November 16, 2015

Ms. Oluwafunmilayo (Funmi) Taylor
Internal Revenue Service
Department of Treasury
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Rulemaking for Disguised Payments for Services under Section 707(a) (2) (A) for the Internal Revenue Code – REG: 115452-14

Dear Ms. Taylor:

The Association for Corporate Growth (ACG) appreciates the opportunity to comment on the Notice of Proposed Rulemaking (NPRM) issued by the Internal Revenue Service (IRS) regarding when an arrangement will be treated as disguised payments for services under section 707(a)(2)(A) of the Internal Revenue Code (Code). ACG is concerned that the proposed rulemaking unfairly targets management fee waivers, a common practice in the private fund industry that benefits both investors and private equity firms alike. ACG believes that if enacted, the new regulations would unduly limit the use of management fee waivers to the detriment of both investors in, and managers of, middle-market private equity firms. We fear that ultimately the proposed regulations would hamper the flow of capital from private equity firms to deserving middle market companies and businesses and stifle economic growth.

Background on the Association for Corporate Growth

ACG was founded in 1954 and has more than 14,500 members and 57 chapters throughout the world, 45 of which are located within the United States. ACG members are people who invest in, own, lead, advise or lend to growing middle-market companies. This includes professionals from private equity firms, corporations, banks and other lenders to middle market companies, as well as professionals from law firms, accounting firms, investment banks and other advisors to middle-market deal making.

The mission of ACG is to “drive middle-market growth.” ACG helps to facilitate growth by bringing together middle-market dealmakers and business leaders who build value in companies. ACG accomplishes this by hosting hundreds of chapter events every year, providing online tools for its members, structuring networking opportunities and providing leading-edge market intelligence and thought leadership.

Middle Market Private Equity

A particular focus of ACG is middle-market private equity (MMPE). ACG’s membership includes over 1,000 private equity firms that focus on the middle-market.

Earlier this year, ACG updated its ground-breaking research survey, www.GrowthEconomy.org, using multiple independent databases to better understand the positive impact that private capital investment has on corporate growth and job creation. The research found that between 1995 and 2013:

- Private equity-backed companies grew jobs by 83.7%, while all other companies in the U.S. economy grew jobs by 26.5%;
- Private equity-backed companies grew sales by 134%, while all other companies in the U.S. economy grew sales by 31%; and
- Middle-market private equity-backed companies created more than three times the amount of new jobs (970,869) than any other employment stage.[1]

Almost half of all private equity investment comes from pension funds, foundations and university endowments. These investors have realized a 10-year annualized return in excess of 10% and superior to all other asset classes[2] – helping enable these organizations to meet their ongoing obligations. MMPE firms provide this rate of return by improving the operational efficiency, governance and market strength of the companies in which they invest.

These facts are among the reasons that private equity continues to attract the investment and trust of highly demanding, sophisticated investors. Investors in private equity funds are almost always "qualified purchasers,"[3] "qualified clients"[4] and/or "accredited investors"[5] under federal statutes. Moreover, institutional investors such as pension funds, foundations and endowments typically hire outside attorneys, consultants and/or gatekeepers to advise them and negotiate on their behalf before an investment in a private equity fund is made.

These investors are well aware of, and as described below benefit from, management fee waivers.

Compensation of Fund Managers and Related Tax Consequences

Most private equity fund groups consist of three separate legal tax entities: a fund, a general partner and, lastly, the management company. Investments in a private equity fund are made via a written agreement (Limited Partnership Agreement or LPA) between investors in the fund (limited partners) and the general partner of the fund (general partner). The general partner is responsible for the day-to-day operations of the fund, and typically there is overlap in personnel between the general partner and management company, which may sponsor one or more different funds.

Limited Partnership Agreements are complex and highly negotiated. As noted above, institutional and other investors typically have outside attorneys, advisers and

[1] *See*, http://www.growtheconomy.org/.
[2] Data according to Prequin.
[3] Investment Company Act of 1940, Section 2(a)(51), 15 U.S. Code § 80a–2(a)(51).
[4] Investment Adviser Act of 1940, Rule 205-3(d)(1), 17 CFR 275.205-3(d)(1).
[5] Securities Act of 1933, §230.501(a), 17 CFR 230.501(a).

consultants review and negotiate the Limited Partnership Agreements they enter into, including the provisions relating to management fee waivers.

