Private Equity Is a Business:  
Sun Capital and Beyond  
By Steven M. Rosenthal

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The First Circuit recently decided that a private equity fund is a trade or business for purposes of ERISA. This article describes that decision and its implications for tax law and policy.

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Table of Contents

A. Introduction 1459
B. Sun Capital, the First Circuit’s Decision 1460
  1. The business model of the Sun Funds 1460
  2. Establishing ERISA liability 1461
  3. The Sun Funds engage in a trade or business 1462
C. ‘Trade or Business’ for Tax Purposes 1463
  1. Groetzinger, Higgins, Whipple, and Giblin distinguish active from passive investors 1463
  2. Taxpayers use agents and contractors to engage in business 1465
D. The True Business of Private Equity 1466
  1. Private equity funds are corporate developers 1466

E. Future Policy Direction 1467
  1. ERISA policy for ‘trade or business’ 1467
  2. Income tax policy for trade or business 1468

A. Introduction

Private equity has “grown exponentially.”

Today there are 2,797 private equity firms headquartered in the United States, and each firm sponsors one or more private equity funds. These funds now back, control, or operate 17,744 U.S. companies that employ more than 7.5 million workers.

Private equity is just that: private. Offerings are confidential and difficult to parse. To the extent fund structures can be examined by the public, they are complicated, with layers and layers of entities, domestic and foreign, without apparent purpose, apart from tax and regulatory avoidance.

However, the private equity industry and its advisers offer a simple mantra: Private equity funds are passive investors, without employees, equipment, or offices. Under this view, funds (and their owners) are not subject to the tax rules for more active enterprises. The industry explains that “for decades, investors have relied on the fact that making and deriving income from investments (in the form of income and capital gains), and paying
professional managers to manage those investments, does not constitute a ‘trade or business’ for purposes of the Internal Revenue Code.”

Because they are organized as partnerships for tax purposes, private equity funds are subject to the usual partnership tax rules. However, private equity funds, like many other widely held partnerships, are almost never audited. As a result, the IRS and the courts have not tested the funds’ view.

So, last month, in Sun Capital, the First Circuit surprised the private equity community by holding that a private equity fund was a trade or business under ERISA. The court borrowed the interpretation of the phrase “trade or business” from the leading tax cases to determine that private equity funds were trades or businesses under ERISA (although it cautioned that in some cases, tax law might not dictate the ERISA result). This article describes the court’s use of those tax cases and suggests a slightly different approach. However, this article agrees that private equity funds generally are, and should be, trades or businesses, not passive investors. The article also discusses the tax implications of this status for private equity funds and recommends that Treasury write tax regulations to conform.

B. Sun Capital, the First Circuit’s Decision

1. The business model of the Sun Funds. Marc Leder and Roger Krouse founded Sun Capital Advisors Inc. (SCAI), a private equity firm that sponsors several funds, including Sun Capital III and Sun Capital IV (the Sun Funds). Each of the Sun Funds is a limited partnership (the blue triangle above), with a general partner (the gray triangle) that also is controlled by Leder and Krouse. Each of the Sun Funds also raises and pools investor money from its limited partners (the green oval), which include tax-exempt institutions, foreigners, and wealthy individuals. To attract pension investors, the Sun Funds were designated and operated as venture capital operating companies (VCOCs) under ERISA. That designation requires the funds to have “direct contractual rights to substantially participate in or substantially influence the management of operating companies comprising at least 50 percent” of their portfolio and “to actively exercise those management rights.” Slip op. at 6-7, n.4. The First Circuit rejected “the argument that any investment fund classified as a VCOC is necessarily a trade or business.” Id.

The actual Sun Fund structure differs somewhat from this simplified version. For example, Sun Fund III and Sun Fund IV aggregated their investments in a limited liability company and then used another holding corporation to own Scott Brass Inc. Presenting the precise holding structure is difficult because the organizational documents and various contracts were sealed, but the precise structure is not essential to this article’s core arguments.

“This article discusses the tax implications of this status for private equity funds and recommends that Treasury write tax regulations to conform.”

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5Brief of the Private Equity Growth Capital Council as amicus curiae in support of appellees’ petition for panel rehearing or rehearing en banc, Sun Capital, No. 12-2312 (1st Cir. Aug. 14, 2013).
6Amy S. Elliott, “Audit Proof? How Hedge Funds, PE Funds, and PTPs Escape the IRS,” Tax Notes, July 23, 2012, p. 351 (“The IRS lacks the capacity to audit more than a few large, widely held partnerships each year.”).
8Slip op. at 31.
operations, to provide such intervention, and then to sell the companies."

The Sun Funds expect to complete “significant operating improvements” within the first two years of purchase and to exit investments within “two to five years (or sooner under appropriate circumstances).”

