Americans for Financial Reform
Education Fund

The Honorable Janet Yellen
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Commissioner Charles P. Rettig
Internal Revenue Service
1111 Constitution Avenue N.W.
Washington, DC 20224

May 12, 2021

Dear Secretary Yellen and Commissioner Rettig:

The 18 organizations below urge the Internal Revenue Service (IRS) to prioritize rebuilding its auditing and enforcement capabilities in order to tackle systemic tax abuses, including in particular those by the private equity industry. The private equity industry has generated greater untaxed revenues over the past decades by structuring their funds to avoid taxes and through a strategy of misclassifying certain earnings, exploiting tax loopholes like carried interest, and utilizing complex and opaque business structures to shield earnings from IRS scrutiny. We applaud President Biden's plans to fund the IRS and tax enforcement more robustly and believe that these needed changes are a strong argument for such additional resources.

As a result of these PE strategies, some of the most profitable firms, with executives that rank among the world's richest people, are effectively paying lower tax rates than working people who earn an hourly wage or annual salary. Most Americans like teachers, firefighters, and nurses are paid salaries or wages that are subject to ordinary income tax rates that can reach 37 percent. But the way private equity firms and managers structure their earnings means that large portions of their income is taxed at a far lower rate, exacerbating America's growing income and wealth inequality. Private equity firms often charge 2% on

all of a fund's assets and an additional 20% performance fee (or even more) if investments meet a certain target rate. Private equity firms have minted several new billionaires over the past two decades going from three in 2005 to 22 in 2020.[1] The 2021 *Forbes* billionaire list included 40 private equity leaders with a combined net worth of over $200 billion.[2]

As the Biden Administration prepares to invest trillions of dollars into America's infrastructure and the economy, the IRS must strengthen its oversight of these highly lucrative private equity firms so that they pay their fair share. Many private equity-owned firms received taxpayer funded support during the pandemic,[3] making their tax avoidance strategies even more unjust.

The IRS should promptly strengthen oversight and enforcement over the most common private equity tax avoidance techniques. This includes devoting more resources to auditing of private equity firms, and enforcement against their violations, along with specific attention to issues like firms' deducting monitoring fees that should be considered dividend income and the use of fee waivers to inappropriately shift income to be taxed as capital gains; tightening the capital gains loophole that remains after the limited and ineffective changes in the 2017 Tax Cuts and Jobs Act; and preventing private equity from evading taxes through offshore tax havens.

Even if the IRS were to successfully enforce these laws, billions of dollars in private equity owed taxes have already been lost due to the statute of limitations. The IRS cannot go back past two decades to collect those taxes, but it must attempt to collect all back taxes, penalties, and interest that it still can.

Strengthen IRS auditing and enforcement capacity

The inequitable impact of private equity's tax avoidance techniques is exacerbated by the IRS's dwindling ability to audit private equity firms and enforce federal tax requirements. As the private equity industry has grown in size and complexity, earlier Congresses and the Trump administration have repeatedly trimmed the IRS' auditing and enforcement budget and capacity. From 2010 to 2019, the agency's total funding was cut by 21 percent and its enforcement budget shrank by 24 percent while the total number of tax returns rose by 9 percent.

The budget cuts have depleted staff and expertise necessary to untangle the complex layers of private partnerships commonly used by private equity firms. The IRS has lost a third of the staff with the knowledge and experience to audit very complex tax returns.[4] The share of pass-through businesses like private equity that faced audits has fallen by 40 percent since 2010 to just 0.2 percent of these tax filers — or 1 out of every 500 of these complex firms.

Over the same period, U.S. private equity assets under management grew by about one-third to over $1.5 trillion dollars according to Pitchbook. Pass-through businesses, which include S Corporations and

partnerships, account for 44 percent of the gross tax collection gap due to underreporting by these filers, which is the greatest source of uncollected tax liabilities.[5] The IRS needs to dedicate resources, including rebuilding its staff and capacity, to audit private equity firms, their funds, their portfolio companies, and the general partners (GPs) that manage private equity funds. Resources should be shifted away from activities like targeting the use of tax credits by low-income workers and towards these urgent needs

Recommendation — Dedicate additional enforcement professionals to private equity tax abuses: *The IRS must be well staffed to handle auditing private equity firms, general partners, their portfolio companies, and tax advisors who encourage aggressive interpretations of tax law. These groups account for a large portion of the taxes lost and should be a focus of the agency's enforcement.****[6]***

Prevent private equity firms from inappropriately classifying monitoring fee structures

Privately owned companies have always been incentivized by federal income tax law to reclassify dividends as fees paid for rendered services, since those expenses can be fully tax deductible. Private equity firms take advantage of the different tax treatment by charging portfolio companies "monitoring fees," which have become a significant source of revenues for the general partners. Since these monitoring fees are classified as services provided by the general partnership to the portfolio company, the fees can be deducted from their income as a provided service, significantly lowering their tax burden.

