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Vanguard, a Champion of Low Fees, Faces a Peculiar Tax Challenge

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Vanguard may have committed a sin while pursuing a virtue.

Its virtue — providing simple, diversified investments at very low cost — is well known. Its sin — if that's what it deserves to be called — involves obscure details of tax accounting and corporate structure. It's not easy stuff.

It's worth examining anyway. If a Vanguard whistle-blower is correct, Vanguard could end up owing the Internal Revenue Service a great deal of money, and millions of shareholders could end up paying somewhat higher fees. It seems most likely that even if Vanguard owes some money — and it says it does not — the outcome won't have a big impact on investors. Yet the dispute illuminates the unique structure and operations of a widely influential mutual fund company.

First, consider Vanguard's virtues. Since John C. Bogle founded it in 1975, Vanguard has relentlessly cut costs for fund shareholders, offering simple index funds and "at cost" operations that have been a boon to millions of people, in the view of many academics and investment analysts. It did this with the help of an unusual corporate structure, which is at the root of the whistle-blower's tax complaint.

Mutual fund shareholders, not a separate profit-making entity, are the ultimate owners of the Vanguard Group, which provides services to the individual funds, an arrangement approved by the Securities and Exchange Commission. "Vanguard was designed to eliminate conflicts of interest," said Tamar Frankel, a professor of law at Boston University. "That structure was also one of the ways in which Jack Bogle reduced the cost for investors, and it's been an absolutely great thing."

Vanguard's overall fees are the lowest in the industry, according to Morningstar. Its funds' average expense ratio is only 0.16 percent annually, compared with 1.16 percent for the industry. That 1 percentage point difference may not sound like much, but it is. One extra percentage point in annual fees compounded over a lifetime can shrink your retirement nest egg by 40 percent.

That's the easy part of this story. The harder part is the claim that while providing at-cost services, Vanguard may have run afoul of some I.R.S. rules. That is what David Danon, a former Vanguard tax lawyer, says in whistle-blower claims against Vanguard filed with the I.R.S. and other authorities. The I.R.S. won't comment on the claims, and John Woerth, a spokesman for Vanguard, said, "Vanguard believes they are without merit."

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Mr. Danon and Reuven S. Avi-Yonah, a University of Michigan law professor who has served as Mr. Danon's paid expert, have some intriguing arguments, if you are partial to this sort of thing. The issue is technical, so bear with me: Mr. Danon says that because the Vanguard Group was set up as a "C corporation," and not a partnership, it has potential tax liabilities, even if it does not actually earn a profit. And because it is owned by its mutual funds, for tax purposes, he says, it is required to account for the profits that it could have earned if it had charged the higher fees that the marketplace would have borne.

This may sound like a through-the-looking-glass sort of world, where a company will be punished if it spares investors exorbitant fees, but it could conceivably be the world in which we actually live.

"This is a classic transfer-pricing issue," Professor Avi-Yonah says. "The law is very clear."

Transfer-pricing tax problems typically come up when American corporations apportion income to their foreign subsidiaries to minimize domestic taxes. Professor Avi-Yonah is a prominent expert on this subject and has discussed it eloquently in congressional hearings. Companies like Apple, Microsoft, General Electric and Pfizer have been skillful practitioners of it. Sometimes such companies run afoul of the rules. In 2006, for example, GlaxoSmithKline reached a $3.4 billion settlement with the I.R.S. in what the agency then called the largest transfer-pricing dispute in its history.

On technical grounds, the I.R.S. "could surely win in court" if it applied transfer-pricing rules in the Vanguard case, Professor Avi-Yonah said.

Not everyone is sure of that, though. David M. Schizer, a professor and dean emeritus at Columbia Law School, put the matter succinctly. "The transfer-pricing rules are intended to capture economic reality and not distort it," he said, adding that they weren't intended to apply in a situation like this and result in taxes when no profit existed. "I think it would be absurd to force Vanguard to pay taxes in this case," he said. And John D. Morley, a Yale law professor who is an expert on mutual fund structure, said, "I consider this litigation a little silly."

