May 11, 2016

The Honorable Jack Lew
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner, Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

The Honorable William J. Wilkens
Chief Counsel, Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lew, Commissioner Koskinen, and Chief Counsel Wilkins:

We are writing to highlight serious tax abuses perpetrated by private equity firms when they acquire portfolio companies. The abuse, which involves the improper characterization and deduction of purported "monitoring fees" paid by the portfolio companies, harms workers and the public at large in two ways. First, the improper deduction of monitoring fees deprives the U.S. government of hundreds of millions if not billions of legally owed tax revenue each and every year; this requires the government to make up the difference in the form of higher taxes on honest taxpayers. Second, the improper deduction of monitoring fees also facilitates private equity's business model of stripping large amounts of capital out of operating portfolio companies, which impedes their growth and makes them more susceptible to financial failure.

While the improper deduction of monitoring fees was reported on the pages of the Wall Street Journal over two years ago,[1] the Internal Revenue Service (IRS) does not appear to have undertaken any enforcement activities. The private equity industry continues to charge significant monitoring fees in new deals, which suggests that little, if any, enforcement actions has been taken by the IRS. We urge you to take immediate action and shut down these abusive practices.

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[1] Mark Maremont, Buyout Firms' Fees Get a Closer Look, Wall Street Journal, February 3, 2014, http://www.wsj.com/articles/SB10001424052702303743604579354870579844140.

Description of Monitoring Fee Practices

When a portfolio company is acquired by a private equity firm, the company often signs a management agreement with the private equity firm that obligates the company to pay periodic "monitoring fees" to the private equity firm for periods of ten years or longer. In many cases, these monitoring fees total millions of dollars per year, and total contract values sometimes exceed two hundred million dollars. The monitoring fees are purportedly paid in exchange for extremely nebulously described monitoring, advisory, financial, and consulting services. Despite the large sums involved, the private equity firm is typically granted complete discretion in determining the scope and amount of services that it is obligated to perform under the contract. In addition, the management fee agreements ordinarily explicitly provide that the private equity firm is not obligated to provide any minimum amount of services. Furthermore, these management agreements are executed at the moment the private equity firm acquires the portfolio company; at that time, it is not clear whether and to what extent any monitoring services will ever prove to be necessary or useful above and beyond that which the company's traditional management and consulting team will provide.[2]

In many cases, when the management agreement is terminated, the private equity firm is entitled to receive the full present value (discounted using the U.S. treasury rate) of all future monitoring fees under the remaining term of the contract despite the fact the purported obligation to perform monitoring services ceases. There have been many cases where these terminations have resulted in lump sum payments of tens of millions of dollars. Sometimes, the private equity firm can unilaterally terminate the management agreement at its sole discretion and still receive the full present value of the contract. As private equity journalist Dan Primack has noted, the unilateral right to terminate and receive full value is an especially bizarre provision in these agreements.[3]

Especially large monitoring fees (and termination of monitoring fees) are often seen in situations where a consortium of private equity firms collaborate to acquire a portfolio company (in so-called "club deals"). In club deals, the monitoring fees are typically distributed among the various private equity owners in accordance with their pro rata ownership of the portfolio company. As discussed below, this pro rata sharing arrangement is very strong evidence that the monitoring fees are in substance dividends.

Application of the Relevant Tax Law Principles

Under the federal income tax law, compensation paid to service providers is generally deductible by the payer, while dividends are not. This dichotomy creates a well-known incentive for closely held corporations to disguise dividends as compensation. Because of this incentive, the compensation arrangements of closely held corporations are subject to special scrutiny to ensure that dividends are not being disguised as compensation.

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[2] Dan Primack, The Death of Private Equity's Fee Hogs, Fortune, September 5, 2013, http://fortune.com/2013/09/05/the-death-of-private-equitys-fee-hogs/.

[3] Dan Primack, Private Equity's New Tax Problem, Fortune, February 3, 2014, http://fortune.com/2014/02/03/private-equitys-new-tax-problem/. (''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 payment anyway.'')

To qualify as compensation for services and, hence, be deductible, payments must satisfy two conditions: (1) the payer must have compensatory intent, and (2) the amount of the payment must be reasonable in relation to the services that are being performed.[4] In determining whether there is the requisite compensatory intent, the fact that the parties call the payment "compensation" or "fees" is not determinative. Instead, all of the facts and circumstances surrounding the payment must be evaluated. Courts have paid particular attention to the terms and structure of the purported compensation arrangement in determining whether the compensatory intent requirement has been satisfied.

In the typical monitoring fee context, the compensatory intent prong cannot be satisfied. Despite the large annual payments, often in the millions of dollars, required to be paid by the portfolio companies, there is no requirement in the management agreement that the private equity firm actually perform any services to receive these payments. In fact, the private equity firm itself is allowed to decide how much, if any services, it will perform under the management agreement. This is why Professor Ludovic Phallipou, a leading finance professor at Oxford University and noted academic private equity researcher, calls monitoring fees "money for nothing."[5]

When the management fee agreements are terminated, the private equity firms receive the full present value of all future fees, despite the fact it is certain that no future monitoring services will ever be performed because of the termination. Professor Phallipou has aptly noted that, while monitoring fees are amounts that are received to do no work, termination-of-monitoring fees are amounts that are received to stop not working.

