source earnings through intercompany debt.

Below, Part I of this letter describes concerns of the asset management industry regarding the Proposed Regulations, and in Part II, the letter discusses SIFMA AMG's support of specific recommendations in the Federal Tax Committee Letter. Also in Part II, the letter analyzes the impending fallout from the recent referendum on June 23, 2016, that determined the United Kingdom ("UK") would leave the European Union ("EU"), its impact on the asset management industry, and the interplay with intercompany debt. Finally, in Part III, the letter addresses the IRS and Treasury's request for comments on "blocker" entities.

## I. ASSET MANAGEMENT INDUSTRY CONCERNS

An asset management group must have the ability to frequently and efficiently redeploy cash generated from one affiliate of the group to another affiliate in order to meet the investment needs of client investors. To do so, the redeployment of cash is generally through the issuance of debt instead of equity. Not only does declaring and paying dividends take more time than making payments on debt (e.g., due to the need to obtain board approvals), but certain foreign regulatory regimes condition distributions on having an excess of distributional reserve amounts, as well as the timing thereof. These non-tax restrictions may limit, or even prevent, the amount that can be declared and paid out as distributions. Additionally, dividends are often subject to foreign withholding taxes. In contrast, debt can be issued and repaid relatively quickly and is subject to fewer restrictions which apply to the distributional reserve amounts throughout various taxing regimes.

Moreover, during times of market turmoil, asset managers may need to quickly contribute cash to sponsored funds in order to mitigate undue reductions in fund net asset value, such as "breaking the buck" relative to stable dollar money market funds, funds under stress via heavy redemption orders, or portfolio and market illiquidity. In these instances, the fund's sponsor may not have the cash reserves on-hand to provide temporary financial support to its funds and may look to affiliates for funding. For these commercial, market, and regulatory reasons, debt frequently is the most practical method for rapidly redeploying cash within an asset management group. The Proposed Regulations would disrupt this process, forcing asset managers to decide between potentially adverse tax consequences arising from the proposed debt recharacterization rules or providing an efficient means to support their sponsored funds and investors.

An asset management group is similar to a multinational manufacturing group with a global supply chain and distribution network. Just as the manufacturing group cannot function without the ability to transfer raw materials and finished products between its members, an asset

management group cannot functionally operate without the ability to transfer cash between its affiliates and between jurisdictions. In addition to meeting the investment needs of client investors, cash transferability is necessary to settle outstanding payables for everyday services (such as investment management, administrative, and back-office functions) provided from one affiliate to another affiliate within the group. Indeed, in many cases, asset management group affiliates will engage in tens of thousands of intercompany debt transactions totaling over hundreds of millions of dollars over the course of a single year. The sheer volume of intercompany transactions, i.e., amounts due between affiliates, heightens SIFMA AMG's concern regarding the broad application of the Proposed Regulations.

In the asset management industry, intercompany debt financing, in form, typically involves utilization of term loans and revolving credit facilities (for long term intercompany financing) and cash pooling arrangements (for short term needs). SIFMA AMG notes that subjecting these types of obligations to recharacterization as stock will severely disrupt the asset management industry and the financial sector as a whole. Specifically, disruption to cash pool arrangements pose significant unintended consequences ranging from loss of foreign tax credits to taxable reorganizations. For instance, an affiliate's plan to enter into a tax-free corporate reorganization pursuant to section 368(a)(1)(C) of the Internal Revenue Code ("Code") may not come to fruition if another affiliate's short-term borrowing (unrelated to the reorganization) is recharacterized as an equity interest, diluting the control necessary to effect a tax-free reorganization.

Provided below are further instances where asset management groups are concerned about the impact of the Proposed Regulations.

