CENTER FOR ECONOMIC AND POLICY RESEARCH

Fees, Fees and More Fees:

How Private Equity Abuses Its Limited Partners and U.S. Taxpayers

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Contents

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"One nice thing about running a private equity firm is that you get to sit between investors who have money and companies who need it, and send both of them bills. This has made a lot of private equity managers rich."

Matt Levine[1]

Executive Summary

The private equity industry receives billions of dollars in income each year from a variety of fees that it collects from investors as well as from companies it buys with investors' money. This fee income has come under increased scrutiny from investigative journalists, institutional investors in these funds, the Securities and Exchange Commission (SEC), the Internal Revenue Service (IRS), and the tax-paying public. Since 2012, private equity firms have been audited by the SEC; as a result, several abusive and possibly fraudulent practices have come to light.

This report provides an overview of these abuses — the many ways in which some private equity (PE) firms and their general partners gain at the expense of their investors and tax-payers. Private equity general partners (GPs) have misallocated PE firm expenses and inappropriately charged them to investors; have failed to share income from portfolio company monitoring fees with their investors, as stipulated; have waived their fiduciary responsibility to pension funds and other LPs; have manipulated the value of companies in their fund's portfolio; and have collected transaction fees from portfolio companies without registering as broker-dealers as required by law. In some cases, these activities violate the specific terms and conditions of the Limited Partnership Agreements (LPAs) between GPs and their limited partner investors (LPs), while in others vague and misleading wording allows PE firms to take advantage of their asymmetric position of power vis-à-vis investors and the lack of transparency in their activities.

In addition, some of these practices violate the U.S. tax code. Monitoring fees are a tax deductible expense for the portfolio companies owned by PE funds and greatly reduce the taxes these companies pay. In many cases, however, no monitoring services are actually provided and the payments are actually dividends, which are taxable, that are paid to the private equity firm.

The Problem

Private equity firms charge their portfolio companies monitoring fees that can cost the company millions of dollars each year. The practice itself is fraught with conflicts of interest. The monitoring fee is stipulated in the Management Services Agreement between the private equity firm and a

1 Levine (2015).

portfolio company that it controls. The PE firm has representation on the portfolio company's Board of Directors that approves the agreement, and fees are paid directly to the PE firm.

Abusive Fee Allocation and Expense Practices Include:

- *Double-dipping*: PE firms have been found to directly charge the limited partner investors in their funds for back office expenses that should have been covered by the 2 percent annual management fee that the limited partners already pay.
- *Failure to share monitoring fee income*: PE firms are paid monitoring fees directly by the portfolio companies for consulting and advisory services they ostensibly provide. In many cases, they are required to share a portion of this fee income with their limited partner investors, but have failed to do so. In other cases, where they have shared fee income, LPs do not receive an accurate accounting of the fee income and are unable to assess whether they have received their fair share.
- *Using consultants to avoid sharing fees*: Monitoring fees are supposed to cover advisory services that PE firm professionals provide to portfolio companies. But some firms hire outside consultants instead and bill their services to the portfolio company. In cases where outside consultants are used, PE investors do not receive the fee income they would otherwise be entitled to. Moreover, the profits of the PE firm are increased because the salaries of the executives providing advice have been shifted to the portfolio company. In addition, fees paid by portfolio companies for advisory services are tax deductible, so the entire scheme is subsidized by taxpayers.

Money for Doing Nothing

Beyond basic fee and expense allocation abuses, more egregious ones include "accelerated monitoring" and "evergreen" fees.

- "Accelerated monitoring" fees are fees for services never rendered. Here, the Management Services Agreement (MSA) (signed by the portfolio company and the PE firm) stipulates that the company must pay the annual monitoring fee to the private equity firm for a given time period, perhaps 10 or more years — regardless of when the private equity fund sells the company. If the PE fund sells the company in five years, as is often the case, the portfolio company must nonetheless pay off all the remaining monitoring fees in one lump sum — for services it will never receive.
- "Evergreen" fees are accelerated monitoring fees, charged to a portfolio company, that automatically renew each year. An initial 10 year agreement automatically renews each year for 10 years. When the company is sold, it must pay for 10 years of services it will never receive.

Transaction Fees and Acting as a Broker-Dealer

The transaction fees collected in the course of a leveraged-buyout of a portfolio company by a PE fund have the potential to create a conflict of interest. Because PE general partners receive a fee for every transaction they execute, they may be motivated to carry out transactions that generate substantial fee income for themselves without regard to whether that transaction is in the best interest of the limited partners in the PE fund. These fees provide an immediate cash windfall to the GP, regardless of how well or poorly the investment performs.

Because of these potential conflicts of interest, securities laws require that anyone engaged in the business of securities transactions register as a broker-dealer and be subject to increased scrutiny and transparency. A whistleblower lawsuit filed in 2013 identified 200 cases of leveraged buyouts (LBOs) in which the private equity general partner had failed to register as broker-dealer, but the SEC has taken no action on these cases even though it has flagged this activity as a potential violation of securities laws.

Waiver of Fiduciary Responsibility

Some Limited Partnership Agreements specifically state that private equity firms may waive their fiduciary responsibility towards their limited partners. This means that the general partner may make decisions that increase the fund's profits (and the GP's share of those profits — so-called carried interest) even if those decisions negatively affect the LP investors. This waiver has serious implications for investors, such as pension funds and insurance companies, which have fiduciary responsibilities to their members and clients. These entities violate their own fiduciary responsibilities if they sign agreements that allow the PE firm to put its interests above those of its members and clients.

SEC Enforcement

Despite the mounting evidence of private equity abuses and potentially illegal behavior, SEC enforcement actions have been minimal, with only six actions against PE general partners between 2014 and 2016. In 2014, the SEC targeted two small private equity firms — Lincolnshire Management and Clean Energy Capital — for infractions that were relatively minor. In 2015, KKR paid $30 million to settle an enforcement action for misallocating expenses in failed buyout deals; Blackstone paid $39 million to settle charges of improper fee allocation; Fenway Partners paid modest fines for failing to share fee income with investors; and Cherokee Investment Partners paid minimal fines for inappropriate expense charges. The SEC allowed the PE firms in these cases to pay fines with no admission of guilt.

Limited Partners Have Failed to Challenge the Status Quo

Despite growing evidence of fee manipulation by private equity GPs and major media exposés in recent years, pension funds and other limited partners have been unable or unwilling to challenge the improper or illegal behavior of PE firms. They remain in the dark about how much private equity firms collect from their portfolio companies. They are not privy to the contracts between PE firms and portfolio companies, and fees are paid directly to the PE firm without passing through the PE fund. As a result, LP investors cannot determine whether portfolio company fees are reasonable or excessive and whether they have received their fair share. Some investors, e.g., CalPERS, under pressure from media and public scrutiny, have insisted on receiving information on the amount of carried interest they paid to their PE partners. But information about portfolio fee income remains largely unavailable.

In January 2016, the Institutional Limited Partners Association (ILPA) finally released a template for private equity fee reporting that requires standardized reporting of fees, expenses, carried interest, and all capital collected from investors and portfolio companies. While this would provide the kind of transparency that is needed, its implementation is voluntary. The only state that has taken action to remedy private equity's lack of transparency is California, where in 2016, legislation was introduced to require PE firms to report all fees and expenses charged in relation to their LP agreements, including portfolio company fees.

Tax Compliance and Private Equity

Private equity firms have a long history of taking advantage of tax avoidance schemes: carried interest taxed as capital gains even though it is essentially a profit sharing performance fee; locating many of their funds in tax havens like the Cayman Islands; and making excessive use of debt, which lowers tax liabilities via the tax deductibility of interest payments. Less well known are some of the other tax strategies used to further reduce the taxes that private equity firm partners and portfolio companies pay: management fee waivers and improper monitoring fee expenses.

- Management Fee Waivers: In a management fee waiver, the private equity fund's GP "waives" part or the entire annual management fee that the LP investors pay — typically 2 percent of capital committed to the fund. In exchange, the general partner gets a priority claim on profits earned by the fund. This turns the ordinary income the GP would have received for providing management services into capital gains income — thereby reducing the tax rate on this income from up to 39.6 percent to 20 percent. These waivers may be legal if the conversion of the fee income to profit income involves real risk, but private equity waivers are typically structured so that no risk is involved, and as such are most likely a violation of the tax code. In July 2015, the

IRS proposed new rules to clarify the intent of the tax code provisions governing fee waivers. Recent reports suggest that the IRS has belatedly begun auditing the use of fee waivers by GPs. While this is a welcome development, the statute only allows recovery of back taxes, penalties, and interest for the past three years of improper waiver activity — a small fraction of the tax savings PE partners have claimed.

- Disguising Dividends as Monitoring Fees to Avoid Taxation: Under the U.S. tax code, if a portfolio company pays monitoring fees to a private equity firm, the company gets to deduct the fees from its income tax liability. But to qualify as a tax write-off, the fee payment must be intended as compensation for services actually rendered. Many Management Services Agreements between a PE firm and its portfolio company, however, do not specify the scope or minimum amount of services the PE firm will provide. And several indicators suggest that often, no services are actually provided. Rather, the monitoring fees are essentially a disguised dividend paid to the PE firms. In these cases, characterizing the payments as monitoring fees and using this expense to reduce tax liabilities is a violation of the tax code. Despite mounting evidence that many of these fee payments are in fact disguised dividends, it appears that the IRS has not investigated this issue. Lack of transparency in these agreements makes it impossible to estimate the millions of dollars in lost tax revenue.