The Sun Funds own only the stock of their portfolio companies; they do not own or lease offices or other property, and they do not employ any workers. Instead, they authorize their general partner to carry out their objectives, which include “investing in securities, managing and supervising any investments and any other incidental activities the general partner deems necessary or advisable.” The general partner may receive large amounts for its efforts: the well-publicized “two-and-twenty.”

The general partner, in turn, creates a wholly owned management company to administer the fund and manage the portfolio company. The management company hires employees and consultants from SCAI to deliver those services. The management company also may collect consulting fees from the portfolio companies. If the management company collects any consulting fees, the general partner reduces the management fee from the portfolio companies. If the management company also may collect consulting fees, the general partner deems necessary or advisable.

The general partner may receive large amounts for its efforts: the well-publicized “two-and-twenty.”

In 2006 the general partners of the Sun Funds identified Scott Brass Inc., a closely held manufacturer of brass products, as a potential portfolio company. They negotiated to buy the company at a 25 percent discount to reflect its unfunded pension liabilities. In early 2007, Sun Fund III and Sun Fund IV completed the purchase, dividing the ownership of the company 30 and 70 percent, respectively.

The Sun Funds appointed SCAI employees to two of the three director positions of Scott Brass. The management company also assigned other SCAI personnel to help operate Scott Brass. Scott Brass sent weekly “flash reports” to SCAI that detailed Scott Brass’s revenue streams, key financial data, market activity, sales opportunities, meeting notes, and action items. Scott Brass copied SCAI personnel on e-mails discussing liquidity, possible mergers, dividend payouts, and revenue growth.

After almost two years of the new management, Scott Brass collapsed, largely because of declining metal prices. In October 2008 Scott Brass stopped contributing to its pension fund. The next month, creditors forced Scott Brass into bankruptcy. If the pension fund is found insolvent, the Pension Benefit Guaranty Corp. will pay reduced pension benefits to the Scott Brass workers.

The Sun Funds themselves are healthy — owning, operating, and selling various portfolio companies. Sun Fund IV, the larger of the two funds, reported total investment income of about $144 million from 2007 through 2009 (from selling portfolio companies at “significant profits”).

2. Establishing ERISA liability. When Scott Brass stopped contributing to its pension plan, it withdrew from the plan and became liable for its proportionate share of the plan’s unfunded vested liability. Under ERISA, the members of the company’s controlled group also are jointly and severally liable for those unfunded liabilities.

The pension plan demanded that Scott Brass pay its share of the unfunded liability, which was $4.5 million at the time. The pension plan also demanded the same amount from the Sun Funds, as members of a controlled group with Scott Brass, for joint and several liability.

An organization is part of a company’s controlled group if the organization is (1) under common control with the company and (2) a trade or business. Congress did not define common control or trade or business but directed the PBGC to write regulations that are “consistent and coextensive”
with regulations under code section 414(c), which prescribes tax rules for employee benefit plans maintained by partnerships and proprietorships that are under common control. The PBGC has written regulations to define common control (which is generally 80 percent or greater common ownership by vote or value, going up and down the chain of ownership), but it has not written regulations to define trade or business.

In 2007 the PBGC held administratively that a private equity fund was a trade or business, explaining:

Although the term “trade or business” is not defined in ERISA, the IRC, or regulations issued by the Treasury Department, courts generally construe the term in accordance with the statute’s purpose and use the test articulated in Commissioner v. Groetzinger, 480 U.S. 23 (1987), for purposes of distinguishing trades or businesses from purely personal activities or investments.

The PBGC also distinguished a private equity fund that is actively involved with its investments from a “passive” investor described in Higgins and Whipple. A federal district court in Michigan dubbed the PBGC’s approach “investment plus.”

3. The Sun Funds engage in a trade or business.

The trial court rejected the PBGC approach as unpersuasive. The First Circuit disagreed, explaining that when the ERISA issue “is one of whether there is mere passive investment to defeat pension withdrawal liability, we are persuaded that some form of an ‘investment plus’ approach is appropriate” to determine trade or business for ERISA purposes. The First Circuit also acknowledged Groetzinger as the origin of the PBGC’s analysis.

The First Circuit unanimously found that Sun Fund IV was a trade or business and not merely a passive investor, and it remanded the case to the trial court to determine whether Sun Fund III also was in a trade or business and whether the funds in combination satisfied the 80 percent test.

a. The Sun Funds actively manage their property.

The First Circuit determined that the “Sun Funds make investments in portfolio companies with the principal purpose of making a profit.” The First Circuit also quoted the conclusion of my earlier article that “private equity funds are active enough to be in a trade or business” (that is, with sufficient continuity and regularity). These determinations satisfy the tests in Groetzinger, which are described in Section C below.

The First Circuit also carefully distinguished the Sun Funds from passive investors — the “plus” of its analysis. The court described several factors that might constitute “plus,” although it noted that “none is dispositive in and of itself.” The court observed that the funds’ controlling stake in their portfolio companies allowed them to be “intimately involved in the management and operation” of the businesses. The court described the Sun Funds’ active management of their portfolio companies, which included “small details, including signing of all checks for [their] new portfolio companies and the holding of frequent meetings with senior staff to discuss operations, competition, new products, and personnel.” In short, the funds “actively managed...

