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Flip This Company, but Don't Leave Its Pensioners Out in the Cold: *Sun Capital* as a Call to Action to Change Taxation of Private Equity Funds*

INTRODUCTION

On the reality television show “Flip This House,” real estate dealers buy properties at low cost, renovate the houses, and resell them at a profit.¹ With an analogous investment strategy, private equity funds “flip” their portfolio companies.² Private equity funds buy companies that they believe can increase in value, hire others to manage and improve the companies, and then sell the companies at a profit.³ Because real estate dealers, like those starring in “Flip This House,” engage in a “trade or business” for tax purposes, their profits from selling real estate are taxed as ordinary income.⁴ Despite their similarity to real estate investment companies, private equity funds

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1. See *Flip This House Show Summary*, TV.COM, <http://www.tv.com/shows/flip-this-house> (last visited Apr. 12, 2014).

2. See Steven M. Rosenthal, *Private Equity is a Business: Sun Capital and Beyond*, 140 TAX NOTES 1459, 1467 (2013); Lee A. Sheppard, *The Sun Capital Decision in Perspective*, 140 TAX NOTES 1351, 1351 (2013).

3. See Rosenthal, *supra* note 2, at 1467. Another similarity between real estate dealers and private equity funds is that private equity funds often put their portfolio companies into debt by acquiring them through leveraged buyouts. See Andrew W. Needham, *Private Equity Funds*, 735 TAX MGMT. PORTFOLIO (BNA) § II.B.2 (2d ed. 2010). The debt of a portfolio company could compare to buying real estate with a mortgage secured by the property. For a discussion of the analogy between private equity funds and real estate dealers, see Rosenthal, *supra* note 2, at 1467 (citing N. Gregory Mankiw, *Capital Gains, Ordinary Income and Shades of Gray*, N.Y. TIMES, Mar. 4, 2012, at BU4).

4. When a taxpayer improves real property, for example by subdividing and developing it, and then sells the property, that taxpayer holds property for sale to customers in the ordinary course of a real estate business. See *Bynum v. Comm'r*, 46 T.C. 295, 300 (1966). An asset that is “held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” does not qualify as a capital asset, and therefore any gain on such property will not be taxed at the long-term capital gains rate. See I.R.C. §§ 1221(a)(2), 1231 (2012). The line between a passive real estate investor and real estate dealer can be hard to draw, though, and courts determine this issue based on the facts of each case. See *Bynum*, 46 T.C. at 299. Many courts, including the Supreme Court, consider the continuity, frequency, and substantiality of real estate sales when determining whether real estate is held as in the course of a trade or business or as a passive investment, though courts have not adopted a uniform standard for making this determination. See 1 STEFAN F. TUCKER, SUSAN T. EDLAVITCH & BRIAN J. O’CONNOR, TAX PLANNING FOR REAL ESTATE TRANSACTIONS § 4:5 (2013).

historically have not classified themselves as engaged in a “trade or business” for tax purposes.⁵ Categorized as investors and structured as pass-through entities,⁶ private equity funds pay tax on their profits at long-term capital gains rates⁷ instead of at higher ordinary income rates.⁸

In *Sun Capital Partners III v. New England Teamsters & Trucking Industry Pension Fund*,⁹ the First Circuit may have taken a step toward ending this preferential tax treatment by classifying a private equity fund as a “trade or business”¹⁰ under a section of the Employee Retirement Income Security Act of 1974 (“ERISA”).¹¹ By finding that a private equity fund engaged in a “trade or business,”

5. See Brief of the Private Equity Growth Capital Council as Amicus Curiae in Support of Appellees’ Petition for Panel Rehearing or Rehearing En Banc at 6, *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312) (“For decades, investors have relied on the fact that making and deriving income from investments . . . and paying professional managers to manage those investments, does not constitute a ‘trade or business’ for purposes of the Internal Revenue Code.”). Private equity funds have characterized themselves as engaged in investment activity, and the Internal Revenue Service (“IRS”) has not challenged that characterization. See Rosenthal, *supra* note 2, at 1459–60; Amy S. Elliott, *Audit Proof? How Hedge Funds, PE Funds, and PTPs Escape the IRS*, TAX ANALYSTS (July 23, 2012), <http://www.taxanalysts.com/www/features.nsf/Articles/6BF2832AEAE95EE785257A44005DBB39?OpenDocument> (stating that the IRS lacks the resources to audit many private equity funds and that the 1982 Tax Equity and Fiscal Responsibility Act hinders the IRS’s efforts in auditing these firms).

6. By “pass-through entity,” I mean a partnership or limited liability company that is taxed as a partnership. Section 701 of the Tax Code provides that partners, not the partnership itself, are subject to income tax. See I.R.C. § 701. The income of the partnership passes through to the partners under § 702(a)(8) of the Code. See *id.* § 702(a)(8); WILLIAM H. LYONS & JAMES R. REPETTI, PARTNERSHIP INCOME TAXATION 6–7 (5th ed. 2011). Since partnership income is taxed to the individual partners, partnerships are subject to a single tax on gains. See *id.* at 2. In contrast, corporations subject to taxes under Subchapter C of the Internal Revenue Code (“C corporations”) are subject to double taxation. See I.R.C. §§ 301–385. “Income realized by a C corporation is taxable to the corporation . . . as an entity separate from its stockholders.” LYONS & REPETTI, *supra*, at 2. When a C corporation distributes income to its stockholders, the stockholders also recognize taxable income. See *id.* at 2–3.

7. Needham, *supra* note 3, § IV.A; Alexander Ripps, *Private Equity Funds Face Tax Threat as Court Questions Active Management*, BLOOMBERG BNA (Aug. 14, 2013), http://news.bna.com/airn/AIRNWB/split_display.adp?fedfid=35521557&vname=airnotallissues&wsn=492029500&searchid=22504690&doctypeid=1&type=date&mode=doc&split=0&scm=AIRNWB&pg=0 (“Traditionally, carried interest earned by private equity fund investors and managers has been taxed at capital gains rates based on the premise they are passive investors.”).

8. See I.R.C. § 1.

9. 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

10. *Id.* at 148–49.

11. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 26 and 29 U.S.C. (2012)).

the court determined that two private equity funds could face pension withdrawal liability.¹² Generally, an employer incurs pension withdrawal liability when it participates in a multiemployer pension plan but then ceases covered operations under the plan and does not further contribute to the plan, even though vested benefits remain unfunded.¹³ A withdrawing employer is liable for its share of the plan's remaining vested, unfunded benefits.¹⁴ When the withdrawing employer cannot cover its withdrawal liability, related entities of the withdrawing employer will be subject to the liability if (1) the entity and the employer are under common control, and (2) the entity is engaged in a "trade or business."¹⁵

Some view *Sun Capital* as a purely positive outcome, providing a victory for "widows and orphans" over highly profitable private equity funds and their wealthy managers.¹⁶ On the other hand, pension funds represent a large percentage of private equity investors.¹⁷ *Sun Capital* has the potential to increase these investors' risk of loss if funds can now be saddled with pension withdrawal liability.¹⁸ Private equity funds and their investors also worry that other courts may find that private equity funds engage in a "trade or business" under the Internal Revenue Code ("IRC" or "Code").¹⁹

12. See *Sun Capital*, 724 F.3d at 148–49.

13. See 29 U.S.C. §§ 1381, 1383(a)(2) (2012). "Covered operations under the plan" means the operations of the business that result in a requirement to make contributions under the plan. *Vipond & Vipond, Inc. v. United Mine Workers of Am., 1950 & 1974 Pension Plans*, Civ. A. No. 90-05J, 1992 WL 266000, at *3 (W.D. Pa. June 1, 1992).

14. See § 1391(b).

15. See *id.* § 1301(b)(1).

16. See James Surowiecki, *Private Inequity*, NEW YORKER (Jan. 30, 2012), http://www.newyorker.com/talk/financial/2012/01/30/120130ta_talk_surowiecki; Victor Fleischer, *Sun Capital Court Ruling Threatens Structure of Private Equity*, N.Y. TIMES DEALBOOK (Aug. 1, 2013, 12:28 PM), <http://dealbook.nytimes.com/2013/08/01/sun-capital-court-ruling-threatens-private-equity-structure>.

17. Needham, *supra* note 3, § II.C.3 ("Although [pension funds] invest most of their assets in far less risky, more liquid securities, they usually allocate a very small percentage of their portfolios to aggressive asset classes, including hedge funds and private equity funds. In absolute dollars, however, these small percentages represent the majority of the capital in the private equity sector.").

18. See Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 4; see also Steven Rosenthal, *Court of Appeals Finds a Trade or Business: Could This Mean Higher Taxes for Private Equity?*, TAXVOX: THE TAX POLICY CTR. BLOG (July 25, 2013, 4:30 PM), <http://taxvox.taxpolicycenter.org/2013/07/25/court-of-appeals-finds-a-trade-or-business-could-this-mean-higher-taxes-for-private-equity> (mentioning pension withdrawal liability as one concern for private equity after *Sun Capital*, but highlighting higher taxes as the primary concern).

19. See Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 6.

However, the First Circuit carefully limited its holding to ERISA.²⁰ The court emphasized that the term “trade or business” has no set meaning throughout ERISA or the IRC and that the definition of “trade or business” in the IRC was not at issue in the case.²¹

The court avoided directly implicating tax law by refusing to articulate a clear standard by which to evaluate whether an entity is a “trade or business” under ERISA²² and encouraged the Pension Benefit Guaranty Corporation (“PBGC”) to provide guidance on the issue.²³ The Sun Funds may ultimately escape pension withdrawal liability on remand because ERISA requires common control as well as “trade or business” status,²⁴ and the court confined its holding on the meaning of “trade or business” to the particular ERISA context at issue.²⁵ The Supreme Court denied the Sun Funds’ petition for certiorari²⁶ and has thus declined to reevaluate the First Circuit’s decision regarding Sun Fund IV’s status as a “trade or business” under this section of ERISA. The narrowness of the court’s holding and the Supreme Court’s denial of certiorari will limit *Sun Capital’s* practical effect on private equity.

This Recent Development argues that the First Circuit properly held that the private equity fund Sun Fund IV was a “trade or business” for purposes of this section of ERISA.²⁷ The court, however, refused to provide a clear standard for future determinations of whether a private equity fund engaged in a “trade or business,”²⁸ perhaps with the worthy goals in mind of preventing other courts from applying this holding in the tax context and prompting the PBGC to provide further regulation in the ERISA context.²⁹ This approach probably reflects a desire to avoid drastically

20. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 144–45 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

21. See *id.* (noting that the meaning of “trade or business” is not consistent even within the Code).

22. See *id.* at 141.

23. See *id.* at 148.

24. See *infra* text accompanying notes 109–11, 120–23.

25. See *Sun Capital*, 724 F.3d at 144 (emphasizing that provisions of the IRC are not “determinative of the issue of whether an entity is a ‘trade or business’ under § 1301(b)(1)”).

26. *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 134 S. Ct. 1492 (2014).

27. See *Sun Capital*, 724 F.3d at 141.

28. See *id.* (“We see no need to set forth general guidelines for what the ‘plus’ is [in the ‘investment plus’ standard].”).

29. See *id.* at 148 (“We express our dismay that the PBGC has not given more and earlier guidance on this ‘trade or business’ ‘investment plus’ theory to the many parties affected.”).

increasing the tax burden on existing private equity funds and their investors without the benefits of public notice and comment.³⁰ Rather than legislating from the bench by creating its own regulations, the court indicated that Congress has a duty to clarify the law in order to protect investors.³¹ Since Congress has not clarified the meaning of “trade or business,”³² the Department of Treasury should impose clearer standards for what “trade or business” means throughout the IRC. With this guidance, other courts would be armed with clearer standards to apply in determining whether a pension fund is a “trade or business” for purposes of any particular section of the IRC. However, the Treasury is unlikely to provide this guidance because such a drastic change in the taxation of private equity funds could harm investment.³³ The Treasury and the Internal Revenue Service (“IRS”) will probably not make this change in the absence of Congressional action.

This Recent Development proceeds in four parts. Part I describes the facts surrounding the private equity funds at issue in *Sun Capital: Sun Fund III and Sun Fund IV* (collectively “Sun Funds” or “the Funds”). This Part also discusses ERISA and pension withdrawal liability under the Multiemployer Pension Plan Amendment Act of 1980 (“MPPAA”).³⁴ Part II explains the district court’s holding and the basis for the First Circuit’s reversal and remand. Part III analyzes the First Circuit’s adoption of an “investment plus” standard and shows that this standard is consistent with existing case law defining “trade or business” in the context of other IRC sections. This Part also discusses the First Circuit’s application of agency law to find that Sun Fund IV engaged in a “trade or business.” Part IV considers the implications of the First Circuit’s holding for future cases, particularly the issue of whether other courts should follow this precedent when interpreting

30. The court expressed concern at changing the definition of “trade or business” without notice and comment within the context of ERISA, let alone in the context of the IRC. *See id.* (“The PBGC has not engaged in notice and comment rulemaking or even issued guidance of any kind which was subject to prior public notice and comment.”).

31. *See id.* In rejecting the Sun Funds’ argument that Congress did not intend ERISA’s common control requirement to force owners of a business to pay the withdrawal liability of a company they own, the court noted that Congress was not explicit. *See id.* (“We recognize that Congress may wish to encourage investment in distressed companies by curtailing the risk to investors in such employers of acquiring ERISA withdrawal liability. If so, Congress has not been explicit . . .”).

32. *See infra* notes 112–14 and accompanying text.

33. *See* Fleischer, *supra* note 16.

34. Multiemployer Pension Plan Amendment Act of 1980, Pub. L. No. 96-364, 94 Stat. 1208 (codified as amended in scattered sections of 26 and 29 U.S.C. (2012)).

provisions of the Code. This Part argues that the First Circuit's failure to adopt a clear standard for determining whether a particular fund is a "trade or business" calls for action on the part of Congress, the Treasury, or the IRS to provide guidance. Ideally, Congress should act; but, given its lack of direction in this arena, the Treasury would likely be tasked with clarifying through regulations that a private equity fund is a "trade or business." However, any action on the part of Congress, the Treasury, or the IRS to change the taxation of private equity is ultimately unlikely.