Taxing Carried Interest

Carried interest is the share of the profits that private equity GPs receive when they sell or exit a portfolio company. It is taxed at the capital gains rate of 20 percent rather than at the ordinary income rate of up to 39.6 percent. However, a growing consensus has emerged — among industry players as well as critics — that carried interest is simply a form of profit sharing, or performance-based pay, which private equity GPs receive as a result of managing PE fund investments. Carried interest does not represent a return on capital that GPs have invested because nearly all of the capital in the PE fund is put up by the fund's limited partners. Given that general partners put up only one to two percent of the capital in a fund, they should be entitled at most to capital gains treatment for one to two percent — not 20 percent — of the fund's profit.

The SEC and Private Equity: Lack of Transparency, Misallocation, and Fraud

Private equity is among the least transparent financial actors in the economy. Prior to implementation of the Dodd Frank Financial Reform Act of 2010, private equity funds and their advisors were able to avoid scrutiny by the Securities and Exchange Commission (SEC). PE funds limited the number of investors in order to be exempt from regulatory oversight. The funds and their advisors were excluded from coverage by the Investment Company Act of 1940, which requires disclosure of financial policies, restricts activities such as the use of leverage and short selling, and requires a board structure with a substantial percentage of disinterested members. Similarly, the advisors to private equity funds avoided coverage under the Investment Advisors Act of 1940, which requires fund "advisors" or "managers" to register with the SEC, comply with fiduciary responsibilities, and limit the performance fees they charge.

Private equity also lacks transparency because of its complex structure. Private equity firms raise investment funds that are used to acquire portfolio companies in leveraged buyouts. Investors in private equity funds include pension funds, university and other large endowments, insurance companies, and other financial entities. The PE fund is a partnership between the general partner (GP) — a committee comprised of members of the PE firm — who is the "advisor" to the fund and the limited partners (LPs) who are the investors in the fund. The Limited Partnership Agreement (LPAs) stipulates the terms of the partnership for the fund's duration, typically 10 years. One widespread provision in LPAs requires the PE fund to indemnify the private equity firm principals, the fund's general partner, the manager, and their respective officers, employees, and agents.[2] That is, it is the PE fund and not the general partner or the PE firm that is expected to pay any fines or settlements imposed as a result of the GP's actions.[3] In the context of possible SEC enforcement actions related to abusive fee practices of general partners, however, it is important to note that the SEC's Letter of Acceptance, Waiver and Consent that accompanies settlements in administrative proceeding and enforcement actions prohibits GPs from activating the indemnification clause in the LPA. The GP must make restitution and pay any fines. Unlike the SEC's enforcement order, which is published, letters of acceptance, waiver and consent are not public documents; many LPs mistakenly believe they will bear some or all of the legal expenses and penalty the SEC imposes. This would be true in cases of civil lawsuits or collusion or price fixing, but not in SEC settlements.

2 Schell (1999, pp 9–23).

3 Morgenson (2014a); Smith (2014). (Includes a link to a KKR Limited Partner Agreement with an indemnification provision.)

LP investors contribute about 98 percent of the equity in a private equity fund, while less than 2 percent is contributed by the GP. The GP promises investors that its financial and management expertise will yield outsized returns. All decisions of the PE fund — which companies to acquire, how much to pay for them, how much debt to load on them, how they are managed, who is on the company's board of directors, when and how to exit the investment — are made by the GP. In return for these services and the promise of returns substantially above stock market returns, the LPs pay the GP an annual management fee (typically 2 percent of the capital they have committed to the fund) and 20 percent of the fund's profits.[4]

The Dodd-Frank Act achieved modest improvements in the regulation of PE firms and their funds. It amended the Investment Advisers Act so that most PE fund general partners must now register with the SEC as the funds' investment advisors. Since August 2012, GPs of PE funds with assets over $150 million have been subject to oversight by the SEC and are required to submit annual reports on the funds they supervise. The Dodd Frank Act requires the use of a standard procedure for calculating assets under management, and stipulates that reports must include basic organizational and operational information such as size, types of services, fund investors, fund employees, and potential conflicts of interest.

Under these new requirements private equity GPs submitted 8,407 reports on their funds to the SEC in the fourth quarter of 2014. They comprised about one-third of all private investment fund reports received in that period. The gross assets under management in these PE funds were almost $1.9 trillion. Sixty-three percent of the funds were domiciled in the US, while 31 percent were based in the Cayman Islands. Pension funds made up a third (33.2 percent) of fund investors.[5]

The reporting requirements for private equity GPs under Dodd Frank are modest compared with what publicly traded companies, mutual funds, and other investment funds must disclose to the SEC. Private equity GPs are not covered by the Dodd Frank corporate social responsibility clauses requiring disclosure of executive compensation. They are not required to report the incomes of partners and senior managers, which companies their funds own, or financial information about companies in their portfolios. There is no legal requirement to notify employees, unions, vendors, or other stakeholders when private equity takes over the ownership of a company or to publicly disclose the amount of leverage used in the acquisition. Moreover, unlike in the case of publicly traded companies, most of the information in the private equity reports filed with the SEC is not publicly available.

4 For a full explanation of how private equity makes money see Appelbaum and Batt (2014).
5 SEC, Division of Investment Management Risk and Examinations Office (2015).

Despite the weak provisions in the law and understaffing at the SEC, however, the reporting requirements in Dodd-Frank have enabled SEC regulators to identify widespread abuses that harm the interests of private equity's limited partner investors. These include misallocating PE firm expenses and inappropriately charging them to investors, failing to share income from portfolio company monitoring (or advisory) fees with their LPs, waiving their fiduciary responsibility to LPs (including pension funds), manipulating the value of companies in their fund's portfolio, and collecting transaction fees from portfolio companies without registering as broker-dealers as required by law. In some cases these activities may violate the specific terms and conditions of the Limited Partnership Agreements (LPAs) between GPs and LPs, while in others they may be due to the vague wording in these agreements that allows PE firms to take advantage of their asymmetric power position vis-à-vis investors and the lack of transparency in their activities. In many instances these practices are also an abuse of the tax code, an issue we address below in the section on private equity tax compliance.

Misallocating PE Firm Expenses and Portfolio Company Fee Income

The public first learned of the widespread failure of private equity general partners to comply with the terms of the LPAs with their investors in late April 2014 when the SEC's top regulator, Mary Jo White, pointedly described these abuses in her testimony to Congress. Reporting on what SEC investigators had found in their examinations of PE funds and the activities of funds' general partners, White said,[6]

> *"Some of the common deficiencies from the examinations of these advisors that the staff has identified included: misallocating fees and expenses; charging improper fees to portfolio companies or the funds they manage; disclosing fee monitoring inadequately; and using bogus service providers to charge false fees in order to kick back part of the fee to the advisor."*

White's testimony was followed on May 6 by the "sunshine" speech delivered by Andrew J. Bowden, then the Director of the SEC's Office of Compliance Inspections and Examinations to PE fund compliance officers at the Private Equity International Forum in New York City.[7] Commenting on the more than 150 examinations conducted by that date, Bowden stunned his listeners when he reported that in over half the cases, SEC examiners found violations of law or material weaknesses in controls in the handling of fees and expenses. As he pointed out, PE advisors use limited partner investors' funds to obtain control of non-publicly traded companies. This control combined with a

6 White (2014).
7 Bowden (2014).

lack of transparency provides numerous opportunities for the PE fund's general partner to enrich themselves and their firms at the expense of the pension funds, insurance companies, foundations, and endowments that supply most of the PE fund's capital. Fees collected from portfolio companies are, in many instances, supposed to be shared with investors in PE funds. But the SEC found that the vague wording in the Limited Partnership Agreements often left investors in the dark about whether they were receiving their fair share of these fees. Note that the SEC's examinations focus only on process — whether private equity GPs complied with the terms of the Limited Partnership Agreements — and not on the implications of this transfer of resources for the financial stability of the Main Street companies owned by PE funds. But many GPs did not even meet this low bar.

Several practices related to fees and expenses are especially troubling. On the expense side, management fees paid by the limited partners are supposed to cover the expenses of the general partner. But, without naming names, the SEC reported that its examinations revealed some general partners shifting their back office expenses onto the LPs during the middle of the fund's life. For example, it found that some PE firms reclassified operating partners as consultants rather than employees and charged investors for their services.

More spectacular and of particular interest to the SEC are the many ways that PE firms use fees charged to portfolio companies to enrich themselves. These include transaction fees and monitoring fees, which are often substantial. Transaction fees are fees charged to the portfolio company for such activities as buying or selling the portfolio company, asset sales, mergers or acquisitions with other companies, structural reorganizations, recapitalizations, or reorganization of the ownership structure. These activities are initiated by the PE fund's general partner, and the fees are paid to the GP's PE firm, setting up a potential conflict of interest with the LPs. For example, a GP may decide to acquire a portfolio company in order to generate transaction fee income for its PE firm whether or not the purchase is in the best interest of the PE fund and its LPs.

Monitoring fees are ostensibly for advisory and other services to the portfolio company over and above the services intended to improve operations already covered by the annual management fees that LP investors pay. A study by finance professors at the University of Oxford and the Frankfurt School of Finance and Management notes that the monitoring fees represent potential conflicts of interest because GPs who charge these fees also hold seats on the Board of Directors of the portfolio companies, which gives them the authority to approve these fees.[8] Transaction fees and monitoring fees are covered in the Management Services Agreement (MSA) between the PE firm and the portfolio company signed at the time the portfolio company is acquired.

