SUTHERLAND

LEGAL ALERT

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Not Exactly a Day in the Sun: U.S. Court of Appeals Holds Private Equity Fund Is Engaged in a Trade or Business

In *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund,* No. 12-2312, 2013 WL 3814984 (1st Cir. July 24, 2013), the U.S. Court of Appeals for the First Circuit effectively found that the separate activities of a private equity fund's managers caused the fund managed by those managers to be engaged in a "trade or business." While this decision addressed the issue in connection with pension funding liabilities under Title IV of ERISA, the court reached its conclusion in part based upon an analysis of federal tax authorities. If the court's conclusions were to be applied more broadly, it could drastically alter the landscape for structuring private equity funds, significantly heighten the tax risks for equity fund investors and managers, and potentially "dry up" financing for cash-starved portfolio companies.

Private equity funds (as well as hedge funds and other pooled investment vehicles) provide efficient structures for various types of investors to pool their funds for investment purposes. The traditional structures utilized for these vehicles have intended tax consequences that encourage various classes of investors and fund managers to participate in these vehicles with expectations of achieving certain goals – foreign (non-U.S.) investors prefer not to pay U.S. federal incomes taxes; U.S. tax-exempt investors prefer to avoid unrelated business income taxes (UBIT); U.S. taxable investors find capital gains appealing; and fund managers seek to realize value in the profitability of the fund's investments through a share of the upside gains. The success of these ventures is well-documented—many portfolio companies have been salvaged or allowed to grow only because of private equity financing and the investors willing to take the risks have been rewarded.

The success of pooled investment vehicles as an efficient means of providing capital to portfolio companies hinges, in no small measure, upon the underlying position that these vehicles are not considered engaged in trades or businesses, but, rather, are treated as mere investors in the underlying portfolio companies. This position is based on long-standing precedent providing that a mere investor is not engaged in a trade or business, no matter how extensive the investor's activities in managing its investments. *See Higgins v. Commissioner*, 312 U.S. 212 (1941). However, the decision in *Sun Capital Partners* calls this position into question and could present a material risk to pooled investment vehicles (primarily private equity funds) that these vehicles may be considered engaged in U.S. trades or businesses.

Background Facts of Sun Capital Partners

In 2007, two affiliated private equity funds (the Sun Funds) purchased 100% of the equity of a portfolio company, Scott Brass. The general partners of both Sun Funds were controlled by two individuals, who also were the sole shareholders of Sun Capital Advisors, Inc. (SCAI). Following the equity purchase by the Sun Funds, Scott Brass entered into contracts with the Sun Funds' general partners for management services; the general partners, in turn, entered into agreements with SCAI to provide employees and consultants to Scott Brass. The management fees derived by the general partners, from Scott Brass, were offset against and reduced the management fees of at least one of the Sun Funds. (These offsets are a common mechanism to avoid any perceived "double-dipping" by the fund manager.) The court noted that "[n]umerous individuals with affiliations to various Sun Capital entities, including [the two individuals that controlled the general partners], exerted substantial operational and managerial control over [Scott Brass]."

In 2008, Scott Brass experienced financial difficulties and was placed in bankruptcy. Unable to obtain additional financing, the company stopped contributing to, and withdrew from, the multiemployer pension plan in which it had participated. Under ERISA, upon withdrawal an employer is required to pay its remaining unfunded pension liabilities. If the withdrawing employer fails to meet its obligation, the multiemployer pension plan may seek payment from a different entity that (1) is under common control with the withdrawing employer, and (2) is a "trade or business." Following the withdrawal of Scott Brass from the multiemployer plan, the plan sought payment not only from Scott Brass, but also from the Sun Funds on the grounds that the Sun Funds and Scott Brass were commonly controlled and that the Sun Funds were engaged in a trade or business.

The Sun Funds filed a motion for declaratory judgment in a U.S. District Court in Massachusetts, which held, *inter alia*, that the Sun Funds were not engaged in a trade or business, and therefore were not liable for the unfunded pension liability of Scott Brass. The pension fund appealed to the First Circuit.

First Circuit Finds Private Equity Fund Is Engaged in a Trade or Business

The principal issue before the First Circuit was whether the Sun Funds were engaged in a trade or business for ERISA purposes. In this respect, ERISA provides that "all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer and all such trades and businesses as a single employer." *See* 29 U.S.C. § 1301(b). The Pension Benefit Guaranty Corporation, while authorized to issue implementing regulations "consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c) of title 26," has not issued any such implementing regulations addressing the "trade or business" requirement.

