NEW YORK UNIVERSITY SCHOOL OF LAW

SPRING 2015
COLLOQUIUM ON TAX POLICY
AND PUBLIC FINANCE

.

"A Compendium of Private Equity Tax Games"

Gregg Polsky
University of North Carolina

May 5, 2015
NYU Law School
Vanderbilt Hall-208
Time: 4:00-5:50 p.m.
Number 14

SCHEDULE FOR 2015 NYU TAX POLICY COLLOQUIUM
(All sessions meet on Tuesdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 20 – Brigitte C. Madrian, Harvard Kennedy School.
   "Does Front-Loading Taxation Increase Savings? Evidence from Roth 401(k) Introductions."

2. January 27 – David Kamin, NYU Law School. "In Good Times and Bad: Designing Legislation That Responds to Fiscal Uncertainty."

3. February 3 – Kimberly Blanchard, Weil, Gotshal & Manges. "The Tax Significance of Legal Personality: A U.S. View."

4. February 10 – Eric Toder, Urban Institute. "What the United States Can Learn From Other Countries' Territorial Tax Systems."

5. February 24 - Linda Sugin, Fordham University, School of Law. "Invisible Taxpayers."

6. March 3 – Ruth Mason, University of Virginia Law School. "Citizenship Taxation."

7. March 10 – George Yin, University of Virginia Law School. "Protecting Taxpayers from Congressional Lawbreaking."

8. March 24 – Leigh Osofsky, University of Miami School of Law, "The Case for Categorical Nonenforcement."

9. March 31 – Shu-Yi Oei, Tulane University Law School. "Can Sharing Be Taxed?"

10. April 7 – Lillian Mills, University of Texas Business School. "Managerial Characteristics and Corporate Taxes."

11. April 14 – Lawrence Zelenak, Duke University School of Law. "For Better *And* Worse: The Differing Income Tax Treatments of Marriage at Different Income Levels."

12. April 21 – David Albouy, University of Illinois and NBER
    "Should we be Taxed Out of Our Homes? The Optimal Taxation of Housing Consumption."

13. April 28 – David Schizer, Columbia Law School. "Energy Tax Expenditures: Worthy Goals, Competing Priorities, and Flawed Institutional Design."

14. **May 5 – Gregg Polsky, University of North Carolina School of Law, "A Compendium of Private Equity Tax Games."**

A Compendium of Private Equity Tax Games

Gregg D. Polsky[*]

This paper will describe and analyze tax strategies, lawful and unlawful, used by private equity firms to minimize taxes. While one strategy—the use of "carried interest"—should by now be well understood by tax practitioners and academics, the others remain far more obscure. In combination, these strategies allow private equity managers to pay preferential tax rates on all of their risky pay (through carried interest), pay preferential tax rates on much of their non-risky pay (through management fee waivers and misallocations of their expense deductions), and push much of the residual non-risky pay down to their funds' portfolio companies who, unlike the fund, can derive significant tax benefits from the resulting deductions (through monitoring fees and management fee offsets).

After describing these strategies, the paper turns to their implications. Two of the strategies are undoubtedly abusive and should have been eliminated by the IRS years ago. But because of woeful tax enforcement in the private company sector, the strategies persist despite the fact that the taxpayers are advised by elite law firms and Big 4 accounting firms, whose professional norms are supposed to protect the tax system from this sort of abuse. This race to the bottom of tax compliance has serious implications for a variety of actors. While it has obvious relevance for the IRS and tax practitioners, the state of affairs is also important for policymakers to understand. Fundament tax reform is (allegedly) on the horizon, and reformers need to understand how tax law is really practiced on the ground.

I. *Background: Private Equity Activities and Structure*

Private equity funds pool capital to make investments in portfolio companies, usually in connection with increasing the leverage of these companies. Typically, these funds will, alone or in concert with other funds, buy all or nearly all of a portfolio company's outstanding stock.[1] A fund's investments, whether stock or debt, are held as capital assets and typically for more than one year; therefore nearly all of the gains realized by the funds will be characterized as long-term capital gains or dividend income, both of which are preferentially taxed.

Professional fund managers organize and manage the funds and, in exchange for these services, generally receive the following compensation: (1) an annual management fee paid by the fund (the "management fee"), (2) a contingent incentive fee paid by the fund, entitling the manager to a specified percentage of the fund's overall net gain (the "carried interest"), and (3) periodic "monitoring fees" and "transaction fees" paid by the fund's portfolio companies. The annual management fee is typically equal to two percent or so of capital commitments, and the incentive fee is usually approximately 20 percent of the fund's profits;[2] thus, the famous "two and twenty" deal.

---

[*] Willie Person Mangum Professor of Law, University of North Carolina School of Law. Thanks to… for comments and suggestions on earlier drafts. Disclosure: I am involved in tax whistleblower claims relating to some of the issues discussed in the Article.

[1] Venture capital funds, a specialized subset of private equity, generally take only minority interests in their portfolio companies, and they do not use leverage. While venture capital funds use some of the tax strategies described in this Article, they do not use all of them.

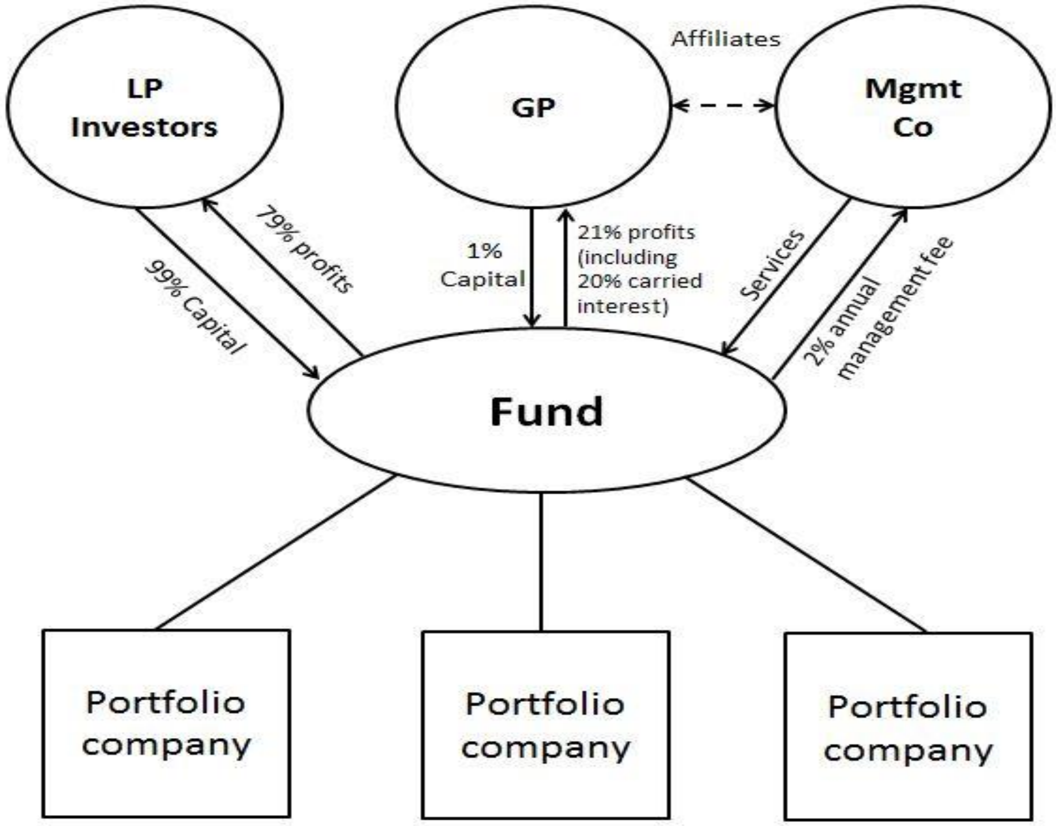
[2] Often there is a hurdle rate of return that the fund must surpass before carried interest is earned.

Management fees and monitoring/transactions fees are inter-connected through a "fee offset" provision, which generally reduces management fees on, or very close to, a dollar-for-dollar basis by the amount of monitoring/transaction fees received by the manager. As discussed in depth below, the effect of a fee offset is simply to push management fees down from the fund level to the portfolio company level. Given the overlapping interests between the portfolio companies and the funds that own them, the economic results are nearly the same as if monitoring/transaction fees were not charged. For ease of exposition, most of the discussion below will ignore monitoring/transaction fees and focus on management fees and carried interest.

Although fund managers receive both the management fee and the carried interest, they generally use different entities to receive each type of compensation. Fund managers set up one company, usually a partnership for tax purposes, to perform the management services for every fund under its management. This entity is referred to interchangeably as the management company, the private equity firm, or the sponsor, and it receives the annual management fee. In addition, for each fund under management, the manager organizes a new flow-through entity to serve as the general partner of the fund. This entity is known as the general partner, and it receives the carried interest. Thus, a fund manager will operate through a single management company and multiple general partners (one for each fund under its management).

Investors generally require that fund managers also contribute capital to the fund to ensure that they have some "skin in the game." The general partner (or an affiliate of the general partner) typically is required to make a capital commitment of one percent or more of the total capital committed; in exchange, the general partner receives a proportionate capital interest in the fund.