But monitoring fees are often really a disguised dividend paid to private equity firms from the portfolio firms and not a service provided to investors.[7] The monitoring component of these fees is a misnomer since the private equity firms do little in the way of monitoring to justify such fees. The hundreds of millions of dollars a private equity firm might charge may not reflect the value of the minimal service provided to the portfolio company. Such misclassification becomes abundantly clear when monitoring fee arrangements are terminated early, requiring portfolio companies to pay the present value of all future fees, or literally as Oxford University professor Ludovic Phallipou refers to the fees, "money for nothing."[8] A 2015 University of North Carolina paper estimated that private equity firms charged 600 companies $20 billion in monitoring fees over two decades that should have been counted as dividend income.[9]

Recommendation — fully audit monitoring fees: *The IRS must fully audit private equity monitoring fees to determine whether they are legitimately tax-deductible service expenses or are inappropriately misclassified dividend income that should be taxed.*

Clarify when management fee waivers should be treated as income

Some private equity executives and managers (known as general partners of the fund) choose to waive their management fees in exchange for a larger share of the fund's profits. Choosing to waive fees in exchange for increased future profits effectively converts fees that are taxed as ordinary income into returns from the fund which are taxed at the lower capital gains rate that can be deferred for years. A sample of about 2% of private equity controlled firms show at least $10 billion in fees over the past two decades was shielded from ordinary income tax rates through management fee waivers.[10]

Management fee waivers offer such lucrative tax benefits that tax lawyers have referred to them as the "holy grail."[11] In one startling example, a Bain Capital management fee waiver turned about $1 billion in management fees that would have been taxed as ordinary income into fund profits taxed as capital gains[12], saving partners $200 million in income taxes.[13]

Recommendation — finalize the 2015 "disguised compensation rule": *The IRS should finalize its 2015 disguised compensation rule to prevent private equity firms from inappropriately reclassifying ordinary income as capital gains and to hold private equity firms accountable for their prior use of those fee waivers as allowed under the statute of limitations. The 2015 proposed but never finalized rule closed this loophole by amending Section 707(a)(2)(A) of the Internal Revenue Code of 1986 to establish more clearly defined conditions in which a partner bears "significant entrepreneurial risk" to determine whether waivers benefit from capital gains treatment.* ***[14]***

Strengthen and enforce three-year holding period for carried interest treatment

The income earned by private equity fund managers from managing the funds often flows largely into the firm's General Partnership and are taxed at the lower 20 percent capital gains rate instead of at the ordinary income tax rate. This is due to the long running carried interest loophole, estimated to reduce federal tax revenues by $180 billion over 10 years .[15]

Most private equity funds charge not only a management fee but also take a fixed cut of the profits from the sale of assets in the fund (above an agreed upon threshold return). A common fee structure is a 2 percent annual monitoring fee for assets under management and 20 percent of the profits above the target return, known as a performance fee. Until 2017, the carried interest was taxed as long-term capital gains rather than ordinary income as long as the investments were held for one year.

The 2017 Tax Cuts and Jobs Act extended the holding period from one year to three years for carried interest to qualify for long-term capital gains. The IRS rule implementing this change went into effect in January 2021. The IRS did manage to clarify that private equity firms could not operate through S corporations to claim a corporate exemption from the new rule in 2018.[16] Nonetheless, private equity firms will still be able to wiggle through the carried interest loophole. The holding period extension was poorly crafted and too short to capture much of private equity earnings from performance fees since most

assets are held for more than 3 years. Most firms will employ tax attorneys to successfully evade scrutiny even for shorter holdings.

