The Untold Story of *Sun Capital*: Disguised Dividends

By Gregg D. Polsky

Gregg D. Polsky

Gregg D. Polsky is the Willie Person Mangum Professor of Law at the University of North Carolina School of Law. He is co-counsel for an individual who has filed IRS whistleblower claims based in part on the arguments made in this article.

Polsky addresses the tax implications of monitoring fees paid to private equity firms and argues that they typically are improperly deducted by the portfolio companies that pay them.

Much ink has been spilled in the tax press about the recent *Sun Capital* case,[1] which concluded that a private equity fund was in a trade or business for ERISA purposes. This conclusion could ultimately make the fund liable for the underfunded pension obligations of its insolvent portfolio company.[2] In reaching its decision, the First Circuit emphasized that the portfolio company paid management fees to the fund's sponsor, and that those fees had reduced the fund's obligation to pay its own management fees.[3] In the parlance of the private equity industry, the portfolio company had paid ''monitoring fees,'' and those monitoring fees reduced the fund's management fees through a ''management fee offset.'' Based on the court's reasoning it seems that absent the monitoring fee/offset structure the case could have turned out much differently.

Because the monitoring fee/offset structure is prevalent in the private equity industry, the *Sun Capital* approach — if it were adopted by other circuits or affirmed by the Supreme Court[4] — would apply in nearly every situation when a private equity controlled company becomes insolvent with an underfunded pension plan. While the decision itself was expressly limited to ERISA issues, the court's reasoning could have dramatic federal income tax implications. If private equity funds were determined to be in a trade or business for tax purposes as a result of the monitoring fee/offset structure, foreign investors might have to recognize effectively connected income, and tax-exempt investors might have to recognize unrelated business taxable income.[5] In addition, if private equity funds were determined to be in a trade or business for tax purposes, the fund manager's favorable tax treatment of its carried interest could be in jeopardy.[6]

Therefore, it is not surprising that there has been so much interest in the case, as well as angst in the private equity community over its implications. What is very surprising is even though *Sun Capital* highlighted the commonplace monitoring fee/offset structure, no one has yet called attention to the fact that the primary purpose of the structure is almost certainly tax avoidance — particularly the effort to disguise dividends paid by portfolio companies as deductible compensation.[7] Further, the dividends are typically so thinly disguised that

[1] *See, e.g.*, Amy S. Elliott, ''Panelists Agree on Fee Offsets, But Disagree on *Sun Capital*,'' *Tax Notes*, Oct. 7, 2013, p. 16; Steven M. Rosenthal, ''Private Equity is a Business: *Sun Capital* and Beyond,'' *Tax Notes*, Sept. 23, 2013, p. 1459; Lee A. Sheppard, ''The *Sun Capital* Decision in Perspective,'' *Tax Notes*, Sept. 23, 2013, p. 1351.

[2] *See generally Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 1259 (1st Cir. 2013).

[3] *Id.* at 143 (noting that the economic benefit that the fund received from the ''offset was not from an ordinary investment activity, which in the Sun Funds' words 'results solely in investment returns'''); *id.* at 146 (''Most significantly, Sun Fund IV received a direct economic benefit in the form of offsets against the fees it would otherwise have paid its general partner.''); *id.* at 148-149 (remanding case back to the trial court to determine, among other things, ''whether Sun Fund III received any benefit from an offset from fees paid by'' the portfolio company).

[4] The private equity fund filed a petition for certiorari on November 21, 2013.

[5] *See* Rosenthal, *supra* note 1, at 1469.

[6] *Id.* at 1468.

[7] Although there is no publicly available proof that portfolio companies are actually claiming deductions for monitoring fees, it is reasonably certain that they are. The monitoring fee arrangements themselves go to great lengths to characterize the payments as payments for ongoing services. It is difficult to see why the parties would go through the trouble of characterizing the fees and implementing the convoluted monitoring fee/offset structure if they did not intend to have portfolio companies attempt to deduct the monitoring fees for tax purposes. One alternative reason might be to oppress minority shareholders by skimming funds out of the portfolio company, but that skimming is so transparent that, generally, minority shareholders must be fully aware of the monitoring fee arrangement. It is therefore reasonable to conclude that oppression of minority shareholders is not the purpose. Further, in some cases, monitoring agreements are required to be filed with the SEC, including the HCA Inc. monitoring fee arrangement discussed later in this article. In those cases the monitoring fees themselves are identified as compensation payments in SEC Form 10-K filings. If the portfolio companies disclaimed tax deductions for monitoring fees, that action would be flatly inconsistent with the way those fees are characterized in the SEC filings. For those reasons, this article assumes that portfolio companies characterize the monitoring fees for tax purposes in a manner consistent with how they are labeled in the monitoring fee arrangements and reported to the SEC.