The relationships among the investors, the general partner, the management company, the fund, and the portfolio companies are depicted below, assuming a 2 and 20 deal with a 1 percent capital commitment by the general partner:



As mentioned above, the general partner and the management company are flow-through entities. Their owners are the individual fund managers, who typically are high-income U.S. individuals. On the other hand, the limited partners generally do not pay U.S. taxes, either because they are tax-exempt or foreign. The portfolio companies in which domestic private equity funds invest are typically U.S. corporations. As will be seen, the different tax statuses of the parties play a significant role in the private equity industry's tax games.

II. *Strategy #1: Pay Preferential Tax Rates on All Risky Pay*

The carried interest is structured not as a contingent-fee-for-services, but rather as a special allocation of items of capital gain or dividend income to the general partner. Under the existing partnership rules, the capital gain/dividend character sticks to the items as it flows-through the fund partnership to the general partner, and then flows through the general partner to the individual fund managers.[3] Thus, the individual fund managers recognize capital gain and dividend income, even though these are the fruits of the managers' labor and even though such income is almost universally taxed at ordinary income rates.[4]

[3] See I.R.C. § 702(b) (providing that the character of partnership tax items are characterized at the partnership level).

[4] See generally Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. Rev. 1 (2008). Some exceptions that prove the rule that labor income is taxed as ordinary income are incentive stock options and founder's stock. However, both of these types of compensation forfeit the corresponding

While the carried interest loophole has already been the subject of intense debate and scrutiny, the role of the investors' tax-exempt status in facilitating its exploitation is often ignored.[5] If the carried interest were structured as a contingent-fee (instead of as a partnership interest that is characterized as a profits interest), then the managers would realize ordinary income, but the investors would also receive an ordinary deduction. When the carried interest is structured as a profits interest, the manager realizes capital gains, and the investors realize reduced capital gains because 20 percent of the gains, which would otherwise be allocated to the investors, are sheared off and re-directed to the manager; this has the same effect as giving the investors a capital loss in respect of the incentive fee. To illustrate, assume that a fund realizes $100 of capital gains and pays $20 in carried interest. If the carried interest was structured as a fee, the investors would realize $100 of capital gains and $20 of ordinary deductions, and the manager would realize $20 of ordinary income. If the carried interest was structured instead as a profits interest, the investors would realize $80 of capital gains--which is the same as realizing $100 of capital gains but also $20 of capital loss instead of $20 of ordinary deduction, and the manager realizes $20 of capital gains. The table below summarizes and compares these results.

---

employer deduction. Thus, in many situations, these items would result in an increase of overall tax liability. In the cases where they do not, the employee tax benefit can be viewed as partially ameliorating the tax law's unfortunately harsh treatment of the employer corporation's net operating losses. For further discussion of these points, see Gregg D. Polsky & Brant J. Hellwig, Examining the Tax Advantage of Founders' Stock, 97 Iowa L. Rev. 1085 (2012).

[5] Chris Sanchirico was the first to utilize a multi-lateral tax perspective in analyzing the tax benefits from carried interest's current tax treatment. See Chris William Sanchirico, The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?, 75 U. Chi. L. Rev. 1071 (2008). Some other analysts subsequently adopted the approach. See, e.g., Michael S. Knoll, The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profits Interests as Ordinary Income, 50 Wm. & Mary L. Rev. 115 (2008); Karen C. Burke, The Sound and Fury of Carried Interest Reform, 1 Columbia J. of Tax Law 1 (2010); Gregg D. Polsky, Private Equity Management Fee Conversions, Tax Notes, February 9, 2009 (all adopting Sanchirico's approach).

Structure	*Manager's Tax Consequences*	*Investor's Tax Consequences*
Incentive Fee	$20 O.I.	$100 C.G. & ($20) O.D.
Carried Interest	$20 C.G.	$80 C.G. [equals $100 C.G. & ($20) C.L.]
Difference	O.I. into C.G.	O.D. into C.L.

Therefore, by converting the incentive fee to carried interest, the manager has turned ordinary income into capital gain (as is well understood), but the investors have simultaneously turned ordinary losses into capital losses. If the investors and the manager were both taxable and subject to the same tax rates, then this character swap detriment to the investors[6] would precisely offset the character benefit to the managers, and the net cost to the fisc would be zero. (It might appear that there would still be distributional concerns from this situation—the investors appear to be getting a raw tax deal and the manager a tax windfall—but sophisticated parties would take these tax consequences into account in setting the pre-tax amount of compensation.)

In fact, however, private equity investors are, for the most part, tax-indifferent. Tax-indifferent investors do not care at all about turning ordinary losses into capital losses.[7] Thus, the managers win and the investors do not lose, which means that the fisc loses on an overall, net basis. This shows that the carried interest loophole exists in substantial part because of the tax-indifference of the manager's counterparties.[8] The loophole leverages this tax-indifference to the manager's advantage—in the form of reduced tax rates—and also likely to the investors' advantage—in the form of a reduction in the fees that they must pay managers.

While the investors' tax indifference is generally a good thing for the parties (because they can exploit it to their mutual advantage), it can also present a problem. Consider the two percent management fee that is paid by the fund annually. When the fund pays that fee, it generates an ordinary deduction for the fund, which is allocated to the limited partner investors. But the tax-indifferent investors do not receive any benefit from these ordinary deductions. Thus, the

[6] Turning ordinary losses into capital losses is a character swap detriment because capital losses will shelter low-rate capital gains while ordinary losses will shelter high rate ordinary income. In addition, only capital losses are subject to the section 1211 limitations, but because carried interest is only earned if the fund is profitable (meaning that carried interest allocations will always reduce gains to the investors as opposed to resulting overall losses), the section 1211 limitation will have no impact here, unless the investor has large capital losses outside of the fund that it otherwise cannot use currently.

[7] Even the minority of private equity investors who are taxable investors in private equity funds typically would not mind this conversion. Investors that are taxable corporations will often be indifferent as to the character swap here because there is no corporate tax preference for capital gains. (If the corporation has substantial capital losses outside the fund, then it might nevertheless prefer ordinary losses so that it could utilize those outside losses to absorb the extra capital gains realized through the fund.) U.S. individuals also might not be significantly adversely affected by the character swap because the lost ordinary deductions are characterized as miscellaneous itemized deductions, which are subject to the two percent floor in section 67 for regular income tax purposes and disallowed entirely for alternative minimum tax purposes. In light of these limitations, some individual investors may be better off with a capital loss than with an impaired miscellaneous itemized deduction; even if not better off, the limitations on deductibility will often reduce the tax cost of the character swap.

[8] For further elaboration on this point, see generally Sanchirico, supra note 5.

management fee results in the worst-of-both-worlds—ordinary income to the managers and an offsetting useless deduction. The parties respond to this in three ways: by attempting to convert management fees into additional allocations of preferentially taxed income, by sheltering the management fee income using the private equity firm's deductions, and by trying to push management fees down to the portfolio companies.

III. *Strategy #2: Management Fee Waivers*

Management fee waivers are designed to convert the ordinary income from management fees into additional allocations of capital gains or dividend income. Of course, such a character swap could easily be accomplished by reducing management fees in exchange for a larger profit share. For example, two-and-twenty could be converted into one-and-thirty; this would undoubtedly be effective in converting income. However, private equity managers and investors do not appear to be interested in changing the economics of their deal, so managers are left with trying to dress up their two-and-twenty as something else, which is what management fee waivers accomplish.

I have previously explored management fee waivers in great detail,[9] so I will only briefly describe them and the related tax issues here. There are two main types of fee waivers: elective waivers and upfront (or hardwired) waivers, though they are in fact very similar. In elective waivers, the management company periodically elects to waive future installments of the management fee; in exchange the general partner (or its affiliate) receives an additional partnership interest (i.e., in excess of its 1 percent capital interest and 20 percent profits interest) in the fund.

In upfront waivers, the management company's election to waive all or some its future management fees is made upon inception of the fund rather than periodically during the life of the fund. For example, some upfront fee waivers provide that a specified percentage or dollar amount of future management fees are waived upon inception. Other upfront fee waivers provide that a certain percentage or dollar amount of the general partner's capital contribution obligations will be satisfied through the reduction of the management company's future management fees.

Whether elective or upfront, fee waivers provide for an exchange of the right to fees for an additional partnership interest in the fund. The exchange is intended to cause the general partner to ultimately realize an amount of long-term capital gains and dividend income equal to the amount of the management company's forgone management fee. If successful, the fund manager will have converted immediate ordinary compensation income into deferred preferentially-taxed long-term capital gains and dividend income, and, given the tax statuses of the fund's investors, this swap will have little or no detrimental consequences to the limited partners.

When a management fee is waived by the management company (whether via an elective or upfront waiver), the general partner becomes entitled to a priority allocation of long-term capital gains and dividend income equal to the amount of the waived fee.[10] In addition, to maintain similar

[9] See Polsky, supra note 5.