Under most Limited Partnership Agreements, the management company typically receives an annual management fee equal to a defined percentage of aggregate LP capital commitments, often 2%. The general partner will make direct investments in their funds, often representing 2% or more of the total fund limited partner commitments. The general partner will also be entitled to and receive a "carried interest" in the fund's future profits, often 20 %. Often, the carried interest is payable only after limited partners receive a compounded return or "hurdle." In almost all cases, except possibly for tax distributions, cash is distributed to the limited partners before any carry is distributed.

In a typical private equity fund structure, the management company is a separate legal entity that receives fees, which are typically taxed at ordinary income rates for the partners. The carried interest received by the general partner often manifests itself as an allocation income or gain derived by the partnership, whether such income/gain is long-term capital gain which is generally taxed at a preferential rates or short-term capital gains, which are taxed at regular tax rates, plus the 3.8% tax on net investment income.

Management Fee Waivers

Although a management fee waiver can take a variety of forms, it generally involves the manager foregoing some, or all, of its unearned management fees in exchange for the general partner receiving a larger profits interest in the fund.

There are many non-tax reasons why management fee waivers are common in the private equity industry. Perhaps first and foremost, management fee waivers allow for limited partners to avoid making out-of-pocket cash payments to the fund in order to cover management fees. This is beneficial for limited partners, including public pension funds and other institutional investors who need to manage cash outflows.

In addition, management fee waivers may also help the common owners/members of the general partner and management company fulfill their capital commitment obligations to the fund. Such commitments are often required by limited partners to ensure that all members of the management team have appropriate "skin in the game." Management fee waivers are relied on particularly by junior members of the management team, who may not otherwise have the resources available to fulfil their obligations.

Management fee waivers also help to strengthen the alignment of interests between LP investors and the fund manager. With a management fee waiver, the manager is giving up a contractual right to earn a fee in exchange for a larger portion of the fund's profits, which the manager receives *if and only if* it is able to deliver a satisfactory return on invested capital. In this regard, a management fee waiver helps ensure that managers are focused on, and incentivized to, achieve superior investment results.

Finally, most waiver programs require the consent of the limited partners in order to be effectuated – either directly or through the approval of a limited partner advisory

committee. Thus, if the limited partners do not agree to allow the manager to waive the management fees it would be otherwise entitled to, under most Limited Partnership Agreements the manager is not permitted to do so.

Safe Harbor Rules for Profits Interest

The preamble of the proposed regulations indicates that the IRS will provide an additional exception to the safe harbor contained in Revenue Procedure 93-27 where a profits interest is issued in conjunction with a partner forgoing payment of an amount that is substantially fixed, including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments. ACG respectfully suggests that such an exception is unwarranted.

We disagree with the rationale stated in the preamble that (a) the service provider does not perform services for the benefit of the partnership and (b) the service partner effectively transferred an interest in the partnership through a constructive transfer to the related partner. The partnership clearly benefits from the elimination of the formula based fee in exchange for the grant of a profits interest that may never generate a payment. Where the GP receives the additional profits interest, there can be no question that the general partner provides services to or for the benefit of the partnership. Where the recipient of the profits interests is owners or employees of the investment manager, these people provide services that benefit the partnership. Moreover, there can be no constructive transfer where the investment manager did not already perform the services to which the fee related. The preamble does not indicate that the exception would be limited to such cases.

The additional exception to the safe harbor is likely to renew the valuation disputes that initially were part of the reason for the safe harbor in the first place. Certainly, it goes without saying that the fixed right to 2% of the assets of a partnership is not the same as a contingent right to a payment of profits designed to yield a payment of 2% of the assets of a partnership.