there leaves little doubt that, under well-established tax law governing the deductibility of compensation, deductions for the monitoring fees would often not be allowed. In other words, the idiosyncratic monitoring fee/offset structure is a blatant earnings-stripping strategy that often does not work, although the IRS has apparently not seriously scrutinized it yet. The irony, of course, is that if the private equity industry had not engaged in this earnings-stripping scheme, amounts that would have been paid out as monitoring fees would instead have been paid out as dividends, which means that the *Sun Capital* decision might very well have turned out differently.

Given the large amounts of monitoring fees charged by many private equity firms, the improper deduction of monitoring fees appears to cost the treasury hundreds of millions (or even billions) of dollars in annual revenue. Yet, despite the intense spotlight on the monitoring fee/offset structure as a result of *Sun Capital*, the pervasiveness of the structure, and the sheer amount of tax revenue at stake, the tax implications of monitoring fees have thus far been unexplored. This article endeavors to fill that void, arguing that under the typical monitoring fee/offset structure monitoring fees are nondeductible.

A. The Monitoring Fee/Offset Structure

Private equity firms (also known as private equity sponsors) establish and manage private equity funds, which make substantial long-term investments in the equity or debt of private businesses. To acquire capital for those investments, private equity funds pool contributions from a variety of sources, although most of the capital is provided by large institutional investors such as public pension funds. The funds are structured as limited partnerships. The private equity firm manages the fund, and an affiliate of the firm receives the general partnership interest, while fund investors receive limited partnership interests.

The private equity firm generally receives three types of payments for managing the fund. First, the firm receives an annual management fee from the fund, usually equal to approximately 2 percent of the capital that has been committed by the investors. Second, the general partner receives a percentage (usually approximately 20 percent) of the profits realized by the fund; that profits interest is known as the carried interest. Third, private equity firms also receive periodic monitoring fees directly from the portfolio companies.[8] As described below, management fees and monitoring fees are interconnected through management fee offsets.

Investors in private equity funds have long been skeptical about the purported benefits that portfolio companies receive by paying monitoring fees to private equity firms and, accordingly, investors typically negotiate for and receive management fee offsets. Under a fee offset, monitoring fees received from a portfolio company reduce the amount of future management fees that will be owed from the fund to the firm (that is, monitoring fees reduce the "2" in the "2 and 20" arrangement).[9] In the last few years, most new funds offset 100 percent of the monitoring fees received against future management fees,[10] which means that monitoring fees reduce future management fees dollar for dollar. In earlier years, it appears that 80 percent fee offsets were the most common. Under an 80 percent offset, $1 million of monitoring fees would reduce future management fees by $800,000. As the court in *Sun Capital* rightly recognized, the fund benefits from the sponsor's receipt of monitoring fees, because its liability for future management fees is substantially reduced.[11]

---

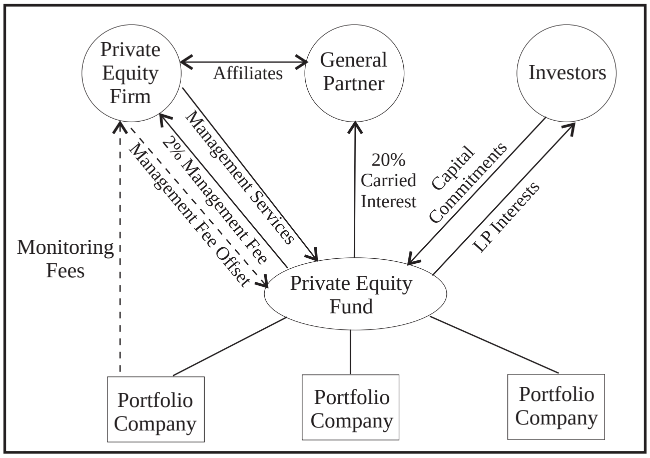
[8]Many private equity firms also receive a fourth type of payment directly from portfolio companies, called transaction fees (also known as deal or success fees), which are charged by the firm in connection with the completion of an acquisition or other transaction.

