AMERICANS
FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

November 16, 2015

Sent via electronic mail:

Ms. Jaclyn M. Goldberg, Attorney
Office of the Associate Chief Counsel
Pass-through and Special Industries
Branch 1, Room 5012
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, D.C. 20044

Re: Reg-1115452-14 Disguised Payments for Services, Docket No. 2015-36

Dear Ms. Goldberg:

The undersigned organizations are writing to provide comments to the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") on the proposed regulations relating to disguised payments for services between private equity partnerships and partners under Section 707(a)(2)(A) of the Internal Revenue Code.

We strongly support the proposed regulations to close the loopholes in the tax code that permit private equity firms to lower their taxes by converting management fees, typically taxed as ordinary income, into capital gains. The regulations are in keeping with congressional intent and represent a reasonable approach to determining abusive arrangements from legitimate partnership allocations. We urge the IRS to finalize the proposed regulations as soon as possible, and to immediately enforce the principles underlying the proposed regulations to ensure that full taxes, penalties, and interest are paid with respect to existing abusive fee waiver arrangements.

<u>Background</u>

The proposal addresses management fee waivers, a technique used by many private equity firms in an attempt to convert the tax character of their members' salary income from ordinary income, taxed at the maximum rate of 39.6 percent, into capital gains, taxed at 20 percent, by inserting a few magic words that lack meaningful economic effect into their fund agreements. Private equity firms pool capital from investors in a private equity fund, which buys and eventually sells controlling interests in portfolio companies. In return for their services, private equity managers receive two principal types of compensation: annual management fees of approximately 2 percent of capital committed by investors (the "management fee") and a "carried interest" or a percentage of the fund's net profits, usually 20 percent.[1] Under the IRS's current view of the law, the character of the carried interest allocations is determined by the nature of the underlying investment and, because private equity investments are typically characterized as capital gains, managers are able to report their carried interest income as preferentially taxed long-term capital gains. The management fee, on the other hand, is characterized as ordinary income.

These loopholes are unfair because they benefit wealthy fund managers at the expense of ordinary taxpayers. They also distort the economy by subsidizing the private equity industry.

Fee waivers must be considered against this backdrop of unjustified, unfair, and inefficient tax loopholes that benefit a small number of wealthy individuals at the expense of everyone else. With fee waivers, fund managers claim that they have converted their salary income into capital gains without changing the economics in any meaningful way.[2] Fund managers, not content with avoiding ordinary income taxes on their incentive compensation (i.e., the carried interest), try to avoid ordinary income taxes on what are effectively their weekly paychecks.

This greedy behavior is made even more troubling by the fact that more than 30 years ago, Congress enacted section 707(a)(2)(A) to address this specific situation and ensure that magic words without any meaningful economic effect would not alter the tax character of compensation received from a partnership. The proposal appropriately focuses on whether the manager bears "significant entrepreneurial risk."[3] Fee waiver arrangements rarely, if ever, satisfy, that standard. This proposed guidance simply confirms that section 707(a)(2)(A) and its legislative history mean what they say. As a result, the guidance should be entirely noncontroversial.

While precise numbers are unavailable because the amount of aggregate fee waivers is not publicly available, the revenue loss from abusive fee waivers is significant. Fee waivers have been used pervasively for at least the past 15 years. During Mitt Romney's presidential campaign in 2012, documents were disclosed that indicated that a single private equity firm, Bain Capital, saved approximately $250 million over a 10-year period.[4] This strongly implies that the overall revenue losses from fee waivers have been in the billions of dollars. And, because of the general 3-year statute of limitations, even a vigorous, industry wide enforcement of the law would be unable to recapture the vast majority of revenue losses during the 15-year period in which fee waivers were pervasively used.

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[1] Many managers also receive monitoring and transaction fees directly from portfolio companies. The tax positions of private equity firms with respect to these fees have also been called into question. Like the leveraging of the portfolio companies, monitoring and transaction fees harm portfolio companies, workers, and the economy by draining cash out of operating companies. Mark Maremont, *Private-Equity Firms' Fees Get a Closer Look,* The Wall Street Journal, February 2, 2014.

[2] Saba Ashraf & Alyson K. Pirio, Management Fee Waivers: The Current State of Play, 27 J. Tax'n & Reg. Fin. Inst. 5, 18 (2013) ("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 is one where, if tax considerations are put aside, there is *essentially no change* to their right to receive the funds.") (emphasis added).

[3] Internal Revenue Service 26 CFR Part I [Reg-115452-14] RIN 1545-BM12 Disguised Payment for Services. Available at: https://www.federalregister.gov/articles/2015/07/23/2015-17828/disguised-payments-for-services

[4] Floyd Norris, *A Tax Tactic That's Open to Question,* The New York Times, September 13, 2012.

In summary, an industry that already receives the benefit of two enormous tax loopholes has for many years ignored a clear statutory directive and claimed that magic words somehow convert their weekly paychecks into capital gains. The result has been billions of dollars of tax revenue losses, most of which are no longer recoverable due to the statute of limitations. The proposed guidance is fully consistent with the underlying statutory language, history, and purpose.

<u>Recommendations</u>

(1) Finalize the regulations as quickly as possible.

In light of the long, sordid history of fee waivers, and the consistency of the proposed regulations with the statute, the proposed regulations need to be finalized as quickly as possible. The government must resist the calls to delay or water down the guidance.

(2) Vigorously and efficiently enforce the principles of the proposed regulations to existing fee waiver structures.

The preamble makes clear that the government believes that the proposed regulations are consistent with current law. This means that these principles are applicable to the numerous existing fee waiver structures in current funds. The Private Equity Growth Capital Council indicates that there are nearly 4,000 private equity firms headquartered in the United States.[5] It has been estimated that approximately one-third to one-half of private equity firms routinely use fee waivers in their funds, and many firms operate multiple funds. This means that there are likely thousands of existing fee waiver structures to which the principles of the proposed regulations are applicable. As noted above, even if the IRS were to vigorously enforce the law, the vast majority of revenue lost from fee waivers (totaling billions of dollars) has already been permanently lost due to the statute of limitations. Thus, fund managers who use fee waivers have already won, even if every single cent of back taxes, penalties, and interest is collected from "live" abusive fee waiver structures. The IRS cannot go back and collect taxes for which the statute of limitations has closed, but it must make every effort to collect all available back taxes, penalties, and interest for abusive fee waivers.

Sincerely,

AFL-CIO
American Federation of State, County and Municipal Employees (AFSCME)
American Federation of Teachers (AFT)
Americans for Financial Reform
Strong Economy For All Coalition

[5] Available at: http://www.pegcc.org/education/pe-by-the-numbers/

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- AARP
- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Center for Effective Government
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Green America
- Greenlining Institute
- Good Business International

- Government Accountability Project
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Home Defenders League
- Information Press
- Institute for Agriculture and Trade Policy
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lawyers' Committee for Civil Rights Under Law
- Main Street Alliance
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development

- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Partners

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)

- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- New Economy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network

- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- UNET