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24PBGC Appeals Board Decision at 10 (Sept. 26, 2007), citing Central States, Southeast & Southwest Pension Fund v. Personnel, 974 F.2d 789 (7th Cir. 1992) (Central States).
27See Sheet Metal Workers’ Nat’l Pension Fund, 722 F. Supp.2d at 869 (finding that a private equity fund may be a trade or business for ERISA purposes).
29Slip op. at 23.
31Slip op. at 19, 23.
32The liability will turn in part on whether the trial court determines that the funds controlled Scott Brass, which requires an 80 percent ownership. ERISA law is unclear on whether the trial court can combine the 30 and 70 percent interests.
33Slip op. at 24.
34Id. at 35, quoting Steven Rosenthal, “Taxing Private Equity Funds as Corporate ‘Developers,’” Tax Notes, Jan. 21, 2013, p. 361. I based this conclusion on a private equity fund’s extensive efforts to raise and return capital and to acquire, develop, and finally sell businesses.
35The First Circuit added, “It seems highly unlikely that a formal for-profit business organization would not qualify as a ‘trade or business’ under the Groetzinger test.” Slip op. at 35, quoting Central States, 668 F.3d at 878. Compare partnerships with corporations. “The Code, in effect, presumes that all corporate transactions arise in the corporation’s trade or business, with the important exception of transactions serving the interest of the corporation’s shareholders rather than its own interests.” Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, para. 5.03[1].
36Slip op. at 24. The court analogized the “plus” factor as “perfectly consistent with” the “without more” directive from Whipple (“Devoting one’s time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged”) (emphasis added).
37The court also observed that “owning property can be considered a personal investment, if the owner spends a negligible amount of time managing the property, although a more substantial investment of time managing the property] may be considered regular and continuous enough to rise to the level of a ‘trade or business.’” Slip op. at 30, n.24, citing Central States, 668 F.3d at 878-879.
38Slip op. at 26 (citing private placement memos).
and operated the companies in which they invested, rather than passively investing in them.\textsuperscript{39}

Finally, the First Circuit added that Sun Fund IV received a direct economic benefit that a passive investor would not have: the $186,000 offset against the management fees it otherwise would have paid to its general partner. The First Circuit concluded that “the sum of all of these factors satisfy the ‘plus’ in the ‘investment plus’ test.”\textsuperscript{40}

\textbf{b. The Sun Funds act through their general partners.} A fund must pursue its business through others, because a fund is merely a legal fiction (that is, a partnership), not a real person. The First Circuit added, “The investment strategy of the Sun Funds could only be achieved by active management through an agent, since the Sun Funds themselves had no employees.”\textsuperscript{41} The First Circuit treated the funds’ general partner as their agent, relying on Delaware law.\textsuperscript{42}

The First Circuit attributed the activities of the general partner to the fund to determine the status of the fund (that is, trade or business or passive investor).\textsuperscript{43} The general partner’s activities included those of the management company that the general partner had engaged to deliver management services to Scott Brass. The court found that the provision of management services “was done on behalf of and for the benefit of the Sun Funds.”\textsuperscript{44}

\textbf{C. ‘Trade or Business’ for Tax Purposes}

\textbf{1. Groetzinger, Higgins, Whipple, and Giblin distinguish active from passive investors.} The code uses “trade or business” hundreds of times, without defining the phrase.\textsuperscript{45} However, the leading tax authorities indicate that the term is commonly used to distinguish active from passive endeavors (including distinguishing active and passive investors).

\textbf{a. Groetzinger determines a trade or business for tax purposes.} A trade or business analysis generally starts with Groetzinger, the most recent and comprehensive discussion by the Supreme Court.\textsuperscript{46} Robert P. Groetzinger devoted 60 to 80 hours per week studying racing forms and betting on dog races for his own account. His gambling “was not a hobby or a passing fancy or an occasional bet for amusement.” He intended to make a living through his wagering, although he lost money in the year under challenge. He sought to attribute his gambling losses to a trade or business, which was necessary to fully offset his gambling gains.