8 Phalippou, Rauch, and Unger (2015).

An illustrative case is the MSA for Energy Future Holdings (EFH), acquired by KKR, TPG Capital, and Goldman Sachs PE unit for $45 billion in the largest ever LBO. The MSA specified that EFH would pay a one-time transaction fee of $300 million to its owners to cover their costs of acquisition. In addition, the company would pay a 1 percent transaction fee for any other transactions involving a merger, add-on acquisition, recapitalization, or sale of assets. Also specified was an annual advisory fee of $35 million to be paid to the three PE firms, with the fee to rise by 2 percent each year, but the MSA fails to specify the scope or duration of services provided for this fee. In addition, the portfolio company would pay for "…all reasonable out-of-pocket expenses incurred, including unreimbursed expenses incurred prior to the date [of the agreement] hereof, in connection with the retention and/or transactions contemplated by the Merger Agreement, including travel expenses (private jets) and expenses of any legal, accounting or other professional advisors to the Managers [General Partners] or their affiliates." [9] Traditionally, these expenses would have been covered in the annual management fees paid by limited partners. Similar types of fees, but with slightly different terms and conditions, are found in the MSAs for the $33 billion buyout of Hospital Corporation of America (HCA), the $27 billion buyout of Harrah's (now Caesars') Entertainment, and a smaller $3.3 billion buyout of West Corporation.[10]

Limited partners in a PE fund are not a party to the negotiation of the MSA and often do not know the terms of the agreement. Monitoring and transaction fee agreements with portfolio companies predate the financial crisis, but they had gone largely unnoticed by investors in PE funds. These fees drew more attention as the financial crisis unfolded. PE funds in the crisis years were largely unable to deliver on their promise of outsized returns, and limited partners in PE funds began to push back against the 2 percent annual management fee. Some LPs were able to reduce their out-of-pocket expense by negotiating a share of the PE firm's monitoring fee income as a rebate against the management fee. That is, the rebate was used to offset the LP's cash outlay for the management fee. PE firms continued to collect these monitoring fees through the financial crisis and recession. Various units of KKR, for example, pulled $117 million in a variety of fees out of First Data, at the time a struggling portfolio company of a KKR fund.[11]

Many current Limited Partnership Agreements stipulate that a portion of the transaction and monitoring fees charged to portfolio companies will be rebated to the PE fund's limited partners. But vague and confusing wording in the LPAs has meant that too often, as the SEC's Andrew Bowden noted, these investors have not received the fee income that is owed them; instead, it has

9 Phalippou, Rauch, and Umber (2015, pp. 41).
10 Phalippou, Rauch, and Umber (2015).
11 Chassany and Sender (2014).

been pocketed by the PE firm. Even when LPs are reimbursed out of these fees, the LP can only receive the amount it has paid in management fees. Monitoring fees in excess of those payments are retained solely by the PE firm.

There are also indirect ways that private equity monitoring fees may negatively affect their limited partner investors, and these have not been part of SEC oversight. The extraction of large monitoring fees reduces the retained earnings of a portfolio company and what it can invest to improve its performance — ultimately shrinking its resale value. A lower price at exit reduces the return to the private equity fund so that, indirectly, monitoring fees come out of the pockets of the limited partners. Thus, when the lower profit on the resale of these companies is taken into account, it is clear that there has been no cost saving to the investors in the PE fund.

Indeed, Phalippou and colleagues argue that any accounting of the full range of fees pension funds and other investors in a PE fund pay to the PE firm should include transaction and monitoring fees. They argue that it shouldn't make a difference to the LPs whether they pay the GPs directly through management fees or indirectly through monitoring fees. Their conclusion is that "what matters is the total fee charged, not the amount of one of the fee components." [12]

Another way that private equity firms avoid sharing monitoring fees with LPs is to hire consultants to provide the monitoring services — a practice the SEC has flagged. Traditionally the executives that provide these services were salaried employees of the PE firm and they were paid by the PE firm. More recently, PE firms have used consultants instead and charged their services to portfolio companies. By treating these executives as consultants rather than as affiliates or employees of the PE firm, the firm is able to get around the requirement to share these fees with the LPs. An investigative report by the *Wall Street Journal*, for example, raises questions about the relationship between KKR and KKR Capstone, which provides advisory services to portfolio companies owned by KKR-sponsored PE funds. [13] The *Wall Street Journal* found that KKR Capstone is listed as a KKR subsidiary in its 2011 annual report and as a KKR "affiliate" in regulatory filings by several portfolio companies owned by KKR PE funds. In this case, fees charged by KKR Capstone would have to be shared with LPs in its 2006 PE fund, who are entitled to 80 percent of any "consulting fees" collected by any KKR "affiliate." Capstone's consulting fees constitute the bulk of the roughly $170 million KKR collected over a three year period. KKR says it misspoke and KKR Capstone is owned by Capstone's management, not KKR, and isn't an affiliate. As a result, KKR has told LP investors in its PE funds that it doesn't share the firm's fees with them.

12 Phalippou, Rauch, and Umber (2015, pp. 12).
13 Maremont (2014a).

The *New York Times* reports that this is common practice. It notes that the large Silicon Valley private equity firm, Silver Lake Partners, reported in a 2014 filing with the SEC [14]

> *"…that when it retained 'senior advisors, advisors, consultants and other similar professionals who are not employees or affiliates of the advisor,' none of those payments would be reimbursed to fund investors. Silver Lake acknowledges that this creates a conflict of interest with its investors, 'because the amounts of these fees and reimbursements may be substantial and the funds and their investors generally do not have an interest in these fees and reimbursements.' Similar language is found in regulatory filings across the country."*

In cases where the consultants' salaries appear as expenses of the portfolio company, PE investors do not receive any fee income. Moreover, the profits of the PE firm are increased because the salaries of the executives providing advice have been shifted to the portfolio company.[15] Adding insult to industry, fees paid by portfolio companies to PE firms for monitoring services are tax deductible, so the entire scheme is subsidized by taxpayers.

Even when private equity firms do share fee income with their investors, they retain billions for themselves. According to the *Wall Street Journal*, "The four biggest publicly traded buyout firms — Blackstone, Carlyle, Apollo and KKR — collectively reported $2.1 billion in net transaction and monitoring fees (that is, after rebating part of the fees to investors in their PE funds) from their private-equity businesses between 2008 and the end of 2013." [16] Aggregate fee income retained by all PE firms over this period is substantially higher.

Money for Doing Nothing

"Accelerated monitoring fees" (also known as "termination fees") are a particularly egregious practice that PE firms use to enrich themselves at the expense of both their portfolio companies and their investors. They are fees for services never rendered. Here, the Management Services Agreement stipulates that the portfolio company must pay the annual monitoring fee to the PE firm for a given time period, perhaps 10 or more years — regardless of when the private equity fund exits the investment in the company. If the PE fund sells the company in five years, as is often the case, the company must nonetheless pay off all the remaining monitoring fees in one lump sum — for services it will never receive. Even more flagrant is the use of so-called "evergreen fees" — accelerated monitoring fees that automatically renew each year for a period of years, say 10 years.

14 Morgenson (2014b).
15 Ibid.
16 Spector and Maremont (2014).

For example, TPG has a contract with Par Pharmaceuticals, one of its portfolio companies, that requires Par to pay TPG annual monitoring fees of at least $4 million for 10 years. The contract was struck in 2012, but filings show that it will renew automatically each year after 10 years have passed.[17]

When the company is sold, Par Pharmaceuticals and other companies whose MSAs include such evergreen fees will need to pay a full 10 years of fees to the PE firm for services never rendered. Additionally, because the company is no longer owned by the PE fund, accelerated monitoring fees do not have to be shared with the fund's investors.[18] Of course, the payment of accelerated monitoring fees will be taken into account by buyers when the portfolio company is sold. This diminishes the price that potential buyers will pay — in turn reducing the return to LP investors in the PE fund.

Enforcement actions by the SEC led Blackstone — a PE firm that has made extensive use of accelerated fee contracts — to do a U-turn. The SEC found that three private equity fund advisors (i.e., GPs) within the Blackstone Group had "failed to fully inform investors about benefits that the advisors obtained from accelerated monitoring fees and discounts on legal fees." Blackstone agreed to pay nearly $39 million to settle these charges.[19] Following the judgement against it, Blackstone — the world's largest private equity firm — told one of its firm's investors that it would no longer collect extra advisory fees for services no longer needed nor provided once a portfolio company is sold or returned to the public markets through an IPO.[20] Now that the practice has been exposed, some PE fund limited partners have expressed their dissatisfaction with such payments, which unfairly provide a large and undeserved bonanza to PE firms. However, the use of accelerated fees to boost profits remains widespread and is used by major players in the industry, as **Figure 1**, taken from the *Wall Street Journal*, demonstrates.[21] The latest PE firm to find itself in the SEC's sights as a result of its long-standing use of accelerated monitoring fees is Carlyle. [22] This practice strips resources from portfolio companies and enriches PE firms at the expense of these companies and their workers as well as at the expense of limited partners in PE funds who lose out when the companies are sold and of taxpayers who lose out because monitoring fees are tax deductible as company expenses.

17 Morgenson (2014b).
18 Spector and Maremont (2014).
19 SEC (2015a).
20 Maremont and Spector (2014a).
21 Ibid.
22 Primack (2016). Primack reports: "The Carlyle Group disclosed in its 10-K that the SEC has made an 'informal request' for 'additional information about our historical fee acceleration practices — a topic of a recent enforcement action within the private equity industry.' Carlyle said that it is cooperating fully with the inquiry, and added that there could be additional SEC scrutiny over its use of — and compensation structure for — outside advisors."

FIGURE 1

Fee Bonanza

Accelerated payments received by buyout firms after shedding holdings

Company	Lead private-equity firm(s)	Year triggered	Accelerated monitoring fee
HCA Holdings	Bain, KKR, Merrill	2011	$181.0 million
Biomet	Blackstone, KKR, TPG, Goldman Sachs	Pending	$88.0M
SeaWorld	Blackstone	2013	$46.3M
Realogy Holdings	Apollo	2012	$40.0M
GoDaddy	KKR, Silver Lake	Pending	$25.0M

Source: Securities and Exchange Commission filings, Maremont and Spector (2014a).