[9]Technically, the fund pays the management fees and receives the fee offset. However, only limited partners must contribute towards the management fee payment; the general partner is effectively not charged. Therefore, while the fund technically pays the fees and receives the benefit of the management fee offset, as an economic matter the investors bear the burden of those fees and receive the benefit of offsets.

[10]*See* Dan Primack, "The Death of Private Equity's Fee Hogs," *Fortune* (Sept. 5, 2013) (noting a report showing that 63 percent of funds formed in 2012 and 2013 provided 100 percent fee offsets, up from 51 percent of funds formed in 2010 and 2011).

[11]*See Sun Capital*, 724 F.3d at 146 ("Most significantly, Sun Fund IV received a direct economic benefit [from the fees paid by its portfolio company] in the form of offsets against the fees it would otherwise have paid its general partner.").

This diagram illustrates the private equity industry structure:



B. The Relevant Tax Law Principle

To deduct compensation for services, there are two independent conditions, both of which must be satisfied: (i) the payer must have a compensatory purpose, or stated differently, an intent to pay compensation; and (ii) the amount paid must be reasonable in light of the services that are being purchased.[12] In most reported cases regarding the deductibility of compensation, it is the second prong — reasonableness — that is at issue. In the case of monitoring fees, however, the first condition — compensatory intent — is often not satisfied. If compensatory intent is lacking, no deduction will be allowed, even if the amount paid might be considered reasonable.[13]

In determining compensatory intent, the label that the parties place on the payment is not determinative.[14] Instead, all of the facts and circumstances surrounding the payment must be examined to determine whether, in substance, the payer had the requisite intent to pay compensation.[15] In particular, the terms and structure of the purported compensation arrangement are the critical facts that must be examined in determining the payer's intent.[16] Because of the well-known incentive for closely held C corporations to disguise dividends as compensation, courts and the IRS give close scrutiny to their compensation arrangements.[17]

In researching this article, numerous monitoring fee arrangements were reviewed. Those arrangements are typically included in a management agreement executed between a portfolio company and one or more private equity firms. A very large percentage of these arrangements would not be able to satisfy the compensatory intent requirement.[18]

---

[12]*See O.S.C. Associates Inc. v. Commissioner*, 187 F.3d 1116 (9th Cir. 1999); *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359 (9th Cir. 1974); FSA 200042001; *see also* reg. section 1.162-7(a) (''The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.'').

[13]*See* FSA 200042001 (''Lack of compensatory purpose has been relied upon to find amounts paid to employees are not deductible even though they might have been reasonable in amount.''); *Electric & Neon Inc. v. Commissioner*, 56 T.C. 1324 (1971) (''The test of deductibility of alleged compensation is, as we mentioned, two-pronged. However, in this case, the [IRS] does not contend that the amounts which [the service provider] received from [the taxpayer], including the withdrawals and his stated salary, constituted unreasonable compensation for his services. Rather, the [IRS's] position is that the amount which [the service provider] received from [the taxpayer] in excess of his stated salary were not intended to be paid as compensation. It is settled law that such intent must be shown as a condition precedent to the allowability of a deduction to the corporation.''); *Paula Construction Company v. Commissioner*, 58 T.C. 1055, 1058 (1972) (''It is now settled law that only if payment is made with the intent to compensate is it deductible as compensation.''); *Charles McCandless Tile Service v. United States*, 422 F.2d 1336, 1339 (Ct. Cl. 1970) (''Even a payment deemed reasonable, however, is not deductible to the extent that it is in reality a distribution of corporate earnings and not compensation for services rendered.''); *O.S.C. Associates*, 187 F.3d at 1121 (The taxpayer ''would have the Tax Court fixate entirely on the reasonableness of the amounts involved and then draw an inference of compensatory intent, without regard to the other evidence. However . . . if there *is* evidence that the payments contain disguised dividends, the corporation must separately satisfy *both* the reasonableness *and* the compensatory intent prongs of the test. Reasonableness alone will not suffice'' (emphasis in original).).