I. THE SUN FUNDS' PRIVATE EQUITY STRUCTURE AND POTENTIAL ERISA PENSION WITHDRAWAL LIABILITY

In *Sun Capital*, two private equity funds attempted to avoid pension withdrawal liability after a commonly owned portfolio company went bankrupt.³⁵ This Part seeks to shed light on why the private equity firm involved in *Sun Capital* structured its private equity Sun Funds and their investments as it did. The Funds' structures allowed them to minimize tax liability,³⁶ and the Funds' method of investing in the portfolio company at issue gave the Funds legal grounds for denying that they had incurred any pension withdrawal liability when the portfolio company went bankrupt.³⁷ Section A describes the Sun Funds' structure and shows that the Funds were typical, indicating that the First Circuit's holding in *Sun Capital* could impact other private equity funds. Section B provides

35. See *Sun Capital*, 724 F.3d at 132.

36. See *id.* at 133–35 (describing the formation and structure of the Sun Funds). Compensation of private equity fund managers through service-compensatory profit interest (also known as "carried interest") represents a form of tax arbitrage, and there is a net tax reduction for both parties inherent in this structure. See 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, 1078 (2008). The tax benefits for private equity fund managers of receiving compensation in the form of carried interest include both conversion of ordinary income to long-term capital gains and tax deferral until the fund's investments are sold, as opposed to paying tax on the compensation as the fund managers earn it. See *id.* at 1075.

37. See *Sun Capital*, 724 F.3d at 135–36 (describing the Sun Funds' acquisition of Scott Brass, Inc. and their division of ownership at seventy percent and thirty percent). The seventy percent/thirty percent division of ownership of the portfolio company between the two Sun Funds allowed the Funds to avoid the common control requirement under the MPPAA. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 121 (D. Mass. 2012) ("[T]he Sun Funds do not deny that they considered legal advice that they could minimize their chances of facing withdrawal liability in the future if they limited their investments to less than the 80% threshold."), *aff'd in part, vacated in part, rev'd in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied* 134 S. Ct. 1492 (2014); see also *infra* notes 99–116 and accompanying text (explaining withdrawal liability under the MPPAA).

background information on ERISA and the MPPAA and explains how these laws impose liability on employers that withdraw from multiemployer pension funds.

A. *The Sun Funds' Formation and Structure*

Like most private equity funds, the Sun Funds were “complicated, with layers and layers of entities, domestic and foreign, without apparent purpose, apart from tax and regulatory avoidance.”³⁸ Private equity funds make money by buying companies that they believe can increase in value with improved management and then selling the companies at a profit.³⁹ To be profitable for a private equity fund, the company “must be acquired cheaply and the borrowed money to buy it [through a leveraged buyout] must be cheap.”⁴⁰ The acquired company is a “portfolio company” of the private equity fund.⁴¹ Through a complicated structure, private equity funds hire others to manage the portfolio companies to make them more profitable.⁴² Finally, the funds sell the companies at a profit.⁴³

First, Sun Fund III and IV both had structures that allowed them to minimize tax liability, particularly by classifying themselves as passive investors not engaged in a “trade or business.”⁴⁴ Generally, private equity firms (also known as “sponsors”) create private equity funds that are structured as a limited partnership or another type of pass-through entity for tax purposes.⁴⁵ Funds usually have a predetermined lifespan of seven to ten years.⁴⁶ The funds solicit

38. Rosenthal, *supra* note 2, at 1459.

39. *See id.* at 1467.

40. Sheppard, *supra* note 2, at 1351. Sheppard describes private equity investments as an overall “rip, strip, and flip” strategy, this cheap acquisition stage being the “rip.” *See id.* The “strip” involves taking management fees directly from the portfolio company to insulate the fund managers from loss. *See id.*; *infra* text accompanying notes 71–77. The “flip” refers to selling the portfolio company and enjoying long-term capital gains treatment with no effectively connected income for foreign investors and no unrelated business taxable income for tax-exempt investors. *See* Sheppard, *supra* note 2, at 1352; *infra* text accompanying notes 88–94.

41. *See* Rosenthal, *supra* note 2, at 1467.

42. *See id.* at 1461, 1467.

43. *See id.* at 1461; Sheppard, *supra* note 2, at 1352.

44. *See* Appellees’ Response Brief at 1, Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312) (“Under settled law, an entity is not a ‘trade or business’ if its only activity is making and managing investments and it earns only investment returns. The Sun Funds are quintessential investors.”).

45. Needham, *supra* note 3, § II.A.2.a; *supra* note 6.

46. Needham, *supra* note 3, § II.A.2.a.

investments,⁴⁷ and the investors are the limited partners of the fund, while an affiliate of the sponsor serves as the general partner.⁴⁸ The Sun Funds' sponsor was the private equity firm Sun Capital Advisors, Inc. ("SCAI"),⁴⁹ and each fund had a lifespan of ten years.⁵⁰ SCAI's co-CEOs and sole shareholders were Marc Leder and Rodger Krouse.⁵¹

Fund sponsors usually create a general partner for each private equity fund.⁵² The general partner is a pass-through entity, often either a partnership or a limited liability company ("LLC"), that serves as a holding company for carried interest.⁵³ Carried interest is the amount of the fund's profits that the sponsor of the fund allocates to the general partner.⁵⁴ The general partner passes on this amount to the fund management company.⁵⁵ Carried interest is usually twenty percent of the fund's investment gains.⁵⁶ Sun Fund III and IV each had a general partner structured as a limited partnership: Sun Capital Advisors III, LP and Sun Capital Advisors IV, LP, respectively.⁵⁷

Because the general partner is usually a pass-through entity for tax purposes, income can pass through it to its members but retain its character as capital gains income, which is taxed at a lower rate than ordinary income.⁵⁸ The members of the general partner are often individuals who can receive the carried interest as capital gains disguised as compensation and thereby avoid employment tax while

47. *Id.*

48. *See* Rosenthal, *supra* note 2, at 1460.

49. *See* Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund, 903 F. Supp. 2d 107, 109 (D. Mass. 2012), *aff'd in part, vacated in part, rev'd in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

50. *See id.* at 120 n.5.

51. Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 133 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

52. *See* Needham, *supra* note 3, § II.A.2.b.

53. *See id.*

54. *See id.*

55. *See id.*

56. *See id.*

57. Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 133–34 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

58. *Compare* I.R.C. § 1(a)–(e) (2012) (ordinary income taxed at a maximum rate of 39.6%), *with id.* § 1(h) (long-term capital gains taxed at a maximum rate of twenty percent). *See generally* Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743, 746–47 (2009) (describing the tax advantages of capital gains treatment for carried interest). If the general partner were organized as a corporation subject to double taxation, then income would be taxed first as the money comes into the corporation and again upon distribution of the income to shareholders. *See* LYONS & REPETTI, *supra* note 6, at 2–3.

also enjoying preferential long-term capital gains rates.⁵⁹ In addition, fund managers enjoy the benefit of tax deferral because they do not pay tax on the carried interest until they realize income from those profits upon sale of the assets, instead of paying tax as they earn the interest.⁶⁰ For the Sun Funds, Leder and Krouse controlled the general partner and the private equity firm.⁶¹ Like with most private equity funds, each Sun Fund's general partner received twenty percent of profits, and the limited partners, who were the investors in the Sun Funds, received the other eighty percent.⁶² Of the Sun Funds' general partners' twenty percent profit, Leder and Krouse together were entitled to receive over sixty percent.⁶³

Similar to the general partners, the management company of a private equity fund is generally structured as a pass-through entity, often an LLC, and manages the fund's investments in portfolio companies.⁶⁴ Many of the same people involved in the general partner are also involved in the fund management LLC.⁶⁵ The management company usually receives a fee equal to two percent of the total capital commitments to the fund.⁶⁶ Like most private equity general partners, the Sun Funds' general partners created their respective management companies, but the Sun Funds were unusual in that the general partners also owned the fund management LLCs.⁶⁷ The fund manager usually receives both twenty percent of profits, constituting carried interest, and a two percent fee.⁶⁸ Since the Sun Funds' fund managers were wholly owned by the general partners,⁶⁹ Leder and Krouse were entitled to over sixty percent of these amounts through their involvement in the general partner.

59. See Needham, *supra* note 3, § II.A.2.b.

60. See Sanchirico, *supra* note 36, at 1075.

61. See *Sun Capital*, 724 F.3d at 134; Rosenthal, *supra* note 2, at 1460.

62. See Rosenthal, *supra* note 2, at 1460 (illustrating the structure of the Sun Funds and the distribution of profits).

63. See *Sun Capital*, 724 F.3d at 134.

64. See Needham, *supra* note 3, § II.A.2.c.

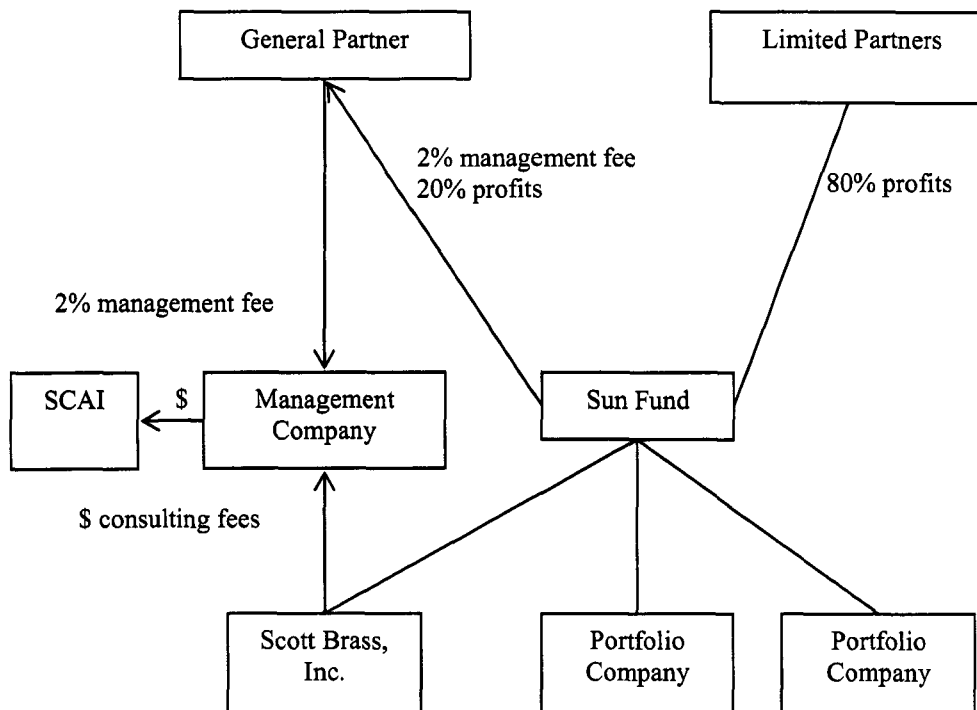
65. See Sheppard, *supra* note 2, at 1352–53.

66. See Polsky, *supra* note 58, at 744.

67. Sheppard, *supra* note 2, at 1352–53.

68. Polsky, *supra* note 58, at 744.

69. See Rosenthal, *supra* note 2, at 1461.

Structure of the Sun Funds⁷⁰

In addition, private equity fund managers have often taken payments directly from the portfolio companies that the fund pays them to manage.⁷¹ To justify these fees, “[p]rivate equity managers used to argue that portfolio companies should pay them to be managed and monitored, otherwise they’d have to pay [the management consulting firm] McKinsey for the same privilege.”⁷² Some have criticized private equity funds for demanding these consulting fees from their portfolio companies because the fees put portfolio companies into greater debt, increasing the risk that the portfolio company will be forced into bankruptcy.⁷³ Critics have expressed concern that the management fees are just a way for

70. *Id.* at 1460.

71. See Dan Primack, *The Death of Private Equity’s Fee Hogs*, FORTUNE (Sept. 5, 2013), <http://finance.fortune.cnn.com/2013/09/05/the-death-of-private-equity-fee-hogs>.

72. Sheppard, *supra* note 2, at 1351.

73. See Surowiecki, *supra* note 16.

private equity firms to take money out of portfolio companies so they can be sure to profit whether or not the portfolio company succeeds.⁷⁴

The initial reason for fund managers to take consulting fees directly from portfolio companies was that the fund managers could take these fees in addition to the two percent fee paid by the fund.⁷⁵ However, investors have become less willing to pay the full two percent if the portfolio company pays the fund manager as well.⁷⁶ Limited partners now often demand rebates, also called “offsets,” for the amounts that the portfolio companies pay the fund manager.⁷⁷ In *Sun Capital*, Sun Fund IV took offsets from its general partner⁷⁸—a factor the court seemed to give great weight in its decision that the Fund was engaged in a “trade or business,” rather than acting as a passive investor, though the court denied that this factor was determinative.⁷⁹ It was not clear whether Sun Fund III had received offsets, and the court remanded for the district court to make factual findings on this issue before deciding whether Sun Fund III was also engaged in a “trade or business.”⁸⁰

The classification of private equity funds as engaged in investment activity also minimizes tax for investors, i.e., the limited partners. Private equity funds require significant investments and tend to attract tax-exempt investors, foreign investors, funds of funds,

74. *See id.* But see Amy S. Elliott, *Panelists Agree on Fee Offsets, But Disagree on Sun Capital*, 141 TAX NOTES 16, 18 (2013) (quoting investment management and tax attorney Patrick B. Fenn’s comment that, viewing fee offsets within the economic unit of private equity funds, “you can pay it out of your left pocket, you can pay it out of your right pocket, but you’re still paying the fee” and that investors do not “derive some kind of benefit from that offset that expands the activities that the fund is undertaking”).

75. *See* Primack, *supra* note 71.

76. *See id.*

77. *See id.* (reporting that sixty-three percent of 2012/2013 vintage funds rebate one hundred percent of portfolio companies’ consulting fees to the limited partners of the fund). But see Lydia Beyoud, ‘*Sun Capital*’ Result for Private Equity Gains May Affect Main Street, *Practitioner Says*, BLOOMBERG BNA DAILY TAX REPORT (Oct. 1, 2013), http://news.bna.com/dtln/DTLNWB/split_display.adp?fedfid=36930309&vname=dtrnot&wsn=509628000&searchid=22504735&doctypeid=1&type=date&mode=doc&split=0&scm=DTLNWB&pg=1 (“Sun Capital departed from the traditional structure in that the management fees paid by the limited partners in a fund could be offset by the 2 percent annual management fee paid to the general partner.”).

78. *See Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 143 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

79. The court took into account “a number of factors, cautioning that none is dispositive in and of itself.” *Id.* at 141. However, the court also stated that “the Sun Funds’ active involvement in management under the agreements provided a direct economic benefit to at least Sun Fund IV that an ordinary, passive investor would not derive: an offset against the management fees it would otherwise have paid its general partner for managing the investment in [its portfolio company, Scott Brass, Inc.]” *Id.* at 143.