These facts make clear that the payers of monitoring fees—the portfolio companies—lack the requisite compensatory intent. Nobody pays millions of dollar for services while allowing the service provider to decide whether it will actually do any work. Nobody allows a service provider to unilaterally terminate a service agreement and still receive the full value of the entire remaining contract.

In fact, these monitoring fees are in reality disguised dividends. This becomes abundantly clear in club deals, where monitoring fees are shared perfectly pro rata, strictly in accordance with the share ownership of the portfolio company, often down to the hundred-thousandth decimal point, which is the same manner in which dividends would be shared. If monitoring fees were really intended as compensation, they would be allocated according to the respective value of any services provided, not strictly in accordance with share ownership. As many courts and commentators have noted, pro rata sharing of purported compensation is often strong evidence of disguised dividends.

<u>Revenue Losses</u>

The Wall Street Journal article mentioned above noted that nearly $4 billion of suspicious monitoring fees were paid over a five-year period. Because this tally was based only on

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[4] For a full discussion of the tax law principles with citations to the relevant statutes, regulations, rulings, and cases, see Gregg D. Polsky, The Untold Story of Sun Capital: Disguised Dividends, Tax Notes, February 3, 2014.
[5] Ludovic Phallipou, "Oxford Said Business School Private Equity - Ludovic Phalippou - MBA Taster Lecture," Online video clip. YouTube, October 30, 2014. https://www.youtube.com/watch?v=m1paFqPIj6Q&noredirect=1

management agreements that were publicly filed with the SEC, it reflects only a subset of the universe of suspicious monitoring fees. It is safe to say that the deduction of suspicious monitoring fees costs the U.S. government more than a billion dollars per year in lost corporate tax revenue.

Effect on Workers

One key aspect of the private equity business model is to strip cash out of operating companies and into the hands of the private equity managers, lenders, and investors. Monitoring fees and termination-of-monitoring fees are some of the mechanisms used to strip out cash. Under basic tax law principles, these payments, which are in substance dividends, would need to be made on an after-tax basis, because they are non-deductible. In addition, withholding taxes would be applied to the dividends to the extent they benefit foreign investors in private equity. However, absent IRS enforcement of the letter of the law, the required corporate and withholding taxes are not being paid, thereby facilitating the flow of cash out of operating companies. As has been well documented, this stripping of capital harms workers by stunting the growth of operating companies and making them more vulnerable to financial insolvency and bankruptcy. The failure to enforce the tax law facilitates these unfortunate effects.

The issue of improperly deducted monitoring fees came to public attention in February 2014 when they were reported by the Wall Street Journal, and a variety of commenters have since agreed that the deductions appear to be inappropriate.[6] Unfortunately, monitoring fee practices by private equity firms do not seem to have changed, and it does not appear that the IRS has taken any action. We urge you to vigorously enforce the law to protect both the public fisc and the workers of private equity controlled companies.

We note that the IRS recently issued guidance making clear that a different private tax equity strategy—involving the misreporting of management fees as capital gain through management fee waivers—is unlawful, but this only took place over fifteen years after private equity's use of these waivers first appeared on the scene.[7] Since the guidance was issued last year, there have been reports of very significant nationwide audit activity focused on management fee waivers by private equity firms.[8] While it is certainly gratifying to finally see vigorous application of the law to management fee waivers, it is disheartening that the majority of illegal tax savings generated by the waivers appear to be beyond the statute of limitations and therefore unable to be recouped by the government. Unlawful monitoring fee deductions likewise have been claimed by the private equity industry on an annual basis for many years, so, as with fee waivers, time is of the essence. Hundreds of millions, if not billions, of tax revenue is lost each and every year of enforcement delay because of the statute of limitations. We hope and expect the IRS to actively,

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[6] See, e.g., Dan Primack, supra note 3 (arguing that "a dividend by any other name is a dividend… and it should be taxed as one" and that private equity should "stop taking a dividend and pretending it's something else"); Nicolas Donato, A Debate Worth Monitoring, PE Manager, February 24, 2014 ("in some cases, it's hard to argue with [the] claim that monitoring fees are 'disguised dividends'"); James Harris, A Feeble Excuse, RealDeals, February 21, 2014 (calling monitoring fees an "earnings-stripping strategy" that "in any other context... would not work").
[7] Gretchen Morgenson, I.R.S. Targets Tax Dodge by Private Equity Firms, NYTimes, July 22, 2015, http://www.nytimes.com/2015/07/23/business/irs-targets-tax-dodge-by-private-equity-firms.html.
[8] Amy S. Elliott , "Private Equity Fee Waiver Audits Are on the Rise," Tax Notes, March 28, 2016.

vigorously, and expeditiously enforce current law with respect to ongoing monitoring fee arrangements.

Sincerely,

American Federation of Labor and Congress of Industrial Organization (AFL-CIO)
American Federation of State, County and Municipal Employees (AFSCME)
American Federation of Teachers (AFT)
Americans for Financial Reform (AFR)
Citizens for Tax Justice
Financial Accountability and Corporate Transparency (FACT) Coalition
Public Citizen
Strong Economy For All Coalition

cc: Chairman Orrin Hatch, Senate Committee on Finance
Ranking Member Ron Wyden, Senate Committee on Finance

Chairman Kevin Brady, House Ways and Means
Ranking Member Sander M. Levin, House Ways and Means