[10] In funds that are intended to satisfy the substantial economic effect safe harbor, this priority allocation is explicit in the allocation provisions. In funds that use targeted allocations, the special allocation presumably results from the distribution waterfall, which allows the general partner to receive additional distributions on account of the fee waiver.

cash flows, the general partner's obligation to make capital contributions to the fund is reduced by the amount of the waived fee, and the investors instead make an extra capital contribution on the general partner's behalf. Even though the investors fund the general partner's capital contribution, the general partner is entitled to receive distributions from the contribution in precisely the same manner as if the contribution were made by the general partner in cash, leaving aside the critical "available gains/profits" limitation discussed below.

To illustrate, assume that a general partner, who has previously waived $1M of management fees, is required to contribute one percent of the fund's capital commitments, and the fund is now calling $100M of capital to buy Company X, and Company X is subsequently sold by the fund for $200M. (It is assumed that there is no carried interest to keep the illustration simple.) Because of the fee waiver, the investors fund all $100M of the capital to buy Company X, whereas absent the fee waiver the general partner would have been required to contribute $1M. Nevertheless, the general partner still effectively has a one percent interest in Company X, so that when the company is sold, the general partner is entitled (subject only to the available gains/profits limitation) to receive $2M of distributions (i.e., one percent of the $200M sales price). From a tax perspective, the general partner will be allocated $2M of the $100M of capital gains resulting from the sale of Company X; $1M is the priority allocation resulting from the $1M waived fee, $1M represents the investment gain on the general partner's "capital interest" in Company X.[11] The remaining $198M of cash from the sale is distributed to the investors, who are also allocated the remaining $98M of capital gains.[12]

In contrast, had the waived fee of $1M been paid in cash and the general partner's capital commitment been satisfied in cash, the cash flows stemming from the sale of Company X would be identical: $2M to the general partner and $198M to the limited partners. But tax-wise the manager would have realized $1M of ordinary income when the fee was paid and only $1M of capital gains (one percent of the $100M total gain) when Company X was sold. The investors would realize $1M of ordinary deductions when the management fee was paid by the fund and, upon the sale of company X, the remaining $99M of the total gain. Thus, the end result is the character swap described above in the discussion of carried interest: $1M of ordinary income into $1M of capital gains for the manager and $1M of ordinary deductions into $1M of capital losses for the investors.

Key to the manager's tax position that fee waivers are effective is the available gains/profits condition. If, after the waiver, the manager was entitled to precisely the same distributions from portfolio investments as it was before the waiver, then there would be a clear taxable capital shift in favor of the general partner. The taxable capital shift (or, in other words, the receipt of a capital interest in the fund) would result in immediate ordinary income realized by the general partner, defeating the tax purpose of the fee waiver technique. To prevent this capital shift, the fund partnership agreement will purport to either (i) limit distributions in respect of the fee waiver partnership interest or (ii) claw back such prior distributions, if the fund does not realize "available gains" or "available profits" in an amount sufficient to cover the waived fees.

Available gains are often defined as the cumulative amounts of gains or other gross income items realized after the date of the fee waiver election; losses and deduction items are ignored in

[11] "Capital interest" is in quotes because managers take the position that their indirect interest in Company X is not a capital interest because of the available gains/profits condition discussed below.

[12] The remaining $100M of distributions represents the return of the investors' capital contributions.

computing available gains.[13] Available profits are commonly defined as the cumulative amounts of net income during accounting periods following the date of the fee waiver; accounting periods with net losses are ignored in computing available profits. In determining both available gains and available profits, all of the fund's assets are supposed to be booked up or booked down to fair market value at the time of the waiver so that built-in gains at the time of the fee waiver will not be not counted as available gains or in calculating available profits.

These definitions are bizarre in that they ignore either loss transactions (in the case of available gains) or accounting periods with losses (in the case of available profits). In contrast, entitlement to carried interest distributions is based on the overall profitability of the fund; in other words, all transactions and accounting periods "count" in determining entitlement to carried interest distributions. The definitions are intended to qualify, at least under a hyper-literal interpretation, the partnership interest resulting from a fee waiver as a "profits interest" under the Rev. Proc. 93-27 safe harbor. If the fund were liquidated immediately after the issuance of a fee waiver interest, there would be no distributions made in respect of that interest because there will not have been any opportunity for any of the fund's investments to appreciate in value and thus no available gains/profits (assuming a proper book-up of the fund's assets to fair market value in the context of an elective waiver).

However, the fact that the fee waiver interest might satisfy the technical definition of a "profits interest" under the safe harbor should not insulate the fee waiver technique from challenge. First, it appears likely that the conditions for the Rev. Proc. 93-27 safe harbor are not satisfied in the typical case, which means that the IRS is not precluded from taxing fee waiver partnership interests, which are easy to value considering that they have clearly been received in lieu of a fixed fee.[14] Second, it is not clear that such a hyper-literal interpretation of the safe harbor is appropriate, considering that the drafters of the safe harbor surely were had garden variety profits interests in mind. Finally, and perhaps most importantly, Congress enacted section 707(a)(2)(A) precisely to counteract this sort of strategy to artificially disguise fees-for-services as a partnership interest in an effort to turn ordinary income into capital gains.

Section 707(a)(2)(A) was designed to address artificial partnership transactions that are, in substance, merely fee-for-service transactions. In fact, the possibility that artificial partnership transactions could transmute ordinary income into capital gains was explicitly cited in the legislative

[13] See, e.g., Amended and Restated Agreement of Limited Partnership of Incline Equity Partners III (PSERS), L.P. (dated as of September 30, 2011), available at http://nakedcapitalism.net/LPAs/verified-as-LPAs/164334_psers-011-019.pdf. While this limited partnership uses the term "Available Profits," it is really an available gains condition because the term is defined to include "the sum of the share… of all gains (without offset for losses)."

[14] See Polsky, supra note 5, at 754-62. For example, because the management company performs the services giving rise to the right to the fee waiver partnership interest, while the general partner (or a related special limited partner) receives that the partnership interest, there has been a constructive transfer of the partnership interest within two years, which removes the interest from the safe harbor. See Afshin Beyzaee, Current Tax Structuring Techniques for Private Equity Funds, 20 J. Taxation & Reg. of Fin. Inst. 16, 20 (2007) (noting that "the most probably treatment would be deemed distribution of the Waiver Interest by the management company followed by a deemed contribution to the affiliated limited partners" and that "because the deemed transfer would occur within two years of the deemed initial grant, the grant of the profits interest would not fall squarely within the four corners of Rev. Proc. 93-27").

history as a problem intended to be addressed by this provision.[15] The legislative history also makes clear that the critical issue in distinguishing between fee-for-service transactions disguised as partnership transactions and bona fide partnership transactions is the absence or presence of entrepreneurial risk. The existence of entrepreneurial risk would be indicative of a bona fide partnership transaction; in the absence of such risk, the transaction would be recast under section 707(a)(2)(A).[16]

Therefore, the critical issue under section 707(a)(2)(A) is whether the available gains/profits condition results in the requisite amount of entrepreneurial risk necessary to avoid recharacterization. An available gains condition constitutes a special allocation of gross income, which was recast as compensation even before section 707(a)(2)(A) was enacted.[17] An available profits condition is a special allocation of net income during the particular accounting period used (annual or quarter). But even if annual net income is allocated (without any reduction for prior net losses nor subject to clawback in the event of future net losses), it is clear that whatever risk is assumed, it is non-entrepreneurial because the holder can receive substantial distributions even if the fund does not make any profits and, in fact, even if the fund loses a substantial amount money overall.

This conclusion that section 707(a)(2)(A) applies to common types of fee waivers is consistent with the conclusions of other commentators. Professor Karen Burke believes that "section 707(a)(2)(A) clearly should suffice to catch a typical management fee conversion."[18] Professor Howard Abrams similarly concludes that section 707(a)(2)(A) applies to typical fee waiver provisions:

> [Section 707(a)(2)(A)] should capture not only gross income allocations (as are captured under current law) but also annual net income allocations that will not be offset by subsequent allocations of loss even if the partnership suffers losses in the future. That is, allocation on a carried interest, followed by the distribution of the allocated amount, to the extent not subject to a potential claw-back allocation does not reflect an entrepreneurial return because it is independent of the overall success of the venture. Such allocations and distributions, therefore should be 'properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership.[19]

[15] See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 224 ("[I]f a service-providing partner was allocated a portion of the partnership's capital gains in lieu of a fee, the effect of the allocation/distribution will be to convert ordinary income (compensation for services) into capital gains.") See also S. Rep. No. 169, 98th Cong., 2d Sess. 225, 228 (1984).

[16] See Polsky, supra note 5, at 763-64.

[17] Rev. Rul. 81-300, 1981-2 C.B. 143 (characterizing allocations of gross rental income as guaranteed payments for services under section 707(c)). The legislative history of section 707(a)(2)(A) subsequently confirmed the result, but clarified that the facts would now be recharacterized under that provision rather than as guaranteed payments. See Staff of Joint Comm. on Taxation, H.R. 4170, 98th Cong., P.L. 97-248, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 230.

[18] Karen C. Burke, Back to the Future: Revising the ALI's Carried Interest Proposals, Tax Notes, October 12, 2009.