80. *Id.* at 148–49.

and ultra-wealthy individuals.⁸¹ Tax-exempt investors constitute the largest category of investors, and within that group, pension funds invest the most capital.⁸² Although pension funds invest only a small part of their total value in private equity as part of a broader diversification strategy, pension funds are so large that these small percentages make up a majority of the capital in private equity.⁸³ Foreign investors, who generally do not pay U.S. federal income tax on their investment gains, also contribute a large percentage of private equity capital.⁸⁴

Both tax-exempt and foreign investors can maximize the returns on their investments because of the classification of private equity funds as engaged in investment rather than “trade or business” activity.⁸⁵ Historically, private equity funds have successfully characterized their activity as investment and not “trade or business,”⁸⁶ and the IRS has not challenged that categorization.⁸⁷ Therefore, pension funds and other tax-exempt investors can escape unrelated business taxable income (“UBTI”) they would have to pay if they engaged in a “trade or business” directly.⁸⁸ Congress imposed UBTI to prevent tax-exempt entities from reinvesting profits from business income without first paying tax, since this tax advantage would give tax-exempt entities a competitive business advantage.⁸⁹ UBTI excludes “dividends, interest, royalties, and gains or losses from the disposition of property,” but includes “gains from the sale of property primarily held for sale to customers in the ordinary course of a trade or business.”⁹⁰ Similarly, foreign investors can escape effectively connected income (“ECI”), on which they would have to pay tax if they invested directly in a “trade or business.”⁹¹ Congress imposed a tax on ECI to balance the policy goals of taxing all income generated from U.S. business activities and encouraging foreign

81. See Needham, *supra* note 3, § II.C.1–4.

82. See *id.* § II.C.3.

83. See *id.*

84. See *id.* § II.C.4.

85. See *id.* § II.C.3–4.

86. See Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 6.

87. See Rosenthal, *supra* note 2, at 1459–60; Elliott, *supra* note 5 (stating that the IRS lacks the resources to audit many private equity funds and that the 1982 Tax Equity and Fiscal Responsibility Act hinders the IRS’s efforts in auditing these firms).

88. See I.R.C. § 511(a) (2012); Needham, *supra* note 3, § II.C.3.

89. See Rosenthal, *supra* note 2, at 1469.

90. *Id.* (citing § 512(b)(5)(B)).

91. See § 882(a); Needham, *supra* note 3, § II.C.4.

investments.⁹² ECI safe harbors exempt trading in stocks, securities, or commodities through an independent agent or for the taxpayer's own account, but no safe harbor exempts dealers in stocks or securities.⁹³ If a private equity fund constitutes a dealer rather than an investor, then some would argue that dealing in property besides securities is analogous and should not fall into the ECI safe harbor.⁹⁴

Because the Sun Funds' structures were typical of private equity funds, the First Circuit's holding in *Sun Capital* could significantly impact how most private equity funds are structured if other courts rule similarly in the future. Like most private equity funds, the Sun Funds had a sponsor, general partners, limited partners, and management companies. The complicated structure of the Sun Funds helped them minimize their investors' tax liability while maximizing profits. Part of their tax-minimizing strategy involved creating as many corporate layers of separation as possible between the Funds and their portfolio companies in order to avoid the Funds' classification as engaged in a "trade or business." The Sun Funds seemed to live up to the criticism of private equity that "these firms have become increasingly adept at using financial gimmicks to line their pockets, deriving enormous wealth not from management or investing skills but, rather, from the way the U.S. tax system works."⁹⁵

B. The Sun Funds' Acquisition of Scott Brass, Inc. and the Funds' Attempt to Minimize Risk of Pension Withdrawal Liability

Although the structure of the Sun Funds had a substantial impact on the outcome of *Sun Capital*, the ultimate issue was whether the Sun Funds could be held liable for their portfolio company's withdrawal from the multiemployer pension fund in which the portfolio company was participating.⁹⁶ The Sun Funds invested in Scott Brass, Inc. ("SBI") as a portfolio company, but SBI went bankrupt while the Sun Funds held it.⁹⁷ SBI then withdrew from the pension, leaving some of the pension's fully vested benefits for SBI's

92. See Rosenthal, *supra* note 2, at 1469.

93. See *id.* (citing § 864(b)(2)).

94. See *id.* at 1469–70 (arguing that the Treasury should clarify that private equity funds do not trade stock and securities for purposes of the ECI safe harbor).

95. Surowiecki, *supra* note 16.

96. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 132 (1st Cir. 2013) ("This case presents important issues of first impression as to withdrawal liability for the pro rata share of unfunded vested benefits to a multiemployer pension fund of a bankrupt company . . ."), *cert. denied*, 134 S. Ct. 1492 (2014).

97. See *id.* at 135–36.

employees unfunded.⁹⁸ This Section describes how the Sun Funds acquired SBI as a portfolio company and provides background information regarding multiemployer pension withdrawal liability and how the Sun Funds sought to avoid incurring this liability when investing in SBI.

Multiemployer pension plans result from collective bargaining agreements with trade unions and involve more than one employer, generally in a single industry.⁹⁹ Under ERISA, if a multiemployer plan fails, the PBGC will provide financial assistance to the plan.¹⁰⁰ ERISA requires each employer in a multiemployer pension plan to pay premiums to the PBGC so that, if the plan fails, the PBGC can pay a percentage of the total vested benefits owed to each plan beneficiary.¹⁰¹ Before the MPPAA, the PBGC could face overwhelming liability under this system if one employer failed to meet its funding obligations and withdrew from a multiemployer pension plan.¹⁰² In that case, the other employers in the plan were required to cover the vested, unfunded benefits of the employer that terminated its participation in the plan.¹⁰³ The remaining employers often could not or would not cover the inherited liabilities of the departing employer on top of their own liabilities and they also withdrew from the plan.¹⁰⁴ These withdrawals would create a domino effect, ultimately destroying the multiemployer pension plan and potentially leaving vested benefits unfunded.¹⁰⁵ The MPPAA sought to avoid this problem by requiring an employer that withdraws from a multiemployer pension plan to incur withdrawal liability.¹⁰⁶ The amount of liability equals the employer's share of the plan's unfunded vested benefits accrued for the withdrawing employer's covered employees.¹⁰⁷

98. *See id.* at 136.

99. *See* 29 U.S.C. § 1301(a)(3) (2012); *How PBGC Operates*, PENSION BENEFIT GUAR. CORP., <http://pbgc.gov/res/factsheets/page/pbgc-facts.html> (last visited Apr. 7, 2014).

100. *See* § 1361 (“The corporation shall provide financial assistance to pay benefits under a multiemployer plan which is insolvent . . .”); *see also How PBGC Operates*, *supra* note 99 (stating that instead of paying benefits directly to employees whose multiemployer pension plans fail, the PBGC provides financial assistance to the plans themselves).

101. *See Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 720 (1984).

102. *See id.* at 721, 722 n.2.

103. *See id.* at 722 n.2.

104. *See id.*

105. *See id.*

106. *See* 29 U.S.C. § 1381(a) (2012); *R.A. Gray & Co.*, 467 U.S. at 723–25.

107. *See* § 1381(b)(1).

Since a private equity fund is not an employer, it does not incur withdrawal liability automatically under ERISA.¹⁰⁸ Generally, to impose withdrawal liability on an organization that is not the withdrawing employer, ERISA requires two elements: (1) common control of the employer and the organization, and (2) that the organization is a “trade or business.”¹⁰⁹ ERISA provides that the PBGC must make regulations consistent with § 414(c) of the IRC to clarify these requirements.¹¹⁰ According to the IRC, common control exists between two corporations where a parent corporation owns at least eighty percent of the total stock of a subsidiary.¹¹¹ However, ERISA and the MPPAA,¹¹² the IRC,¹¹³ and Treasury regulations¹¹⁴ all fail to define the term “trade or business.” Even though ERISA authorizes the PBGC to promulgate regulations in this area,¹¹⁵ the PBGC has also not defined “trade or business.”¹¹⁶

With this background information in mind, the methods the Sun Funds employed to acquire SBI make more sense. The Sun Funds’ overall purpose was to “flip” underperforming companies—to invest in them with the aim of turning them around and selling them for a profit.¹¹⁷ Pursuant to this goal, the Sun Funds began to invest in SBI as a portfolio company in 2006.¹¹⁸ SBI manufactured metal products, employed 208 people, and had liability to a multiemployer pension

108. *See id.* § 1381(a) (stating that if an “employer” withdraws from a multiemployer plan, it incurs withdrawal liability).

109. *See id.* § 1301(b)(1); *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 138 (1st Cir. 2013) (quoting *McDougall v. Pioneer Ranch Ltd. P’ship*, 494 F.3d 571, 577 (7th Cir. 2007)), *cert. denied*, 134 S. Ct. 1492 (2014).

110. *See* § 1301(b)(1).

111. *See* I.R.C. § 1563(a)(1) (2012).

112. *See, e.g., Sun Capital*, 724 F.3d at 139; *Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC*, 706 F.3d 874, 878 (7th Cir. 2013) (“The phrase ‘trade or business’ is not defined by section 1301(b)(1).”); *Cent. States Se. & Sw. Areas Pension Fund v. Fulkerson*, 238 F.3d 891, 895 (7th Cir. 2001) (“[The] MPPAA does not define ‘trades or businesses.’”).

113. *See, e.g., Fulkerson*, 238 F.3d at 895 n.2 (“[T]he phrase ‘trade or business’ appears almost two hundred times in the tax code. The particular meaning given to any single instance of the phrase may be shaped by the surrounding statutory context of the tax code and thus involve considerations that are absent in MPPAA.” (citing *Cent. States Se. & Sw. Areas Pension Fund v. Ditello*, 974 F.2d 887, 889 (7th Cir. 1992))).

114. *See, e.g., Connors v. Incoal, Inc.*, 995 F.2d 245, 250 (D.C. Cir. 1993) (“Unfortunately, neither section 414(c), nor the regulations prescribed thereunder, define ‘trade or business.’” (citing *Bd. of Trs. of W. Conference of Teamsters Pension Trust Fund v. Lafrenz*, 837 F.2d 892, 894 n.6 (9th Cir. 1988))).

115. *See* 29 U.S.C. § 1301(b)(1).

116. *Sun Capital*, 724 F.3d at 139.

117. *See id.* at 134.

118. *Id.* at 135.

fund, the New England Teamsters and Trucking Industry Pension Fund (“TPF”).¹¹⁹ At least partially to evade pension withdrawal liability, the Sun Funds divvied up the purchase price between their respective subsidiaries so that Sun Fund III contributed thirty percent of the purchase price and Sun Fund IV contributed the other seventy percent.¹²⁰ With neither Fund owning over eighty percent of SBI, the Funds assumed they would not be deemed under common control with SBI.¹²¹ Thus, the first of the two requirements for pension withdrawal liability would not be met.¹²² By consistently taking the position that they were not engaged in a “trade or business,”¹²³ the Funds sought to ensure that they would also not meet the second requirement to incur pension withdrawal liability.

After the Sun Funds’ acquisition of SBI, the fund managers, including Leder and Krouse, “exerted substantial operational and managerial control” over SBI.¹²⁴ The Funds’ management companies served as middle men between the Funds and SBI. The management companies provided SBI with employees and consultants from SCAI,¹²⁵ the private equity firm that created the Sun Funds.¹²⁶ SBI continued to meet its pension obligations after the Sun Funds’ acquisition in 2006 until the fall of 2008, when declining copper prices reduced the value of SBI’s inventory.¹²⁷ In November 2008, an involuntary bankruptcy petition was filed against SBI, and the Sun Funds asserted that they lost all of their investment in SBI in the bankruptcy.¹²⁸ As it struggled financially, SBI ceased to be able to meet its pension obligations.¹²⁹ In order to avoid being left with unfunded benefits, the TPF presumably sought out any entities related to SBI that could satisfy SBI’s withdrawal liability.

119. *See id.* at 135–36.

120. *See Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 120–21 (D. Mass. 2012), *aff’d in part, vacated in part, rev’d in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

121. *See id.* at 121 (“[T]he Sun Funds do not deny that they considered legal advice that they could minimize their chances of facing withdrawal liability in the future if they limited their investments to less than the 80% threshold.”).

122. *See supra* text accompanying notes 109, 111.

123. *See* Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 6 (“For decades, investors have relied on the fact that making and deriving income from investments . . . and paying professional managers to manage those investments, does not constitute a ‘trade or business’ for purposes of the [IRC].”).

124. *Sun Capital*, 724 F.3d at 136.

125. *See Sun Capital*, 903 F. Supp. 2d at 111.

126. *Sun Capital*, 724 F.3d at 133.

127. *See id.* at 136.

128. *Id.*

129. *Id.*

Accordingly, the TPF sent a demand letter to the Sun Funds for SBI's withdrawal liability.¹³⁰ In the letter, the TPF argued that SBI was under common control with the Sun Funds and that the Sun Funds were therefore jointly and severally liable for SBI's pension withdrawal,¹³¹ which the TPF calculated at \$4,516,539¹³²—a very large amount relative to the Funds' investment of \$7.8 million to acquire SBI.¹³³

II. THE DISTRICT COURT OPINION AND THE FIRST CIRCUIT'S REVERSAL

In response to the TPF's demand letter, the Sun Funds sued, seeking a declaratory judgment that they were not subject to withdrawal liability under § 1301(b)(1) because (1) the Sun Funds did not meet the common control requirement, and (2) neither of the Funds was a "trade or business."¹³⁴ The TPF counterclaimed that the Sun Funds were liable for SBI's withdrawal and also that they had engaged in a transaction to evade liability under § 1392(c).¹³⁵ Both parties filed cross-motions for summary judgment in September 2011.¹³⁶

Judge Woodlock in the District of Massachusetts held that the Sun Funds were not engaged in a "trade or business" and therefore did not meet the second requirement under § 1301(b)(1).¹³⁷ Although the PBGC Appeals Board released an opinion in an informal 2007 adjudication stating that a private equity fund was a "trade or business" under ERISA,¹³⁸ the district court owed no deference to the

130. *Id.*

131. *Id.* at 136–37.

132. *Id.* at 137.

133. *See id.* at 136 (indicating that Scott Brass Holding Corporation purchased all of SBI's stock for \$3 million of cash on hand and \$4.8 million in additional borrowed money); *see also infra* note 202 (describing the Funds' acquisition of SBI by forming Sun Scott Brass, LLC, which in turn formed Scott Brass Holding Corporation, which ultimately made the acquisition).

134. *Sun Capital*, 724 F.3d at 137.

135. *Id.* If the principal purpose of a transaction is to evade pension withdrawal liability, then the transaction will be ineffective to avoid liability. *See* 29 U.S.C. § 1392(c) (2012).

136. *Sun Capital*, 724 F.3d at 137.