In the absence of regulatory guidance, the First Circuit found at least one of the Sun Funds to be engaged in a trade or business for ERISA purposes based upon an "investment-plus" test, where an investment may be transformed into a trade or business if certain "plus" factors are extant. Here, the plus factors included:

- The private placement memorandum noted that the fund was actively involved in the management and operation of its portfolio companies;
- The general partner of the fund was empowered by the fund's limited partnership agreement to be involved in hiring, termination and compensation decisions for employees of the funds and the portfolio companies;
- The fund and its affiliates owned a controlling interest in Scott Brass, and employees of SCAI held two of the three seats on the company's board; and
- Fees paid by Scott Brass to the general partners for management services were offset against the management fees otherwise incurred by one of the funds.

The First Circuit, while observing the rule established in *Higgins* and other tax cases (i.e., that a mere investor is not engaged in a trade or business), found that such authority was not controlling in a case brought under ERISA and that, in any event, there was no single, uniform definition of "trade or business" under the Tax Code. Nonetheless, the court affirmatively concluded that its determination (effectively attributing to the private equity fund the general partners' management services rendered to Scott Brass) was consistent with the tax authorities because the Sun Funds' involvement in the management of Scott Brass was distinguishable from that of a mere investor. Of concern, in reaching this conclusion, the court specifically found irrelevant the fact that the Sun Funds did not directly engage in these management activities. Instead, the court focused on the activities of the general partners and found that the general partners engaged in these activities in an agency capacity on behalf of the Sun Funds. In making this determination, the court fixated on the fact that the fund benefited from a reduction (or offset) of its management fees owed to the general partner by the amounts paid by Scott Brass. (The court, unable to determine on the record whether both Sun Funds had similar offset provisions, remanded the case for further factual development.)

Potential Impact of Sun Capital Partners on Private Equity Funds

Apart from the obvious concern that a private equity fund may be found liable for the unfunded pension liabilities of its portfolio companies, *Sun Capital Partners* could portend significant and potentially adverse U.S. federal income tax consequences for the investment fund industry's traditional participants. If a similar "investment-plus" test were to be employed to determine whether a private equity fund was engaged in a U.S. trade or business, the status as a mere investor could be difficult to maintain. From the record, nothing appears to be unique in the Sun Funds' operating structure to distinguish it from that of any other typical private equity fund. And, if a private equity fund were found to be engaged in a U.S. trade or business:

- Foreign investors would be subject to U.S. federal income tax on income effectively connected with the U.S. trade or business (and attributable to a permanent establishment in the U.S., if a treaty applies). Further,
  - The foreign investor could be required to file a U.S. federal income tax return;
  - The fund could be required to withhold U.S. federal income tax on any allocations (or the distribution, if earlier) of fund income or gains to the foreign investor; and
  - If the investor is a foreign corporation, the investor could be subject to U.S. branch profits tax.
- U.S. tax-exempt investors would similarly be exposed to U.S. federal income tax.
  - To the extent that the fund realizes an offset for management fees received by the general partner for the management of the portfolio companies, the U.S. tax-exempt investor's share may be treated as unrelated business income;
  - Gains from the sale of the equity in the portfolio companies may not be exempt from UBIT if the fund were considered to hold the equity interests primarily for sale to customers in the ordinary course of a trade or business; and
  - The traditional use of a foreign blocker to block any income from debt-financed property being allocated to the investor might no longer be a tax-efficient alternative.
- U.S. taxable investors also could suffer adverse consequences if the fund were considered engaged in the business of holding the portfolio company equity interests primarily for sale to

customers in the ordinary course of a trade or business, and the resulting gains were not considered to be capital gains entitled to a reduced maximum rate of taxation.

- Fund managers also would be subject to additional tax on their carried interests.
    - If the gains from the sale of the equity in the portfolio companies are not considered capital gains, the managers (like other taxable U.S. investors) would be subject to tax on such income at ordinary rates (rather than the reduced maximum rates applicable to long-term capital gains); and
    - In addition, such income would likely be subject to self-employment tax.

Going forward, advisers to and managers of private equity funds and other pooled investment vehicles must be alert to the implications of the “trade or business” issue presented in *Sun Capital Partners* to ensure that the structures remain efficient vehicles for investors and managers (and provide a ready flow of financing for portfolio companies).

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