Saint Louis University Public Law Review

Volume 34
Number 2 *General Issue (Volume XXXIV, No. 2)*

Article 12

2015

A Step in the Right Direction: How Sun Capital's Trade or Business Decision Could Promote Common Sense and Fair Treatment Under the Tax Code

Richard Bailey
rbailey8@slu.edu

A STEP IN THE RIGHT DIRECTION: HOW *SUN CAPITAL*'S TRADE OR BUSINESS DECISION COULD PROMOTE COMMON SENSE AND FAIR TREATMENT UNDER THE TAX CODE

The First Circuit's decision in *Sun Capital*[1] burst onto the scene last summer, reenergizing the debate over the favorable tax treatment of private equity funds. While commentators jumped at the opportunity to discuss the case's possible tax implications, they stopped short of considering its relevance in light of America's growing economic inequality.[2] Since the start of the Great Recession, the federal government has subsidized America's "one percent" at the expense of the rest in at least two ways. First, the Federal Reserve's (the "Fed") bond buying program spurred inflation in the value of stock and consumer goods without spurring corresponding wage inflation.[3] This has allowed the private equity industry to thrive on the sale of inflated stock prices, while working Americans struggle with less purchasing power.[4] Second, the Internal Revenue Code (IRC) taxes the income from the sale of inflated stock[5] at lower rates than wages earned by working Americans.[6] But private equity firms exert the same type of effort to earn their income as ordinary Americans. So why should an industry exclusive to the country's wealthiest be rewarded with tax windfalls not enjoyed by the average

1. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013).

2. America's economic inequality is growing. *See* Annie Lowry, *The Wealth Gap in America Is Growing, Too*, N.Y. TIMES, Apr. 2, 2014, http://economix.blogs.nytimes.com/2014/04/02/the-wealth-gap-is-growing-too/; Drew DeSilver, *U.S. Income Inequality, on Rise for Decades, is now Highest Since 1928*, PEW RES. CTR., Dec. 5, 2013, http://www.pewresearch.org/fact-tank/2013/12/05/u-s-income-inequality-on-rise-for-decades-is-now-highest-since-1928/. Private equity plays a role in that growth. *See Growing Apart*, ECONOMIST, Sep. 21, 2013, http://www.economist.com/news/leaders/21586578-americas-income-inequality-growing-again-time-cut-subsidies-rich-and-invest.

3. *See infra* text accompanying notes 219–21 (discussing the economic impact of the monetary policy as it relates to the impact of the tax policy).

4. *See infra* text accompanying notes 219–21 (discussing the economic impact of the monetary policy as it relates to the impact of the tax policy). Private equity is not the sole beneficiary of inflated financial asset prices. However, to fully understand the benefit created by the taxation of the industry, it is important to consider the effects of other governmental policies.

5. Stock is treated as a capital asset; the sale of stock held for a minimum of one year is treated as a capital gain. I.R.C. §§ 1221(a)(1), 1222(3) (2012).

6. Ordinary income is taxed at a maximum rate of 39.6%, while capital gains are taxed at a maximum rate of 20%. I.R.C. § 1(a)–(h) (2012).

American? This note's policy discussion explores the relationship between the Fed's monetary policy, the tax code, and the *Sun Capital* decision. By recognizing that private firms are active managers rather than passive investors,[7] the First Circuit provides a potential mechanism for helping slow America's economic inequality.

In *Sun Capital*, the First Circuit confirmed what those opposing the taxation of private equity had long contended: that private equity funds are trades or businesses.[8] Currently, however, they are not treated as trades or businesses, but as passive investors.[9] This allows much of the income generated by private equity funds to be treated as capital gains and taxed at the capital gains rate, which is about 20% less than the rate at which ordinary income is taxed.[10] Further, because private equity funds are organized as partnerships, the income they generate retains its character as it flows through to the partners.[11] This allows the partners to pay tax on the income at the reduced capital gains rate instead of their marginal tax rate, which would vary depending on each partner's ordinary income.[12] Most individual private equity partners are extremely wealthy[13] and are thus reducing their tax rate from 39.6%—the highest ordinary income rate[14]—to 20%—the capital gains rate.[15]

7. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 133 (1st Cir. 2013).

8. *Id. Compare* Steven Davidoff Solomon, *A Chance to End a Billion-Dollar Tax Break for Private Equity*, N.Y. TIMES, Oct. 22, 2013, http://dealbook.nytimes.com/2013/10/22/chance-to-end-billion-dollar-tax-break-for-private-equity/ (suggesting *Sun Capital* provides a chance for the Internal Revenue Service (IRS) to change its treatment of private equity funds), *with* Victor Fleischer, *Sun Capital Court Ruling Threatens Structure of Private Equity*, N.Y. TIMES, Aug. 1, 2013, http://dealbook.nytimes.com/2013/08/01/sun-capital-court-ruling-threatens-private-equity-structure/, *and* Steven M. Rosenthal, *Private Equity is a Business: Sun capital and Beyond*, TAX NOTES, Sept. 23, 2013, at 1459, 1460 (suggesting private equity funds are trades or businesses), *with* Steve Judge, *Why a Pension Case Will Not Change Private Equity Tax Law*, N.Y. TIMES, Nov. 4, 2013, http://dealbook.nytimes.com/2013/11/04/why-a-pension-case-will-not-change-private-equity-tax-law (criticizing the notion that Sun Capital may upend the tax treatment of private equity funds), *and Partnership Taxation*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/issues/private-equity-and-tax-policy/private-equity-partnership-taxation/ (last visited Feb. 17, 2014) [hereinafter PEGCC] (advocacy organization representing several private equity firms), *and* Lee A. Sheppard, *The Sun Capital Decision in Perspective*, TAX ANALYSTS, Sept. 27. 2013, http://www.taxanalysts.com/www/features.nsf/Articles/8B05403F5733231385257BF3004B0C78?OpenDocument.