137. *See Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 113, 117 (D. Mass. 2012), *aff'd in part, vacated in part, rev'd in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

138. *See PENSION BENEFIT GUAR. CORP., (LIABILITY WITHIN A GROUP OF COMPANIES) 14 (2007)*, available at <http://www.pbgc.gov/Documents/apbletter/Decision--%28Liability%20within%20a%20group%20of%20companies%29%202007-09-26.pdf>.

ruling and did not find it persuasive.¹³⁹ Since the district court found that the Sun Funds were not engaged in a “trade or business,” the court did not decide whether the Sun Funds and SBI were under common control.¹⁴⁰ The district court also held that the Funds’ “principal purpose” in dividing ownership of SBI was not to evade withdrawal liability under § 1392(c), even though the Funds did consider the potential to lessen their withdrawal liability in choosing this division.¹⁴¹ Therefore, the court granted the Sun Funds’ motion for summary judgment.¹⁴²

In deciding that the Sun Funds were not engaged in a “trade or business,” the district court refused to pierce the corporate veil and instead analyzed only the actions of the Sun Funds themselves. Because ERISA does not define “trade or business” and refers to the IRC in § 1301(b)(1), the court applied the “trade or business” rules from Supreme Court tax cases,¹⁴³ notably *Higgins v. Commissioner*¹⁴⁴ and *Whipple v. Commissioner*.¹⁴⁵ In *Higgins*, the Supreme Court held that “[n]o matter how large the estate or how continuous or extended the work required may be,” managing investments is not a “trade or business.”¹⁴⁶ In *Whipple*, the Court similarly held that “[w]hen the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business.”¹⁴⁷ Therefore, according to the district court’s logic, if the Sun Funds participated only in investment activity, the Funds were not engaged in a “trade or business” for purposes of this section of ERISA.¹⁴⁸

The district court also relied on *Commissioner v. Groetzinger*¹⁴⁹ in determining that the Sun Funds were not engaged in a “trade or business.”¹⁵⁰ *Groetzinger* dealt with a taxpayer who questioned the Commissioner’s application of a minimum tax in connection with his

139. See *Sun Capital*, 903 F. Supp. 2d at 115.

140. *Id.* at 118.

141. See *id.* at 121, 124.

142. *Id.* at 124.

143. See *id.* at 113–14.

144. 312 U.S. 212 (1941).

145. 373 U.S. 193 (1963).

146. *Higgins*, 312 U.S. at 218.

147. *Whipple*, 373 U.S. at 202.

148. See *Sun Capital*, 903 F. Supp. 2d at 114 (“It is generally accepted that *Higgins* and *Whipple* remain good law, and their caution that investments are not trades or businesses survives *Groetzinger*.”).

149. 480 U.S. 23 (1987).

150. See *Sun Capital*, 903 F. Supp. 2d at 116–17.

gambling losses.¹⁵¹ The key issue was whether the taxpayer's gambling activity constituted a "trade or business" for federal income tax purposes.¹⁵² The Supreme Court acknowledged that no consistent definition for "trade or business" exists within the Code or federal regulations,¹⁵³ and the determination must be fact specific in each case.¹⁵⁴ The Court also stated that difficulty rested "in the absence of an all-purpose definition by statute or regulation, and in [the Court's] concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code."¹⁵⁵ In addition, the Court observed that Congress had the ultimate responsibility to define "trade or business."¹⁵⁶ The Court also stated that, "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."¹⁵⁷

Despite the Court's warnings about the limitations of its holding, the district court stated that *Groetzinger* had established a test and purported to apply it.¹⁵⁸ According to the district court, "for a person to be engaged in a trade or business, (1) the primary purpose of the activity must be income or profit, and (2) the activity must be performed with continuity and regularity."¹⁵⁹ The parties did not dispute that the Sun Funds met the first prong of the test because the Funds' primary purpose was clearly to make a profit.¹⁶⁰ As to the second prong, the court found that the Sun Funds were merely passive investors, and passive investment does not meet *Groetzinger*'s continuity and regularity requirement for "trade or business" activity.¹⁶¹

151. See *Groetzinger*, 480 U.S. at 25. The taxpayer was subject to a particular minimum tax because he had taken gambling deductions, which were an "item of tax preference." See *id.* He could lessen his "item of tax preference" with trade or business deductions, so he argued that he was in the "trade or business" of gambling. See *id.*

152. *Id.* at 24.

153. See *id.* at 27.

154. See *id.* at 36.

155. *Id.*

156. *Id.*

157. *Id.* at 35.

158. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 114 (D. Mass. 2012), *aff'd in part, vacated in part, rev'd in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

159. *Id.* (citing *Groetzinger*, 480 U.S. at 35).

160. *Id.* at 116–17.

161. See *id.* at 117.

In making this determination, the district court looked only at the Funds' actions and did not attribute to the Funds the actions of the management companies or SCAI.¹⁶² The court specifically stated that the 2007 PBGC Appeals Board decision was unpersuasive in its finding that a private equity fund was a "trade or business."¹⁶³ According to the court, the Appeals Board had incorrectly used agency law to attribute the activity of the private equity fund's general partner to the fund.¹⁶⁴ The court found that the Sun Funds themselves had no employees or offices, only made a single investment in SBI, and only earned dividends and capital gains; the Funds were therefore engaged in investment activity.¹⁶⁵ Even though SCAI participated in managing SBI and put its employees on SBI's board of directors,¹⁶⁶ the Funds themselves took no action and did not directly manage SBI.¹⁶⁷ The court thus found it insignificant that the same person represented both Sun Fund IV's fund manager and SBI in the contract between the two entities.¹⁶⁸ By looking at the Funds in isolation, separate from the fund managers they hired, and by refusing to attribute the fund managers' actions to the Funds, the court respected the corporate form that the parties created.¹⁶⁹ Because the Funds themselves met the definition of passive investors, the court found that they were not engaged in a "trade or business" and not liable for SBI's pension withdrawal under § 1301(b)(1).¹⁷⁰

The First Circuit, in contrast to the district court, willingly pierced the corporate veil to find the Sun Funds liable for SBI's pension withdrawal. In describing the MPPAA, the First Circuit emphasized that § 1301(b)(1) pierces the corporate veil to impose

162. *See id.* at 117–18.

163. *See id.* at 115–16.

164. *See id.* at 116.

165. *See id.* at 117.

166. *See* Memorandum in Support of Defendant/Counter-Plaintiff's Motion for Summary Judgment at 25, *Sun Capital*, 903 F. Supp. 2d 107 (No. 10-10921).

167. *Sun Capital*, 903 F. Supp. 2d at 117 (stating that consulting agreements required SBI to give updates to SCAI employees but that this requirement did not involve the Funds themselves).

168. *See id.* at 118; Memorandum in Support of Defendant/Counter-Plaintiff's Motion for Summary Judgment, *supra* note 166, at 25.

169. *See Sun Capital*, 903 F. Supp. 2d at 119. The TPF argued that the Funds were part of a partnership with Sun Scott Brass, LLC, the holding company that invested in the Sun Funds, because ERISA and the Code do not recognize the LLC as a corporate form. *See id.* at 118. The court rejected this argument as ignoring "Sun Scott Brass, LLC's chosen corporate form" and standing "in direct conflict with the plain language of the regulations and the case law governing corporate liability." *Id.* at 119.

170. *See id.* at 118–19.

liability on owners and related businesses.¹⁷¹ The First Circuit's agency analysis differed from that of the district court, and the First Circuit also formulated a new test to replace what the district court had called the "*Groetzinger* test."¹⁷²

The First Circuit first considered the PBGC Appeals Board decision and agreed with the district court that the decision was entitled to little deference,¹⁷³ finding that the decision received deference only to the extent that its reasoning and analysis had the "power to persuade."¹⁷⁴ However, the First Circuit did find the Appeals Board's analysis persuasive.¹⁷⁵ In its 2007 decision, the Appeals Board resolved an issue similar to that of *Sun Capital*: whether a private equity fund was a "trade or business" and therefore liable for its bankrupt portfolio company's pension withdrawal.¹⁷⁶ Like the Sun Funds,¹⁷⁷ the private equity fund before the PBGC Appeals Board argued that it was an investor and therefore not engaged in a "trade or business."¹⁷⁸

The private equity fund at issue in the 2007 Appeals Board decision was a limited partnership established under Delaware law, with a Delaware corporation as fund sponsor.¹⁷⁹ The Appeals Board therefore applied Delaware agency law and considered the actions of the fund's general partner in determining whether the fund was a "trade or business."¹⁸⁰ The Appeals Board applied the test it referred to as the *Groetzinger* test,¹⁸¹ the same test the district court applied in *Sun Capital*.¹⁸² Under that test, the Appeals Board found that the fund met the first requirement: that the fund's activities had a profit motive.¹⁸³ As to the second requirement—that the activities be engaged in with regularity—the Appeals Board found that the private equity fund did conduct activities with regularity through the

171. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 138 (1st Cir. 2013) (citing *Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC*, 706 F.3d 874, 877 (7th Cir. 2013)), *cert. denied*, 134 S. Ct. 1492 (2014).

172. See *supra* text accompanying notes 158–59.

173. See *Sun Capital*, 724 F.3d at 137.

174. *Id.* at 141 (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)).

175. See *id.* at 140–41.

176. See *PENSION BENEFIT GUAR. CORP.*, *supra* note 138, at 4–5.

177. See Appellees' Response Brief, *supra* note 44, at 1.

178. See *PENSION BENEFIT GUAR. CORP.*, *supra* note 138, at 8.

179. See *id.* at 2–3.

180. See *id.* at 9.

181. See *id.* at 10.

182. See *supra* text accompanying notes 158–59.

183. See *PENSION BENEFIT GUAR. CORP.*, *supra* note 138, at 11.

activities of its agent, the general partner, who in turn hired the management company.¹⁸⁴ In acquiring the portfolio company, the Appeals Board determined that the fund put itself in a position to exercise control over the portfolio company's management.¹⁸⁵ The Appeals Board found that the private equity fund was engaged in a "trade or business" and was therefore liable for its portfolio company's pension withdrawal.¹⁸⁶

Even though the PBGC Appeals Board decision was not binding authority, the First Circuit found the decision persuasive, perhaps out of a sense that it was not the court's job to decide this issue.¹⁸⁷ Section 1301(b)(1) authorizes the PBGC to promulgate clarifying regulations,¹⁸⁸ and the court asserted that the PBGC should have defined "trade or business" in its regulations.¹⁸⁹ The court referred to the approach taken by the PBGC Appeals Board as an "investment plus" standard¹⁹⁰ and approved of its use in persuasive Seventh Circuit case law.¹⁹¹ In adopting this new approach, the First Circuit refused to clarify what the "plus" of "investment plus" meant.¹⁹² Instead, the court took a "very fact-specific approach," considering "a number of factors, cautioning that none is dispositive in and of itself."¹⁹³

The court found that Sun Fund IV's receipt of an offset against the management fees it would otherwise have paid the fund manager was a benefit that "an ordinary, passive investor would not derive."¹⁹⁴ SBI paid \$186,368.44 in consulting fees to the general partner of Sun Fund IV, and this payment reduced the two percent fee that the Fund

184. *See id.* at 11.

185. *Id.* at 13.

186. *See id.* at 14–15.

187. *See infra* notes 232–38 and accompanying text.

188. *See* 29 U.S.C. § 1301(b)(1) (2012) (stating that other organizations and an employer withdrawing from a multiemployer pension fund may be treated as a single employer "under regulations prescribed by the [PBGC]").

189. *See* Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 148 (1st Cir. 2013) ("We express our dismay that the PBGC has not given more and earlier guidance on this 'trade or business' 'investment plus' theory to the many parties affected."), *cert. denied*, 134 S. Ct. 1492 (2014).

190. *See id.* at 140 (citing Bd. of Trs., Sheet Metal Workers' Nat'l Pension Fund v. Palladium Equity Partners, 722 F. Supp. 2d 854, 869 (E.D. Mich. 2010)).

191. *See id.* at 141 (citing Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC, 706 F.3d 874, 882, 885–86 (7th Cir. 2013)).

192. *See id.* ("We see no need to set forth . . . what the 'plus' is, nor has the PBGC provided guidance on this.")

193. *Id.*

194. *Id.* at 143.

would otherwise pay to the general partner.¹⁹⁵ Although the court insisted that no single factor was dispositive,¹⁹⁶ the First Circuit remanded to the district court to determine whether Sun Fund III had also received a management fee offset.¹⁹⁷ Because the court found that Sun Fund IV was a “trade or business” after discussing the offset and noting no additional factors supporting this conclusion,¹⁹⁸ this factor seems to have been most important to the court’s analysis. The other factors the court discussed were insufficient for the court to hold that Sun Fund III was a “trade or business” without evidence of offsets;¹⁹⁹ therefore, despite the court’s contrary assertion, offsets appear to be the dispositive factor.

In addition to offsets, the court addressed the fact that the Funds empowered their general partners to take part in managing the Funds’ portfolio companies, a level of involvement that “encompass[e]d even small details, including signing of all checks.”²⁰⁰ In stark contrast to the district court’s analysis,²⁰¹ the First Circuit seemed to conflate the activities of the Sun Funds themselves and the activities of their related entities.²⁰²

Ultimately, the First Circuit adopted a new “investment plus” standard to evaluate whether a private equity fund is engaged in a “trade or business.”²⁰³ The court also reversed the district court’s grant of summary judgment to Sun Fund IV and vacated and remanded for determination of whether Sun Fund III received offsets for management fees, which would, in the court’s analysis, make Sun

195. *Id.*

196. *Id.* at 141.

197. *Id.* at 148–49.

198. *See id.*

199. *See id.* (remanding to the district court “to resolve whether Sun Fund III received any benefit from an offset from fees paid by SBI”).

200. *See id.* at 142.

201. *See Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 117 (D. Mass. 2012) (“Other examples offered by the Pension Fund to demonstrate alleged control and management by the Sun Funds are unavailing. Employees of Sun Capital Advisors, not of the Sun Funds, . . . gave advice on . . . matters within the scope of their management and consulting agreements.”), *aff’d in part, vacated in part, rev’d in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

202. For example, the First Circuit stated that “the Sun Funds’ controlling stake in SBI placed them and their affiliated entities in a position where they were intimately involved in the management and operation of the company.” *Sun Capital*, 724 F.3d at 142. However, this statement ignores the fact that “the Sun Funds formed Sun Scott Brass, LLC . . . as a vehicle to invest in SBI” and that this LLC formed a wholly owned subsidiary, Scott Brass Holding Corporation, which actually purchased the stock of SBI. *Id.* at 135–36. Although the Sun Funds provided the capital for the investment in SBI, it does not seem that the Funds themselves held the SBI stock directly. *See id.* at 136.

203. *See id.* at 140–41.

Fund III a “trade or business.”²⁰⁴ Since the district court did not decide the issue of common control,²⁰⁵ the First Circuit also remanded for a determination on that issue with respect to both Funds.²⁰⁶ The Sun Funds submitted a petition for rehearing, but the First Circuit denied the petition.²⁰⁷ The Sun Funds also submitted a petition for certiorari to the Supreme Court in which they argued that the First Circuit incorrectly held that the Funds engaged in “trade or business” activity.²⁰⁸ The Supreme Court denied the Sun Funds’ petition for certiorari,²⁰⁹ leaving the First Circuit’s determination on the “trade or business” issue untouched.