The new exception would appear to apply whether or not the profits interest meets the requirements of the proposed regulations for being considered to be a distributive share of partnership profits. The proposed regulations constitute a sufficient safeguard against disguised compensation payments. Moreover, if it is intended that the grant of a profits interest may be both taxable on receipt and treated as a disguised payment of compensation, this creates an unfair possibility of accelerated taxation, and an intentional mismatching of income and deduction (i.e., both the grant of the interest and the payment would be ordinary income under the proposals, and a deduction would be permitted only upon the liquidation of the partnership interest, which deduction may be capital in nature).

The Proposed Rule and "Significant Entrepreneurial Risk"

The NPRM seeks to provide a mechanism for determining whether an arrangement should be treated as a disguised payment for services under Section 707(a) (2) (A) of the Code by describing six non-exclusive factors to be considered. The most important of these

factors is whether the allocation and distribution is subject to "significant entrepreneurial risk." An arrangement that lacks significant entrepreneurial risk will generally be treated as a disguised payment for service irrespective of the other five factors.

However, the definition of "significant entrepreneurial risk" in the proposed regulations is vague and should be narrowed in order to focus specifically on waived fee arrangements. For example, the proposed regulations state that having substantial entrepreneurial risk will encompass having a distributable share, but ultimately the determination depends on all facts and circumstances. Adding to the confusion, the proposed regulations state that only partners extract profits of a partnership with reference to the success of the venture while non-partners receive payments which are not subject to entrepreneurial risk. In most private equity fund structures, the management company typically has risk when it waives a contractual predetermined fixed management fee in return for an increased profit interest in a fund that may or may not return an equivalent cumulative waived fee from exits of its investments.

Overemphasis of Claw Back

Examples in the proposed regulations put significant emphasis on the existence of a claw back arrangement in determining whether a profits interest will be respected as a distributive share. We believe that less emphasis should be given to such arrangements.

Although they are very common in the private equity context, these arrangements are not universal. However, this does not in and of itself indicate the lack of entrepreneurial risk. Even in the absence of a claw back provision, cash is almost uniformly distributed to investors in advance of carry partners. Moreover, it is very common for the investors to receive a preferred distribution or hurdle return before carry partners receive any distributions other than tax distributions. Thus, it strains the imagination to suggest that such an arrangement lacks entrepreneurial risk in the absence of a claw back provision. Limited partners in private equity fund as a class tend to be highly sophisticated investors, primarily institutions or very high net worth individuals, and the limited partnership agreements are heavily negotiated documents. If there is some small risk that a carry partner may get more than the typical 20% carry as a result of the lack of a claw back feature but the agreement otherwise provides for payment of carry only after returning capital, it generally should be assumed that this is the deal the sophisticated parties intended to be struck. Certainly, significant entrepreneurial risk should be considered to exist.

The Proposed Regulations Fail to Give Due Regard to GP Valuations

In the proposed regulations, Section 1.707-2(c)(1)(i)-(v) contains examples of arrangements that purportedly show lack of entrepreneurial risk and, as a result, are treated as disguised payment for services. The examples make note of capped allocations of partnership income, allocations for only fixed period of time where the share of income is reasonably certain, allocations of gross income items and, lastly, allocations under a formula that is mostly fixed in amount.

In these examples, a key justification as to why the arrangements presumptively lack significant entrepreneurial risk appears to be the assumption that private equity fund managers have unfettered ability to control the value of the partnership assets. The proposed regulation claims, among other things, that "[o]ne fact is that the value of partnership assets is not easily ascertainable," and the partnership agreement allows the service provider "to control the determination of asset values."

It is simply wrong to say that private equity fund advisers "control" the determination of portfolio company asset values. Private equity fund valuations are subject to audit by independent audit firms and are required to be in conformance with generally accepted accounting principles (GAAP). Moreover, private equity advisers have a fiduciary duty to their clients, and are required to value portfolio company assets fairly. Typically, advisers are at least annually required to present a detailed analysis of their valuation process and methodology to an advisory committee comprised of the fund's key investors.

Advisers are not only subject to regulation under the Investment Advisers Act of 1940, they are also subject to examination by the Securities and Exchange Commission (SEC). SEC examinations include a detailed review of the adviser's valuations, as well as the methodology used to derive the valuation and any changes that have been made in valuation methodology. Advisers that are found to have been manipulating the valuation process will not only be in trouble with the SEC, they will also find it extremely difficult to raise another fund.