[19] Howard E. Abrams, Taxation of Carried Interests: The Reform That Did Not Happen, 40 Loy. Univ. Chi. Rev. 197, 222 (2009).

Even tax practitioners have explicitly recognized the lack of meaningful risk resulting from current fee waiver practices:

> The reality is that most partners engaging in fee waivers want to do so on terms that do not *meaningfully alter* their right to receive the underlying funds, or subject it to *greater risk*. The ideal result for most waiver arrangements is one where, if tax considerations are put aside, there is *essentially no change* to their right to receive the funds.[20]

The lack of entrepreneurial risk is apparent even if you assume unrealistically that the available gains/profits conditions will be carefully applied and stringently enforced. In fact, however, it is doubtful that this is happening. The fund agreements typically give the general partner the unilateral discretion to calculate the amount of available gains/profits and to determine whether and how any limitation on distributions (or clawback of prior distributions) is to be made. In addition, the critical terms "available gains" or "available profits" are sometimes completely undefined[21] or so ambiguously or complicatedly defined that general partners can define the terms any way they like. In these cases, the available gains/profits condition is effectively an illusory condition because, given the discretion afforded the general partner and the ambiguity of the condition, no limited partner would ever be able to successfully sue to recover fee waiver distributions that were improperly received.[22]

Fee waivers, therefore, do not work under current law. Treasury and the IRS have fee waivers listed on the current guidance plan, and there have been suggestions that such guidance is imminent. The guidance should confirm that section 707(a)(2)(A) recharacterizes fee waiver arrangements that do not, at a minimum, condition fee waiver distributions on the fund's overall profitably after the fee waiver election. Thus, fee waivers would have to use available profits and define that term to mean the amount of overall net economic income, if any, realized by the fund after the fee waiver election (i.e., taking into account <u>all</u> gains and <u>losses</u>).

This approach is both simple and consistent with the purpose and language of section 707(a)(2)(A).[23] It will also significantly reduce revenue losses from fee waivers, because it would require fund managers who wish to turn water into wine to subject their nonrisky pay to meaningful entrepreneurial risk. Fund managers will typically be loath to do this and therefore the approach should go a long way towards killing off management fee waivers.

Even if this approach is ultimately adopted by the IRS, however, it would be too little too late. Management fee waivers have been pervasive over at least the past 15 years. A well-traveled Wilson Sonsini powerpoint presentation from back in 2001 describes fee waivers in detail. During

---

[20] See Saba Ashraf & Alyson K. Pirio, Management Fee Waivers: The Current State of Play, 27 J. Taxation & Reg. Fin. Inst. 5, 18 (2013) (emphasis added).

[21] See, e.g., Amended and Restated Limited Partnership Agreement of Platinum Equity Capital Partners-A III, L.P. at p. 42 ("available profits" undefined), available at http://naked-capitalism.com/LPAs/verified-as-LPAs/179321_psers-011-082.pdf.

[22] In fact, as Lee Sheppard has recently reported, a 2006 KKR fund actually allows the manager to unilaterally amend, in its sole discretion, the clawback that would be triggered in the event of insufficient Available Profits. See Lee A. Sheppard, Investment Fund Revenue Reporting and Clawback Provisions, Tax Notes, August 18, 2014.

[23] See supra note 19 (concluding that section 707(a)(2)(A) applies to allocations that are not based on the overall profitability because of the lack of entrepreneurial risk).

the Romney campaign for president, it was disclosed that a single private equity firm, Bain Capital, had waived in excess of $1 billion of management fees over a decade, saving its partners roughly $250 million in taxes over that period. If and when the IRS finally enforces the law, it will generally be able to recover taxes (plus penalties and interest) for the past three years of fee waiver activity, a small fraction of the taxes that have been avoided since the dawn of fee waivers.

IV. Strategy #3: *Allocation of All Manager Expenses to Management Fee*

Existing carried interest rules allow managers to pay preferential tax rates on all of their risky pay (strategy #1). Management fee waivers purport to allow managers to pay the same low rates on some of their non-risky pay (strategy #2). Strategy #3 deals with the residual amounts of non-risky pay: the management fees that remain after fee waiver. Managers allocate all of their out-of-pocket expenses to this residual management fee, even though these out-of-pocket expenses are attributable to both the management fee stream and to carried interest. In fact, it seems that at least some managers are able to zero out their management fee income in this manner.[24]

Managers—through the management company— incur significant amounts of out-of-pocket expenses, from office rent to staff salaries, which they immediately deduct against their management fee income. As previously described, however, managers receive two distinct sets of income streams from their activities: management fees characterized as ordinary income and carried interest allocations of capital gains or dividends. In theory, these out-of-pocket costs should be reasonably allocated between these two income streams, which would mean that the costs would reduce both the amount of immediate net ordinary income from management fees and also the amount of net capital gains/dividends they eventually realize through the carried interest. Nevertheless, the current tax rules appear to allow the managers to allocate 100 percent of their out-of-pocket costs to their current management fee income.

This allocation is tax-beneficial. To illustrate, assume that a firm realizes $100 of management fees in Year 1 and $100 of carried interest in Year 2 and that the firm incurs $100 of out-of-pocket expenses in Year 1. Assume further that a reasonable allocation of the expenses would be fifty percent to the management fees and fifty percent to the carried interest because the expenses were equally related to the two income sources. If allocated 50/50, the managers would realize $50 of net ordinary income in Year 1 and $50 of net capital gain in Year 2. Under current law, however, the managers would realize $0 of net ordinary income in Year 1 and $100 of net capital gain in Year 2. The following table compares these results, assuming a 40 percent marginal tax rate on ordinary income and a 20 percent marginal tax rate on capital gains, and a 6 percent discount rate.

[24] See Jeff Coen & Bob Secter, Rauner Used Strategy Now Under IRS Scrutiny to Slash Income Taxes, Chicago Tribune (July 2, 2014) (reporting that private equity manager Bruce Rauner, recently elected as the governor of Illinois, reported zero compensation and self-employment income in certain years despite earning tens of millions of dollars in adjusted gross income during the period).

	Year 1 O.I.	Year 2 C.G.	PV of Tax in Yr 1
Theoretical Result [Tax Owed]	$50 [$20]	$50 [$10]	[$29.43]
Current Law [Tax Owed]	$0 [$0]	$100 [$20]	[$18.87]
Difference	$50 [$20]	($50) [($10)]	[$10.56]

In effect, the misallocation of expenses allows the managers to turn the $50 of current ordinary income into deferred capital gain, which is exactly what fee waivers are designed to accomplish.[25] But, unlike abusive fee waivers, the strategy is permissible under current law.

In order for some portion of the out-of-pocket expenses to be property allocated to the carried interest, they would have to be required to be capitalized. The relevant capitalization rules (in the so-called INDOPCO regulations), however, appear to allow all of these out-of-pocket expenses to be deducted even though there is no doubt that some of those expenses are attributable to future capital gains. First, the INDOPCO regulations include a very generous blanket rule that allows all employee compensation, guaranteed payments to partners, and overhead costs to be immediately deducted regardless of whether they facilitate the acquisition or creation of intangible assets or value.[26] This blanket rule likely covers the vast majority of a private equity firm's out-of-pocket expenses. In addition, because the INDOPCO regulations require capitalization only for narrowly defined expenditures that relate to specified types of intangible assets,[27] it appears that even expenses that are not covered by the blanket rule are also immediately deductible against ordinary income.

V. Strategy #4: Allocate Deductions to Portfolio Companies

The first three strategies all deal with the income side of the equation, and they all convert the manager's current ordinary income into deferred capital gain/dividend income without any material adverse effect on any other party to the transaction. The carried interest loophole covers all of the manager's risky pay. The misallocation of managerial expenses covers the amount of nonrisky pay that can be sheltered by those expenses. And many private equity firms convert the remaining nonrisky pay (i.e., the "profit" from management fees) into additional carried interest via abusive fee waivers. In combination, these strategies can permit the manager to claim preferential tax rates for <u>all</u> of his or her compensation, whether risky or nonrisky.[28]

What about the deduction side of the ledger? As explained above, carried interest and fee waivers cause management fee deductions to morph into capital losses, though this potentially

[25] In addition, there are no negative consequences to any counterparties from this misallocation of expenses.
[26] See Treas. Reg. § 1.263(a)-4(e)(4)(i), (ii).
[27] See Treas. Reg. § 1.263(a)-4(b)(1).
[28] See Coen & Secter, supra note 24 (describing how Bruce Rauner realized zero compensation and self-employment income in certain years).

adverse character swap is not materially harmful given the tax-indifference of most private equity investors and the limitations on miscellaneous itemized deductions. But what about the management fees that are not converted via fee waiver? While the manager gets to shelter some or all of that income with its out-of-pocket expenses (i.e., strategy #3), without any other restructuring the compensation deductions with respect to management fees that are left unconverted would be allocated to the private equity fund's investors, who cannot utilize the deductions. If there's anything a tax lawyer hates, it's to see a perfectly good deduction go to waste. Strategy #4 aims to solve this problem.