Transaction Fees and Acting as a Broker-Dealer

The transaction fees collected in the course of a leveraged-buyout have the potential to create a conflict of interests: PE general partners may be motivated to carry out transactions that generate substantial fee income for themselves and their PE firms, without regard to whether that transaction is in the best interest of the limited partner investors. These fees provide an immediate cash windfall to the GP, regardless of how well or poorly the investment performs.

Because transactions of this type create potential conflicts of interest, they are typically covered by securities laws designed to protect investors. Securities laws require that anyone engaged in the business of affecting transactions in securities for the account of others must register as a broker and be subject to increased oversight by the SEC to ensure fair behavior. The SEC requires that the advice that is provided is "suitable" and imposes penalties on broker-dealers for violating this standard. But unlike investment bankers, PE general partners have generally not registered as broker-dealers with the SEC, even though for decades they have collected billions of dollars in transaction fees associated with leveraged buyouts and other transactions.[23] A whistleblower case filed in 2013 by a former PE executive identified 200 cases of unregistered broker-dealer activities related to private equity LBOs over the prior decade, including 57 cases worth $3.5 billion in fees.[24]

23 Katz (2014).

24 Morgenson (2014c).

These activities would appear to be securities law violations, but have not been subject to any oversight — let alone increased oversight by the SEC.

In April 2013 an SEC commissioner flagged the transaction fees that many PE firms charge portfolio companies in the course of acquiring them in a leveraged buyout as a potential violation of the Securities Exchange Act of 1934. Collecting these fees may make it necessary for the GP of a private equity fund (the PE fund's advisor) to register as a broker-dealer. This would generally be the case if the PE fund advisor, its personnel, or its affiliates receive transaction-based compensation for investment banking or other broker activities in regard to a portfolio company. The commissioner noted that the SEC staff [25]

> *"…has observed that advisors to some funds — for example, advisors to private equity funds executing a leverage buyout strategy — may also collect many other fees in addition to advisory fees, some of which call into question whether those advisors are engaging in activities that require broker-dealer registration. Examples include fees the manager directs a portfolio company of the fund to pay directly or indirectly to the advisor or one of its affiliates in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company. The fees are described as compensating the private fund advisor or its affiliates or personnel for 'investment banking activity,' including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions."*

Clearly, most PE firms oppose any requirement that GPs register as broker-dealers, although in recent years many large PE firms including Blackstone Group and TPG Capital have established brokerage units in order to comply with the 1934 law.[26] The position of the Private Equity Capital Growth Council (PEGCC), industry's lobbying organization, is that PE general partners are not broker-dealers, but rather "investment advisors," hired for their expertise to advise their affiliated funds and portfolio companies.[27] It maintains that the Dodd-Frank reporting requirements are sufficient to meet the concerns of the SEC. The SEC rules governing broker-dealers are much more stringent than those for investment advisors — including more frequent audits and greater legal liabilities and capital requirements. The SEC audits 55 percent of broker-dealers, but only 9 percent of investment advisors.[28] PE firms are particularly worried they will be held legally liable for past violations of the law, and GPs would face huge liabilities. Fines for broker-dealer violations are dollar for dollar of the transaction value.

25 Blass (2013).
26 Katz (2014).
27 PEGCC (2015).
28 Morgenson (2014c).

Despite the whistleblower lawsuits and public acknowledgement of potentially illegal broker-dealer activity by private equity firms, SEC staff in 2014 began to consider an exemption for PE fund advisors from the broker-dealer registration requirement, which would make it legal for GPs to continue collecting deal fees in the future and unlikely that the SEC would take action against the PE firms for transaction fees improperly collected in the past.[29] As of early, 2016 — two years later — the agency had taken no further action, suggesting that private equity firms are likely to get a free pass and be exempt from the requirement to register as a broker-dealer.

An example of how all of these fees, taken together, enrich private equity partners is found in a 2016 report on Univision[30] — owned since 2007 by a consortium of PE firms including TPG Capital, Thomas Lee Partners, Madison Dearborn Partners, and Providence Equity Partners. Between 2007 and the end of 2015, the PE sponsors extracted $573 million in fees from the portfolio company. These included $193 million in management fees as specified in the Management Services Agreement to cover management, consulting, and advisory services. The Agreement stated that the private equity firms that owned Univision were not obligated to commit any minimum amount of time to such services. In addition, Univision paid its PE sponsors $200 million in transaction fees and $180 million in a "termination" or accelerated monitoring fee. The 2007 LBO, worth $13.7 billion, saddled the company with almost $9 billion in debt. The agreement also included a "10-year evergreen term," requiring the portfolio company to pay the PE sponsors any unpaid fees at the end of the agreement. In 2010, that agreement was extended to 2020 and amended to include automatic annual extensions so that the remaining term would always be 10 years. In preparation for an IPO in July 2015, Univision agreed to pay $180 million to terminate the contract. But still burdened with $10 billion in debt from the original LBO, Univision was unable to execute the IPO.

Waiver of Fiduciary Responsibility

Analyses of Limited Partnership Agreements (LPAs) have also uncovered clauses that specifically allow private equity firms to waive their fiduciary responsibility towards their limited partners — leading to serious conflicts of interest and negative spillover effects for the beneficiaries of pension funds that invest in private equity. PE firms can — and often do — include a waiver in the LPA of the general partner's fiduciary responsibility to its investors.

TPG Partners Private Placement Memo, shared with potential investors in its 2015 flagship fund — TPG Partners VII — provides a salient example. The memo clearly states that the general partner may make decisions to increase the fund's profits (and the GP's share of those profits — its so-

29 Katz (2014).
30 UNITE HERE (2016).

called carried interest) even if those decisions negatively affect the limited partners. This may occur if a GP decides to sell a portfolio company earlier than is desirable — for example, if the PE firm is raising a new fund and needs to demonstrate to prospective investors that it is making distributions to prior investors.

The language in the Private Placement Memo specifies:

> *"Since the amount of carried interest payable to the General Partner depends on the Partnership's performance, we may have an incentive to approve and cause the Partnership to make more speculative investments than it would otherwise make in the absence of such performance-based compensation. We may also have an incentive to dispose of the Partnership's investments at a time and in a sequence that would generate the most carried interest, even if it would not be in the Partnership's interest to dispose of the investments in that manner.*
>
> *"The General Partner may take its own interests into account in the exercise of such discretion. The exercise of such discretion may negatively impact the Limited Partners generally or may impact some Limited Partners disproportionately."*

Even mainstream analysts are critical; in his Term Sheet column of December 18, 2015,[31] *Fortune's* Dan Primack characterized TPG's "pieces of boilerplate" as "fairly egregious, even if they are industry standard" — suggesting that this type of waiver of fiduciary responsibility by PE fund advisors is commonplace.

This waiver of fiduciary responsibility is problematic at two levels: the responsibility of the private equity fund's general partner to the fund's limited partners and the responsibility of those investors (especially pension funds and insurance companies) to their members and clients. Limited partners typically commit capital to the private equity fund for a period of 10 years, during which time they have very little control over how the money is invested. Side letters may place some very general restrictions on a GP, but the general partner is vested with complete decision making authority. Pension funds, however, have their own fiduciary responsibility to ensure that their investments maximize benefits to their members. They may legally delegate that responsibility to service providers, such as PE general partners, as long as those partners put the interests of the pension beneficiaries first. It is problematic, therefore, when pension funds and insurance companies sign waivers that allow the PE general partner to put its interests above those of the LPs.

31 Primack (2014).

With pension funds unable to directly exercise fiduciary duty and PE fund advisors waiving responsibility for fiduciary duty, the main protection that pension fund beneficiaries and insurance company annuitants have is the vigilance of the SEC's enforcement unit in ferreting out conflicts of interest and penalizing firms that thwart SEC regulations.

SEC Enforcement

After Andrew Bowden's shocking "sunshine" speech detailing private equity firms' abuses of fee income, enforcement action was slow to follow — with only six actions brought between the spring of 2014 and 2016. In 2014, the SEC targeted two small private equity firms — Lincolnshire Management and Clean Energy Capital — for infractions that were relatively minor. More serious cases were filed in 2015, when the SEC brought enforcement actions against KKR, three Blackstone Group funds, Fenway Partners, and Cherokee Investment Partners.

In June 2015, however, the SEC brought an enforcement action against a major PE firm, Kohlberg Kravis Roberts & Co. (KKR), for misallocating expenses related to failed buyout attempts (so-called "broken deal" expenses) to the investors in their flagship PE funds. The SEC charged KKR with misallocating more than $17 million in "broken deal" expenses to its flagship private equity funds in breach of its fiduciary duty. Over a period of several years, KKR had $338 million in expenses related to unsuccessful buyouts that should have been paid in part by co-investors but were charged instead to investors in its PE funds. Co-investors got part of the action on deals that were completed, but didn't pay any of the expenses for deals that failed. KKR failed to disclose to investors in its PE funds that these expenses were not allocated to the co-investors. In a statement, the SEC's Andrew J. Ceresney said, "Although KKR raised billions of dollars of deal capital from co-investors, it unfairly required the funds to shoulder the cost for nearly all of the expenses incurred to explore potential investment opportunities that were pursued but ultimately not completed." Without admitting or denying the SEC charges, KKR agreed to pay nearly $30 million to settle the charges, including a $10 million penalty.[32]

KKR's settlement with the SEC over improper allocation of fees could have resulted in the PE firm being designated an "ineligible issuer" by the SEC and losing its status as an eligible securities issuer. But on the day that KKR settled with the SEC, the PE firm requested a waiver and the Commission granted it, thus allowing KKR to keep its status as an issuer.[33]

32 SEC (2015b).
33 Bradford (2015a).

In October 2015 the SEC announced that it had reached a settlement with advisors to three Blackstone Group funds — Blackstone Management Partners, Blackstone Management Partners III, and Blackstone Management Partners IV — for failing to adequately disclose the acceleration of monitoring fees paid by fund-owned portfolio companies at the time of a sale or IPO. According to the SEC, "The payments to Blackstone essentially reduced the value of the portfolio companies prior to sale, to the detriment of the funds and their investors." [34] The SEC also found that investors were not informed that Blackstone negotiated a better discount on legal services for itself than for its funds, despite the fact that the funds provided the law firm with far more business.