In addition, unlike some other private funds, private equity funds only receive compensation when there is a realization – i.e. the portfolio company is actually sold. Private equity advisers do not receive compensation for unrealized gains.

The same analysis holds true for the suggestion in the proposed regulations that the adviser "controls the entities in which the partnership invests, including controlling the timing and amount of distributions by those controlled entities." To suggest that private equity fund advisers would arbitrarily come up with valuations or manipulate the timing and amount of distributions in order to enhance their compensation ignores the fact that they are subject to scrutiny of federal regulators, independent auditing firms, and also their investors – and the penalties for improper conduct are significant.

The secondary factors to determine whether there is a disguised payment for service consist of five factors, although none of these as important as significant entrepreneurial risk. The fifth factor of the secondary factors deals with arrangements that provide for different allocations or distributions with respect to different services provided. In explaining this factor, the proposed regulations make reference to a common practice in private equity funds – a claw back obligation. The proposed regulations differentiate between a general partner and a management company that are related under IRC section 707(b) both receiving profit interest from waived management fees with the general partner having a claw back obligation and the management company not having a claw back.

Because the general partner has the claw back obligation, the general partner is deemed to not be receiving a disguised payment for services while the management company is deemed to receive disguised payment for services due solely to a lower level of entrepreneurial risk because there is no claw back obligation. In most private equity fund structures, the management company is the entity that waives the fees in return for the general partner entity to receive an increased profit interest while they also have a claw back obligation and the management company does not have the same obligation.

Each of the six examples discussed in the proposed regulations refer to 'all facts and circumstances' needing to be considered as these can vary in each situation. Also, each example refers to presence or absence of entrepreneurial risk. Examples 5 and 6 are the two that most closely resemble typical waived management fee arrangements in private equity structures. Both examples refer to the additional profit interest earned by the general partner as additional interest which serves as the waived management fee that is given up. Both examples refer to the general partner having a claw back provision which enables it to achieve significant entrepreneurial risk. Example 6 talks about the management company providing written notice to the limited partners of private equity fund typically at the beginning of the fund creation about the waived management fees. Both examples make reference to the fact the management company is foregoing and waiving a predetermined, binding, non-changing fixed fee that is based on the net profits in return for the related general partner entity receiving a larger profit interest in the fund. This shows that the management company does in fact have entrepreneurial risk as well as the general partner.

Both examples explain that the additional interest the general partner receives is neither highly likely to be available nor reasonably determinable. This creates enough risk for the waived fee not to be a disguised payment for services.

The New Fifth "Other Factor" is Inappropriate

The proposed regulations include a new presumption that if an arrangement provides for different allocations or distributions with respect to different services received, where the services are provided either by a single person or related persons, and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly, the arrangement that involves the lesser level of entrepreneurial risk is disguised compensation. This is the only factor not previously identified in the legislative history to the disguised payment rules and, we believe, inappropriate. If an arrangement otherwise would be considered to constitute a distributive share, the fact that the same or related person may have another arrangement with respect to which they have a more significant entrepreneurial risk should be irrelevant. Moreover, it places such persons in a worse position than another person with the same arrangement that does not have an additional entrepreneurial risk in the partnership allocations. The provision also discriminates against smaller investment managers, whose investment funds and/or managers are more likely to be considered related to the general partner.

Conclusion

Management fee waivers are a common practice in the private equity industry that benefit investors and private equity firms alike. ACG believes that the NPRM is overly restrictive, and will result in legitimate management fee waivers being deemed to be payments for services. This will have a chilling effect on the use of management fee waivers, which will harm both investors and middle-market private equity firms alike.

ACG appreciates the opportunity to comment on the NPRM and welcomes the opportunity to discuss further any of the issues addressed in this letter. If you have any questions, or if we can provide any additional information, please feel free to contact Amber Landis, Vice President of Public Policy, at alandis@acg.org or at (312) 957-4272.

Sincerely,

Gary A. LaBranche, FASAE, CAE
President & CEO
Association for Corporate Growth