Strategy #4 involves pushing management fee deductions down from <u>the fund</u> whose owners generally do not pay U.S. taxes down to the <u>portfolio companies</u> who do. They accomplish this through the use of excessive monitoring and transaction fees charged to the portfolio companies and management fee offsets. Without management fee offsets, excessive fees paid by portfolio companies would significantly alter the economic deal between managers and investors, leaving managers with a windfall that is borne by investors. Management fee offsets, which typically reduce management fees by the monitoring/transaction fees on a dollar-for-dollar basis, are designed to prevent this distortion.[29] The end result is that, though the pre-tax economics are unchanged, compensation deductions are purportedly moved from the fund level down to the portfolio company level.

A. Application of Existing Law to Monitoring Fees

As I have explained in detail previously, this strategy ordinarily does not work under current law.[30] The portfolio companies claim compensation deductions for monitoring fees paid, but these deductions are not allowed under section 162. In order for a taxpayer to deduct purported compensation for services, there are two independent conditions: (i) the payor must have, in making the payment, a compensatory purpose, or stated differently, an intent to pay compensation, and (ii) the amount paid must be reasonable in light of the services that are being provided.[31] In most reported cases involving the deductibility of compensation, it is the second prong—reasonableness—that is at issue. In the case of monitoring fees, however, the first condition—compensatory intent—is often not satisfied. It is well-established that if compensatory intent is absent, no deduction will be allowed, even if the amount paid might be considered reasonable.[32]

---

[29] The clear trend is towards these 100 percent offset arrangements, though 80 percent offsets also remain commonplace. In the case of 80 percent fee offsets, the pre-tax deal is altered to the detriment of the investors, but once tax effects are taken into account, it will usually be a win-win for managers and investors. See Gregg D. Polsky, The Untold Story of *Sun Capital*: Disguised Dividends, Tax Notes, February 3, 2014, at 561 n.36 (explaining how fee offsets as low as 60 percent can leave investors better off).

[30] See Polsky, supra note 29; Gregg D. Polsky, Private Equity Monitoring Fees as Dividends: Collateral Impact, Tax Note, June 2, 2014.

[31] See O.S.C. Associates, Inc. v. Comm'r, 187 F.3d 116 (9th Cir. 1999); Nor-Cal Adjusters v. Comm'r, 503 F.2d 359 (9th Cir. 1974), IRS Field Service Advice 200042001; see also Treas. Reg. § 1.162-7(a) ("The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.").

[32] See, e.g., IRS FSA 200042001 ("[L]ack of compensatory purpose has been relied upon to find amounts paid to employees are not deductible even though they might have been reasonable in amount."); Electric & Neon, Inc. v. Comm'r, 56 T.C. 1324 (1971) ("The test of deductibility of alleged compensation is, as we mentioned, two-pronged. However, in this case, the [IRS] does not contend that the amounts which [the service provider] received from [the taxpayer], including the withdrawals and his stated salary, constituted unreasonable compensation for his services. Rather, the [IRS's] position is that the amount which [the service provider] received from [the taxpayer] in excess

In determining compensatory intent, the label that the parties place on the payment is not determinative.[33] Instead, all of the facts and circumstances surrounding the payment must be examined to determine whether, in substance, the payor had the requisite intent to pay compensation.[34] In particular, the terms and structure of the purported compensation arrangement are the critical facts that must be examined in determining the payor's intent.[35] In addition, in light of the well-known incentive of closely held C corporations to disguise dividends as compensation, courts and the IRS subject their compensation arrangements to particularly close scrutiny.[36]

A large number of recent monitoring fee agreements have been filed with the Securities and Exchange Commission and are publicly available. A quick perusal of a sampling of these agreements leads to the conclusion that many monitoring fee deals would not be able to satisfy the compensatory intent requirement. These agreements universally require large regular payments to private equity firms over a lengthy period of time (commonly ten years) purportedly in exchange for future nebulously described management, consulting, financial, and advisory services. The amount of fees are set well before it is known whether there will be any need for substantial "monitoring" services above and beyond what the company's traditional management can provide.[37] Many of the monitoring fee contracts expressly give the manager unfettered discretion in determining whether and when any monitoring services will be performed as well as the extent and scope of any such services. Many arrangements are also explicit in providing that no minimum number of hours or other quantity of services must be performed.

In addition, a number of monitoring fee contracts allow the private equity firm to terminate the arrangement in its sole discretion (i.e., whether with or without "cause") at any time and still get paid the full present value of all of the future monitoring fees that it would have received had the contract run its full course. In these cases, the portfolio company has obligated itself to pay the entire amount of monitoring fees called for under the contract (discounted only for the time-value of money) even if the private equity firm unilaterally decides to prematurely terminate the agreement, regardless of the reason for such termination and even if the termination were to occur

---

of his stated salary were not intended to be paid as compensation. It is settled law that such intent must be shown as a condition precedent to the allowability of a deduction to the corporation.").

[33] See Nor-Cal Adjusters v. Comm'r, 503 F.2d 359 (9th Cir. 1974) (payments designated as bonuses lacked compensatory intent and therefore were nondeductible disguised dividends); O.S.C. Assoc. v. Comm'r, 187 F.3d 1116 (9th Cir. 1999) (payments made pursuant to an incentive compensation plan lacked compensatory intent and therefore were nondeductible disguised dividends).

[34] See Electric & Neon, Inc. v. Comm'r, 56 T.C. 1324, 1340 (1971) ("Whether such intent [to pay compensation] has been shown is, of course, a factual question to be decided on the basis of the particular facts and circumstances of the case.")

[35] See O.S.C. & Assoc., T.C. Memo 1997-300 at 9 (explaining that "the most persuasive evidence of the petitioner's lack of compensatory intent is the plan itself"); Charles Schneider & Co. v. Comm'r, 500 F.2d 148, 153 (8th Cir. 1974) ("The provisions of the agreements themselves tend to support the notion that they provided for a distribution of profits rather than compensation for services rendered.").

[36] See, e.g., Elliots, Inc. v. Comm'r, 716 F.2d 1241, 1243 (9th Cir. 1983); Charles McCandless Tile Service v. U.S., 422 F.2d 1336, 1339 (Ct. Cl. 1970); IRS FSA 200042001 (each concluding, in the context of analyzing the deductibility of compensation, that close scrutiny is warranted when a closely held corporation is involved).

[37] Private equity observer Dan Primack has specifically noted this idiosyncratic feature of monitoring fees: "The monitoring fee agreements are determined at the time of sale, not at the time of any specific consulting need." Dan Primack, Private Equity's New Tax Problem, CNNMoney, Feb. 3, 2014.

the minute after the management agreement is executed. As private equity journalist Dan Primack explains, this is an extremely unusual deal term: "This isn't like paying a termination fee to your cellphone provider because you don't want to fulfill the term of your two year agreement. It's like your cellphone provider terminating your service after six months, and then demanding the next 18 months of payments anyway."

And, if one needs any more proof that monitoring fees are not paid with the requisite compensatory intent, when a portfolio company is acquired by a consortium of private equity funds, the monitoring fees are typically allocated among the respective private equity managers perfectly proportional to share ownership of the portfolio company, often down to the hundred thousandth percentage point.[38] In addition, some monitoring fee arrangements in these deals provide that the allocation of monitoring fees among the private equity sponsors is automatically adjusted if the funds' respective share ownership percentages fluctuate. And, when a pension fund co-invests alongside one or more private equity funds, the pension fund sometimes receives a "special dividend" at the same time and in the same per-share amount as the monitoring fees.[39]

All of these factors indicate a lack of compensatory intent. A payor with compensatory intent would not allow the service provider to decide unilaterally whether, when, and to what extent services are required to be performed under a contract that calls for millions of dollars of payments over a ten year term, especially when the required services are only nebulously described. Likewise, a payor with compensatory intent would not allow a service provider to unilaterally cancel the services contract at any time and for any reason and still get paid in full. Pro rata allocations also belie compensatory intent because payments made with compensatory intent would be allocated among multiple service providers based on the respective value of their services, not based on mere share ownership.[40] It would be an incredible coincidence if a private equity firm that controlled, say, 7.2347 percent of shares was also expected to provide 7.2347 percent of the monitoring services, but that is the only way to show that monitoring fees can be proven to be "in fact payments purely for services."[41]

Accordingly, the compensation deductions claimed by many private-equity-controlled portfolio companies with respect to monitoring fees should be disallowed. Instead, the monitoring

---

[38] Cf. Kennedy v. Comm'r, 671 F.2d 167, 175 (6th Cir. 1982) ("One factor which is indicative of a distribution of capital rather than compensation is if the payments are in proportion to… stockholdings."); Paul E. Kummer Realty Co. v. Comm'r, 511 F.2d 313, 316 (8th Cir. 1975) ("It is also significant that the net pre-tax profits distributed to the three [purported service providers] were almost identical to the percentage of stock held by each of them."); 2002 IRS NSAR 20023 ("Paying the bonuses in exact ratio to stockholdings supports the finding that the purported bonuses were in substance a dividend rather than compensation for services.")