The Court viewed the words “trade or business” as “broad and comprehensive,” and it deferred to a “common-sense concept of what is a trade or business.”\textsuperscript{47} The Court ultimately believed that “fairness” demanded that a full-time devotion to gambling as a source of livelihood “be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.”\textsuperscript{48} The Court held that “to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”\textsuperscript{49}

The Court cautioned, however, that “caring for one’s own investments” is not a trade or business, unless one is an “active trader.”\textsuperscript{50} Thus, the Court’s holding did not “overrule or cut back” its prior holding for stock investors in Higgins.\textsuperscript{51}

\textbf{b. Higgins and Whipple were passive investors.} Eugene Higgins made “permanent” investments and rarely shifted his portfolio, except to adjust for redemptions, maturities, and accumulations. He “merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.”\textsuperscript{52} Higgins tried to deduct his expenses as incurred in a trade or

\textsuperscript{39}Id. at 25 (citing McDougall v. Pioneer Ranch, 494 F.3d 575, 577-578 (7th Cir. 2007)). See also Chris William Sanchirico, “The Tax Advantage to Paying Private Equity Fund Managers With Profit Shares: What Is It? Why Is It Bad?” 75 U. Chi. L. Rev. 1071, 1102 (2008) (“It is one thing to manage one’s investments in businesses. It is another to manage the businesses in which one invests”). But see David R. Sicular and Emma Q. Sobol, “Selected Current Effectively Connected Income Issues for Investment Funds,” 56 Tax Law. 719, 772 (2003) (suggesting a private equity fund is not engaged in a trade or business).

\textsuperscript{40}Slip op. at 28.

\textsuperscript{41}Id. at 38.

\textsuperscript{42}Id. at 36.

\textsuperscript{43}By contrast, the Sun Funds and the trial court refused to attribute the activities of an agent to its principal on the grounds that a trade or business of an agent cannot be attributed to its principal. The First Circuit criticized this view as “simplistic,” since the activities, not the trade or business, must be attributed. Slip op. at 39, n.30.

\textsuperscript{44}Id. at 38.


\textsuperscript{46}480 U.S. 23 (1987). See, e.g., Central States, 706 F.3d 874 (adopting for ERISA purposes the trade or business test from Groetzinger).

\textsuperscript{47}Groetzinger, 480 U.S. at 31.

\textsuperscript{48}Id. at 33.

\textsuperscript{49}Id. at 35.

\textsuperscript{50}Id. at 31.

\textsuperscript{51}312 U.S. at 218.

\textsuperscript{52}Id. at 218.
business. A slightly different case arose later, with an investor who helped his corporations’ businesses directly: Whipple. For many years, A.J. Whipple was a construction superintendent and an estimator for a lumber company. Later in his career, he organized and assisted corporations. He made a bad loan to one of those corporations and tried unsuccessfully to deduct the bad loan as incurred in his trade or business. The Court explained, “Devoting one’s time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged.” That is, “Absent substantial additional evidence, furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business.” That is because that return “is distinctive to the process of investing and is generated by the successful operation of the corporation’s business as distinguished from the trade or business of the taxpayer himself.”

The Court acknowledged, however, that a taxpayer who is engaged in a regular course of promoting corporations for a fee or commission or “for a profit on their sale” may engage in a trade or business, citing Giblin. In “such cases there is compensation other than the normal investor’s return, income received directly for his own services rather than indirectly through the corporate enterprise.” But Whipple did not promote corporations for a profit on their sale, which distinguished his case from Giblin. And he had no intention of developing the corporations as going businesses for sale to customers in the ordinary course.

c. ‘Rule established in Giblin.’ In Whipple, the Court distinguished taxpayers that promoted or developed corporations for a profit on their sale, citing Giblin. Giblin involved a lawyer, Vincent Giblin, who owned and operated a range of corporations, including a horse racing track, a surety bond business, a dog track, a laundry, a dry cleaning business, and a restaurant/bar. He did not claim that he was engaged in the restaurant business or in any of the other businesses which he had promoted and dealt with during the preceding twenty years. Rather, he sought to prove that he was regularly engaged in the business of seeking out business opportunities, promoting, organizing and financing them, contributing to them substantially 50 percent of his time and energy and then disposing of them either at a profit or loss.” The Fifth Circuit agreed and permitted Giblin to deduct a loss for a bad loan to the corporation that had run the restaurant.

For a taxpayer to fall within “the rule established in Giblin,” the Tax Court considers whether “the entities were organized with a view to a quick and profitable sale after each business had become established, rather than with a view to long-range gains.” An “early resale” makes the profits income

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53Section 162. A. Higgins, Congress added section 212 to permit individuals to deduct expenses to produce or collect income.
54G. Groeitzinger, 480 U.S. at 30 (summarizing the holding of Higgins).
55H. Higgins, 312 U.S. at 215 (government characterizing Higgins’s activities, which the Court accepted).
56373 U.S. 193.
57Id. at 202 (emphasis added). In other words, a “corporation has a personality separate from its shareholders and its business is not necessarily their business.” United States v. Generes, 405 U.S. 93, 102 (1972) (describing the underlying rationale of Whipple).
58Id. at 203 (citations omitted).
59Here the Court referred to a return that may “produce income, profit or gain in the form of dividends or enhancement in the value of an investment.” But the real crux of the decision is in the Court’s later statement that “one who actively engages in serving his own corporations for the purpose of creating future income through those enterprises” is not in a trade or business. Id. See Charles Dillingham, “Ordinary vs. Capital Losses on Business Investments,” 48 Marq. L. Rev. 53, 70 (1964) (“For the organization and, apparently, the management of the corporation to constitute a business, the income which is to be derived apparently must come from some other source than the corporation itself, either in the form of a fee to be paid by some third party, or a purchase price to be paid by some third party”). (Dillingham helped Whipple organize his corporations and represented him before the Court.)
received directly for services, and "the longer an interest is held the more the profit becomes attributable to the successful operation of the corporate business."72

**d. Three principles to identify a trade or business.** These cases establish three key principles to identify a trade or business. First, activities must be profit-oriented, not personal, for a trade or business. Profit-oriented activities exclude hobby, entertainment, or other personal activities. And they exclude mere managerial attention to one's own investments, even to produce or collect income.