Blackstone agreed to settle the SEC's case that it breached its fiduciary duty to the funds, failed to properly disclose information to the funds' investors, and failed to adopt and implement reasonably designed policies and procedures. Without admitting or denying the findings, Blackstone agreed to cease and desist from further violations, to distribute $28.8 million to affected fund investors and to pay a $10 million civil penalty.[35]

The SEC closed 2015 with two cases, again against smaller targets. In November 2015, the SEC brought an enforcement action against zombie private equity firm Fenway Partners and four of its executives. Fenway's earlier funds have struggled and it has announced that it will wind down its current funds and not raise another, thus making it a zombie. The temptation in such cases is to milk the funds for personal gain, and that appears to be the case in this instance. The SEC charged the PE firm with diverting portfolio company fees that it should have collected and shared with investors in its PE funds to a Fenway Partners affiliate principally owned by several of the PE firm's partners. The LPAs between Fenway Partners and investors in its PE funds required the PE firm to rebate 80 percent of portfolio company fees as an offset to the management fees paid by these investors. By diverting the fee payments to an affiliate, Fenway Partners avoided sharing these payments with the investors in its PE funds. Fenway Partners failed to notify the investors of this change and to disclose the conflict of interest it engendered. Fenway Partners and the executives agreed to settle the SEC case without admitting or denying the SEC's finding and to pay a total of $10.2 million that will be placed in a fund for harmed investors.[36]

Also in November 2015, the SEC settled an enforcement action against Cherokee Investment Partners for misallocation of expenses. The SEC charged the small PE firm with inappropriately charging its PE funds for expenses incurred in complying with SEC regulations without disclosing this to the fund's investors. Cherokee Investment Partners neither admitted nor denied the SEC

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34 SEC (2015a).
35 Ibid.
36 SEC (2015c).

charges, but it reimbursed the funds for the full amount of expenses (a little over $456,000) and paid a fine of $100,000.[37]

With only six cases brought by the SEC in the three and a half years since general partners of PE funds have had to register as fund advisors, results are not reassuring. No matter how egregious the PE firm's behavior or how inconsequential the firm, the SEC has not insisted on an admission of guilt. Financial penalties have been trifling in relation to the size of the PE firm, and other remedies available to the SEC have been waived. Self-dealing appears to be widespread among PE firms. TPG and other PE firms continue to flaunt the fact that they will waive their fiduciary responsibility to their investors whenever it is in their own best interest to do so. The SEC's enforcement actions appear too timid to have the effect of putting the industry on notice that it will have to change deep-seated behaviors that enrich PE firm partners at the expense of other stakeholders.

Limited Partners Have Failed to Challenge the Status Quo

If the SEC has had difficulty following through on enforcement efforts, the Limited Partners are in an even weaker position to bring about reform. Whether through lack of power or political will, they have not been able to change the rules of the game. Lack of power is part of the story. Pension funds and other LPs lack the legal and other resources necessary to go up against the deep pockets of private equity firms even when LPs are so inclined. Lack of political will is also salient, as many state legislators and fund Trustees believe that PE firms can deliver higher yields on their funds, and in recent years have voted to allocate even more of their assets to private equity. And in some cases, pension fund managers have their own interests at stake as their pay is tied to PE returns, which are typically inflated by the industry's use of metrics such as the internal rate of return. Reform is also stymied by institutional norms and relationships that have been set in place for many years. When a private equity firm launches a new fund, it typically presents the same boiler plate LP agreement to the pension fund that it has signed in the past. This puts the burden of proof on pension fund managers to explain why what they agreed to before doesn't work now. And PE firms often market the same terms and conditions to other potential investors to intensify competition among institutional investors to sign up or be left out.

This asymmetry is evident in the fact that LPs have been unable to obtain even the basic information they need about how GPs determine which portfolio companies they buy, how they evaluate their assets under management, how they measure performance, and the like. For example, shortly after the SEC's $17 million settlement with KKR for fee misallocation, a coalition of 12 state treasurers and comptrollers sent an open letter to SEC Chair Mary Jo White urging her to tighten

37 SEC (2015d).

and standardize disclosure rules. A "culture of opacity" and lack of disclosure by private equity firms created an "uneven playing field," they stated. Of four types of fees — management fees, fund expenses, allocated incentive fees, and portfolio-company charges — only management fees were clearly segregated and reported. PE firms didn't provide the kind of information needed for LPs to calculate their fair share of portfolio fee income. The SEC needed to establish standard disclosure rules because the private equity giants were not going to do it voluntarily[38]

It is also evident in cases where private equity firms have threatened to end their investment relationship with LPs if they make public the fee and expense structures in their Limited Partnership Agreements. In 2014, for example, when the Iowa public pension fund received a public-records request regarding the fees it paid to private equity firms, KKR advised the fund that making the information public could "jeopardize" its access to investment opportunities.[39]

Some limited partners in PE funds, mainly large pension funds and endowments, have been able to negotiate offsets to management fees, as noted above, but beyond this their accomplishments are few. In particular, even the largest LPs do not appear able or willing to challenge the allocation of fees collected from portfolio companies or the PE firms' use of consultants rather than salaried employees to monitor and advise these companies — a practice that fattens the bottom line of PE firms at the expense of limited partners. Limited partners may be afraid to challenge PE firm practices because they fear that they will be blackballed from PE funds in which they want to invest.

Even after aggressive media exposés in recent years, the SEC's investigation into fraudulent use of fees, and the fines imposed on a few industry players, many private equity firms appear unpersuaded to change their behavior. In 2015, for example, the *New York Times* reported that a TPG partner, Kevin Burns, was being paid twice for work he was doing on their portfolio company, yogurt maker Chobani. First, Burns received a salary from the management fees paid by the LPs. Second, he was assigned to work on TPG's "recovery" team, whose job it is to recover monitoring and advisory fees for TPG. For this role, he was paid again from "recovery" fees charged to Chobani. This fee income should be shared with the limited partners, but it goes to Burns instead. According to the *New York Times* report, TPG fund investors are paying twice for Burns' work on the Chobani deal — once through the management fees they pay and again through fee income they do not receive. And this is apart from the effect that paying these fees has on the company's performance and resale value. As the *New York Times* article pointed out, this type of double dipping at the expense of limited partner investors appears to be the norm at TPG:[40]

38 SEC (2015e).
39 Maremont and Spector (2014b).
40 Alden (2015).

> *"Such a payment plan appears to fall within TPG's stated business practices. Members of the firm's operations group may serve in management roles at the firm's portfolio companies, at the expense of clients, according to a regulatory filing by TPG in March.*"

TPG shares this information with its limited partners, which apparently satisfies the SEC and makes its behavior legal. But for the investors and Chobani, it doesn't make it right.

Limited partners, as SEC Commissioner Bowden pointed out in his "sunshine" speech,[41] have a long history of not recognizing and/or understanding the fees they pay to private equity firms and the expenses allocated to them. Even now that the extent to which fees and expenses are misallocated has been made clear, most pension funds and other investors in private equity have not been able to obtain the information they need to hold private equity firms accountable for their actions nor to negotiate better terms and conditions. One exception is CalPERS, which under pressure from intense media and public scrutiny, obtained information on the carried interest performance fees it paid to its PE partners over the past 25 years and made it public in late 2015.

Even mainstream trade publications have criticized the timidity of limited partners in confronting general partners and demanding fair treatment. In December 2015, for example, *Pensions & Investments* called out pension funds, insurance companies, and other "asset owner fiduciaries" for their failure to challenge the lack of transparency, the one-sided agreements that disadvantage investors, and the excessive fees charged by private equity and other firms engaged in alternative investments. The *P&I* editorial opens with a strongly worded criticism:[42]

> *"Asset owner fiduciaries have fallen short in their oversight in identifying, understanding and disclosing investment management fees, especially in alternative investments. They have just not been up to the task."*

As a remedy, California State Treasurer John Chiang issued a call for legislation to establish transparency and set new reporting requirements for PE firms in that state. In February, 2016, Assemblyman Ken Cooley responded by introducing Assembly Bill 2833 to require "private equity fund managers, partnerships, portfolio companies, and affiliated alternative investment vehicles, as defined, to make specified disclosures regarding fees and expenses in connection with limited partner agreements." [43] The original bill would require PE firms to provide a full accounting of

41 Bowden (2014).
42 Pensions & Investments (2015).
43 California Assembly (2016a).

management fees, carried interest, and other payments and expenses, as well as all fees and expenses paid by portfolio companies, but proposed amendments substantially undermine the reporting requirements.[44]

As the *P&I* editorial rightly notes, "…[s]uch a law is necessary only because trustees have failed to undertake that fiduciary duty." As *P&I* points out

> *"Asset owners have the clout to demand more transparency. Pension funds, private and public, as well as foundations and endowments accounted for 57 percent of all investment in private equity in 2013…"*

At the end of January 2016, the Institutional Limited Partners Association (ILPA) finally released a template for private equity fee reporting that requires standardized reporting of fees, expenses, and carried interest.[45] It also requires details on all capital collected from investors and portfolio companies — fees charged, fund expenses, carried interest, and income received by the GP through parallel vehicles to the fund. This could be an important step in the direction of increased transparency. Use of the reporting template, however, is voluntary. Its adoption depends on the ability of LPs to successfully negotiate use of the template in their Limited Partnership Agreements with GPs. And while several major players — CalPERS, TPG Capital, and The Carlyle Group — have publicly endorsed the fee reporting template, it is unclear how many will adopt it. Indifference and reluctance of LPs to demand this information and failure of GPs to agree to provide it led ILPA chief executive Peter Freire to warn that private equity firms should embrace the reporting guidelines or expect closer regulatory scrutiny. According to *Private Equity Manager*,[46] Freire's message "…was that if GPs and the broader private equity community fail to adopt the template, regulators around the world could get involved."