[39] See Primack, supra note 37 (describing how the Ontario Teachers' Pension Fund, in the acquisition of GNC Holdings, received "special dividends" at the same times and in the same amounts as monitoring fees were paid to its equal private equity co-investor). See also Polsky, supra note 30, and Mark Maremont, Buyout Firms' Get a Closer Look, The Wall Street Journal, Feb. 3, 2014 (describing the receipt of millions of dollars of purported monitoring fees paid to a self-described homemaker by a company with 200,000 employees on the payroll).

[40] The fact that the private equity firm, rather than the fund (who owns the shares of the portfolio companies that pay monitoring fees), receives the monitoring fee payments does not change the analysis because management fee offsets allow the fund to capture the economic benefit of monitoring fees in the form of reduced management fees. See Polsky, supra note 29, at 561. For further discussion of this point and how monitoring fees should be recast, see Polsky, supra note 30.

[41] Treas. Reg. § 1.162-7(a).

fees paid by the portfolio companies to the private equity firm should be recast as dividends paid by the portfolio companies to the private equity fund, which then uses those dividends to pay its own management fees to the private equity firm.[42] To the extent that the dividends deemed to be received by the fund are allocated its foreign investors, the dividends would generally be subject to withholding taxes of 30 percent or 15 percent, depending on whether a treaty applied.

B. In Theory, Should Some Monitoring Fees Be Deductible by Portfolio Companies?

The previous subsection explained that, as a matter of current doctrine, monitoring fees paid by portfolio companies are often nondeductible. The deductions should be disallowed because the terms of the monitoring fee arrangements are often flatly inconsistent with the existence of compensatory intent, which is a separate and distinct condition (apart from reasonableness) to deductibility.

This subsection steps back from current monitoring fee practices and current law to discuss the question of whether, in theory, some monitoring fee deductions should be allowable. This issue is essentially a cost allocation issue. Private equity managers perform a variety of services at the fund level, for the benefit of investors. Among other things, managers investigate investment opportunities, select the investments that are worth pursuing, negotiate the purchase prices of investments, arrange for the financing of acquisitions or recapitalizations, determine the structure of investments, engage in potential recapitalizations of portfolio companies, decide when to exit investments, negotiate the sale of investments, and determine the structure of exits. These activities benefit the fund, and they are also fully consistent with the conventional tax position of private equity funds that the funds are merely investors and not engaged in a trade or business. These fund-level activities relate to the investment decisions of the fund in managing the investors' money.

Private equity managers also may, from time to time, perform services for a portfolio company's benefit. The extent and scope of these activities may vary from manager to manager and from portfolio company to portfolio company. Managers may interact with the portfolio company's management and provide oversight and advice on the company's operations. In some cases, this activity might be minimal, in others it could be substantial.

From a tax policy perspective, the cost of the services provided to the portfolio company (as opposed to the fund) generally ought to be deductible by the portfolio company, while the cost of the fund-level services should generally be deductible by the fund.[43] Deductions generated by the portfolio company can provide significant tax benefits because the deductions shelter corporate income that would otherwise have been taxed.[44] On the other hand, deductions at the fund level are generally useless because they are allocated to mostly to tax-indifferent investors who get no benefit from them.

---

[42] For a more detailed discussion of this recast, see Polsky supra note 30.

[43] Costs that are in the nature of capital expenditure should be capitalized. The capitalization doctrine is most relevant to the fund-level services because those services are generally attributable to the long-term investments. However, as discussed above, given the tax-indifferent nature of the fund's investors, the precise tax treatment of the fund's expenses (as immediate deductions or capital expenditures) turns out to be mostly irrelevant.

[44] The exception is where the portfolio company has large net operating losses. In that case, the deductions are added to the net operating loss (NOL) carryforward. The NOL carryforward may be monetized in the future if the company becomes profitable before the carryforwards expire after 20 years.

In practice, there is no attempt to even approximate the right answer to the cost allocation question. Instead, monitoring fee practices appear to be based on a rough assessment of the tax costs and benefits of different allocation schemes, not based on an assessment of the proper placement of the deduction. While pushing compensation down to the portfolio companies allows for a potentially usable deduction, it also eliminates the opportunity for the manager to receive tax-preferred carry. This is because the manager, when it receives monitoring fees, is receiving compensation from a corporation, as opposed to an allocation from a partnership, and compensation from a corporation cannot be structured as carried interest. Managers seem to prefer receiving the tax-preferred carry over tax-deductible monitoring fees.[45] So, they receive all of their risky pay and some of their nonrisky pay as tax-preferred carry, and try to use monitoring fee arrangements to treat whatever is left as deductible compensation by the portfolio companies.

The tax-nirvana result would be to treat all of the manager's compensation above and beyond its out-of-pocket expenses as carried interest (or "converted" management fees taxed as carried interest), use the manager's out-of-pocket expenses to zero out the manager's ordinary income, and move all of the non-carried interest expense down to the portfolio company level. Even if the tax-nirvana result is not accomplished because the managers earns more fixed income than its out-of-pocket expenses, excess monitoring fees still result in the underpayment of corporate taxes. The corporate tax is intended to tax corporate income twice, once at the company level (when the income is earned) and again at the shareholder level (as gains on the sale of stock). When stock is owned (directly or indirectly) by tax-exempt or foreign investors, their share of corporate income is supposed to be taxed once and only once, at the corporate level; their stock gains are exempt from tax. To the extent corporate income is sheltered by excessive monitoring fees, however, taxable investors' share of corporate income would be taxed only once (at the shareholder level), while the tax-exempt investors' share of corporate income would not be taxed at all.

The theoretically correct result would be to allow deductions for monitoring fees properly allocable to the portfolio company but to deny deductions for the remainder of monitoring fees paid. As argued above, current doctrine disallows all monitoring fees in many cases because the structure in place belies any compensatory intent. The structure is flawed because the private equity industry does not attempt to fairly apportion management fees between the fund and the portfolio companies. Monitoring fees are set well in advance of knowing what needs the portfolio company might have, and the fees charged are either a fixed annual amount or a fixed percentage of EBITDA or similar metric. There is simply no relationship between the amount charged and the amount of services reasonably expected to be performed for the benefit of the portfolio company.

As a result, current law would overtax the portfolio companies to some extent. However, this result could be avoided through a simple restructuring of the manager's deal with its portfolio companies. For example, if the private equity manager billed, at market rates, the portfolio

[45] This may seem irrational in that carried interest only saves about 20 percentage points in taxes for the manager, while deductibility at the portfolio company can save 35 percentage points. But net operating losses at the portfolio companies, agency problems (namely, the prioritization of the manager's tax position over the portfolio company's), and the exaltation of book earnings over real (i.e., after-tax) earnings may explain this phenomenon. For discussion of the prioritization of the manager's tax position, see Mark P. Gergen, Tax Law Influences on the Form and Substance of Equity Compensation in the United States, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2326732.

companies by the hour or by the project or by some other reasonable method for work actually performed at the , then those payments would be deductible by the portfolio company level. This would be appropriate, as the portfolio companies' income would now be fairly reflected.

VI. Explaining Fee Waivers and Monitoring Fee Deductions

Two of the four strategies—management fee waivers and monitoring fee deductions—are flatly inconsistent with current tax law. At the same time, private equity managers and their pay have been under a very intense spotlight for nearly a decade now. Despite the clear abuse and the salience of the subject matter, the IRS still does not appear to have even challenged these transactions. This state of affairs raises two separate issues concerning the monitoring of the tax system: where is the IRS and where are the lawyers?

A. Where is the IRS?

Management fee waivers are evidence of what many have suspected for years and what was recently confirmed by the Government Accountability Office (GAO): the IRS is absolutely atrocious when it comes to auditing large partnerships. It is quite incredible that fee waivers have not yet been challenged. Fee waivers have been pervasive for at least 15 years. Through some economically meaningless "magic words" placed in the fund's limited partnership agreement, fee waivers purport to provide the tax equivalent of turning water into wine for some of the richest people in the country. The tax treatment of their compensation has been firmly in the public consciousness since at least 2007.[46] There is a specific anti-abuse statute, section 707(a)(2)(A), whose legislative history indicates that Congress was concerned with precisely this sort of strategy. Making matters even worse, the fee waiver provisions in the few fund limited partnership agreements that are publicly available are sloppily designed, with some drafters not even bothering to define "available profits." Yet, it appears that to date the IRS has not challenged even a single fee waiver transaction.

IRS guidance on fee waivers apparently is (finally) imminent, though closing the barn door at this point seems too little, too late. What did it take for the IRS to finally get fee waivers on its radar screen? Nobody knows of course, but it appears that it helped that a former CEO of the 8th largest private equity firm of the country won the Republican nomination for president of the United States and, during the course of the campaign, it was disclosed that the firm had waived $1 billion worth of fees over a ten year period, saving its partners about $250 million in taxes.

This embarrassing state of affairs suggests that the IRS is not effectively monitoring the tax affairs of large partnerships. Fee waivers are not even terribly complicated in the world of partnership tax. Most industries that use the partnership form (such as real estate and oil and gas) operate at a far lower level of public awareness than private equity and are not embroiled in high-profile debates about their tax treatment. The revenue loss from fee waivers is significant, as evidenced by the Bain partners saving $250 million—that's one private equity firm (albeit a large one). In light of all this, the fact that fee waivers have been untouched for 15+ years by the IRS seems like the canary in the coal mine of partnership tax compliance.