**A. Seed Capital**

Asset managers are continually seeking out new investment opportunities and expanding the scale of existing ones. Many asset managers deploy seed capital, or cash that is invested by that asset manager in sponsored funds, to do so. Seed capital is necessary for a number of reasons including, but not limited to: (1) establishing a track record to demonstrate the investment manager's acumen and to help market the fund to unrelated investors; (2) providing the scale necessary to purchase the requisite quantity of shares (e.g., in the case of index funds) in order to offer a viable product that can meet its investment objective; and (3) aligning the asset manager's interests with those of its investors. Additionally, seed capital may be necessary when the fund is subject to foreign regulatory capital requirements where a minimum amount of seed capital is required by regulators. In practice, asset manager's seed capital investment tends to remain for a relatively modest period of time until the original need for provision of such seed capital no longer exists (e.g., the fund has attracted enough third party capital to operate efficiently and be marketed to third party investors).

Intercompany loans to facilitate seed capital funding may be subject to the Proposed Regulations. For example, a U.S. affiliate provides a loan to its foreign advisory affiliate that will subsequently make a capital contribution, as seed capital, into a new foreign investment fund. The investment by the foreign affiliate is common industry practice, for instance, to comply with regulatory requirements where it would either be impermissible or impracticable for the U.S.

affiliate to invest, itself, in the foreign fund. By design, the loan from the U.S. affiliate to the foreign affiliate is intended to be short term – if the fund is successful, it should normally be out of the seed stage within one to three years, and thus, the foreign affiliate would anticipate redeeming its equity interest at some point. SIFMA AMG's concern is that such intercompany loan would be subject to the recharacterization rules of Prop. Reg. section 1.385-3(b)(3) ("Funding Rule") and section 1.385-3(b)(3)(iv)(B) ("Per Se Rule"). Recharacterization of these loans as equity for tax purposes would be a real impediment to the natural operation of the asset management business. Investors (and regulators) require seed capital, while investment managers want to grow their business. The Proposed Regulations lead to a commercially impractical result thereby harming not only asset managers but individual savers and investors.

### B. Integrated Asset Management Group Transactions

An asset management group coordinates amongst its affiliates to provide investment and investment related services. A group will provide a number of services such as performing market research and analysis, selling investments, making investments, and numerous administrative services, making up an entire web of services resulting in many transactions within a group. Journal entries are kept to record intercompany payables and receivables as the services are rendered. The intercompany payables become due within a specific period of time (such as monthly or quarterly) after which, interest may or may not begin to accrue. Due to the high volume of intercompany transactions, oftentimes the number of payments and amount of interest (in some cases) will accrue until a settlement payment is made and documented.

SIFMA AMG's concern is that the sheer number of intercompany transactions coupled with the absence of immediate payments imposes burdensome documentation requirements upon asset managers under Prop. Reg. section 1.385-2 generally ("Documentation Rule"). Under the Documentation Rule, satisfying the preparation and maintenance of the documentation and information of the debt instrument is a threshold matter to determining whether the debt instrument should be treated as stock or indebtedness. Considering the nature and extent of intercompany transactions in an integrated asset management enterprise, performing a reasonable exercise of creditor status every time an intercompany payable is created becomes an impossible task. In effect, the Proposed Regulations' minimum standard, as set forth in the Documentation Rule, is far greater than that called for in the asset manager's normal course of business in dealing with its third party clients. That is, where payments are regularly made, but perhaps not in an immediate manner, compliance with the Documentation Rule would require the timely submission of "written documentation . . . evidencing the holder's reasonable exercise of the diligence and judgment of [the] creditor."[3] The consequence of not satisfying the Documentation Rule is the instrument being treated as stock, which is highly disruptive to the operational functioning of the asset management industry.

### C. Intercompany Debt Between Foreign Affiliates

The recharacterization of debt as stock will affect even certain debt instruments between two foreign affiliated asset managers that previously had no direct U.S. tax implications.

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[3] Prop. Reg. § 1.385-2(b)(2)(iv).