[14]*See Nor-Cal Adjusters*, 503 F.2d 359 (payments designated as bonuses lacked compensatory intent and therefore were nondeductible disguised dividends); *O.S.C. Associates*, 187 F.3d 1116 (payments made under an incentive compensation plan lacked compensatory intent and therefore were nondeductible disguised dividends).

[15]*See Electric & Neon*, 56 T.C. at 1340 (''Whether such intent [to pay compensation] has been shown is, of course, a factual question to be decided on the basis of the particular facts and circumstances of the case.'').

[16]*See O.S.C. Associates*, T.C. Memo. 1997-300 at 9 (explaining that ''the most persuasive evidence of the petitioner's lack of compensatory intent is the plan itself''); *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 153 (8th Cir. 1974) (''The provisions of the agreements themselves tend to support the notion that they provided for a distribution of profits rather than compensation for services rendered.'').

[17]*See, e.g., Elliots Inc. v. Commissioner*, 716 F.2d 1241, 1243 (9th Cir. 1983); *Charles McCandless Tile Service v. United States*, 422 F.2d 1336, 1339 (Ct. Cl. 1970); FSA 200042001.

[18]A ''top 10'' list of the worst monitoring fee agreements reviewed:

> HCA Inc., available at http://tinyurl.com/hca-inc; Berry Plastics Group Inc., available at http://tinyurl.com/berry-inc; Univision Communications, available at http://tinyurl.com/univision-inc; West Corp., available at http://tinyurl.com/west2-inc; Biomet Inc., available at http://tinyurl.com/biomet-inc; Dunkin Brands, Inc., available at http://tinyurl.com/dunkin-inc; Sensata Technology Holdings, available at http://tinyurl.com/sensata-inc; SunGard Capital Corp., available at http://

(Footnote continued on next page.)

They universally require large periodic payments to private equity firms over a lengthy period (commonly 10 years) purportedly in exchange for future nebulous management, consulting, financial, and advisory services.[19] Nearly all monitoring fee contracts expressly give the private equity firms unfettered discretion in determining whether and when any services will be performed, as well as the extent and scope of those services.[20] Many arrangements explicitly state that there is no minimum number of hours of services that must be performed.[21]

Many monitoring fee contracts allow the private equity firm to terminate the arrangement at its sole discretion (with or without cause) at any time, and still get paid the present value of all of the monitoring fees that it would have received had the contract run its full course.[22] The portfolio company therefore obligates itself to pay the entire amount of monitoring fees even if the private equity firm unilaterally terminates the contract the day after it is executed.

If one needs any more proof that monitoring fees are not paid with the requisite compensatory intent, when a portfolio company is acquired by a consortium of private equity funds (in a so-called ''club deal''), the monitoring fees are typically allocated among the private equity sponsors proportional to share ownership in the portfolio company[23] — often down to a hundred thousandth percentage point.[24] Some monitoring fee arrangements in club deals provide that the allocation of monitoring fees among the private equity sponsors is automatically adjusted as the funds' respective share ownership percentages fluctuate.[25]

All of these factors indicate a lack of compensatory intent. A payer with compensatory intent would not allow the service provider to decide unilaterally when and how to provide future services that are only ambiguously described. Likewise, a payer with compensatory intent would not allow a service provider to unilaterally cancel the services contract at any time and for any reason and still get paid the full amount of future compensation. Finally, pro rata allocations belie compensatory intent because compensatory payments would be allocated among service providers based on the respective value of their services, not based on mere share ownership. It would be an incredible coincidence if a private equity firm that controlled, say, 7.2347 percent of shares was also expected to provide 7.2347 percent of the monitoring services, but that is the only way to show that monitoring fees can be proven to be ''in fact payments purely for services.''[26]