---

[46] The New York Times published an editorial on the carried interest loophole on June 25, 2007. See "Raising Taxes on Private Equity".

A GAO report issued in September 2014 seems to confirm this intuition. For large partnerships—defined by the GAO as having $100 million or more in assets and 100 or more direct or indirect partners—the audit rate for 2012 was determined to be less than one percent, far lower than the 27 percent audit rate for similar C corporations. The GAO also found that, even when audits were actually performed, they often resulted in no change to the amount of income or losses reported by the entity. For audits closed in 2013, 64.2 percent of large partnership audits resulted in no change, compared to a 21.4 percent no-change rate for similar C corporations. Even when changes were made, the changes were significantly smaller than the changes for comparable C corporations. In fact, out of the seven years under study, three years resulted in overall tax <u>reductions</u> for large partnership audits, whereas in the corporate context, all seven years yield tax increases, with the smallest amount of tax revenue raised being $2.4 million per corporate audit. While these results could be consistent with a high level of tax compliance, the report instead concludes, based on discussions with IRS focus group participants, that "large partnership returns have the potential for a high tax noncompliance risk."

B. Where are the Tax Lawyers?

I attribute primary responsibility for the fee waiver situation to the IRS. The facts are relatively complicated and the law is not as clear as one would hope. Add to that the incredible passivity of the IRS on this issue, and you can see why it would be hard for tax lawyers to resist the temptation to tell their clients with a straight face that fee waivers stand a decent chance of being upheld if challenged. This is not to say that lawyers that draft fee waivers are blameless. One has to wear incredibly rose-tinted glasses to believe that a judge would uphold fee waivers, and some fee waiver provisions are so sloppily drafted that it seems clear that the drafter relying on the improper basis that the provisions would never be scrutinized by IRS field agents. My claim instead is that the IRS is more to blame for fee waivers than the elite tax lawyers who draft them.

On the other hand, in the case of monitoring fees, more of the blame has to go to the tax lawyers. The law is simple and the facts are simple. In those circumstances, I don't blame the IRS very much for assuming that leading law firms will get the tax right. Instead the blame falls mainly on the tax professionals who are supposed to be the first line of defense against abusive tax practices.

1. The Ethical Obligations and Norms of Tax Lawyers

Because of the self-assessment nature of the income tax system, tax lawyers face special ethical obligations that might seem foreign to other types of lawyers. Under Circular 230, which sets forth certain minimum standards of diligence that must be exercised by tax advisors, tax advisors may not willfully, recklessly, or through gross incompetence advise a client to take a position on a tax return unless there is, at a minimum "substantial authority" for that position.[47] There is no clear and simple definition of substantial authority but the prevailing view seems to be that it means that the position would have at least approximately a 40 percent chance of success. In determining

[47] If the position is adequately disclosed on the tax return, the lower "reasonable basis" standard applies. Private equity firms and their portfolio companies do not disclose their positions regarding fee waivers and monitoring fee deductions, respectively, and accordingly the substantial authority standard is the relevant standard.

whether substantial authority exists, the tax advisor must assume that the position will be scrutinized and litigated to a final conclusion in a court of law. This means that the fact that there is a very low likelihood of either audit or detection during an audit (the "audit lottery") must be disregarded in determining the likelihood of success for purposes of determining whether substantial authority exists.

In addition to these explicit obligations, there has been a view that tax lawyers have a special obligation to ensure the proper functioning of the tax system, even if a particular position might be better (on a pure cost/benefit analysis) for the client. In their recent book on corporate tax shelters, Professors Rostain and Regan explain:

> Traditionally, tax lawyers were expected to rein in high-wealth clients who wanted to avoid paying taxes. The U.S. tax bar has long adhered to informal professional norms under which its members advised their clients to refrain from overly aggressive strategies that improperly reduced taxes.

Professors Rostain and Regan go on to explain that these informal professional norms were particularly strong among elite tax lawyers:

> Elite [tax] practitioners regarded the exercise of… professional judgment as the feature of their practice that distinguished them from mere technocrats who provided advice based simply on the literal terms of the tax code. The lawyer's aim was for the client to take a position that didn't raise concerns with tax authorities, rather than a position that on balance would be financially advantageous even if challenged by the government….
>
> Elite tax lawyers during this period tended to take a view of a tax advisor's professional obligations that was sensitive to society's interest in a well-functioning tax system….

2. The Current State of Affairs

Professors Rostain and Regan use the corporate tax shelter activities in the 1990s and 2000s to illustrate the significant erosion of these norms and values among the elite tax bar. The corporate tax shelters that were prominent during that period generally involved transactions that were cookie-cutter and non-economic to try to exploit a purported technical loophole in the tax code. Many of the tax shelter transactions eventually were found to not work, either on narrow technical grounds or because the transactions violated the economic substance doctrine. Despite the severe infirmities of the corporate tax shelters, leading law firms were intricately involved in every stage of the process, from the development and marketing of the shelters to the issuance of the flawed (or supremely aggressive) tax opinions on which the promoters relied.

Leading law firms have likewise been involved in the private equity abuses, though there is little overlap between these firms and the ones that were intricately involved in tax shelter work. For example, the limited partnership agreements that include fee waivers are drafted by some of the most elite law firms in the United States, including Simpson Thacher (#6 on the latest Vault law firm rankings), Weil Gotshal (#8), Kirkland & Ellis (#9), Gibson Dunn (#11), Paul Weiss (#14), Debevoise & Plimpton (#16), Ropes & Gray (#22), and Proskauer Rose (#32). Simpson Thacher has drafted fee waiver provisions that did not even go to the trouble of defining the critical term "available profits," thereby effectively allowing the general partner the discretion to define it however it would like.

The same group of elite law firms—basically all of the firms with significant private equity practices— have also been involved in drafting obviously flawed monitoring fee deals. The most striking example may be the 2006 buyout of HCA, Inc. ("HCA") by three private equity firms (including Bain and KKR) and four individual members of the Frist family. In the HCA buyout, a management agreement called for monitoring fees to be paid on a perfectly pro rata basis down to the hundred-thousandth percentage point. Making matters worse, amounts allocated to the Frist family were sub-allocated perfectly pro rata among the four individual Frist family members. Incredibly, 20.974009% of the Frist family share (4.1948018% of the overall amount) was allocated to Patricia Elcan, who consistently described herself in sworn FEC filings during the relevant period as a homemaker. In the end, Elcan received approximately $10,000,000 in monitoring fees for "management, consulting, financial and other advisory services" from 2006 through 2011 purportedly to a company with nearly 200,000 employees on staff.

These facts are outrageous. How could the tax advisors come to the conclusion that these monitoring fee deductions stood a 40 percent chance of success if challenged to final judgment in a court of law? Yet, the law firms on the management agreement were a veritable Who's Who of elite U.S. law firms: Simpson Thacher, Ropes & Gray, Proskauer Rose, and Sullivan & Cromwell. It is very hard to understand how this sort of blatant tax noncompliance could pass through all this review by top-notch tax lawyers. (Not to mention the fact that one of the Big 4 accounting firms surely prepared the tax return incorporating the monitoring fee deductions.) Who could blame the IRS for assuming that patently absurd tax positions will not be claimed by clients of these lawyers?

3. More on the Corporate Tax Shelter Analogy

In addition to the fact that leading law firms were involved in both the corporate tax shelter abuses and the private equity abuses, there are other similarities between the two phenomena. Both were fostered by government neglect, which became so extreme that advisors were lulled into becoming very sloppy and careless. In both contexts, the underlying tax law is extremely esoteric and complicated, which gave cover to tax experts to give dishonest advice that the strategies might actually pass muster in a court of law (e.g., "who knows what the answer is?" and "fee waivers must be ok because they've been around so long"). The resulting herding behavior among advisors gave comfort that individual advisors would not be singled out when the jig was up. Finally, in both contexts, the increasingly intense competition for wealthy and sophisticated clients who were willing and able to pay for premium-fee work (as opposed to "cookie-cutter" work that increasingly faced downward pricing pressure), created a race to the bottom to either try to woo new clients or ensure that their existing clients did not leave to one of the many other firms that was more willing to play ball.

Private equity tax lawyers surely will object to their being analogized to the corporate tax shelter "peddlers," some of whom were eventually disbarred and a few even incarcerated. They will emphasize that they are merely giving tax advice as to "real transactions" as opposed to totally farcical ones that were ginned up to merely to provide tax benefits. However, it is hard to see why this distinction matters as a matter of either moral culpability or professional discipline, given the similarity in the degree of wrongfulness of, and revenue loss attributable to, the respective tax positions taken.