The First Circuit also denied the TPF’s appeal under § 1392(c).²¹⁰ Unlike the district court, the First Circuit did not address the issue of whether the “principle purpose” of the Sun Funds’ division of ownership of SBI had been to evade withdrawal liability.²¹¹ Instead, the First Circuit found that the TPF could attain no remedy under the statute.²¹² The statute would allow the court to disregard a transaction that resulted in evasion of withdrawal liability, but the statute would not allow the court to create a transaction that never occurred in which Sun Fund IV acquired one hundred percent of SBI.²¹³ Therefore, the court affirmed summary judgment on that issue.²¹⁴

III. THE FIRST CIRCUIT’S ADOPTION OF AN “INVESTMENT PLUS” STANDARD AND APPLICATION OF AGENCY LAW

This Part argues that the First Circuit acted consistently with legal precedent in adopting an “investment plus” standard and using agency analysis to find that Sun Fund IV was a “trade or business.” Without a definition for “trade or business,” the court chose to rely on persuasive authority from the PBGC, decisions from other courts,

204. *See id.* at 148–50. Like the district court, the First Circuit also rejected the TPF’s argument that the Sun Funds could be liable for the pension withdrawal of their portfolio company because the Sun Funds sought to evade that liability under § 1392(c). *See id.* at 149–50. The First Circuit used different reasoning from the district court but affirmed the district court’s ruling on this issue. *See id.*

205. *See Sun Capital*, 903 F. Supp. 2d at 118.

206. *See Sun Capital*, 724 F.3d at 150.

207. *See* Order of Court, *Sun Capital*, 724 F.3d 129 (No. 12-02312), 2013 BL 197393.

208. *See* Petition for Writ of Certiorari at 11, *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Fund*, 134 S. Ct. 1492 (2014) (No. 13-648).

209. *Sun Capital*, 134 S. Ct. 1492.

210. *Sun Capital*, 724 F.3d at 149.

211. *See id.*

212. *See id.*

213. *See id.* 149–50.

214. *See id.* at 150.

and Supreme Court decisions defining “trade or business” in other contexts. Although the First Circuit’s “investment plus” test may not clearly flow from any of these persuasive authorities,²¹⁵ the standard does not conflict with any of these sources. However, the court’s failure to articulate its use of agency law in its assertion that the Funds themselves took particular actions that met the “plus” of an “investment plus” standard weakens the court’s analysis. Therefore, the court’s application of agency law in conjunction with its “investment plus” standard is consistent with precedent but perhaps ultimately unpersuasive.

ERISA and the MPPAA, the IRC, and Treasury regulations all fail to define the term “trade or business.”²¹⁶ In interpreting the phrase “trade or business” for purposes of § 1301(b)(1), many courts apply what they call the *Groetzinger* test, asking whether the activity is (1) engaged in for income or profit, and (2) carried on with regularity and continuity.²¹⁷ The Sun Funds argued that “cases interpreting the phrase ‘trade or business’ as used anywhere in the [IRC] are binding because Congress intended for that phrase to be a term of art with a consistent meaning across uses.”²¹⁸ However, this argument is insupportable because the Supreme Court has consistently held that the definition of “trade or business” depends on context and is fact-specific.²¹⁹ Even the use of the *Groetzinger* test is problematic since the *Groetzinger* Court carefully limited its holding to the particular Code sections at issue.²²⁰ The First Circuit therefore correctly stated that interpretations of other provisions of the IRC are not “*determinative* of the issue of whether an entity is a trade or

215. In *Higgins*, *Whipple*, and *Groetzinger*, the Supreme Court interpreted the meaning of “trade or business” in the context of the IRC, not ERISA. See *id.* at 144 (“[W]e reject the proposition that . . . interpretations of other provisions of the [IRC] are *determinative* of the issue of whether an entity is a ‘trade or business’ under § 1301(b)(1).”).

216. See *supra* notes 112–14 and accompanying text.

217. See, e.g., *Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC*, 706 F.3d 874, 878 (7th Cir. 2013) (“To apply the term [‘trade or business’] under the MPPAA, we have adopted the test adopted by the Supreme Court for other tax purposes in [*Groetzinger*].”).

218. *Sun Capital*, 724 F.3d at 144.

219. See *Comm’r v. Groetzinger*, 480 U.S. 23, 27 n.8 (1987); *Higgins v. Comm’r*, 312 U.S. 212, 217 (1941) (stating that the definition of “trade or business” for one issue did not control in a dissimilar inquiry and that a determination of whether a taxpayer is engaged in a trade or business “requires an examination of the facts in each case”).

220. See *Groetzinger*, 480 U.S. at 27 n.8 (“We caution that in this opinion our interpretation of the phrase ‘trade or business’ is confined to the specific sections of the Code at issue here. We do not purport to construe the phrase where it appears in other places.”).

business under § 1301(b)(1).”²²¹ The First Circuit may have wanted to move away from *Groetzinger* as a test in order to avoid perpetuating this common mischaracterization of *Groetzinger*’s holding. Because of these problems concerning *Groetzinger* and the lack of guidance on the meaning of “trade or business,” the First Circuit looked to other persuasive authorities to create a specific definition for “trade or business” under § 1301(b)(1).

A. *The PBGC Appeals Board Decision*

The First Circuit relied in part on a 2007 PBGC Appeals Board decision concluding that a private equity fund was not a passive investor, but rather engaged in a “trade or business.”²²² Despite the problems with the *Groetzinger* test, the PBGC Appeals Board first purported to apply it in deciding that a private equity fund was a “trade or business.”²²³ However, the Appeals Board went beyond the *Groetzinger* analysis to rebut the private equity fund’s argument that it was a passive investor rather than a “trade or business.”²²⁴ Significantly, the Appeals Board conflated the activities of the fund in question with the activities of its affiliates.²²⁵ The Appeals Board held that “the [f]und’s delegation of many of its management functions to other entities, which in [one portfolio company’s] case occurred through its Management Agreement with [the fund’s management company] does not establish that the [f]und was merely a ‘passive investor.’”²²⁶ By holding that the general partner was an agent of the fund, the Appeals Board held that the fund’s active involvement in managing its portfolio companies through its general partner made the private equity fund a “trade or business.”²²⁷ Through the general partner, the fund (1) provided management services, (2) hired a management company to assist in identifying and buying portfolio companies, and (3) received compensation in the form of twenty

221. *Sun Capital*, 724 F.3d at 144.

222. See PENSION BENEFIT GUAR. CORP., *supra* note 138, at 14.

223. See *id.* at 10 (“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 [*Groetzinger*] . . .”).

224. See *id.* at 11–12.

225. See *id.* at 14 (stating that “the much more active involvement of the [f]und (through [its general partner]) with respect to its investments” made its activity distinguishable from passive investment).

226. *Id.*

227. See *id.*

percent of the fund's profits.²²⁸ These activities, the Appeals Board determined, went beyond "passive investment."²²⁹

The First Circuit seemed to find this part of the analysis particularly persuasive,²³⁰ perhaps because the analysis considered the fund's affiliates and attributed their activities to the fund itself. The analysis also went beyond the factors expressed in *Groetzinger* to evaluate whether a private equity fund was a "trade or business." Although the PBGC Appeals Board did not use the term, the court, after approving of the Seventh Circuit's use of this analysis, dubbed it an "investment plus" standard.²³¹

In addition to a possible concern about misapplying *Groetzinger*, the First Circuit also seemed persuaded by the PBGC Appeals Board decision out of a concern that the court had to go beyond its authority to decide whether a private equity fund was a "trade or business." The court implied that it should not make this determination without further statutory or regulatory guidance.²³² The court expressed disappointment that "the PBGC has not given more and earlier guidance on this 'trade or business' 'investment plus' theory to the many parties affected. The PBGC has not engaged in notice and comment rulemaking or even issued guidance of any kind which was subject to prior public notice and comment."²³³ This statement seems to recognize that a judicially provided definition of such an important term lacks the benefits of public notice and comment that a legislative or rulemaking determination would have.²³⁴ The PBGC also has the advantages of expertise in the area of pension withdrawal liability and the ability to craft a specific, consistent regime on the issue, which a single court cannot do.

228. *Id.* at 12.

229. *Id.*

230. *See* *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 141 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

231. *See id.* (citing *Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC*, 706 F.3d 874, 882, 885–86 (7th Cir. 2013)).

232. *See id.* at 148.

233. *Id.*

234. President Barack Obama and other Democrats have led an effort to subject fund managers' carried interest to ordinary income tax rates rather than capital gains rates, but, even after six years, their efforts have not yet succeeded in Congress. *See* Richard Rubin, *Carried Interest Tax Break Risks Being Undercut by Court*, BLOOMBERG (Sept. 25, 2013, 12:00 AM), <http://www.bloomberg.com/news/2013-09-25/carried-interest-tax-break-risks-being-undercut-by-court.html>. If the *Sun Capital* holding were applied in the tax context, this change could affect the "entire legal infrastructure" of private equity funds. *Id.* Therefore, the court may have worried about the implications of changing—through the judicial process and without notice—a rule that Congress has chosen for years not to change.

The court also raised the same concerns that the Supreme Court expressed in *Groetzinger*, namely that a uniform test for “trade or business” could be “precarious for the overall integrity of the Code.”²³⁵ Courts seem legitimately concerned that a change in the definition of such a prevalent term across the Code could have disastrous results.²³⁶ Thus, the First Circuit emphasized that the PBGC has the responsibility to promulgate regulations, and that if Congress disagrees with the court’s interpretation, it should clarify the law.²³⁷ Consistent with this position, the court carefully limited its holding to ERISA, stating, “We go no further than to say that on the undisputed facts of this case, Sun Fund IV is a ‘trade or business’ for purposes of section 1301(b)(1).”²³⁸

B. Guidance from Other Courts

In addition to adopting the PBGC Appeals Board’s analysis, the First Circuit considered Seventh Circuit precedent regarding the “investment plus” standard. The Seventh Circuit served as a logical source of persuasive authority because it is home to the largest teamsters’ pension fund in the country and hears a disproportionately large number of pension withdrawal liability cases.²³⁹ The First Circuit relied on *Central States Southeast & Southwest Areas Pension Fund v. Messina Products, LLC*.²⁴⁰ According to the First Circuit, the *Messina* court employed an “investment plus”-like analysis in its decision.²⁴¹ In *Messina*, the Seventh Circuit applied the *Groetzinger* test²⁴² in affirming the district court’s finding that *Messina Products* was a “trade or business” that could be liable for pension withdrawal under § 1301(b)(1).²⁴³ However, the court also looked at factors outside of the particular activity that *Messina Products* had undertaken.²⁴⁴ The

235. *Comm’r v. Groetzinger*, 480 U.S. 23, 36 (1987).

236. *See id.* at 33 (stating that the prevalence of the term “trade or business” across the IRC explains legislative and administrative reluctance to define the term in any particular setting for fear of creating confusion in the other settings in which the term appears). The phrase “trade or business” “appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations.” *Id.* at 27.

237. *See Sun Capital*, 724 F.3d at 148.

238. *Id.* at 141.

239. *See Sheppard*, *supra* note 2, at 1354.

240. 706 F.3d 874 (7th Cir. 2013).

241. *See Sun Capital*, 724 F.3d at 141.

242. *See Messina*, 706 F.3d at 878, 885.

243. *See id.* at 879.

244. *See id.* (“In deciding MPPAA cases involving withdrawal liability, we have determined certain factors to be particularly relevant to this analysis, including the

court considered Messina Products's operating agreement,²⁴⁵ for example, and the First Circuit used a similar analysis in *Sun Capital* when it considered the Sun Funds' private placement memos.²⁴⁶

The First Circuit also cited the decision of the Eastern District of Michigan in *Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners*²⁴⁷ to support the characterization of the PBGC Appeals Board's approach as "an 'investment plus' standard."²⁴⁸ Similar to *Sun Capital*, *Palladium* involved a multiemployer pension fund suing private equity funds and a private equity firm for pension withdrawal liability after the funds' portfolio companies went bankrupt.²⁴⁹ Although *Palladium* did deem the PBGC Appeals Board's approach an "investment plus" standard, similar to the PBGC, the *Palladium* court purported to apply the *Groetzing* test.²⁵⁰ Though the court found that the fund met the second prong of the *Groetzing* test,²⁵¹ it also admitted that "the opposite inference could be drawn from the facts as well," and the court therefore denied summary judgment for both parties.²⁵² The *Sun Capital* court accurately cited the law in *Palladium* but also went a step further than the *Palladium* court by rejecting the *Groetzing* test altogether and replacing it with an "investment plus" standard.²⁵³ The First Circuit left the contours of this standard unclear, though, by refusing to define the "plus" in "investment plus."²⁵⁴ In application, the "investment plus" standard looks similar to the test the PBGC Appeals Board and other courts have called the *Groetzing* test.

The Private Equity Growth Capital Council ("PEGCC") claimed in its amicus brief in support of rehearing that the First Circuit had abandoned legal precedent "in favor of a novel ERISA-specific definition that defines in very broad terms what constitutes an 'investment-plus situation.'"²⁵⁵ However, this characterization is inaccurate—this definition of "trade or business" was not novel, and

defendant's intent in creating the enterprise, how the enterprise is treated for tax purposes, and its legal form.").

245. See *id.* at 886.

246. See *Sun Capital*, 724 F.3d at 142.

247. 722 F. Supp. 2d 854 (E.D. Mich. 2010).

248. *Sun Capital*, 724 F.3d at 140.

249. See *Palladium*, 722 F. Supp. 2d at 857–58.

250. See *id.* at 869–70.

251. See *id.* at 870.

252. *Id.* at 871.

253. See *Sun Capital*, 724 F.3d at 141.

254. See *id.*

255. Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 6.

the “investment plus” test encompasses the factors considered in *Groetzinger*.²⁵⁶ The First Circuit’s definition expands a definition that other courts had already developed in interpreting “trade or business” under the MPPAA by looking beyond *Groetzinger*²⁵⁷ and adopting the PBGC Appeals Board approach, dubbing it an “investment plus” standard.²⁵⁸ The “investment plus” standard represents the same test that courts have been applying as the “*Groetzinger* test,” just under a more accurate name. Instead of continuing to misrepresent the Supreme Court’s holding in *Groetzinger*, the First Circuit decided to rename the test for “trade or business” and make it more flexible. The court’s refusal to define the “plus” in the “investment plus” standard²⁵⁹ is also reasonable given the court’s concern about delineating factors for a standard without legislative guidance, thus imposing a judicial rule that lacks the benefits of prior public notice and comment.²⁶⁰

C. Supreme Court Definitions of “Trade or Business” in Other Contexts

The First Circuit’s analysis is consistent with Seventh Circuit precedent, and the analysis also does not conflict with Supreme Court precedent on the meaning of “trade or business.” In addition to being consistent with *Groetzinger*, the First Circuit’s holding is also consistent with *Higgins*, in which a taxpayer sought to take deductions for expenses he incurred in managing his personal investments, which included hiring others to assist him and renting an office.²⁶¹ The Court held that these expenses were not deductible because *Higgins* was not engaged in a “trade or business.”²⁶² The Supreme Court stated that “[n]o matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law” for a court to reverse a finding that the taxpayer did not engage in a “trade or business.”²⁶³ However, the Court also pointed out that *Higgins* “did not participate directly or

256. See Rosenthal, *supra* note 2, at 1466.

257. See Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC, 706 F.3d 874, 885 (7th Cir. 2013).

258. See Bd. of Trs., Sheet Metal Workers’ Nat’l Pension Fund v. Palladium Equity Partners, 722 F. Supp. 2d 854, 869 (E.D. Mich. 2010).