C. Example: The HCA Management Agreement

To illustrate monitoring fee provisions, consider the 2006 buyout of HCA Inc., the operator of hundreds of healthcare facilities. In November 2006 HCA was acquired in a buyout by members of the Frist family (Frist) and a private equity consortium including KKR, Bain Capital (Bain), and Merrill Lynch Global Partners (ML). Upon the acquisition, a management agreement was executed between HCA and the so-called managers, identified as KKR, Bain, ML, and Frist. The management agreement stated that KKR, Bain, ML, and Frist would provide ''management, consulting and financial and other advisory services to [HCA] as requested from time to time by the Board of Directors of'' HCA. In consideration for providing those purported ongoing monitoring services, HCA agreed to pay the managers annual monitoring fees through 2016 of $15 million per year, with potential upward adjustments in accordance with increases in HCA's earnings.

HCA's Forms 10-K show that it thereafter paid a prorated portion of the monitoring fee in 2006, the year the acquisition occurred, estimated at $2 million. The Forms 10-K also establish that HCA paid monitoring fees of $15 million in each of years 2007,

---

tinyurl.com/sungard-inc; J Crew Group Inc., available at http://tinyurl.com/j-crew-inc; Immucor Inc., available at http://tinyurl.com/immucor2-inc.

[19]Private equity observer Dan Primack has specifically noted this idiosyncratic feature of monitoring fees: ''The monitoring fee agreements are determined at the time of sale, not at the time of any specific consulting need.''

[20]All 10 agreements in footnote 18 include this provision.

[21]*Id.*

[22]*Id.*

[23]*Id.*

[24]*Cf. Kennedy v. Commissioner*, 671 F.2d 167, 175 (6th Cir. 1982) (''One factor which is indicative of a distribution of capital rather than compensation is if the payments are in proportion to . . . stockholdings.''); *Paul E. Kummer Realty Co. v. Commissioner*, 511 F.2d 313, 316 (8th Cir. 1975) (''It is also significant that the net pre-tax profits distributed to the three [purported service providers] were almost identical to the percentage of stock held by each of them.''); NSAR 20023 (2002) (''Paying the bonuses in exact ratio to stockholdings supports the finding that the purported bonuses were in substance a dividend rather than compensation for services.''); *Olton Feed Yard Inc. v. United States*, 592 F.2d 272, 276 (5th Cir. 1979) (''The evidence established that the payments made to the shareholders were in proportion to their stock ownership and otherwise resembled a dividend.''); *Nor-Cal Adjusters*, 503 F.2d at 362 (noting, in holding that the payments in question were disguised dividends, that the ''bonuses were in exact proportion to the officers' stockholdings''); *Charles McCandless Tile Service*, 422 F.2d at 1340 (explaining that ''compensation . . . in proportion to the stockholdings of the principal shareholders'' is suggestive of disguised dividends).

[25]For example, the HCA monitoring fee arrangement discussed below includes this provision.

[26]Reg. section 1.162-7(a).

2008, and 2009, and $18 million in 2010. In 2011, under the termination-of-monitoring-fees clause that was triggered by HCA's public offering, it paid an additional $181 million.[27] In total, approximately $250 million of monitoring fees (including termination-of-monitoring fees) were paid by HCA to Frist, KKR, Bain, and ML between 2006 and 2011.

As described below, HCA's monitoring fee arrangement is egregious. Nevertheless, it is not *sui generis*; in fact, there are at least nine other monitoring fee arrangements involving large portfolio companies that are substantially identical to the HCA agreement,[28] and there are hundreds of others filed with the SEC that include one or more of its problematic provisions.

1. Managers are not required to perform any services. As is common, the management agreement gave the managers, who are purportedly contractors of HCA, unfettered discretion in determining their ongoing duties under the agreement: "Each of the Managers shall devote such time and efforts to the performance of services contemplated hereby as such Manager deems reasonably necessary or appropriate; *provided, however,* that no minimum number of hours is required to be devoted by Bain, KKR, ML, or each Frist on a weekly, monthly, annual or other basis"[29] (emphasis supplied). Yet, despite not binding manager contractors to any firm service requirements, HCA promised to pay monitoring fees with a present value on day 1 in excess of $100 million.