Second, these activities must be continuous, regular, and substantial. The "resolution of this issue 'requires an examination of the facts in each case.'"68

And third, a shareholder must establish his own trade or business, separate from the trade or business of the corporation whose shares he owns. In these cases, there is "compensation other than the normal investor's return, income received directly for his own services rather than indirectly through the corporate enterprise."69 The presence of more than one corporation helps establish such a business.70 An early resale also helps distinguish a shareholder's business from the corporation's.

2. **Taxpayers use agents and contractors to engage in business.** As the First Circuit observed, "One may conduct a business through others, his agents, representatives, or employees,"71 quoting *Boeing*. In *Boeing*, a taxpayer, along with several others, owned and wanted to sell its timber. It entered into contracts with two different logging companies to cut the timber, transport it, and sell it at market. This enterprise required a logging railroad, logging roads, logging camps, and other structures, all of which needed to be constructed by the logging companies. The taxpayer "gave practically no time or attention to the operations under these contracts during the taxable years involved." The court expressly rejected the taxpayer's argument that a trade or business could be avoided by engaging agents and independent contractors to cut, remove, and market the timber, and it concluded that the taxpayer was in fact conducting a business.72

In real estate, for example:

Sales activity may be carried on by a person other than a taxpayer with the same effect as though the taxpayer had directly engaged in the activity, without regard to whether the other person occupied the legal status of an agent or an independent contractor. The taxpayer cannot insulate himself from the acts of those persons whose efforts are combined with his in a mutual endeavor to make a profit, no matter how the endeavor is denominated.73

In the international context, there is longstanding authority that a foreigner may engage in a U.S. trade or business through a U.S. agent.74 The focus is simply on whether the activities are continuous, regular, and substantial.

Finally, an agent often engages others to fulfill its obligations to its principal, and the activities of the others are attributed to the principal's trade or business.75 Most pertinent, the Tax Court and the IRS accepted that a private equity fund's general partner engaged in a trade or business through the activities of a management company (a contractor) to advance the general partner's business.76

74 See, e.g., *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940) (a nonresident who hired a U.S. agent to maintain 11 properties in New York was engaged in a trade or business within the United States) ("The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor, the purchase of materials, the making of contracts, and many other things which come within the definition of business") (citation omitted); *Adda v. Commissioner*, 10 T.C. 273 (1948) (gains of a nonresident from trading in commodities in the United States through a broker were taxable because the trading was "extensive" enough to be a trade or business).
75 See, e.g., *Handfield v. Commissioner*, 23 T.C. 633, 637 (1955) (there is "some doubt whether the News Company actually sells the cards to the public or whether it acts as a distributor to news dealers who sell to the public. We do not have enough information in the record to make any findings concerning the relationship between the News Company and the dealers. In our view of the case, it is immaterial precisely what that relationship may be because, as will appear below, the important relationship is that between the petitioner and the News Company"); *Leavenhaupt v. Commissioner*, 221 F.2d 227 (1955) (agent executed leases and rented U.S. properties, kept books of accounts, supervised repairs to the properties, and insured the properties on behalf of nonresident owner); *De Amodio v. Commissioner*, 34 T.C. 894, 904 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962) (various property managers and management companies negotiated leases, arranged for repairs, and paid taxes on behalf of a nonresident who owned U.S. property).
76 *Dagres*, 136 T.C. at 279, n.20. I believe the activities attributed to the general partner also would be attributed to the fund (because the general partner was acting on behalf and for the benefit of the fund), but that issue was not before the court.
COMMENTARY / POLICY PERSPECTIVES

D. The True Business of Private Equity

1. Private equity funds are corporate developers.

The First Circuit’s “investment plus” test encompassed Groetzinger, which is the usual starting point. The First Circuit also identified fees that it believed distinguished the Sun Funds from passive investors, which shifted slightly away from the three principles of the leading tax cases. Hopefully, future courts will refocus on the “plus” factors, as discussed below.

As described above, the First Circuit generally followed the approach of Groetzinger, Higgins, and Whipple. The court drew an analogy between its “plus” and the “without more” test from Whipple, which requires compensation other than the normal investor’s return. And the First Circuit identified two returns of the Sun Funds that differed from the returns of an investor: (1) the Sun Funds could “funnel management and consulting fees” to the general partner and its management company, and (2) “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.”