Transfer-pricing rules are meant for situations in which a company controls a subsidiary and can use that control to set artificially low prices, thus concealing profits. That's not true here, Professor Morley said. "As a practical matter," he said, "all mutual funds are completely dominated by their manager. While Vanguard shareholders ultimately own the Vanguard Group, they don't really control it," he said. Vanguard charges low fees "simply because that's the culture of Vanguard, as Jack Bogle created it," he said. "It's a completely unique situation."

Even Professor Avi-Yonah acknowledged in an interview that applying transfer-pricing rules in the case of Vanguard "seems startling." In fact, he said he wasn't sure that the

I.R.S. should enforce the rules in this fashion. “Luckily, I don’t have to make this decision,” he said. “God knows the I.R.S. has enormous discretion in these cases.” The agency “could accept the taxpayer’s argument that it was an innocent mistake,” he continued, even if “it involves an enormous amount of tax revenue.”

Mr. Danon asserts that Vanguard could owe billions of dollars in taxes on the putative, uncollected revenue. “I know that this is a very unpopular position, and that many, many people are shareholders of Vanguard funds,” he said in an interview. “But the law is the law. Like everybody else, Vanguard should pay the taxes it owes. If it doesn’t, somebody else has to make up the difference, and that’s just not fair.”

Others have looked closely at the possible amounts involved. I’ll return to the numbers shortly. But first, some conflict-of-interest disclosures: Professor Avi-Yonah has an obvious conflict. He says he received $10,000 to $50,000 from Mr. Danon for his research and legal opinion. But he also says that the money has not influenced his views and notes that he will collect nothing further if Mr. Danon’s position prevails.

Mr. Danon has a conflict: Now unemployed, he could receive a whistle-blower’s bonus of up to 30 percent of any funds collected by the I.R.S. in the claim. But he says he is fighting for a principle: “I felt I had to become a whistle-blower because I believe I’m right, and the law is the law, and I couldn’t convince anyone at Vanguard about it.”
I have a conflict, too. Vanguard manages the retirement account at my workplace, as it does in many companies and institutions, and so I am a Vanguard shareholder. That’s also true of several experts I contacted.

Federal and state authorities have been considering these arguments. While the I.R.S. claim is pending, a New York judge dismissed Mr. Danon’s suit in November, and Eric Soufer, a spokesman for the state attorney general, said on Wednesday that his office reviewed the case and has decided not to pursue it. Authorities in California declined to comment on a complaint filed by Mr. Danon there. He also has a claim with the S.E.C., which declined to comment.

Mr. Danon has won one battle, however. The Texas comptroller of public accounts awarded him $117,000 for his role as a whistle-blower, said Lauren Willis, a spokeswoman for the agency. Reliable sources said Vanguard settled with the state for roughly $2 million, though the precise reasons for the settlement are not clear. Mr. Woerth of Vanguard wouldn’t confirm the amount of the payment, and said it was merely the “result of a routine audit.” It is possible that it arose from a relatively small part of Mr. Danon’s complaint — questions he has raised about the accounting for a $1.5 billion contingency fund that Vanguard maintains.

Even if the I.R.S. finds Vanguard liable on all counts, the consequences are unlikely to be significant, says Daniel Hemel, a law professor at the University of Chicago (who, like me, is a Vanguard shareholder). He says that, with penalties, a Vanguard settlement with federal and state authorities could raise average annual mutual fund shareholder fees by no more than 0.09 percentage point, and probably less. Professor Avi-Yonah said he has reviewed Professor Hemel's calculations: "I would rely on them." Even with such an extreme outcome — which seems highly unlikely — Vanguard would remain the cheapest overall fund provider by a wide margin.

In short, Vanguard is far from perfect. Mr. Danon appears to have some valid points and may win some further bonuses. And at the end of all this, shareholders would benefit if Vanguard ended up as an even more transparent company than it is right now. How much do top Vanguard executives earn, for example? If we shareholders really own Vanguard, it seems that we should know.

I asked that question again last week and Mr. Woerth wouldn't say.

But even without knowing the answer to that question or others raised by Mr. Danon, there seems to be no compelling reason for Vanguard shareholders to switch their investments to another company.