Suppose a U.S.-based parent of an asset management group owns a global asset manager headquartered in Europe. The manager in Europe decides to create a new fund investing in Asian securities that would be managed by an affiliated asset manager in Asia. The manager in Europe loans $30 million to the manager in Asia for provision of working capital, say, if a new specialist investment team was just hired in Asia and for mitigating undue cash friction caused by certain Asian regulatory or accounting distribution rules requiring sufficient reserves. Under the Proposed Regulations, the debt instrument issued between these two foreign affiliated asset managers could be recharacterized as stock. Aside from the fact that many of these transactions are in the ordinary course of business, intercompany debt between foreign affiliates raises an additional concern.

The implications of recharacterizing intercompany debt as stock appear incongruent with current global tax policy. That is, the U.S. would treat the loan as equity for federal income tax purposes, whereas the European and Asian jurisdictions would treat the loan as debt. The creation of a hybrid instrument, in this instance, raises further concerns under the current Organization for Economic Cooperation and Development's work on the Base Erosion and Profit Shifting ("BEPS") project. SIFMA AMG's concern is that the mismatch of treatment could lead to double taxation. The recharacterization of debt as stock raises the issue of potentially recognizing U.S. taxable income upon receipt of deemed dividends, while local interest deductions are denied by operation of local laws adopting Action 2 of the BEPS project.

**D. Regulatory Requirements and Brexit**

Asset managers are subject to extensive local and supranational (e.g., U.S. SEC, EU, ASEAN Passport) regulation. Setting aside those regulations which apply to the offering of fund interests, asset managers are also required to hold sufficient regulatory capital, maintain adequate liquidity, and operate in a well-controlled manner. An asset manager's capital structure could be comprised of various forms of equity and debt.

In these regards when discussing regulatory requirements, we would be remiss if we did not raise the recent referendum on June 23, 2016, that determined the UK would leave the EU, also known as "Brexit". How this will play out, during transition and afterwards, is unclear at this stage as there is no precedent for a member state leaving the EU. The process does entail negotiations on the withdrawal agreement, on future arrangements between the UK and EU, and on trade deals between the UK and non-EU countries. The statutory period for negotiation, once the UK gives notice to the EU, is two years, which can be extended by unanimous consent amongst the UK and remaining EU member states. Once this process is complete, likely over several years, a whirlwind of change will take effect.

Brexit will cause a paradigm shift in the EU asset management regime. The EU regime is primarily defined by the Undertakings for Collective Investments in Transferable Securities Directives ("UCITS"), the Markets in Financial Instruments Directive, and the Alternative Investment Fund Managers Directive. These rules generally provide strict regulatory requirements on EU member state asset managers, but in return, these managers are given passporting rights. These rights allow managers to establish and market funds in the other EU member states. Once the UK officially leaves the EU, it is likely to have less access to EU

markets. Consequently, this would alter the landscape of the European asset management industry in which U.S.-based managers are leading players.

Under such a scenario, many UK advisory affiliates may need to undergo a massive restructuring in response to the UK and EU rules governing investment funds. The UK fund manager that had access to the EU markets may no longer be able to use, for example, their UCITS passporting rights. Many fund managers may have to revise their investment fund offerings, including domiciling the funds elsewhere. In addition, where many U.S.-based managers might have structured their European business under a single entity, sited in the UK, such asset manager's might need to completely revamp their current structures. While it is too early to readily foresee, the UK business might need to be separated from the rest of the EU business with branches today turning into subsidiaries tomorrow. Most relevant here though is that the regulatory capital and business models of European asset managers might need to be re-cut and organizational designs restructured. One could anticipate a multitude of capital-type restructuring transactions, be they Code section 304 redemptions, tax-free reorganizations (e.g., asset transfers, spin-offs), and Code section 351 transfers, in nature.