In view of the documented inability of pension funds and insurance companies to stand up to private equity, it seems unlikely that voluntary transparency that relies on LPs to include a requirement for its use in investment agreements with GPs will prove to be effective. It will continue to fall to the SEC's compliance and enforcement units to police the behavior of PE firms and protect investor interests and the retirement savings of workers.

44 California Assembly (2016b).
45 ILPA (2016).
46 Private Equity Manager (2016).

Tax Compliance and Private Equity

> *"Our assumption is not that everybody is out there cheating in the partnership area. Our problem is, and they know and we know, that we haven't been auditing them."*
> — John Koskinen (2016), Commissioner of the IRS, as quoted by Bloomberg BNA[47]

The failure of the IRS to audit complex partnerships, including private equity partnerships, is well known to these enterprises and to the lawyers and auditors that advise and monitor them. Some PE firms have taken advantage of this failure of IRS oversight. The full range of tax avoidance schemes devised by these opaque organizations and the extent to which they may violate established tax rules is not known. In the case of private equity funds, however, there are two fairly common practices that are clearly in this category: management fee waivers and improper monitoring fee deductions.

Private equity firms have a long history of taking advantage of tax avoidance schemes: Carried interest taxed as capital gains even though it is essentially a profit sharing performance fee; locating many of their funds in tax havens like the Cayman Islands; and making excessive use of debt, which lowers tax liabilities via the tax deductibility of interest payments. Less well known are other tax strategies some private equity firms use to further reduce the taxes that they and their portfolio companies pay. Operating in the shadows, as they did for 30 years, out of view of the public and with no regulatory oversight, some of these tax schemes went beyond pushing the envelope and crossed over into noncompliance with the tax code. Lax enforcement by the IRS emboldened an increasing number of private equity firms to make improper use of management fee waivers and to claim unlawful monitoring fee deductions. The complicity of tax lawyers in designing these strategies and tax preparers in blessing them provided cover to those PE firms that engaged in these schemes.

Management Fee Waivers

In a management fee waiver, the general partner of a private equity fund "waives" part or the entire management fee that the limited partner investors pay for management services — typically 2 percent of capital committed to the fund by the investor. In exchange, the general partner gets a priority claim on profits earned by the fund. This sleight of hand, so the private equity firms claim, turns the ordinary income the manager would have received for providing management services into capital gains income, and reduces the tax rate on this income from 39.6 percent to 20 percent. This is the tax equivalent of turning water into wine.

47 Davison (2016).

This tax alchemy might be acceptable if the conversion of management fee income into profit income involved any real risk that the PE fund managers might not ultimately get paid their waived fee. However, these waivers are structured to all but guarantee that the PE fund's general partner will be paid, with no actual risk involved. In reality, these management fee waivers are simply disguised payments for management services.[48]

To state this more precisely, in a management fee waiver, the GP waives the fixed management fee. It receives in its place a priority claim on the fund's gross or net profits *from any accounting period* equal to the foregone fee. It is the rare PE fund indeed that never shows a profit in any accounting period. These fee waivers are intended to convert ordinary income from management fees into equivalent profit income taxed at the lower long-term capital gains rate. However, fee waivers generally do not meaningfully alter the economic deal between the GP and the fund's investors. In other words, these fee waivers are window-dressing designed solely to allow fund managers to pay capital gains on what is effectively their fixed salary income.

In 1984 Congress passed section 707(a)(2)(A) of the tax code to address this precise situation. As the statutory text and legislative history make abundantly clear, this provision disallows the claimed tax benefits from fee waivers in cases where the fund manager does not bear significant entrepreneurial risk. Management fee waivers by private equity firms rarely, if ever, satisfy this condition.

Private equity firms' use of management fee waivers first became popular in the late 1990s. It is not possible to know 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, during the Romney campaign for president we learned that his private equity firm, Bain Capital, had waived in excess of $1 billion of management fees over the preceding 10 years and claimed approximately $250 million in tax savings.[49] With management fee waivers used by a majority of U.S. private equity firms for at least the past 15 years, the revenue loss to the IRS from abuse of section 707(a)(2)(A) is likely to be in the billions of dollars.[50]

Having failed for more than a decade to enforce this section of the tax code, the IRS and Treasury proposed new regulations in July 2015 to clarify the intent of the provisions governing management fee waivers — what the IRS refers to as disguised payment-for-services transactions.[51] The proposed regulations confirm the intent of Congress and make clear that entrepreneurial risk is the key consideration in management fee waivers. They have put PE firms on notice that the tax code does

48 Polsky (2014a).
49 Norris (2012).
50 Polsky (2014a).
51 Department of the Treasury, Internal Revenue Service (2015).

not permit PE firm partners to reduce the taxes they owe by disguising payments for the management services they provide as general partners of PE funds as capital gains. And, because the preamble indicated that the proposed regulations are consistent with existing law, the guidance confirms that the IRS can hold PE firms accountable for past misuse of management fee waivers to the extent the years in question remain open under the statute of limitations. In fact, recent reports suggest that significant audit activity focused on fee waivers is now underway.[52] Nevertheless, even if the IRS recovers all back taxes, penalties, and interest for all years still open under the statute, it will generally be able to recoup these amounts only for the past three years of fee waiver activity — a small fraction of the taxes that private equity firms that have abused the tax code in this way have avoided since the dawn of fee waivers over 15 years ago.

Disguising Dividends as Monitoring Fees

As we discussed above, the SEC has focused attention on the monitoring fees that private equity firms charge their funds' portfolio companies. The SEC's concern is whether the PE firm has dealt fairly with its limited partners. The SEC does not, however, concern itself with the content of the monitoring fee agreements or their tax implications. That task falls to the IRS.

As we saw earlier, when a portfolio company is acquired by a private equity firm, the company typically signs a Management Service Agreement with the firm that obligates it to pay periodic monitoring fees to the private equity firm for periods of 10 years or longer. The PE firm typically determines the scope and scale of services it will provide under the MSA. Moreover, these agreements often make it explicit that there is no minimum amount of services that the private equity firm is required to provide.

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 private equity firms to disguise dividends as compensation for services. Because of this incentive, the compensation arrangements of closely held corporations (such as private equity controlled portfolio companies) are subject to special scrutiny by the IRS to ensure that dividends are not being disguised as compensation.

To qualify as compensation for services and, hence, be deductible, payments must satisfy two conditions: (1) the portfolio company must have compensatory intent — that is, it must intend for

52 Elliott (2016).

these payments to compensate the service provider for services actually provided, and (2) the amount of the payment must be reasonable in relation to the services that are being performed.[53]

The portfolio companies paying the monitoring fees deduct them from their income as ordinary business expenses, a move that reduces the taxes they owe. However, there are several features of these monitoring fee agreements that indicate that the payments are not for monitoring services but are actually disguised dividends and, accordingly, that these payments lack the requisite compensatory intent.

First, the agreements are not arms-length transactions. The private equity firm appoints the acquired firm's board of directors, takes a large number of seats on the board for itself, and selects its top management. The private equity firm is thus negotiating a contract with a company it effectively controls. In fact, GPs often sign the Agreement on behalf of the portfolio company. This was true in the case of Energy Future Holdings described earlier, where employees of KKR and TPG signed for the company. Second, the agreement to pay fees to the private equity firm for monitoring and advisory services often provides that it is the private equity firm and not the company contracting for the services that will decide whether and when to provide any services as well as the scope of any services to be provided. Indeed, the contract often requires that monitoring fees be paid regardless of whether or not any services are provided. Thus, in the typical monitoring fee context, the compensatory intent requirement cannot be satisfied because there is no requirement in the Management Services Agreement that the private equity firm must actually perform any services to receive these payments. Furthermore, the obligation to pay millions of dollars in monitoring fees is set at the time the portfolio company is acquired, well before it can be known whether the company will require any additional monitoring services above and beyond that which the traditional management and consulting team will provide.[54] In addition, when a monitoring fee is terminated (sometimes at the unilateral discretion of the private equity firm), the firm is typically entitled to receive the entire present value (discounted using a risk-free rate) of all future monitoring fees, even though no further services will be provided. And finally, when multiple private equity firms take over a company, the monitoring fees are typically allocated among the firms on a pro rata basis in accordance with the shares controlled by each firm and not on the basis of how a priori the workload is shared. This was the case, for example, in the Energy Future Holdings MSA. These facts are flatly inconsistent with compensatory intent and, therefore, they support recharacterizing monitoring fees as nondeductible dividends.