These factors were slender reeds to distinguish a trade or business and, in my view, confused the Whipple inquiry. The Sun Funds benefited, but indirectly, from the management and consulting fees funneled to the general partner and the management company. And Sun Fund IV benefited only a little from the $186,000 fee offset — and may not have benefited at all.

The First Circuit should have focused on each fund’s separate business (and the income and gains received from that business). Each fund pursued and acquired multiple underperforming companies to turn them around and sell them for a profit. Sun Fund IV, specifically, received $144 million for 2007 through 2009. Moreover, each fund planned to improve its companies within two years of purchase and to sell within two to five years of purchase (or sooner under appropriate circumstances). That is, the Sun Funds planned to profit from their turnaround efforts for Scott Brass, not from the independent success of Scott Brass’s metal business. As a result, each of the funds easily satisfied the rule established in Giblin, which looks to “a quick and profitable sale after each business had become established, rather than with a view to long-range gains.”

By analogy, securities traders and dealers profit from buying corporate securities at a low price and selling them at a higher price as a separate trade or business. If the activity is continuous, regular, and substantial, it is a trade or business, as Groetzinger acknowledged. That is because securities traders profit from their own efforts, not just from accumulating earnings from their corporations’ success. Likewise, securities dealers profit from selling securities from their inventory, intermediating between buyers and sellers. Thus, too, private equity funds suggest that the court ultimately did not view the fee offset as critical to its decision. Sun Capital, No. 12-2312 (1st Cir. Aug. 23, 2013).

The management fee payable by Sun Fund IV was estimated to be approximately $30 million per year (which would be $90 million over 2007 through 2009). Slip op. at 8, n.6. However, the general partner later waived the management fee, according to the Sun Funds’ petition for rehearing, See appellees’ petition for panel rehearing or rehearing en banc, Sun Capital, No. 12-2312 (1st Cir. Aug. 7, 2013). In a management fee waiver, the general partner purports to convert the management fee (which is taxed at ordinary income tax rates) into an additional allocation of capital gains or dividend income. See Gregg D. Polsky, “Private Equity Management Fee Conversions,” Tax Notes, Feb. 9, 2009, p. 743 (questioning the strategy on legal and policy grounds). Treasury and the IRS recently identified management fee waivers as a priority guidance issue for 2013-2014.

The Sun Funds petitioned for a rehearing based largely on the fact that Sun Fund IV never received any management fee offset. The First Circuit rejected the request, which might

(Footnote continued in next column.)

1466 TAX NOTES, September 23, 2013
engage in a trade or business from selling securities at a profit, which, under the circumstances, differs from a normal investor’s return.

However, the First Circuit declined to consider whether private equity funds were engaged in the development, promotion, and sale of companies as a trade or business, because the argument was presented too late. A future court should focus on the business of a corporate developer to determine the “plus” factors.

2. Common sense and fairness dictate status.

I am shocked — shocked — to find that gambling is going on in here.

Private equity funds engage in substantial activities continuously and regularly. They seek out portfolio companies that need extensive intervention for their management and operation, they provide that intervention, and they then sell the companies. For example, the Sun Funds together purchased and operated 37 companies, five of them jointly. The First Circuit’s decision to treat each Sun Fund as a trade or business reflected the concepts Groetzinger emphasized: common sense and fairness.

Consider a corporation that is formed to buy, repair, and sell many houses. The corporation raises money from its shareholders. It hires a real estate broker to find the houses and general contractors, carpenters, plumbers, and other workers to repair them. After it repairs the houses, the broker sells them. Under those circumstances, the corporation is engaged in the trade or business of buying, repairing, and selling houses — although not the trade or business of contracting, carpentry, plumbing, or brokering real estate.

Suppose instead that a limited partnership is formed rather than a corporation and that the partnership raises money from its partners and hires the same workers. Again, the partnership is engaged in the same trade or business. Now suppose the partnership does not hire the workers but engages the general partner to hire the workers and direct the services. Same result. Or suppose the general partner engages a management company, affiliated or not, to hire the workers and direct the services. Same result. Or, alternatively, the fund directly engages the management company. Again, same result: a trade or business.

Is the business of buying, repairing, and selling houses the same as the business of buying, repairing, and selling corporations? Yes, in all important respects, a real estate developer is analogous to a corporate developer: They both acquire, develop, and sell property. One might object that real estate is tangible property and corporate stock is intangible property. But ownership of real estate is represented by a deed, while ownership of a business is represented by stock, both of which, physically, are pieces of paper reflecting ownership rights.

One also might object that a corporation is a separate entity, with a separate trade or business. That is correct, but the corporate developer’s business is distinct from the corporation’s business, which is the inquiry of Whipple. A corporate developer establishes the separate trade or business through continuous, regular, and substantial activity just as a stock trader establishes a separate trade or business, also using stock as the medium for profit.