While some of the restructurings may be funded with equity, a greater number of these restructurings would likely involve intercompany debt, for instance, because local asset managers might not have enough cash on-hand to effect at market value such transactions. It would be imprudent that by virtue of the Proposed Regulations that asset managers are forced to secure external borrowing or over-capitalize local asset managers with equity in these instances. Furthermore, because of the long-tenured operation of the Per Se Rule, future responses to the consequences of Brexit may force asset managers to confront decisions whereby regulatory and business models mandate change but doing so will be costly due to dividends distributed in the three preceding years when Brexit's outcome was unknown.

Given the reach of the Proposed Regulations, U.S. asset managers with affiliates in the UK would have their loans unjustly subject to recharacterization as stock. We urge Treasury and IRS to carefully consider the potential impact that the Proposed Regulations will have on this recent development, including the considerable business uncertainties invoked. Brexit serves as an example of why the Per Se Rule, itself, ignores evolving market and regulatory changes that will continue to drive structures, funding, and business models. We urge the IRS and Treasury to scrutinize the Proposed Regulations so that the Proposed Regulations are not finalized in a manner that will permanently impede asset managers and other financial institutions from engaging in commercially appropriate transactions.

## II. SIFMA AMG SUPPORTS THE FEDERAL TAX COMMITTEE LETTER RECOMMENDATIONS

As described below, SIFMA AMG agrees with recommendations described below in the Federal Tax Committee Letter, including the recommendation that the IRS and Treasury grant an exception from the Funding Rule for any debt instrument issued by any member of a "regulated financial group".[4] The consequences of any such debt instrument recharacterized as stock and its

potential cascading effects would directly and indirectly impact all of the financial industry, including asset managers and investors.

Many of the other Federal Tax Committee recommendations would also alleviate investor concerns and/or ensure the proper operational functioning of the financial industry as a whole. SIFMA AMG's support includes but is not limited to the recommendation on the delay of the effective dates of the Funding Rule and Documentation Rule, the exemption for debt instruments issued by a member of a regulated financial group that has a stated maturity of less than one year, and exceptions for ordinary course transactions from the Proposed Regulations. Below, SIFMA AMG highlights a few recommendations and provides additional details on their significance to the asset management industry. We urge IRS and Treasury to consider these concerns in order to ensure that the Proposed Regulations do not negatively impact asset managers and their institutional and individual investors.

### A. Proposed Regulations Section 1.385-2 Recommendations

SIFMA AMG supports the recommendations in the Federal Tax Committee Letter regarding the Documentation Rule. Further, SIFMA AMG submits that the Documentation Rule should not apply to any expanded group instrument issued by a member of an expanded group to another member of that group that is an investment company or investment adviser, as both are defined under 12 C.F.R. § 249.3.[5] As indicated earlier in this letter, asset managers engage in tens of thousands of intercompany transactions, involving hundreds of millions of dollars over the course of a single year. Accordingly, even the consequences of "foot faulting" on the Documentation Rule is exacerbated within the asset management industry.

Alternatively, SIFMA AMG recommends an exception to the Documentation Rule similar to the one provided under the Per Se Rule. The Per Se Rule provides an exception for certain debt instruments under Prop. Reg. section 1.385-3(b)(3)(iv)(B)(2) (the "Trade or Services Payable Exception"). The Trade or Services Payable Exception applies to debt instruments that arise in the ordinary course of the issuer's trade or business in connection with the purchase of property or the receipt of services.[6]

As an analog to the exception for the Per Se Rule, the Documentation Rule should provide a specific exception for any expanded group instrument issued by an expanded group member to another group member that is an investment company or investment adviser, in the ordinary course of its business of investment management. Such an exception is not only consistent with the Trade or Services Payable Exception, but it allows asset managers to continue using its current business models rather than forcing managers to seek unrelated third party debt

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[4] "Regulated financial group" is defined in the Federal Tax Committee letter with reference to "regulated financial company" as defined under 12 C.F.R. § 249.3.