259. See *Sun Capital*, 724 F.3d at 141 (“We see no need to set forth general guidelines for what the ‘plus’ is, nor has the PBGC provided guidance on this.”).

260. See *id.* at 148.

261. *Higgins v. Comm’r*, 312 U.S. 212, 213–14 (1941).

262. See *id.* at 218.

263. *Id.*

indirectly in the management of the corporations in which he held stock or bonds.”²⁶⁴ The First Circuit used this fact to distinguish *Sun Capital* from *Higgins*.²⁶⁵

The Sun Funds argued that they were passive investors because, like *Higgins*, they received only investment income and provided no services to portfolio companies and thus derived no income in the form of payment for services.²⁶⁶ However, *Higgins* did not explicitly hold that all taxpayers who receive only investment income are not engaged in a “trade or business.” As one commentator has said, “It is one thing to manage one’s [own] investments in businesses. It is another to manage the businesses in which one invests.”²⁶⁷ The “trade or business” issue in *Higgins* is therefore conceptually different from the “trade or business” issue in private equity.²⁶⁸ In addition, *Higgins* held that a determination about whether a taxpayer is engaged in a “trade or business” is a fact-specific inquiry.²⁶⁹ Therefore, the First Circuit could legitimately distinguish *Higgins* from the facts of *Sun Capital*.

The First Circuit also distinguished *Whipple*, in which the Supreme Court denied a taxpayer’s deductions for business bad debt stemming from personal loans he made to a corporation he owned.²⁷⁰ The taxpayer claimed he was engaged in the “trade or business” of the corporation, but the Court countered that “[d]evoting 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.”²⁷¹ The Court’s holding means that the “trade or business” of a corporation is not imputed to a private equity fund that holds shares in the corporation; but this rule does not necessarily mean that the private equity fund is not engaged in a “trade or business.”²⁷² Applying this rule to the Sun Funds would mean that SBI’s manufacturing business cannot be imputed to the Funds; but *Whipple*’s holding has no bearing on whether the Funds were engaged in the “trade or business” of flipping portfolio companies. The *Whipple* analysis thus does not answer whether private equity funds engage in a “trade or business” because private equity is a “hyperactive investor/service provider”

264. *Id.* at 214.

265. *See Sun Capital*, 724 F.3d at 145.

266. *See* Appellees’ Response Brief, *supra* note 44, at 27.

267. Sanchirico, *supra* note 36, at 1103.

268. *See id.* at 1102–03.

269. *Higgins*, 312 U.S. at 217.

270. *Whipple v. Comm’r*, 373 U.S. 193, 196–97, 203 (1963).

271. *Id.* at 202 (emphasis added).

272. *See* Sanchirico, *supra* note 36, at 1102 n.101.

arrangement for which the tax law has no clear rule.²⁷³ Private equity does not fall neatly into the category of passive investment,²⁷⁴ so the question of whether a private equity fund does more than devote its energies to a separate corporation remains unclear.

The First Circuit rejected the Sun Funds' argument that they were not engaged in a "trade or business" under *Whipple* because they earned only investment income.²⁷⁵ The court distinguished *Whipple* by reasoning that Sun Fund IV's receipt of management fee offsets constituted activity that was "more" than mere investment activity.²⁷⁶ In their petition for rehearing, the Sun Funds argued that the court should have applied *Whipple* alone to reach its result rather than creating a new "investment plus" standard.²⁷⁷ One critic has similarly argued that the First Circuit's analysis "confused the *Whipple* inquiry," and that the court should have held instead that the activity of identifying and improving portfolio companies is itself a "trade or business."²⁷⁸ However, these arguments do not contradict the First Circuit's contention that the "investment plus" test is consistent with *Whipple*.

D. *The First Circuit's Questionable Application of Agency Law*

Although the "investment plus" test is consistent with legal precedent, the First Circuit clouded its "investment plus" analysis when it assumed that an agency relationship existed between the Funds and their affiliates, but failed to articulate how it found this agency relationship until later in the opinion. The Sun Funds argued that the status of the general partners could not be attributed to the Funds themselves.²⁷⁹ In their brief, the Sun Funds argued that, under agency law, a principal does not necessarily take on the status of its agent.²⁸⁰ Therefore, the Sun Funds implied, even if its general partners were engaged in a "trade or business," that would not make

273. See Sheppard, *supra* note 2, at 1355.

274. See Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate 'Developers,'* 138 TAX NOTES 361, 363 (2013) ("[P]rivate equity funds are not easily categorized as dealers, traders, or investors in stocks.").

275. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 145–46 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

276. See *id.* at 146.

277. See Appellees' Petition for Panel Rehearing or Rehearing En Banc at 5, *Sun Capital*, 724 F.3d 129 (No. 12-2312).

278. See Rosenthal, *supra* note 2, at 1466.

279. See *Sun Capital*, 724 F.3d at 146.

280. See Appellees' Response Brief, *supra* note 44, at 33.

the Sun Funds themselves engaged in a “trade or business.”²⁸¹ This analysis is correct, but the court disputed a different argument—that the *activities* of the Sun Funds’ affiliates could not be attributed to the Funds.²⁸² The First Circuit rejected the argument that attributing the activities of the general partners to the Funds was the same as attributing their status to the Funds.²⁸³

The court looked first to Delaware agency law regarding partnerships to determine whether the activities of the general partners could be attributed to the Funds.²⁸⁴ Delaware law states that “each partner is an agent of the partnership for the purpose of its business, purposes or activities” and that the act of a partner “for apparently carrying on in the ordinary course [of] the partnership’s business, purposes or activities . . . binds the partnership.”²⁸⁵ Although the statute concerns apparent agency, the court applied the statute to hold that the limited partnership agreements made the general partners the agents of the Sun Funds.²⁸⁶ Since the case presented no issue of apparent agency, this reasoning adds confusion to the court’s analysis.

The court also found that the Sun Funds’ grant of authority to the general partners created an actual agency relationship between them.²⁸⁷ This argument is more logical and finds support in the *Restatement (Third) of Agency*, which states that an actual agency relationship forms when a principal manifests to an agent that the principal assents to the agent taking action on the principal’s behalf.²⁸⁸

281. Although neither the Sun Funds nor the court argued this point, some commentators have found the Sun Funds’ argument to be supported by partnership tax law. See Shepard, *supra* note 2, at 1357 (“The funds argued, correctly under tax law, that the trade or business of a partnership cannot be attributed to the investors.”). *But see* Elliott, *supra* note 74, at 20 (“[Steven Rosenthal said:] ‘The way our tax rules work with financial intermediaries is that the activities of the agents or contractors are attributable to the fund itself. . . . That’s just section 702(b). That’s the way our partnership tax rules work.’”). However, this analysis should not be determinative for purposes of ERISA.

282. See *Sun Capital*, 724 F.3d at 146 (“The Sun Funds make an additional argument: that because none of the relevant activities by agents and different business entities can be attributed to the Sun Funds themselves, withdrawal liability cannot be imposed upon them. We reject this argument as well.”).

283. See *id.* at 148 n.30 (quoting Rosenthal, *supra* note 274, at 365 n.43); see also Rosenthal, *supra* note 2, at 1463 (stating that the First Circuit attributed the activities of the general partner to the Funds to determine whether the Sun Funds were engaged in a “trade or business” and arguing that the general partner’s activities also included those of the management company that the general partner hired to manage SBI).

284. See *Sun Capital*, 724 F.3d at 146–47.

285. DEL. CODE ANN. tit. 6, § 15-301 (2014).

286. See *Sun Capital*, 724 F.3d at 147.

287. See *id.*

288. See RESTATEMENT (THIRD) OF AGENCY § 3.01 (2006).

The limited partners did give the general partners the authority to act on behalf of the limited partnerships to effectuate their purposes,²⁸⁹ so this analysis makes sense.

The court rejected the Sun Funds' argument that no agency relationship connected the Funds to the "trade or business" activity of the general partner because the general partner, not the Sun Funds, entered into the management service contract with SBI.²⁹⁰ The court reasoned that the general partners acted within the scope of their authority and worked to benefit the Sun Funds by providing management services to SBI.²⁹¹ In support of this argument, the court stated that 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."²⁹²

The argument that the Funds must have had an agent in order to function constitutes a practical, rather than a legal, reason for finding an agency relationship. This analysis lends support to critics' argument that the decision is results-oriented,²⁹³ because the court looked beyond the law for its reasoning. However, some commentators find this practical argument persuasive.²⁹⁴ The Sun Funds did not argue this issue in their petition for certiorari,²⁹⁵ and one commentator believes that this omission constitutes the Funds' admission that a clear agency relationship existed between the Funds and their general partners.²⁹⁶ However, it is also possible that the

289. See *Sun Capital*, 724 F.3d at 147.

290. See *id.*

291. See *id.* at 147–48.

292. *Id.* at 148.

293. See Sheppard, *supra* note 2, at 1354 ("The fund in question had a controlling interest in the portfolio company whose termination liability was at issue. One does have to put termination liability where the money resides."); Lydia Beyoud, *Analyst: 'Sun Capital' Could Lead to Review of Policies Governing Private Equity Taxation*, BLOOMBERG BNA DAILY TAX REPORT (Sept. 30, 2013), http://news.bna.com/dtln/DTLNWB/split_display.adp?fedfid=36851649&vname=dtrnot&wsn=509826000&searchid=22504919&doctypeid=1&type=date&mode=doc&split=0&scm=DTLNWB&pg=1 ("The case may have been results-oriented in an attempt to hold the private equity fund liable for the unpaid pension obligations under ERISA for one of the companies it held in its portfolio.").

294. See, e.g., Rosenthal, *supra* note 2, at 1463 ("A fund must pursue its business through others, because a fund is merely a legal fiction (that is, a partnership), not a real person.").

295. See Petition for Writ of Certiorari, *supra* note 208.

296. See Amy S. Elliott, *Sun Capital Petitions for Review of Trade or Business Case*, 141 TAX NOTES 819, 820 (2013) ("[Steven] Rosenthal said that he found it interesting that the Sun Capital funds dropped their agency arguments, which he said had originally been at the heart of their case. 'Private equity funds act through their agents, and to contend otherwise is silly,' Rosenthal said.").

Funds did not argue this point since the “trade or business” issue has larger tax implications than the agency argument does. The court also contended that the benefit that Sun Fund IV received as a result of management fee offsets supported the argument that the general partner acted within the scope of an agency relationship.²⁹⁷ The Sun Funds correctly argued that the court pierced the corporate veil with this analysis,²⁹⁸ since the Funds chose their corporate structure²⁹⁹ presumably with the intent to separate the investors from the “trade or business” activity.

The court’s failure to discuss this point earlier in the opinion further weakens the court’s agency analysis. The court did not discuss agency until after it had already attributed the activities of the general partners to the Funds. Throughout its application of the “investment plus” standard, the court conflated the Sun Funds with their general partners and the general partners with their subsidiary management companies.³⁰⁰ In addition, the court used the Sun Funds’ limited partnership agreement to argue that the Funds, rather than the general partners, were actively involved in the management of portfolio companies, even though the agreements give the general partner exclusive management authority.³⁰¹ The court’s statement that the Sun Funds have “undertaken activities”³⁰² directly contradicts the court’s later argument that the Funds cannot take action except through an agent.

The court also used the Sun Funds’ private placement memos³⁰³ to show that the Sun Funds were involved in the management of SBI,

297. See *Sun Capital*, 724 F.3d at 147–48.

298. See Appellees’ Petition for Panel Rehearing or Rehearing En Banc, *supra* note 277, at 7–8.

299. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 119 (D. Mass. 2012) (rejecting the TPF’s argument that, because the holding company, Sun Scott Brass, LLC, elected to be treated as a partnership for federal taxation purposes, it should also be treated as a partnership for other purposes and stating that this argument ignored Sun Scott Brass, LLC’s chosen corporate form under state law), *aff’d in part, vacated in part, rev’d in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

300. See *Sun Capital*, 724 F.3d at 142–43 (stating, for example, (1) “the Sun Funds have also undertaken activities as to the SBI property,” rather than stating that general partners have undertaken this activity, and (2) “the Sun Funds’ controlling stake in SBI,” rather than the Sun Scott Brass Holding Corporation’s controlling stake).

301. See *id.* at 142 (“The Sun Funds’ limited partnership agreements and private placement memos explain that the Funds are actively involved in the management and operation of the companies in which they invest.”).

302. *Id.*

303. A private placement memorandum is a type of investment prospectus for investors in a private placement, which is a private offering, as opposed to a public stock

stating that “[t]he Principals typically work to reduce costs.”³⁰⁴ The court included a footnote clarifying that the “Principals” were the individuals who worked for the general partner.³⁰⁵ Thus, the court used the private placement memos to argue that the Funds themselves were liable without clarifying that the Funds were only liable based on agency law through attribution of the general partner’s actions to the Funds.³⁰⁶ Indeed, said one critic, “[t]he court noted that the fund management company stated reorganization of troubled companies as a purpose. Chief Judge Sandra Lynch threw the management company’s promotional materials right back at *them*” by finding that these materials showed that Sun Fund IV was engaged in a “trade or business.”³⁰⁷ However, the court actually threw the management company’s promotional materials at the *Sun Funds*, and the court’s argument would have been stronger if it had first clarified its reasoning for doing so.

By failing to explain its reason for conflating the Sun Funds with the general partner and the general partner’s subsidiary management company, the court effectively ignored the reasoning that the district court had found most persuasive. As the Sun Funds claimed in their petition for rehearing, the court ignored the distinction between Sun Fund IV’s general partner and its subsidiary management company.³⁰⁸ Even if the court’s subsequent agency argument proves there is an agency relationship between the general partner and the Sun Fund, the court should have also addressed the relationship between the general partner and its subsidiary management company.

Despite its inelegant treatment of the agency issue, the court correctly found an agency relationship between the Sun Funds and their general partners based on practical, rather than strictly legal, considerations. Partnerships, such as the Sun Funds, can only act through their agents, so a practical application of agency law would find that a private equity fund’s general partner is an agent of the

offering. See Jean L. Batman, *Raising Money Through Private Placements*, A.B.A. GPSOLO EREP., Dec. 2012, http://www.americanbar.org/publications/gpsolo_ereport/2012/december_2012.html.

304. *Sun Capital*, 724 F.3d at 142 (footnote omitted).

305. *Id.* at 142 n.17.