E. Future Policy Direction

1. ERISA policy for ‘trade or business.’ In 1974 Congress enacted ERISA to “ensure that employees and their beneficiaries would not be deprived of anticipated retirement benefits by the termination of pension plans before sufficient funds have been accumulated in the plans.” Congress wanted “to guarantee that if a worker has been promised a

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87The economic similarity was first observed by N. Gregory Mankiw, “Capital Gains, Ordinary Income and Shades of Gray,” The New York Times, Mar. 4, 2012, at B4. Mankiw illustrated the point with Carl the carpenter, who, on the weekends, buys dilapidated houses, repairs them, and sells them. Mankiw analogized the activities of Carl the carpenter to the activities of private equity funds and described Carl’s earnings as “entirely capital gains.” I believe Mankiw’s economics analogy is correct, but that his tax law is wrong. See, e.g., Barham v. United States, 301 F. Supp. 43 (M.D. Ga. 1969), aff’d, 429 F.2d 40 (5th Cir. 1970) (Ed G. Barham, a lawyer with money to invest, and J. Ryce Martin, a house builder, formed a partnership to purchase, develop, and sell real estate. Both Barham and Martin realized ordinary income on the partnership’s sale of the real estate).

88Finally, one might argue that a portfolio company will incur more tax as its profitability increases. However, development gains enhance the value of a company, but the gains are not taxed currently under our realization-based system. Development gains are, in effect, a valuable intangible asset that is taxed only at disposition (and at that time, the gains might be offset by deductions or losses). By contrast, retained earnings also increase the value of a company, but these earnings have been taxed previously to the corporation.

89However, Congress required traders to treat their stock as capital assets, not ordinary. See Rosenthal, supra note 34, at 363.

defined pension benefit upon retirement — and if he has fulfilled whatever conditions are required to obtain a vested benefit — he actually will receive it.91

In 1980 Congress added the withdrawal liability rules to ERISA to “protect the viability of defined pension benefit plans, to create a disincentive for employers to withdraw from multiemployer plans, and to provide a means of recouping a fund’s unfunded liabilities.”92

Active investors that control a company justifiably bear some responsibility for the company’s unfunded pension liabilities.93 And using tax authority for “trade or business” is warranted, since “one purpose of the Groetzinger test is to distinguish trades or businesses from passive investments, which cannot form a basis for imputing withdrawal liability.”94

2. Income tax policy for trade or business. This concluding section discusses the tax implications of a trade or business for a private equity fund and its partners. With a trade or business, a private equity fund may, for example, pass through “above-the-line” deductions for its management fees.95 However, the private equity fund may also pass through ordinary income (not capital gains), unrelated business taxable income, and income effectively connected to a U.S. trade or business. But these latter consequences deserve more guidance.

Private equity funds are partnerships, which are not taxed themselves. Instead, they collect, distribute, and report their income and expenses to their partners, which pay any tax that is due.96 In addition, the income and expenses that are passed through are classified at the partnership level, not the partner level.97 For example, if a partnership earns capital gains, the partners report them. If a partnership earns ordinary income, the partners report ordinary income. Finally, if a partnership earns income from a trade or business, the partners must report income from a trade or business.98

In general, Congress treats income from a trade or business uniformly (and often differently from income that is not from a trade or business). To be consistent, income of a private equity fund should be taxed like income of other trades or businesses. To achieve that goal, I suggest Treasury clarify the phrase “to customers” for purposes of the capital gains and the unrelated business income tax rules. Treasury should also clarify whether corporate development is covered by the trading safe harbor from the tax on effectively connected income with a U.S. trade or business.

a. Capital gains versus ordinary income. Congress sought to tax profits arising from the everyday operation of a business as ordinary. As a result, the exclusions from capital asset must be “interpreted broadly” because the preference for capital gains is an “exception from the normal tax requirements of the Internal Revenue Code.”99

In a prior article, I examined the exclusion from capital asset “for property held primarily for sale to customers in the course of a trade or business.” I described the activities of a typical fund, which acquires new or struggling companies at a low price, develops them, and resells them at a higher price.100 I explained that Congress added the phrase “to customers” to describe a vendor’s business (that is, a business of intermediation, like developers that buy and improve property intending to resell it in the near term), not to identify specific vendees.101 That they are conduits through which the taxing obligation passes to the individual partners in accord with their distributive share.”