53 Polsky (2014b).
54 Primack (2013).

Compensatory intent means that the fees that are paid must be intended as compensation for services the portfolio company requires and must be commensurate with the services. The facts described in the preceding paragraph suggest that many — perhaps most — monitoring fee agreements violate the requirement of compensatory intent. For example, a company making payments with compensatory intent would never leave it up to the service provider to decide what services to provide or even if it will provide any services at all. Nor would a company entering into an agreement with compensatory intent allow the service provider to cancel the agreement and still get paid in full. Most telling, when more than one private equity firm purchases a company, the fees often are paid based on ownership shares. This suggests that these are not payments for services, but are in fact dividends. In a recent case highlighted in the *Wall Street Journal* we learn about one such case, with purported monitoring fee payments calculated to the seventh decimal place to conform to the shareholders' ownership stake.[55]

> *"One example is HCA Holdings Inc., the hospital chain bought in 2006 by Bain Capital LLC, KKR & Co. and Merrill Lynch, now part of Bank of America Corp. When HCA went public in 2011, it had paid its owners or their affiliates more than $245 million in monitoring fees, filings show. The original agreement called for the fees to be paid in a ratio that closely mirrored the parties' control percentage, with each of three buyout firms initially getting 26.6667 percent, and the other 20 percent going to the founding Frist family, which retained about one-fifth of the stock.*
>
> *"One of those entitled to be paid for 'management, consulting and advisory' services was Patricia F. Elcan, a daughter of Thomas F. Frist Jr., who has described herself as a homemaker in Federal Election Commission filings. Her share of the overall fees was set at 4.1948018 percent, the eventual equivalent of about $10 million."*

Any particular case, of course, is dependent on specific facts. But in addition to fees paid in proportion to ownership shares, the HCA deal includes cancellation of the deal by the PE firm with full payment of the present value of the remaining years of fee payments and would be unlikely to pass muster in an investigation by the IRS.

The study by academics of portfolio-company fees cited earlier found that the 600 portfolio companies in their sample paid about $20 billion in fees over two decades to the PE firms that owned them, evenly distributed over the time period. Monitoring fees comprised half of this amount — nearly $10 billion.[56] In addition to draining federal tax revenues through improper deductions for monitoring fees and unpaid taxes on dividends, there is a second, equally disturbing effect of fees

55 Maremont (2014b).
56 Phalippou, Rauch, and Umber (2015, pp. 3)

paid by portfolio companies. Significant amounts of cash are being transferred from portfolio companies to private equity managers. This transfer of resources increases the company's risk of insolvency and bankruptcy and limits the possibility of growth — all to the detriment of the company's employees and creditors. The failure to enforce clear principles of tax law facilitates this draining of cash out of operating companies.

There is, thus, good reason to suspect that many of the monitoring fees collected by private equity firms may be non-deductible under current law. Despite the widespread use of monitoring fees agreements by the private equity industry, the IRS has apparently so far failed to scrutinize these fees in examinations.

Taxing Carried Interest

Carried interest — the share of PE fund profits that go to the PE fund's GP — has quietly enriched private equity firm partners. Indeed, efforts to understand just how large are the carried interest payments to PE firm partners — who comprise PE fund GPs — from PE fund limited partners are hampered by a startling lack of transparency. This lack of transparency has also made it difficult to estimate the loss to the U.S. Treasury from the unwarranted favorable tax treatment of carried interest. This may now be changing.

As we saw earlier, the GP of a private equity fund typically contributes 1 to 2 percent of the fund's equity but claims 21 to 22 percent of the fund's profit; the excess 20 percentage points represent the carried interest. The fund's limited partners provide about 98 percent of the equity, so the GP is mainly playing with other people's money. This provides a powerful incentive for the general partner to engage in risky behavior — specifically by loading portfolio companies with excessive amounts of debt. If all goes well, debt gooses returns of the private equity fund and the carried interest paid to the GP, which explains the GP's incentive to use lots of it. However, it also increases the risk of default and bankruptcy. In the lopsided world of private equity investing, the downside risks of the debt burden fall mainly on the portfolio company, its workers and its creditors. The general partner, who makes all the decisions about what to buy and how much debt to use, has put up a small fraction of the equity and has the least to lose. However, the upside gains realized by the PE fund accrue disproportionately to the GP. As a result, the general partner can afford to focus on the gains from a risky strategy and ignore the possibility of losses — a classic case of what economists call moral hazard.

The tax treatment of carried interest provides a further incentive for PE firms to load Main Street companies they acquire with excessive amounts of debt. PE fund general partners receive a disproportionate share of the PE fund's profits as carried interest. It is, thus, a form of profit sharing — or performance-based pay — which they receive as a result of their success in managing PE fund investments. Including a profit share as a form of incentive pay in employee compensation is a fairly common practice in various U.S. industries, not just private equity. The United States Steel Corporation provided employees who held positions of responsibility with a share of the company's profits as early as 1903. Today, the company's unionized workforce receives a 7.5 percent share of the profits, and workers were set in December 2015 to vote on a new contract that would increase that share to 15 percent if profits rise above a threshold.[57] Earnings of these workers are tied to the performance of the enterprise, and the profit share provides an incentive for employees to focus on helping the business succeed. Companies that include incentive pay as part of the compensation package track this as carefully as they track other components of pay. Performance based pay — whether CEO bonuses, sales commissions or carried interest — is at-risk pay. It depends on how the enterprise performs and there is no guarantee that it will be forthcoming. Carried interest is the private equity version of a performance fee.

In steel, as in all industries where employees receive a profit share or other form of performance pay, this pay is taxed as ordinary income. In sharp contrast to this, however, carried interest — the performance fee that private equity fund general partners receive — is taxed at the much lower long-term capital gains rate. The top tax rate on ordinary income is 39.6 percent compared with a long-term capital gains tax rate of 20 percent. There is no economic justification for this anomalous tax treatment of carried interest. It reduces the tax revenue received by the IRS to the disadvantage of the tax-paying public and it gives a huge boost to the after-tax income of private equity firm partners, further encouraging the reckless use of debt to spur PE fund earnings. It's a loophole that should be closed.

The Institutional Limited partners Association (ILPA), which represents more than 300 private equity investors, stirred up a tempest when it characterized the share of deal profits PE fund managers take home as incentive compensation. The Private Equity Growth Capital Council (PEGCC), the lobbying arm of the PE industry, was quick to take exception. The PEGCC suggested that the ILPA's document "be modified so that it does not incorrectly describe carried interest as incentive compensation or a fee." [58] Dan Primack, who follows the private equity industry for *Fortune*, quipped in his December 17, 2015 Term Sheet newsletter: "After all, it will make PEGCC's tax lobbying much more difficult if the institutions actually funding private equity have codified that

57 Moore (2015).
58 Lim (2015).

carried interest is incentive compensation (i.e., should be taxed as ordinary income) rather than as a capital gain."

While PE partners would be loath to give up their tax break on carried interest, many admit privately that this tax loophole is indefensible and should be eliminated.[59] Carried interest does not represent a return on capital that GPs have invested because nearly all of the capital in the PE fund is put up by the fund's limited partners. Given that the GP puts up only one to two percent of the capital in the fund, they should be entitled at most to capital gains treatment for one to two percent — not 20 percent — of the fund's profit. This disparity between GPs' investments and returns led the industry publication, *Private Equity Manager*, to conclude that GPs' disproportionate share of a PE fund's gains is "more akin to a performance bonus than a capital gain" and to agree with the view "that a GP's share of profits made on investor capital should be taxed as income, not capital gains." [60] In January 2016 the editorial board of the *Financial Times* labelled the carried interest loophole "a tax break that Wall Street cannot defend." The *Financial Times* wrote[61]

> *"Private equity partners and fund managers do not, for the most part, have their own capital at risk when they make these investments. They are receiving payment for a service, namely to invest money on behalf of limited partners in the fund, while losses on investments fall on their clients alone."*

In calling for legislators in the U.S. and U.K. to tax carried interest as ordinary income, which it clearly is, the *Financial Times* notes that "it is an especially egregious break for the well-off at a time when they should be contributing more, not less."

Lack of Transparency

Having misleadingly characterized carried interest as a return on capital invested rather than a performance fee, many private equity firms have felt no obligation to report to investors in their funds how much they are paying. For example, *Private Equity International* reported that only about a quarter of PE firms include this information along with management fees in their reports — fully three-quarters do not.[62] Many PE investors — including public pension funds, which have a duty to taxpayers as well as to retirees — have failed to insist on receiving this information. Instead most pension funds have allowed the PE firms to report returns net of management fees and carried interest, and have not asked them to report the amount paid in carried interest. The industry and the PEGCC have been adamant in their assertion that carried interest is not a performance fee — so not

59 Lattman (2012).
60 Private Equity Manager (2013).
61 Financial Times Editorial Board (2016).
62 Private Equity International (2015).

a fee paid by investors. And anyway, their argument goes, if PE fund general partners are doing well, then investors in the funds must also be doing well — so why should they be concerned about how much they are paying?

That's an argument that is not holding up so well these days. The flagging performance of PE funds relative to the stock market over the past decade has led to questions about whether the high fees investors pay to PE firms are warranted. PE firms have come under pressure to reveal what they have been paid in carried interest. Pressure on public pension funds from taxpayer watch dogs, union trustees, public employees and the media became particularly intense after major public pension funds had to admit that they had been paying these fees for decades, but had not tracked the fees and had no idea how much they paid. The two largest public pension funds — the California Public Employees Retirement System (CalPERS) and the California State Teachers Retirement System (CalSTRS) — faced scrutiny over how much they had paid. Their responses provide a study in contrasts to the demand for greater transparency and accountability.

In July 2015, after acknowledging the need to get a better handle on the fees it pays, CalPERS announced it was ordering a review of its performance bonus payments to PE firms. In November, it shared this information with the public. To the consternation of California taxpayers and public sector workers, CalPERS announced that it had paid \$3.4 billion in these fees in the 25 years from 1990 to 2015. The size of the fees raised questions about whether investing in private equity was worth it.[63] In the past year, CalPERS paid \$700 million in these performance fees. At this rate, it will pay private equity \$17.5 billion in performance fees over the next 25 years, more than five times what it paid in the last 25.