306. See *id.* at 142 (stating that the “purpose of the Sun Funds” was to “seek out potential portfolio companies . . . in need of extensive intervention with respect to their management and operations, to provide such intervention, and then to sell the companies,” and supporting this statement with a discussion of the private placement memos, to which the general partners, not the Sun Funds, were parties).

307. See Sheppard, *supra* note 2, at 1356 (emphasis added).

308. See Appellees’ Petition for Panel Rehearing or Rehearing En Banc, *supra* note 277, at 7–8.

fund.³⁰⁹ The court also accurately assumed that an agency relationship existed between the general partners and their subsidiary management companies, though clarification would have strengthened the argument. The court concluded, consistent with precedent, that Sun Fund IV was a “trade or business” under agency law and under the court’s newly adopted “investment plus” standard.

IV. THE FIRST CIRCUIT’S HOLDING AS A CALL FOR ACTION RATHER THAN A USEFUL PRECEDENT

The First Circuit’s holding in *Sun Capital* has the potential to greatly increase pension withdrawal liability under ERISA for private equity funds if other courts follow this precedent. In addition to withdrawal liability, the First Circuit’s holding could have an immense impact on all private equity funds’ qualified ERISA plan nondiscrimination testing and coverage testing for their portfolio companies.³¹⁰ If courts expand the holding to the tax arena, *Sun Capital* could have even greater implications, particularly for tax-exempt and foreign investors, and could also affect the tax treatment of carried interest. All of these changes would impact private equity funds and their investors, making it likely that the court narrowed its holding to the ERISA context³¹¹ in order to minimize the potential negative impact on investment. By failing to define the “plus” in its “investment plus” standard, the First Circuit also avoided making a precedent that other courts could easily apply. The court emphasized its use of a “fact-specific approach”³¹² to conclude that Sun Fund IV was a “trade or business.” In addition, the court urged the PBGC to provide guidance on this issue.³¹³ Because of these limitations, it is not clear that *Sun Capital* will have much impact on pension withdrawal liability or on nondiscrimination and coverage testing. The Supreme Court denied certiorari on the “trade or business” issue,³¹⁴ so the

309. See Sheppard, *supra* note 2, at 1358 (“[Private equity firms] wear a lot of hats, which make[s] their investors vulnerable to agency arguments.”).

310. See *infra* notes 332–40 and accompanying text.

311. See *Sun Capital*, 724 F.3d at 144–45 (stating that the term “trade or business” under ERISA does not necessarily have the same meaning as it does under the IRC and that the meaning of “trade or business” is not consistent even within the Code).

312. See *id.* at 141.

313. See *id.* at 148.

314. *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 134 S. Ct. 1492 (2014). Although the Supreme Court did not grant certiorari, some believe that the “trade or business” issue will reemerge later and will be taken up by the Court then, while others think that the Court did not grant certiorari because the Court agreed that a private equity fund engages in a “trade or business.” See Amy S. Elliott, *Supreme Court Won’t Hear Sun Capital*, 142 TAX NOTES 1024, 1024 (2014).

limitations the First Circuit placed on its holding stand, and *Sun Capital* serves as binding precedent only within the First Circuit. Thus, the chance that the case will ultimately change the taxation of private equity funds is even smaller.

Section A reviews the issues on remand to the district court. Section B examines the implications that *Sun Capital* may have on ERISA issues for private equity funds. Section C explores the possible tax implications of *Sun Capital* for private equity funds.

A. Remand to the District Court

The court's disinclination to create a useful precedent can be seen in the narrowness of the court's holding even within the ERISA context. It is likely that, on remand, the district court will find that the Funds are not under common control. Section 1301(b)(1) does not define "trade or business," but it does define common control by reference to the Code's definition.³¹⁵ The Code uses a bright-line test to define common control as possession by the parent company of eighty percent or more of the stock of the subsidiary company.³¹⁶ Sun Fund IV held only seventy percent of SBI stock, while Sun Fund III held thirty percent.³¹⁷ The Funds divided ownership this way, in part, to avoid common control.³¹⁸

The TPF argues on remand that the Sun Funds' co-investment in SBI created a de facto partnership or joint venture.³¹⁹ The TPF further argues that finding that Sun Fund III and IV are a partnership or joint venture does not require the court to pierce the corporate veil.³²⁰ The TPF argues that Leder and Krouse pooled money between the Funds to purchase SBI jointly and that the two Funds thus constituted a de facto partnership or joint venture.³²¹ The TPF's argument rests on the fact that Leder and Krouse created both Funds, that the Funds had identical purposes and investment strategies, and

315. See 29 U.S.C. § 1301(b)(1) (2012).

316. I.R.C. § 1563(a)(1) (2012).

317. *Sun Capital*, 724 F.3d at 135.

318. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 120–21 (D. Mass. 2012), *aff'd in part, vacated in part, rev'd in part*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014); *supra* text accompanying notes 120–22.

319. See Supplemental Memorandum in Support of New England Teamsters & Trucking Industry's Motion for Summary Judgment at 13–14, *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, No. 10-10921 (D. Mass. Dec. 13, 2013).

320. See *id.*

321. See *id.*

that both Funds hired employees of SCAI.³²² Even if the same two people, Leder and Krouse, created and ran both Funds, they clearly chose this particular corporate structure.³²³ A court would have to ignore the Funds' chosen corporate form to find that they were a partnership or joint venture.³²⁴ Asking the court to find the existence of a partnership between the Funds when the Funds were created as separate entities to avoid designation as a partnership is akin to asking the court to create a transaction that did not happen in which Sun Fund IV bought one hundred percent of SBI.³²⁵ Since the First Circuit rejected this argument in relation to the TPF's assertion that the Sun Funds violated § 1392(c),³²⁶ this argument will likely fail on remand as well. Therefore, the Funds are likely to ultimately escape pension withdrawal liability, despite Sun Fund IV's loss on the "trade or business" issue.

B. *Impact on Private Equity Under ERISA*

Commentators speculate that the First Circuit may have found it appealing to rule in favor of a pension fund and against a private equity fund trying to escape liability for a bankruptcy it may have had a hand in causing. One critic asked, "What's a judge to do when a \$10 billion private equity fund walks away from a dying company like a discarded toy, leaving the Teamsters pension plan to pick up the mess?"³²⁷ Those who view the court's holding as results-oriented argue that the court may not have wanted to rule against the "widows and orphans" and allow the private equity funds to use complicated legal structures to dump their pension liability on the PBGC.³²⁸

Despite this criticism, the First Circuit seems to have recognized that it was not the court's role to define "trade or business" across the Code or even across ERISA. The court expressed its frustration that the PBGC had failed to promulgate regulations defining "trade or

322. *Id.* at 17–19.

323. See Memorandum in Support of Plaintiffs' Renewed Motion for Summary Judgment at 12, *Sun Capital*, 903 F. Supp. 2d 107 (No. 10-10921).

324. See *Sun Capital*, 903 F. Supp. 2d at 118 ("It is a basic principle of corporate law that officers holding dual posts can 'wear different hats' when working for each."); Memorandum in Support of Plaintiffs' Renewed Motion for Summary Judgment, *supra* note 323, at 13.

325. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 149–50 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014); Memorandum in Support of Plaintiffs' Renewed Motion for Summary Judgment, *supra* note 323, at 11.

326. See *Sun Capital*, 724 F.3d at 149–50; *supra* text accompanying notes 210–14.

327. Sheppard, *supra* note 2, at 1352.

328. See Fleischer, *supra* note 16.

business” for purposes of § 1301(b)(1).³²⁹ However, the Treasury and the IRS have also been reluctant to promulgate regulations on the meaning of “trade or business” out of concern for making blanket statements on an inquiry that is ultimately fact-specific.³³⁰ Therefore, the courts will likely continue to await guidance on this issue, and the Treasury and the IRS will probably continue to avoid taking action unless Congress acts first.

Even if “trade or business” remains undefined generally, the First Circuit’s holding could have a substantial impact on private equity funds in the ERISA context. The PEGCC argued in its amicus brief that “[w]ithdrawal liability is huge: ‘U.S. multiemployer pension plans are [underfunded by an estimated] \$369 billion.’ ”³³¹ However, the effect that this holding has on ERISA may depend on how the district court rules on remand. If the district court finds that the Sun Funds are not under common control, and therefore not liable for SBI’s pension withdrawal, then other private equity funds could likely also escape pension withdrawal liability fairly easily.

However, *Sun Capital* could impact ERISA nondiscrimination testing for private equity funds’ portfolio companies’ single employer plans, in addition to withdrawal liability in multiemployer plans. In order to receive ERISA’s tax advantages, a plan must be qualified.³³² For a plan to be qualified, it must “not discriminate in favor of highly compensated employees.”³³³ Partnerships that are “trades or businesses” and under common control are considered a single employer for purposes of testing for compliance with the IRC’s nondiscrimination requirements.³³⁴ A portfolio company would be under common control with a private equity fund if the fund owns more than eighty percent of the stock of the portfolio company.³³⁵

329. See *Sun Capital*, 724 F.3d at 148.

330. Sheppard, *supra* note 2, at 1356 (citing Rev. Rul. 2008-39, 2008-2 C.B. 252).

331. Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 3 (footnote omitted). Despite this argument, the PEGCC seems somewhat conflicted on this issue. Steve Judge, representing the PEGCC, “told Tax Analysts that although [*Sun Capital*] could have important effects for the private equity industry in the ERISA context in the First Circuit, it should not be read as significant beyond that.” Amy S. Elliott, *Sun Capital Petitions First Circuit for Rehearing of Trade or Business Decision*, TAX NOTES TODAY (Aug. 9, 2013) (available by subscription at <http://www.taxanalysts.com>).

332. See generally I.R.C. § 401 (2012) (listing the requirements for tax qualification of an ERISA plan); 1 RONALD J. COOKE, ERISA PRACTICE AND PROCEDURE § 1:3 (2013) (discussing the concept of the ERISA-qualified plan).

333. I.R.C. § 401(a)(4).

334. See *id.* § 414(c).

335. See *id.* § 1563(a).

Thus, if a private equity fund is a “trade or business,” it could be under common control with all of its portfolio companies.³³⁶ In that case, a private equity fund would have to conduct nondiscrimination testing by counting all employees of the portfolio companies in its testing.³³⁷ This aggregation could mean that the existence of different plans at different portfolio companies could constitute a violation of ERISA’s nondiscrimination rules.³³⁸ The IRC also requires that qualified plans meet coverage requirements for employee participation.³³⁹ The same issues of aggregation of portfolio companies would apply to coverage testing if a private equity fund were deemed a “trade or business” under IRC § 410.³⁴⁰

C. *Impact on Taxation of Private Equity Funds*

Even though the court carefully limited its holding to ERISA, the tax implications of *Sun Capital* could be greater than its ERISA implications. Some believe that *Sun Capital* may have a significant impact on the tax characterization of private equity fund profits.³⁴¹ In its analysis of Supreme Court precedent in connection with its “investment plus” standard, the First Circuit quoted an article, which advocated for taxing private equity profits at ordinary income rates rather than at capital gains rates, as stating that private equity funds

336. See Appellee’s Petition for Panel Rehearing or Rehearing En Banc, *supra* note 277, at 13 & n.9 (citing *Private Investment Funds May be Liable for Portfolio Company’s Underfunded Pension Liabilities under First Circuit Ruling*, PROSKAUER ROSE LLP (July 31, 2013), <http://www.proskauer.com/news/detail.aspx?news=10205>).

337. See *The Risks for Private Equity in Companies with Underfunded Benefit Plans*, METROPOLITAN CORP. COUNS., Nov. 2013, at 5, available at <http://www.metrocorpounsel.com/pdf/2013/November/05.pdf> (quoting employee benefits and executive compensation attorney Kenneth A. Raskin as saying that “[i]f in fact a fund is part of a controlled group of portfolio companies, fund managers may have to test all the different tax-qualified plans of all the companies in the control group to see if in fact they pass the nondiscrimination test”).

338. See *Private Equity Funds May Be Exposed to ERISA Pension Liabilities and Tax Risks: Preliminary Reflections on the M&A and Private Equity Consequences of the Sun Capital Decision*, SIDLEY AUSTIN LLP (Sept. 11, 2013), <http://www.sidley.com/tax-update-09-11-2013>.

339. See § 410(b).

340. See Christopher Lockman, *The Sun Capital Case Could Have Broader Implications for Employee Benefit Plans*, VERRILL DANA, LLP BENEFITS LAW UPDATE BLOG (Aug. 23, 2013, 4:40 PM), <http://www.employeebenefitsupdate.com/benefits-law-update/2013/8/23/the-sun-capital-case-could-have-broader-implications-for-emp.html> (noting that, after *Sun Capital*, retirement plans could be subject to coverage and nondiscrimination requirements contained in § 410).

341. See Elliott, *supra* note 74, at 20 (quoting Stephen E. Shay, Harvard Law School tax professor, as suggesting that *Sun Capital* “is affecting the debate on capital gains just because of the intersection with the industry that is the highest profile industry as a beneficiary of the capital gains differential rate”).

“are active enough to be in a trade or business.”³⁴² However, two major questions arise if courts expand *Sun Capital*’s holding to find that private equity funds also engage in “trade or business” activity for tax purposes.

1. Should Private Equity Fund Profits Constitute Ordinary Income?

Defining private equity funds as engaged in “trade or business” activity could have a drastically detrimental impact on private equity investment, such as by subjecting tax-exempt investors to UBTI.³⁴³ If private equity investment income constituted UBTI, pension funds, for example, would pay tax on private equity gains that have traditionally been tax free.³⁴⁴ Since pension funds represent a large percentage of private equity investment,³⁴⁵ reducing pension fund investment in private equity would have a significant negative impact on the private equity sector. Characterizing private equity funds as engaged in “trade or business” activity could also deter foreign investors, who currently pay no tax on their private equity gains and would be subject to ECI.³⁴⁶ If private equity constitutes investment activity, then foreign investors are not subject to ECI because they do not invest directly in a “trade or business.”³⁴⁷ Investing in private equity also does not currently qualify as dealing in securities, meaning that no ECI safe harbor would apply if private equity investment gains qualified as ECI.³⁴⁸ Since foreign investments represent a large percentage of private equity investment,³⁴⁹ holding that a private equity fund engages in the “trade or business” of “developing and

342. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 146 (1st Cir. 2013) (quoting Rosenthal, *supra* note 274, at 365), *cert. denied*, 134 S. Ct. 1492 (2014).

343. See Beyoud, *supra* note 77; *supra* notes 86–90 and accompanying text

344. See Rosenthal, *supra* note 2, at 1469; Fleischer, *supra* note 16.

345. Needham, *supra* note 3, § II.C.3 (“Although [pension funds] invest most of their assets in far less risky, more liquid securities, they usually allocate a very small percentage of their portfolios to aggressive asset classes, including hedge funds and private equity funds. In absolute dollars, however, these small percentages represent the majority of the capital in the private equity sector.”).