Recommendation — require alternative asset managers to disclose carried interest earnings and increase audits and enforcement of the carried interest tax provisions: *The IRS should increase its audits and enforcement of the carried interest requirement which would be greatly enhanced by mandating that private equity and other alternative asset managers report carried interest earnings on their annual tax filings. The IRS should require the disclosure of carried interest earnings by reporting "disproportionate waterfall allocations" (which are allocations to a partner disproportionate to the amount of capital they have invested) in a separate line on the IRS's Form 1065 as well as Schedule K-1. This would provide the IRS with much-needed aggregate carried interest earnings by private equity and other private funds and allow it to estimate the amount of forgone tax revenues from classifying ordinary income as capital gains.*

Recommendation — trace partnership earnings to the appropriate taxpayers within private equity firms: *While the additional reporting requirements for partnerships in January's final IRS rule improves the oversight of complex partnership arrangements that generate income for private equity general partners**[17]**, more disclosures are still needed related to general partners' income from related partnerships and tiered partnerships. The IRS can still require the reporting of carried interest allocations at every tiered level through "disproportionate waterfall allocations" collected under Form 1065 and Schedule K-1. Such additional reporting would enable the IRS's audit and enforcement teams to better monitor large pools of capital with unknown owners. A 2015 paper from the Treasury's Office of Tax Analysis estimated that $200 billion annually, or 30 percent of all income in the partnership sector, could not be traced to an identifiable taxpayer due to these tiered partnership structures.**[18]***

Recommendation – the Treasury Department should support and advocate for fully closing the carried interest loophole through legislation.

End tax avoidance schemes aided by offshore havens

U.S. based private equity firms and their investors can and do evade taxes by domiciling their funds in tax havens such as the Cayman Islands, now home to one third of all private funds.[19] Offshore tax havens exist for no economic benefit other than to intentionally disguise transactions and evade taxes. Such tax havens also deprive the IRS and other regulatory bodies of critical transparency into private funds and their investors.

Private equity firms have used holdings in offshore tax havens to reduce their tax obligations. Foreign investors such as offshore private equity funds are subject to taxes on income from U.S.-based business. But private equity funds rely on Section 892 of the Internal Revenue Code to use feeder funds or "blocker

corporations” to enable many foreign investors to defer proceeds. Recent clarifications from the IRS have further allowed foreign investors holding less than 10 percent of a blocker corporation to repatriate principal proceeds tax-free. In some cases, blocker corporations will be structured as perpetual vehicles so that tax bills are put off indefinitely for the fund partners and foreign investors i.[20] Further, carried interest if paid from an offshore corporation and structured as a contractual right, rather than an interest in a fund’s profits, allow general partners to defer payments so they are taxed later.[21]

Recommendation — increase scrutiny of potential private equity tax evasion through offshore tax havens: *Private equity’s prolific use of offshore tax havens, where the IRS has less visibility, need to be further scrutinized, in order to end the novel ways partners are deferring taxes and allowing foreign investors to avoid paying them altogether. U.S. investors in foreign corporations are not allowed to defer carried interest if the corporation has U.S. owners.**[22]** the IRS must strictly apply and enforce these prohibitions on private equity firms.*

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Private equity firms’, partners’, and managers’ evasion of tax liabilities through complex and opaque business practices allow hundreds of billions of dollars of earnings to be untaxed or taxed at inappropriately low rates, contributing to America’s economic inequality. Private equity managers should not be able to pay lower tax rates than America’s workers simply because they can shift the structure of their earnings without providing any additional economic value. The IRS should take strong actions to prevent the private equity industry from continuing to avoid paying its fair share of taxes. All of these efforts require more resources, staffing, and expertise to effectively oversee this large and complex industry.

We appreciate your attention to these questions and look forward to continuing to discuss them with you. For more information please contact Andrew Park at andrew@ourfinancialsecurity.org

Signed

Americans for Financial Reform Education Fund

AFL-CIO

American Economic Liberties Project

American Federation of State, County and Municipal Employees (AFSCME)

American Federation of Teachers

Center for Economic and Policy Research (CEPR)

Center for Popular Democracy

Communications Workers of America

CtW Investment Group

National Education Association (NEA)

Oxfam America

Patriotic Millionaires

Private Equity Stakeholder Project

Public Citizen

Revolving Door Project

Service Employees International Union (SEIU)

Strong Economy for All Coalition

Worth Rises

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