91Id. quoting Nachman Corp. v. PBGC, 446 U.S. 359, 375 (1980).
92Slip op. at 16, citing R.A. Gray, 467 U.S. at 720-722.
93Presumably, a potential purchaser would reduce its purchase price for a business with preexisting pension fund liabilities. But I question the 80 percent ownership test, which is particularly fragile (ownership of a 21 percent interest by an unrelated party would defeat the test). Perhaps Congress should amend the withdrawal liability rules to cover shareholders who control the withdrawing company, not just those with 80 percent overlapping ownership interests.
94Central States, 706 F.3d at 882.
96As the Supreme Court explained, a “partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.” United States v. Bassey, 410 U.S. 441, 448 (1973). The Court expressed frustration with the perpetual debate of whether a partnership should be viewed as an entity or a conduit. Id. at 448, n.8 (“It seems odd that we should still be discussing such things in 1972. . . . The legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but (Footnote continued in next column.)
concluded that corporate developers (including private equity funds) should treat their profits as ordinary income.102

The trade or business of a private equity fund now has been confirmed. However, many practitioners still misapply the phrase “to customers.” Treasury should publish regulations that clarify the phrase “to customers,” and those regulations should treat profits arising from the everyday operation of a business as ordinary.

b. UBIT for tax-exempt investors. Before 1950, the courts generally followed a “destination of income” test whereby income, whatever the source, would be tax free if it were dedicated to a charitable purpose.103 In 1950 Congress added a UBIT for charitable organizations other than churches.104 The Senate Finance Committee explained:

The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [section 501(c)(3)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. . . . [The UBIT provisions] merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors.105

In general, Congress excluded from the UBIT dividends, interest, royalties, and gains or losses from the disposition of property.106 However, gains from the sale of property primarily held for sale to customers in the ordinary course of a trade or business are treated differently.107 The income from those sales is subject to the UBIT.108 This exclusion is worded identically to the exclusion for capital asset described above, and Treasury should presumably interpret it the same way (with regulations clarifying the phrase “to customers”).

c. ECI of foreigners. Foreigners are subject to a U.S. tax on income that is effectively connected with a U.S. trade or business.109 “Effectively connected income” less allocable deductions generally is taxed in the same manner and at the same graduated rate as the income of a U.S. corporation. These rules originated in the Tariff Act of October 3, 1913, which imposed an annual tax on the entire net income of nonresident aliens from “all property owned and of every business, trade or profession carried on in the United States.”110 The Revenue Act of 1936 created a two-tier system under which the tax treatment of foreign persons depended on whether they were engaged in a trade or business. It also excluded “the effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent, or custodian” from the phrase “engaged in trade or business within the United States” (the trading safe harbor).

The Foreign Investors Tax Act of 1966 preserved this basic tax structure for inbound U.S. investments and clarified the trading safe harbor. Congress sought to balance the goal of encouraging foreign investments in the United States with the goal of taxing all income that is generated from U.S. business activities. Also, Congress hoped to resolve the battles, under prior law, between taxpayers and the IRS to distinguish active trading that was subject to tax and passive investing that was not.111 To do so, Congress expanded the safe harbors to protect trading in stocks, securities, or commodities through an independent agent or for the taxpayer’s own account.112 However, it did not extend the safe harbor to dealers in stocks or securities.113

As explained earlier, private equity funds engage in the business of developing and selling businesses, which, I believe, is different from the trading of stock and securities. By analogy, the IRS views a foreign corporation’s lending activities, including offering loans to U.S. borrowers, as different from the trading of stocks and securities.114 Further, the regulations define a dealer in securities as a “merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.”115 This exclusion is similar to a taxpayer that sells “property primarily held for sale to customers in the ordinary course of a trade or business.” So I believe Treasury should clarify the scope of the trading safe harbor (including the phrase “to customers”) for purposes of the tax on income effectively connected to a U.S. trade or business, to indicate that a

102See, e.g., Katz v. Commissioner, T.C. Memo. 1960-200 (taxpayer organized luncheonettes in order to develop and sell them. The stock of eight of these corporations “was held by [the taxpayer] for sale to customers in the ordinary course of business and accordingly was not a capital asset in his hands.”).

103See Lichter Found. Inc. v. Welch, 247 F.2d 431 (6th Cir. 1957).

104In 1969 Congress added churches.


106Section 512(b)(5).

107The unrelated trade or business activities of a partnership are attributed to the partners under section 512(c)(1).

108Sections 871(b) and 882. And section 875 expressly treats a foreigner as engaged in a U.S. trade or business if the foreigner is a partner in a partnership that is so engaged.

109See Sicular and Sobol, supra note 39, at 722.

110Id.

111Id.

112Section 864(b)(2).

113Section 864(b)(2)(B).


115Reg. section 1.864-2(c)(iv)(a).
corporate developer cannot be viewed as trading in stock and securities for purposes of the safe harbor.

d. Conclusion. Sun Capital confirms that private equity funds are trades or businesses. Now there are secondary questions to clarify, which I believe Treasury can accomplish through regulations. Administrative guidance, with notice and comment, is preferable to waiting for case law to unfold.116

116Slip op. at 40. In the absence of guidance, funds may take different positions and whipsaw the government. Some may, for example, claim an ordinary loss on their portfolio sales. Alternatively, a court may, under current law, hold that a fund’s profits are ordinary, subject to UBIT, or taxed as ECl, which could unsettle the marketplace.