346. See *id.* § II.C.4; *Tax Analysts Hosts Conference on Private Equity as a Trade or Business: The Sun Capital Decision*, TAX ANALYSTS (Oct. 2, 2013), <http://www.taxanalysts.com/www/pressrel.nsf/Releases/181E67751AA4A9AD85257BF8005A893D?OpenDocument> (quoting Professor Shay as saying that “[i]f the *Sun Capital* analysis is pushed and it were concluded in the income tax context that a private equity fund management fee offset should be treated as income from service, then that’s going to affect the foreign investors”); *supra* text accompanying notes 91–94.

347. See Rosenthal, *supra* note 2, at 1469–70.

348. See *id.*

349. Needham, *supra* note 3, § II.C.4.

selling businesses” to customers³⁵⁰ would also have a significant impact on the private equity sector.³⁵¹ In addition, if a private equity fund itself engages in a “trade or business,” then the fund’s gains would be taxed at ordinary income rates rather than at capital gains rates.³⁵² This higher tax rate³⁵³ would pass through to the partners.³⁵⁴

Some have argued that characterizing private equity funds as engaged in “trade or business” activity could hurt private equity investment by subjecting fund managers to a higher tax rate and cutting into returns for private equity investors, thus negatively affecting the broader economy.³⁵⁵ Others have argued that classifying private equity funds as engaged in a “trade or business” would actually help private equity by allowing funds to deduct the costs of management fees as business expenses.³⁵⁶ These deductions could be taken above the line and offset ordinary income, instead of being below-the-line deductions subject to the § 67 limits on deductions for investment activity.³⁵⁷ However, many private equity investors are tax-exempt entities that would have no use for a larger deduction for management fees, so this change would have no impact on many investors.³⁵⁸ Even though taxing income to the general partner at ordinary income rates could increase tax revenue by taxing private equity gains at higher rates and providing no offsetting deductions,

350. See Rosenthal, *supra* note 2, at 1469.

351. *But see* Fleischer, *supra* note 16 (“There are some other code sections, like the ‘stock or securities’ exception in section 864 [(the ECI safe harbor)], that may further protect foreign investors from being treated as effectively connected with a United States trade or business.”).

352. See I.R.C. § 1221(a)(1) (2012) (excepting “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” from the definition of capital asset); *see also* Fleischer, *supra* note 16 (describing the increased tax liability fund managers may face after *Sun Capital*).

353. See § 1.

354. See *supra* notes 6–8 and accompanying text (discussing the tax benefits of pass-through entities).

355. See Beyoud, *supra* note 77. Foreign and tax-exempt investors could have less incentive to invest in private equity if private equity funds were “trades or businesses” for tax purposes. See *id.*; *Tax Analysts Hosts Conference on Private Equity as a Trade or Business: The Sun Capital Decision*, *supra* note 346 (quoting Professor Shay as contending that “[t]here’s a different risk profile now than there was before [*Sun Capital*] was decided, and to say otherwise is not being objective about it”).

356. See *Tax Analysts Hosts Conference on Private Equity as a Trade or Business: The Sun Capital Decision*, *supra* note 346 (quoting Patrick B. Fenn as insisting that if funds were trades or businesses, “the government might be a loser in that result more than a winner” because domestic taxpayer investors could deduct their outlays for management fees).

357. See §§ 62(a)(1), 162(a), 1211.

358. See William H. Weigel, *What Warren Buffet Didn’t Tell You About Carried Interest*, 141 TAX NOTES 503, 509 (2013).

private equity sponsors may use other strategies to mitigate the negative tax effects on both themselves and investors.³⁵⁹ These strategies could possibly prevent any economic harm to private equity investment, but would also eliminate any net increase in tax revenue.³⁶⁰

A separate issue involves whether the fund manager's carried interest should be taxed at capital gains rates. *Sun Capital* has sparked debate on this related issue as well.³⁶¹ Some have argued that taxing carried interest at ordinary income rates could harm private equity investment because investors would be able to retain a smaller percentage of return if their investments were taxed at higher rates.³⁶² Most analysts agree, however, that reform of carried interest taxation is needed to increase equity in the application of the Code.³⁶³

Regardless of its effect on private equity investments, there are persuasive legal arguments that income from private equity funds should be taxed at ordinary rates.³⁶⁴ The similarity between private

359. *See id.* at 509–10. Weigel describes an alternative strategy private equity sponsors could use to decrease their tax burden whereby the general partner would take a two percent fee from each portfolio company instead of the current management fee investors pay. *See id.* The general partner would also receive a stock option from the portfolio company that would replace the twenty percent carried interest general partners currently receive from investors. *See id.*

360. *See id.* at 510–11. Weigel argues that taking the fees from the portfolio company would give the companies the benefit of those deductions, which they could take above the line to offset ordinary income, thus reducing tax revenue. *See id.*

361. *See* Jeremy Scott, *Carried Interest Debate Highlights Issues with Progressivity*, 141 TAX NOTES 569, 569 (2013) (stating that the debate on carried interest has not been prevalent in politics since 2010 but that *Sun Capital* touched on the issue and that commentators still push for ordinary income treatment of carried interest). On February 26, 2014, the House Ways and Means Committee Chairman Dave Camp released a draft comprehensive tax reform plan that proposes to tax some carried interest at ordinary income rates. *See* Elliott, *supra* note 314, at 1025. In what some are calling a reference to *Sun Capital*, Congressman Camp stated in the proposal that a partnership “that is in the business of raising capital, investing in other businesses, developing such businesses, and ultimately selling them, is in the trade or business of selling businesses.” Amy S. Elliott, *Camp Draft Forgoes Unified Passthrough Regime*, 142 TAX NOTES 886, 887 (2014). For a discussion of the benefits to both general partners and limited partners of having carried interest taxed at capital gains rates, see Sanchirico, *supra* note 36, at 1079.

362. *See* Steve Judge, *Why a Pension Case Will Not Change Private Equity Tax Law*, N.Y. TIMES DEALBOOK (Nov. 4, 2013, 3:13 PM), http://dealbook.nytimes.com/2013/11/04/why-a-pension-case-will-not-change-private-equity-tax-law/?_r=0. Steve Judge, president and chief executive of the PEGCC, argues that it would be unfair to tax carried interest at ordinary income rates because it would deny private equity funds the favorable tax treatment available to other kinds of businesses that buy and sell capital assets. *See id.*

363. *See* Cory M. Vargo, *Carried Interest Taxation and Private (and Horizontal) Equity*, 137 TAX NOTES 425, 429 (2012).

364. *See* Rosenthal, *supra* note 274, at 365–66.

equity “investment” and dealer activity, such as dealing in real estate,³⁶⁵ is too strong for the two activities to be taxed differently. Like real estate dealers, private equity funds make money from management activities, which are generally taxed at ordinary income rates, rather than merely from passive investment.³⁶⁶ The *Sun Capital* court cited a commentator³⁶⁷ who has explained that “[i]t is one thing to manage one’s investments in businesses. It is another to manage the businesses in which one invests. The hands-on nature of their investment model is arguably a defining feature of private equity partnerships.”³⁶⁸ Private equity funds engage in management activity that should subject them to classification as engaged in a “trade or business.” In addition, there is no particular tax policy justification to prefer those who deal in companies to those who deal in houses or securities, so there should be no reason to give private equity investors preferential tax treatment.³⁶⁹

However, even if private equity funds engage in a “trade or business,” they must still hold property “primarily for sale to customers” in order to be subject to ordinary income rates.³⁷⁰ There has been little analysis of whether private equity funds sell portfolio companies “to customers.”³⁷¹ Traders do not sell securities “to customers” because, when they sell securities, they sell them on a market and not to a particular buyer.³⁷² Private equity funds, in contrast, do not simply dump portfolio companies on the securities market when they sell them.³⁷³ An argument can be made that private equity funds sell their portfolio companies “to customers,” but this issue has not yet been tested since private equity funds, historically, have not been classified as engaging in “trade or business” activity.³⁷⁴ Overall, it seems accurate to say that those in the private equity

365. See Rosenthal, *supra* note 2, at 1467.

366. See Rosenthal, *supra* note 274, at 366 (“The tax law should not permit private equity funds to transform their income from everyday operations of a business into capital gains through the sale of stock of the improved company.”).

367. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 134 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

368. Sanchirico, *supra* note 36, at 1103.

369. See Rosenthal, *supra* note 274, at 365–66.

370. See I.R.C. § 1221(a)(1) (2012).

371. *But see* Rosenthal, *supra* note 274, at 363–66 (arguing that private equity funds could be said to hold portfolio companies “primarily for sale to customers” much like real estate developers deal in real estate, operating as a “middleman business” between sellers and buyers).

372. See *id.* at 363–64.

373. The portfolio companies of private equity are by definition not publicly traded.

374. See Brief of the Private Equity Growth Capital Council as Amicus Curiae, *supra* note 5, at 6.

industry “have been interpreting tax law wrong for 20 years as to whether there’s a trade or business.”³⁷⁵ Since there are strong arguments for taxing private equity funds at ordinary income rates, the issue becomes deciding who should make the change in how private equity funds characterize their income.

2. Should Courts or the Treasury Change Taxation of Private Equity Profits in the Absence of Congressional Action?

The courts do not have the authority to unilaterally alter the taxation of private equity, as the First Circuit itself recognized in its refusal to define the “plus” of its “investment plus” standard and in its “dismay” at the PBGC’s failure to promulgate regulations.³⁷⁶ If courts apply their own definitions without administrative or legislative guidance, private equity funds will lack the procedural protections provided by notice and comment in shaping the rule.³⁷⁷ In addition, some argue that since the private equity industry has been taxed for twenty years at capital gains rates, changing the characterization of their activity now would create more difficulty.³⁷⁸ Although the Treasury, through regulations, could make these changes and characterize private equity as engaged in a “trade or business,” the difficulty of taking action makes it unlikely that the Treasury will act. Some speculate that the Treasury could use *Sun Capital* as a basis for reevaluating its regulations on the characterization of carried interest in particular.³⁷⁹ True, a Treasury spokesman has stated that the Treasury may reconsider its previous

375. Elliott, *supra* note 296, at 820.

376. See *Sun Capital Partners III v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 141, 148 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

377. See Rosenthal, *supra* note 2, at 1470 n.116 (arguing that if courts apply the rule from *Sun Capital* in the tax context without further guidance, funds may also “whipsaw the government,” with some claiming an ordinary loss on portfolio sales and others claiming capital gains rates on their profits). *But see* Jane Sasseen, *With Tax Advantages Looking Shaky, Private Equity Seeks a New Path*, N.Y. TIMES DEALBOOK (Jan. 21, 2013, 3:16 PM), http://dealbook.nytimes.com/2013/01/21/with-tax-advantages-looking-shaky-private-equity-seeks-a-new-path/?_r=0 (indicating that private equity firms have had notice of possible changes to the characterization of carried interest for tax purposes because of the political pressure to characterize private equity income as ordinary income, and stating that firms have already started preparing for this change).

378. See Elliott, *supra* note 296, at 820. William L. McRae, a tax practitioner, has stated that “[w]hatever you think about the last 20 years of advice and what people have called settled law, to deviate from that is going to be very difficult to do in the future without at least a political process.” *Id.*

379. See Rubin, *supra* note 234.

position on carried interest.³⁸⁰ However, even if the Treasury takes action in response to *Sun Capital*, it is problematic to have a court and an administrative agency decide to classify private equity activity as “trade or business” activity when Congress has declined to change this rule in spite of years of political pressure to do so.³⁸¹

CONCLUSION

In holding that Sun Fund IV was a “trade or business,” the First Circuit took a new and unexpected stance on that term’s definition and created a new rule for determining whether an entity is a “trade or business,” at least in the context of § 1301(b)(1). The court left this rule, the “investment plus” standard, intentionally vague in an effort to avoid creating a general precedent with the potential to dramatically alter both ERISA and tax law. In creating this new standard, the court adapted persuasive authority from other sources. The “investment plus” standard represents an improved interpretation of *Groetzinger* while not betraying other Supreme Court precedent. Although the court could have better clarified its agency analysis, even this aspect of the opinion finds some support in legal precedent and plenty of support in basic logic.

Discussion of the First Circuit’s ruling in *Sun Capital* will hopefully prompt Congress, the Treasury, or the PBGC to act and classify private equity funds as engaged in a “trade or business” under both ERISA and the Internal Revenue Code. More cases dealing with the question of whether private equity funds engage in a “trade or business” are likely to arise, and when they do, the courts should not be the ones to decide this crucial issue. Ideally, Congress should act to state that private equity funds are engaged in “trade or business” activity for purposes of the IRC. However, there is no indication that Congress intends to act on this issue, especially when the related issue of taxing carried interest at ordinary income rates

380. See *id.* (quoting Craig Gerson, an attorney-advisor at the Treasury Office of Tax Legislative Counsel, as saying, “There’s a recognition that the court’s decision may give us an opportunity to reassess what ‘trade or business’ means, but I think that there won’t be any rush to issue guidance on this”).

381. See Steven M. Davidoff, *A Chance to End a Billion-Dollar Tax Break for Private Equity*, N.Y. TIMES DEALBOOK (Oct. 23, 2013, 6:23 PM), http://dealbook.nytimes.com/2013/10/22/chance-to-end-billion-dollar-tax-break-for-private-equity/?_r=1. The Obama administration has tried repeatedly to tax private equity profits as income. *Id.* But it may now be that the “battle to tax carried interest is not won or lost in the halls of Congress over high-minded concepts of fairness or equity but rather in the halls of the I.R.S. by applying common-sense presumptions that existed all along.” *Id.*

has not been a major topic of discussion in Congress since 2010.³⁸² Although the tax law does seem to have been wrongly applied by private equity funds for decades, it seems unlikely that the taxation of private equity funds will change in the near future. In the absence of action by Congress, the Treasury should announce regulations that clarify that a private equity fund is a “trade or business.” This determination will have the benefit of giving investors notice, even if it accomplishes through administrative action something that should be accomplished through legislative action. However, this action also is unlikely.

If neither Congress nor the Treasury act, *Sun Capital* indicates that the courts will have to try to reach fair results on an ad hoc basis as they rule on individual cases. These judicial efforts to reach the correct legal conclusion may result in more cases like *Sun Capital* that conflict with the traditional (and incorrect) categorization of private equity funds as investors. These piecemeal judicial determinations could create inconsistent precedent and harm the overall uniformity of the tax system. Therefore, the First Circuit’s holding does not constitute a useful precedent but instead represents a call to action to change through the legislative process the private equity sector’s incorrect interpretation of tax law. Since the Treasury and IRS probably will not use *Sun Capital* as an opportunity to change the taxation of private equity funds, the current taxation regime will likely continue.

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382. See Scott, *supra* note 361, at 569. But see Elliott, *supra* note 361, at 887 (discussing Congressman Camp’s proposal to reform taxation of some carried interest).

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