[5] An "investment company" is defined as a person or company registered with the SEC under the Investment Company Act of 1940 or foreign equivalents of such persons or companies, and an "investment adviser" is defined as a company registered with the SEC as an investment adviser under the Investment Advisers Act of 1940 or foreign equivalents of such company.

[6] Prop. Reg. § 1.385-3(b)(3)(iv)(B)(2).

financing and thereby increasing the expense of investment for institutional and individual clients.

### B. Proposed Regulations Section 1.385-3 Recommendations

SIFMA AMG also supports the recommendations in the Federal Tax Committee Letter regarding Prop. Reg. section 1.385-3. Further, SIFMA AMG submits that if the Prop. Reg. section 1.385-3 is not withdrawn (as recommended in the Federal Tax Committee Letter), the Funding Rule should not apply to any expanded group instrument issued by an expanded group member to another group member that is an investment company or investment adviser, as both are defined under 12 C.F.R. § 249.3.

This exception is necessary because an asset management group routinely engage in debt issuance and acquisition amongst the affiliates of the group to meet the investment needs of client investors and to provide expedient access to cash. As intended under the Proposed Regulations, this exception for investment companies and advisers would appropriately balance between preventing tax-motivated transactions among members of an expanded group and accommodating necessary and ordinary course transactions. Otherwise, the potential recharacterization of debt as stock and its subsequent unintended consequences may force asset managers to seek other methods of debt finance. The business expenses for such finance provided by a third party, multiplied by the volume and frequency of transactions, could ultimately affect the return on investments for institutional and individual clients.

Alternatively, SIFMA AMG recommends that the Trade or Services Payable Exception should extend to the Funding Rule.[7] The IRS and Treasury have acknowledged, to a certain degree, that ordinary course debt issuance transactions should not be subject to recharacterization as stock.[8] While SIFMA AMG is cautiously confident that the Trade or Services Payable Exception applies with respect to certain integrated asset management group transactions, not all debt is issued or acquired in connection with the purchase of goods or receipt of services within the asset management industry. For example, the debt related to the deployment of seed capital could extend beyond the 36-month post-distribution or acquisition period proposed in the Per Se Rule (where the fund is unable to make it out of seed stage quickly), and thus would be ineligible for the Trade or Services Payable Exception. Yet, the Funding Rule would still need to be applied to determine whether it is principal purpose debt. By definition, these operational business transactions should not be treated as a principal purpose debt instrument because they are not "motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context."

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[7] The Federal Tax Committee Letter includes this recommendation as well as applicable to ordinary course business conducted by regulated financial groups.

[8] See discussion in Part II, above, on the Per Se Rule.

## III. BLOCKER ENTITY POLICY CONCERNS

In the Notice of Proposed Rulemaking for the Proposed Regulations, the IRS and Treasury specifically requested comments on "whether certain indebtedness commonly used by investment partnerships, including indebtedness issued by certain 'blocker' entities implicate similar policy concerns as those motivating the proposed regulations, such that the scope of the proposed regulations should be broadened." To the extent that the policy concerns raised is to curb corporate inversion by limiting the benefits of post-inversion tax avoidance transactions through intercompany debt, SIFMA AMG believes that the Proposed Regulations need not be broadened to address blocker entities.

SIFMA AMG recognizes that blocker entities may be employed for purposes of reducing tax liabilities; however, these entities are also used to address specific issues such as having the ability to return monies to investors free of non-tax commercial burdens like financial accounting, legal or regulatory constraints. Moreover, the current limitation on interest expense under Code section 163(j) serves to further govern potential abuses related to blocker entities.

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SIFMA AMG sincerely appreciates the opportunity to provide comments and your consideration of the recommendations. We stand ready to provide additional information or assistance that the IRS and Treasury might find helpful. Please do not hesitate to contact either Timothy Cameron at (202) 962.7447 or tcameron@sifma.org, or Lindsey Keljo at (202) 962.7312 or lkeljo@sifma.org with any questions.

Sincerely,

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