The \$3.4 billion figure is an understatement of what CalPERS actually paid. It only reports carried interest for active funds. Funds in which CalPERS invested more than 10 years ago have mostly been liquidated and carried interest paid to them is not included. More recent funds are accruing carried interest that hasn't yet been paid. This, too, is not included. And some general partners refused to comply with CalPERS' request for fee information.[64] Despite these reporting weaknesses, however, the CalPERS release of information on just how much it has spent on performance fees is likely to lead to greater transparency. While this is not the first time a pension fund has disclosed this fee information, the CalPERS action is very important. Its size and influence as a leader among pension funds is likely to lead other funds to demand a similar accounting. But real and systematic transparency on fees paid to private equity remains a long way off.

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63 Starkman (2015).
64 Primack (2015).

In contrast to CalPERS, CalSTRS has redoubled its efforts to justify its position that carried interest is not a fee paid by the pension fund and therefore does not need to be reported. Like CalPERS, CalSTRS has admitted that it does not track the carried interest its PE funds pay. The pension fund not only doesn't track it, but doesn't think it is appropriate to do so because carried interest, in its view, is not a payment but a profit split. CalSTRS position is that a fee is not a fee if it takes the form of profit sharing. But this argument does not hold up — a profit share paid to the general partner based on the performance of the PE fund is clearly a performance fee. Defending CalSTRS position, CalSTRS Board Chair Harry Kelly made the following argument:[65]

> *"We at CalSTRS are in favor of more, rather than less, transparency and disclosure as our history and current checks and balances show. We agree that it's important for the public to know the estimated amount of carried interest investment managers are earning, tracked as net profits, which a majority of public pension plans report. Almost all private equity partnerships split profits, with the investor (e.g. CalSTRS) taking at least 80 percent and, at most, 20 percent taken by investment managers."*

Yes, net profits are the way in which many PE firms report returns to PE fund investors. But no, this is neither transparent nor a disclosure of how much the investors have paid in carried interest. California State Treasurer and CalSTRS board member John Chiang has continued to press for information on the amount the pension fund has paid in carried interest. CalSTRS is now considering whether to ask for and track the carried interest it pays PE firms.

How Large Is Carried Interest?

The lack of transparency has served the private equity industry well in its quest to keep carried interest from being taxed as ordinary income. Good estimates of the total carried interest the industry collects are not available, making it impossible to reliably estimate the loss of tax revenue as a result of taxing it at the lower capital gains rate. The industry maintains that carried interest is small and the tax revenue gained from treating it as ordinary income is too little to be worth the added effort of the industry to track and report it. At the request of Representative Sander Levin and Senator Tammy Baldwin, who are sponsoring a bill to change the tax treatment of carried interest, the Congressional Joint Committee on Taxation (JCT) estimated the amount of tax revenue from taxing carried interest as ordinary income. The JCT's revenue estimate for the legislation finds that it would increase tax revenue by $1.4 billion in fiscal 2016 and by $15.6 billion over the next 10 years.[66] The Treasury Department estimates that eliminating the carried interest tax loophole would raise

65 Smith (2015).
66 Bradford (2015b).

about $18 billion over 10 years. While these are not trivial amounts of money, they are small in relation to total taxes collected and do seem to support the PE industry's contention that there really isn't much there in additional tax revenue. However, this estimate is disputed by tax experts, notably law professor Victor Fleischer. Fleischer estimates that the amounts the IRS would collect if carried interest were taxed as ordinary income is 10 times as much — $180 billion over 10 years.[67] This suggests that there really is a lot of revenue at stake, and apart from the issue of tax fairness, the country would benefit from taxing carried interest appropriately.

Of course, the lack of transparency on carried interest creates a problem. Without good data, it is difficult to get a precise estimate of the amount private equity GPs (and hedge funds) collect in carried interest. Carried interest is currently comingled with all long-term capital gains income when it is reported to the IRS. But this problem is easily remedied. The IRS could simply require private equity funds (and hedge funds) to disclose on their partnership tax returns, for informational purposes, the amount of carried interest paid to the general partner. It would then be a simple matter for the IRS to calculate aggregate capital gains income. Senator Al Franken has asked the IRS to take this action. Moreover, once the fund reports the carried interest it pays the general partner on its tax form, it will be a routine matter to share this information in a standard format with investors in these funds.[68]

Conclusion: Ending the Abuse of Limited Partners and Taxpayers

Transparency

The SEC's Office of Compliance Inspections and Examinations has done a surprisingly good job of examining the relationship between the PE fund's general partners (the fund's advisor), and the limited partners that invest in that fund, and is expected to continue its focus on expenses and fees in 2016. SEC findings to date have been eye opening. The lack of transparency surrounding PE firm practices and the confidentiality requirements in the Limited Partnership Agreements shield the behavior of private equity firms from public scrutiny. Pension fund participants (and, in the case of public sector pension funds, taxpayers) cannot get this information and assure that their interests are protected. This has made it impossible for outside entities to review what is in these agreements and to determine whether the PE fund is looking out for the interests of investors or for its own

67 Fleischer (2015a).
68 Appelbaum (2015).

interests. That task now falls to the SEC's enforcement arm, which needs to pick up the pace of enforcement, require admissions of wrongdoing in settlements, and require restitution and fines large enough to serve as a deterrent. Greater transparency and stronger regulatory enforcement are investors' and stakeholders' main line of defense against self-dealing by some private equity firms.

Greater transparency is the most pressing requirement if private equity, which plays a large and not well-understood role in the economy, is to be brought in from the shadows. An important step would be to reform the regulations that govern pension plans. Pension fund regulations should ban non-disclosure agreements that conceal the management fees, monitoring and transaction fees, and performance fees (carried interest) paid to private equity funds and other investment funds so that current and future retirees can know more about how their retirement savings are being managed. The non-disclosure provisions of agreements between limited partners and general partners in a fund also prevent LPs from sharing information about fees charged and investments made by the funds in which they have invested and about the funds' performance. Requiring these Limited Partnership Agreements to be made publicly available is another important step toward greater transparency.

Stepped up enforcement by the SEC is critical if regulators want to make clear the importance of fair treatment of investors by private equity firms. SEC examinations have found misallocation of monitoring fee income and PE firm expenses in half the cases they have examined — a very high proportion of improper actions. These are often accompanied by a breach of fiduciary duty as the PE firm puts its own interests above those of the investors in its funds. Enforcement not only discourages actions that violate regulations meant to protect investors, they serve the purpose of alerting investors to the kinds of behavior they should be on guard against. This too increases transparency.

Taxes

The announcement by the IRS that it will adopt a new approach to auditing complex partnerships and intends, in 2018, to implement these new rules and step up its audits of these entities is most welcome. This should begin to remedy the current situation in which partnerships know that the chance of an audit is slim. However, there is no reason for the IRS to delay enforcing clear regulations that, too often, have been skirted by PE funds.

The Treasury and IRS have already put private equity firms on notice that most existing management fee waiver structures do not conform to the tax code. These firms will not be able to claim they were relying on the advice of their tax lawyers and tax preparers; it is to be hoped that lawyers will be unlikely to continue providing such advice and tax preparers will be unwilling to sign tax returns that claim that fees were converted into capital gain. Similarly, the tax code is clear that payments cannot be characterized as monitoring fees and deducted as expenses by PE-owned portfolio companies unless there is the requisite compensatory intent. In both cases, ending these abusive tax practices will depend on the willingness of the IRS to undertake vigorous enforcement actions.

Enforcement of existing provisions of the tax code would go a long way toward establishing tax fairness and ending a system in which some of the wealthiest members of society get away with not paying the taxes they owe. The use of management fee waivers to disguise *fees paid by LP investors* for services provided by the GP and to transform them into a profit share taxed at the lower capital gains tax rate is almost always an abuse of the tax code. This is because the waivers are structured in such a way that there is essentially no entrepreneurial risk. In the case of monitoring *fees paid by portfolio companies* to the private equity firm and deducted by the companies as expenses, the issue is whether there is the requisite compensatory intent, which in many cases appears impossible to establish in light of the unusual terms of the monitoring fee agreements. Both of these are tax-driven strategies whose purpose is to reduce tax payments, at a cost to the U.S. government of hundreds of billions of dollars each year.

Given the widespread (though certainly not universal) use of management fee waivers and monitoring fees by the private equity industry, the IRS should prioritize enforcement of the relevant provisions of the tax code at a national level. The agency should field a dedicated and knowledgeable team of IRS investigators able to appropriately raise the issues of waivers and monitoring fees in examinations and prepared to take enforcement actions in cases where this is warranted. The reported recent surge in fee waiver audit activity is a hopeful sign that the IRS is doing exactly this, at least in the context of fee waivers.[69] There has unfortunately been no indication that the IRS is yet scrutinizing suspicious monitoring fee deductions.

Reform of the tax code to close the "carried interest tax loophole" that allows PE partners to pay the lower capital gains tax rate on profit sharing performance bonuses is another important step forward, and is likely to receive renewed attention in this election year. The blatant unfairness of this loophole, in which some of the richest people in America pay a lower share of their income to the IRS in taxes than some middle-class workers, has made ending the favorable tax treatment of carried interest an issue in both the Republican and Democratic 2016 primary campaigns. Donald Trump, Hillary Clinton and Bernie Sanders all threaten to eliminate this tax break — estimated to be worth

69 Elliot (2016).

billions of dollars a year to PE firm partners. More precise estimates would be possible if the IRS required private equity funds (and hedge funds) to disclose on the tax return the partnership files the amount of carried interest paid to the general partner.

Some observers, most prominently law professor Victor Fleischer, argue that a careful reading of the relevant section of the tax code already makes clear that carried interest should be taxed as ordinary income. In this view, the Administration does not need to wait for Congress to reform the tax code; Treasury and IRS can issue guidance that clarifies that carried interest is ordinary income and is to be taxed as such.[70] Not everyone is convinced that the carried interest tax loophole can be closed without Congressional action, however. But whichever way the tax-favored treatment of carried interest is resolved, it is clearly past time for this loophole to be closed.

70 Fleischer (2015b).

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