2. Managers can terminate the agreement and still get paid all future fees. Like many monitoring fee arrangements, HCA's management agreement allowed the managers to unilaterally terminate the agreement at any time and for any reason yet still receive the present value of the future monitoring fees (discounted using the risk-free yield on U.S. treasuries) that they would have received for the full 10-year term of the management agreement. That fact by itself establishes that HCA did not have compensatory intent when it paid monitoring fees, because HCA was willing to pay those fees even if the management agreement was unilaterally terminated the next day by the managers, in which case HCA would have been assured of receiving nothing of value. In fact, the managers did receive a termination fee in 2011 when HCA's shares were sold to the public, which triggered an automatic termination of the management agreement.

3. Monitoring fees are paid perfectly pro rata. HCA's management agreement allocated the monitoring fees among the managers on a perfectly pro rata basis, according to respective share ownership of HCA. Therefore, 20 percent of each monitoring fee (or termination-of-monitoring fee) was allocated to the Frist family and 26.6667 percent of each fee to Bain, KKR, and ML, corresponding to their respective equity interests in HCA.[30] The management agreement further required the allocation to "be appropriately adjusted in the event of any changes to the proportion of the number of Shares owned in the aggregate by each Manager and its Affiliated Entities."

The Frist allocation was sub-allocated among various Frist family members, apparently in accordance with each family member's respective share ownership, down to the millionth of a percentage point. For example, Thomas F. Frist Jr. was allocated 35.987023 percent and Thomas F. Frist III 15.441588 percent of the Frist family's share of the monitoring fees. The agreement also provided that amounts that are allocated to each Frist are "in consideration of each Frist providing the ongoing services provided by the Managers under Section 1;" that is, management, consulting and financial and other advisory services. 20.974009 percent of the Frist allocation (which equals 4.1948018 percent of the total monitoring fees paid by HCA) was allocated to Patricia F. Elcan, the daughter of Thomas F. Frist Jr. In Federal Election Commission filings, Elcan identified herself in 2006 and 2012 as a homemaker (she apparently made no FEC filings, during the 2008

---

[27]For two separate reasons, it cannot be argued that the $181 million termination payment concerned services performed by the managers in connection with the public offering. First, the exact same termination payment would have been due upon any termination of the management agreement, even a termination that was triggered by the unilateral decision of the managers to terminate the agreement. Second, a separate $26 million transaction fee was paid to the managers purportedly for services rendered in connection with the initial public offering.

[28]The 10 agreements identified in footnote 18 (which include the HCA agreement) are substantially identical for purposes of the deductibility-of-monitoring-fees analysis.

[29]One might argue that the "reasonably necessary or appropriate" language limits the discretion of the managers in deciding how much, if any, services they must perform. However, that argument would not be persuasive for two reasons. First, the monitoring fee services are described in such nebulous terms (*e.g.*, "management, consulting and financial and other advisory services") that the purported limitation on managerial discretion is illusory. Second, the managers themselves control the portfolio company, and it is the portfolio company's request for services that would trigger any service obligation. In effect, for the managers to be obligated to perform any services, they must first ask themselves to perform those services.

[30]Technically, the funds controlled by KKR, Bain, and ML (not the private equity firms themselves) owned the equity interests in HCA, but fee offsets make this immaterial, as discussed below.

and 2010 election cycles).[31] Thus, it appears that HCA paid a self-described homemaker approximately $10 million[32] of fees from 2006 through 2011 purportedly for ''management, consulting, financial and other advisory services.''

Of course, the only reasonable interpretation of the facts is that the monitoring fees were intended as returns to capital, not as a payment for services. Any other conclusion requires that it be pure coincidence that the respective value of the managers' services precisely equaled their respective share ownership and that a self-described homemaker was expected to provide multiple millions of dollars worth of management, consulting, financial, and advisory services to a company with nearly 200,000 employees that identifies itself as the ''nation's leading provider of healthcare services.''[33]

The IRS and courts have rightly recognized that pro rata allocations of purported compensation such as these are a key indicator of disguised dividends. For example, the Sixth Circuit has noted that ''one factor which is indicative of a distribution of capital rather than compensation is if the payments are in proportion to . . . stockholdings.''[34] One nuance to the HCA and other monitoring fee situations is that the private equity firms that receive the monitoring fees are not formally the same entities that own the shares in the portfolio company on which the proportional-to-share-ownership distribution is based. Instead, it is the private equity funds — which are managed by the private equity firms — that actually own the equity. In most cases in which the proportional-to-share-ownership issue has been discussed, the same person both owns equity and receives the purported compensation payments, although there have been some cases in which that overlap does not exist.[35]

