Re: Disguised payments for services (IRS docket ID 2015-0036 and REG-115452-14)

Dear Ms. Goldberg:

I am writing to provide comments in support of the proposed regulations issued by IRS and Treasury under section 707(a)(2)(A) of the Internal Revenue Code relating to disguised payment-for-services transactions.

I am senior economist at the Center for Economic and Policy Research in Washington, DC and Visiting Professor of Management at the University of Leicester, UK. I have coauthored a highly regarded book on private equity (PE), Private Equity at Work: When Wall Street Manages Main Street, which provides a balanced examination of the industry but raises concerns about excessive financial engineering by PE firms.

The proposed regulations clarify existing provisions in the tax code that govern the circumstances in which management fee waivers, commonly employed by private equity firms, can be used. In a management fee waiver, a fund manager waives the fixed management fee and receives in its place a priority claim on the fund’s gross or net profits from any accounting period equal to the foregone fee. Fee waivers are entirely tax motivated. They are intended to convert ordinary income from management fees into equivalent profit income taxed at the lower long-term capital gains rate and to defer income realization from the regular due date of the waived fee until distributions of the funds profits are subsequently made. However, fee waivers generally do not meaningfully alter the economic deal between the fund managers and their investors. In other words, a fee waiver inserted in the fund partnership agreement is mere window-dressing designed solely to achieve a tax result.
In 1984 Congress passed section 707(a)(2)(A) to address this precise situation. As the statutory text and legislative history makes abundantly clear, this provision disallows the claimed tax benefits from fee waivers in cases where the fund manager does not bear significant entrepreneurial risk. The proposed regulations confirm the intent of Congress and make clear that entrepreneurial risk is the key consideration in management fee waivers. Management fee waivers by private equity firms rarely, if ever, will satisfy this condition: there is little risk that the fund will have no accounting period in which the priority claim on gross or net profits can be exercised. The proposed guidance appropriately concludes that window-dressing provisions do not change the tax character of fixed compensation from ordinary income to capital gains.

The proposed regulations are intended to put an end to this abuse of the tax code which enriches private equity firm partners at the expense of the tax-paying public. It is not possible to say precisely how much tax revenue has been lost due to abusive fee waivers because the total amount of fee waivers by the private equity industry is not publicly available. However, we do know that a single PE firm (Bain Capital) claimed approximately $250 million of tax savings from abusive fee waivers over a 10-year period. With management fee waivers for at least the past 15 years used by an estimated third to a half of all U.S.-based private equity firms, the revenue loss to the IRS from taxpayer neglect of section 707(a)(2)(A) is likely to be in the billions of dollars. The general 3-year statute of limitations on enforcement imparts a certain urgency to the finalization of the proposed regulations and to speedy enforcement so that back taxes, penalties and interest can be collected by the IRS in cases of abusive use of management fee waivers. I strongly support the proposed regulations and recommend that they be quickly finalized and enforced.

Some observers have raised the possibility that, in response to the proposed regulations, fund managers may introduce clawback provisions into management fee waiver agreements to provide a façade of entrepreneurial risk. Toothless clawbacks would be just additional window-dressing. To guard against this gamesmanship, the final regulations should make clear that fee waiver clawbacks must have real economic substance. I recommend that the final regulations explicitly require that, in order for a clawback obligation to be considered, the terms of the fee waiver clawback must oblige individual fund managers to personally guarantee the general partner’s fee waiver clawback obligation, just as personal guarantees secure the general partner’s carried interest clawback obligations.

Sincerely,

Eileen Appelbaum
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https://www.russellsage.org/publications/private-equity-work