4. The New Gaping Hole in Tax Compliance

The government eventually won the corporate tax shelter wars. Rostain and Regan explain that there was no single bullet. The IRS, very slow at first to react to corporate tax shelters, eventually engaged in a vigorous multi-faceted attack and, after a few hiccups here and there, began to win consistently in court. Some tax shelter advisors were criminally indicted and a few convicted; it's not hard to see how that would dampen enthusiasm for tax shelter work. Procedural reforms, such as the requirement that corporate tax shelters be registered with the IRS, further diminished the appetite for shelters. The codification of the common-law economic substance doctrine, with the addition of a significant strict liability penalty if economic substance was lacking, may have been the final nail in the coffin.

Two other developments played a significant role in killing off corporate tax shelters. These developments are noteworthy here because unlike the ones mentioned above, these apply not only to tax shelter activities but also to the garden-variety tax reporting of real transactions. First, Sarbanes-Oxley Act of 2002 (SOX) prohibited an audit firm from providing tax services to a public company without prior approval from the company's independent audit committee, and subsequent rulings by the Public Company Accounting Oversight Board (PCAOB), which was established under SOX, provided further limitations and constraints on the provision of tax services relating to shelters by the auditor of a public company.

Second, Financial Accounting Standards Board Interpretation No. 48 (FIN 48), promulgated in 2006, changed the way in which companies reported income tax benefits for financial accounting purposes. FIN 48 provides that companies may recognize tax benefits for financial accounting purposes only if the underlying tax position is more likely than to succeed if the IRS were to challenge it. In addition, FIN 48 also requires that tax benefits meeting this standard must nevertheless be discounted to reflect the risk that the tax benefits will not be allowed. Finally, FIN 48 requires tax benefits that do not meet the standard nevertheless must be disclosed in the company's financial statements.

Combined with the SOX developments, FIN 48 requires all tax positions that are not clear to be evaluated by an independent accounting or law firm using a "more likely than not" standard. This provides a significant constraint on abusive tax planning because if the tax benefits do not satisfy this standard, the company's earnings will be lower; making matter worse, the tax benefits claimed would still need to be disclosed, which highlights the questionable position to the IRS.

This "more likely than not" is a significantly higher level of confidence than that generally applied in the private company sector. In the private company sector, either audited financial statements are not prepared or, if they are, the earnings reflected on such statements are not as significant as in the public sector, where shareholders fixate on earnings results. As a result, tax planning strategies that do not meet the more likely than not remain attractive in this setting. Instead of striving for "more likely than not," tax lawyers in this setting are focused on the lower "substantial authority" standard because that is the standard that applies to the tax preparers. In the tax practitioner's lingo, substantial authority, which as noted above is considered to require a level of confidence of 40 percent, is the standard that must be met for the accountants to "sign off on the transaction."

Thus, in the public company context, the required confidence level is 51 percent and the two sets of eyes (the auditing firm and the independent tax advisor) must get comfortable with the claimed tax position. In addition, tax reporting has become a serious accounting issue, which means that more formal advice (i.e., written opinion letters) is necessary and the stakes of getting it wrong are higher. In contrast, the tax positions of private companies need only achieve substantial authority in the eyes of the tax advisor, and because it's "only a tax issue" informal advice is often sufficient. While taxpayers wishing to avoid penalties would insist on formal opinion letters, sophisticated private companies appear to understand very well the extremely low likelihood of audit and detection.

The combination of esoteric and complicated tax rules, extremely poor enforcement by the IRS, and the herding behavior of leading law firms apparently provides sufficient comfort to the tax preparers that extremely questionable tax positions can meet the lower substantial authority standard. Complexity allows tax experts to throw their hands up in the air and claim that "nobody really knows what a court would do." The fact that leading law firms recommend these strategies and leading accounting firms prepare tax returns that incorporate their benefits allows them to say "it can't be that bad if these esteemed professionals are recommending and signing off on it." The extremely inept monitoring by the IRS means that, even if these two arguments fail, it's all academic anyway because the likelihood of getting caught is miniscule.

And, of course, tax professionals are facing increasingly intense pressure to make their clients happy, lest they start looking elsewhere for less conservative tax advice. In theory, a conservative tax advisor could use the prospect of penalties to persuade the client that a questionable tax strategy is not worth pursuing. But, in practice, given the woeful enforcement by the IRS in the private company context, the threat of penalties is simply not credible and sophisticated taxpayers (such as private equity firms) know it. Sophisticated taxpayers know very well that the audit lottery is a winning game. Even if they may lose a battle or two, they win the war. Consider the fee waiver saga in its entirety. If the private equity firms face penalties for their open years, often there will ten or more years that are closed by the statute of limitations.

To sum up, due to SOX and FIN 48, tax professionals appear to do a significant amount of monitoring of the tax system in the public company context. Combined with the higher audit rate and their increased effectiveness, there should be a high rate of tax compliance in this context. And, there is a virtuous feedback loop: more effective auditing should lead to the provision of more conservative tax advice. On the other hand, in the private company sector, tax professionals are not serving as effective monitors, due to the lower standard of confidence that, as a practical matter applies. Ineffective monitoring by the IRS makes matters worse by emboldening both tax advisors and taxpayers to become more and more aggressive.

VII. Implications for Reform

This article can be described as anthropological study of how subchapter K is actually practiced by extremely sophisticated partnerships who are advised by the leading partnership tax practitioners in the United States. The practices it details therefore have real-world implications for subchapter K reform.

A. Narrow Implications for Carried Interest Reform

The most obvious implications are with respect to carried interest reform. Numerous proposals would tax carried interest allocations as ordinary income. The proposals essentially turn off, with respect to carried interest allocations, section 702(b)'s general rule that the character of partnership tax items is conclusively determined at the partnership level. Even though the partnership realizes capital gains or dividend income, once a portion of those items are allocated to a manager in respect of services, that portion would suddenly morph into ordinary income (with corresponding ordinary deductions for the investors).

If such a proposal were enacted, it would encourage fund managers to push carried interest payments down from the fund, who could not utilize the resulting deduction, to the portfolio companies; after carried interest reform, the managers would now be taxed the same either way, so the result would be a reduction in taxes overall. Michael Knoll recognized this potential response way back in 2008, although he did not get into the details of how fund managers might try to accomplish this.[48]

One method would be to have the portfolio companies simply promise to pay the managers the carried interest payments as a contingent fee for services. (Offshore feeders of <u>hedge</u> funds in fact use a contingent "incentive fee" to replicate the pre-tax economics of carried interest, which is utilized for their onshore feeders.) But it would appear to be extremely difficult, if not impossible, for the parties to replicate the economics of current private equity structures in this manner, because the amount of carried interest distributions ultimately depends on the overall performance of <u>all</u> of the portfolio companies. If, overall, the fund breaks even, then no carry is supposed to be paid. Thus, the payment obligations of PC1 would apparently depend on the performance of PC2 through PC10, and vice versa. While a fund could perhaps make losing portfolio companies pay "negative carry" (i.e., portfolio companies would receive payments from, rather than make payments to, the fund manager if the carry was underwater), this would seem to be a very awkward way for portfolio companies to pay for services. Making matters even more awkward, the total "negative carry" paid could not exceed the total positive carry previously received. Such a cap is necessary because, under the prevailing economic arrangement, overall carry cannot go negative. The bizarreness of the structure—where PC10's obligation to pay "compensation" depends on the increase in value of PC1 through PC9—would surely risk recharacterization by the IRS. The IRS would simply recast the deal as a dressed-up carry arrangement and move the deductions back up to the fund level.

A more realistic alternative would be to simply juice up the existing monitoring fee/management fee offset structure. Under current practices, fee offsets only reduce management fees, not carried interest payments. This is consistent with the notion that the tax benefit to the manager from transmuting ordinary income (management fee income or monitoring fee income) into capital gains (carried interest) is more important than the tax cost of leaving portfolio company deductions on the table. If this were not true, we would expect that fee offsets would also reduce

[48] See Knoll, supra note 5, 153-56 (2008).

carried interest payments. But if carried interest reform were enacted, then the manager would be indifferent as between receiving payments denominated as carried interest or monitoring fees. Accordingly, the parties might restructure their arrangement to provide for (i) vastly larger monitoring fees payable by portfolio companies, and (ii) the expansion of fee offsets so that they serve to reduce not only management fees but also carried interest payments.

If the juiced up monitoring fee/offset structure was respected by the IRS (as opposed to being recast as dividends), the cost of carried interest reform to the private equity industry, and the revenue raised by the government, would be reduced. However, this paper has argued that existing monitoring fee structures are very much ripe for recharacterization.

B. Broader Implications [still working on this]

[can tax lawyers norms go back to the way they were, or maybe they were never that good to begin with (i.e., the good old days maybe weren't all that good) Very skeptical on this.]

[better IRS enforcement; good place to start. Things were pretty depressing in the mid-2000s due to corporate tax shelters, but turned out ok. Maybe the IRS whistleblowing regime could help, but it seems disorganized and very very very slow.]

[simplification? E.g., put all business activity into the corporate tax regime? Throwing the baby out with the bath water]

[change tax preparer standards: require more likely than not OR disclosure plus substantial authority? Maybe limit to larger businesses to avoid increasing costs for small businesses and on the theory that they are already getting sophisticated tax advice, so marginal cost will be relatively small?]