Nevertheless, once management fee offsets are taken into account, it becomes clear that the private equity funds do themselves benefit from monitoring fees. Recall that management fee offsets reduce the management fees that are owed by the fund to the private equity firm, and that the current trend is towards 100 percent fee offsets. In a 100 percent fee offset situation, the private equity fund receives the entire benefit of all monitoring fees because of the corresponding dollar-for-dollar reduction in management fees that it must pay. Even in an 80 percent fee offset situation, the fund receives a very significant benefit from monitoring fees because its management fee liability is reduced by 80 percent of the monitoring fees paid.[36]

D. Conclusion

Sun Capital highlighted the monitoring fee/offset structure that is pervasive in the private equity industry. In fact, that structure appeared critical to the court's conclusion, which has the potential to create serious tax and ERISA concerns for private equity funds and their investors and managers. What has been lost in all of the discussion, however, is that the monitoring fee/offset structure is itself an extremely aggressive earnings-stripping tax strategy. In many cases, it is clear that monitoring fee deductions would not be allowable under the existing tax doctrine. The HCA situation was a classic example of monitoring fees that clearly lacked the requisite compensatory intent necessary to qualify

---

[31]*See* https://tinyurl.com/o7acs7c; https://tinyurl.com/pdyyad5; https://tinyurl.com/o2gmcae.

[32]Approximately $250 million of total monitoring fees (including termination-of-monitoring fees) were paid to the managers; the Frist family's share was approximately 20 percent, and Elcan's share of the Frist share was approximately 20 percent.

[33]*See* http://hcahealthcare.com/about/.

[34]*Kennedy*, 671 F.2d, at 175; *see also Paul E. Kummer Realty Co.* at 316 (''It is also significant that the net pre-tax profits distributed to the three [purported service providers] were almost identical to the percentage of stock held by each of them.''); NSAR 20023 (''Paying the bonuses in exact ratio to stockholdings supports the finding that the purported bonuses were in substance a dividend rather than compensation for services.''); *Olton Feed Yard* at 276 (''The evidence established that the payments made to the shareholders were in proportion to their stock ownership and otherwise resembled a dividend.); *Nor-Cal Adjusters*, 503 F.2d at 362 (noting, in holding that the payments in question were disguised dividends, that the ''bonuses were in exact proportion to the officers' stockholdings''); *Charles McCandless Tile Service,* 422 F.2d at 1340 (explaining that ''compensation . . . in proportion to the stockholdings of the principal shareholders'' is suggestive of disguised dividends).

[35]*See, e.g., Henry Miller Spring and Mfg. Co. v. Commissioner*, T.C. Memo. 1975-323 (holding that purported compensation payments were disguised dividends even though the recipients of the purported compensation payments did not directly own shares of the payer).

[36]In fact, assuming a corporate tax rate of 35 percent, fee offsets of only 60 percent still leave investors and managers better off than if monitoring fees were paid out as nondeductible dividends. To illustrate, assume that a portfolio company earns $100. If the monitoring fee/offset structure were not used, the company would pay $35 in tax, leaving $65 to be distributed to investors. After the 20 percent carry, the investors, who generally do not pay U.S. taxes, would be left with $52, and the manager would receive the remaining $13 (which would be subject to tax at dividend rates). If the monitoring fee/offset structure were used, then all $100 could be paid out because the monitoring fee deduction would shelter the $100 of income. Under a 60 percent offset, the management fee would be reduced by $60, which is greater than the $52 distribution that investors would have received under the alternative scenario. The manager is also better off, because the manager gets to keep an extra $40 by virtue of the fact that the monitoring fees only reduced future management fees by $60. The $40 would be taxed at ordinary income rates.

as deductible compensation. That case alone appears to have cost the treasury more than $85 million in corporate tax revenues.[37]

---

[37]This assumes that HCA's effective marginal tax rate in the years at issue was the top corporate tax rate of 35 percent.