9. I.R.C. §§ 1221–22 (2012); Fleischer, *supra* note 8.

10. I.R.C. § 1(a)–(h) (2012); Fleischer, *supra* note 8; Rosenthal, *supra* note 8, at 1459–60.

11. I.R.C. §§ 701, 702, 703(a)(1), 704(a) (2012); WILLIAM H. HOFFMAN, JR. ET AL., CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS 10-4 (2014).

12. I.R.C. § 1(a)–(h) (2012).

13. *See* Emily Thorton, *Private-Equity Paychecks May Set Record*, BLOOMBERG BUSINESSWEEK, Oct. 29, 2006, http://www.businessweek.com/stories/2006-10-29/online-extra-private-equity-paychecks-may-set-record.

14. I.R.C. § 1(a)–(e) (2012).

To retain their coveted classification as passive investors, private equity funds rely on the IRS to treat the stock of the companies that they invest in as a capital asset.[16] Property held for sale to customers in the ordinary course of a trade or business is *not* a capital asset.[17] Therefore, if private equity funds were treated as trades or businesses, a majority of the industry's income would be treated as ordinary income instead of capital gains. In other words, private equity's favorable tax treatment relies on an industry comprised of multibillion-dollar businesses not being treated as trades or businesses for tax purposes. Although not a tax case,[18] *Sun Capital* provides an opportunity for the IRS to start treating private equity funds as trades or businesses, thus stripping the industry of its tax windfall.[19] The First Circuit threatened the treatment by holding that one of the Sun Capital private equity partnerships was a trade or business for ERISA (Employee Retirement Income Security Act) purposes. Significantly, if the same rationale was applied for tax purposes—that is, if the IRS were to classify private equity funds as trades or businesses—funds could lose the passive investor status that entitles them to treat their income as capital gains.[20] More significantly, while the court limited its holding to ERISA contexts,[21] it relied heavily on a string of tax cases in finding that the fund was a trade or business.[22] *Sun Capital* and its potential impact on private equity is especially relevant considering American's growing inequality,[23] the ongoing debate over tax rates in general, and the favorable tax rates enjoyed by private equity fund managers.[24]

15. I.R.C. § 1(h)(1)(D) (2012).

16. I.R.C. §§ 1(h), 163(d)(5), 1231(a)(3)(A)(ii)(I), 1221(a)(1) (2012).

17. I.R.C. § 1221(a)(1) (2012).

18. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 148–49 (1st Cir. 2013) (reaching its conclusion by applying tax precedent to define "trade or business" for ERISA purposes).

19. *See* Solomon, *supra* note 8; *see also* Higgins v. Comm'r of Internal Revenue, 312 U.S. 212, 217 (1941) ("The Bureau of Internal Revenue has this duty of determining what is carrying on a business.").

20. *See* I.R.C. §§ 1(h), 163(d)(5), 1231(a)(3)(A)(ii)(I), 1221(a)(1) (2012).

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

22. *Id.* at 144–46.

23. Lowry, *supra* note 2; DeSilver, *supra* note 2; *Growing Apart*, *supra* note 2.

24. Solomon, *supra* note 8; *see generally* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); Richard Rubin & Jesse Drucker, *Romney's 13.9% Tax Rate Shows Power of Investment Tax Preference*, BLOOMBERG PERS. FIN., Jan. 24, 2012, http://www.bloomberg.com/news/2012-01-24/romney-paid-13-9-percent-tax-rate-on-21-6-million-2010-income.html; William Alden, *House Proposal Would Raise Taxes on Private Equity Income*, N.Y. TIMES, Feb. 26, 2014, http://dealbook.nytimes.com/2014/02/26/house-proposal-would-raise-taxes-on-private-equity-income/; Dan Primack, *The Case for Raising Taxes on Private Equity*, FORTUNE, July 8, 2011, http://fortune.com/2011/07/08/the-case-for-raising-taxes-on-private-equity/; D.M. Levine, *Obama Tax Plan Would Raise Taxes On*

The Obama administration has publically, and legislatively, criticized this benefit for several years.[25] However, attempts to legislatively change the favorable tax treatment have been stalled by a Congress strongly opposed to raising tax rates.[26] Now, as commentators suggest, *Sun Capital* may pave the way for the administration to bypass Congress and tax private equity funds as trade or businesses—making their income taxable at ordinary rates.[27] Whether or not the administration takes up the fight against some of the country's deepest pockets is another question.[28]

This note first provides a background of the private equity industry and its tax treatment, in an effort to illustrate the potential applicability of the *Sun Capital* rationale to tax situations. The note then discusses the decision itself, focusing on the line of tax cases analyzed by the court. Next, it argues that private equity funds should be taxed as trades or businesses. Finally, it addresses the policy issues, for and against, a change in treatment.

I. BACKGROUND OF PRIVATE EQUITY TAXATION AND THE SIGNIFICANCE OF "TRADE OR BUSINESS"

A. Private Equity in General

Private equity firms pool capital from investors—some wealthy individuals but mostly institutions and other funds—to purchase a controlling interest in the stock of companies with a goal of reselling it for a gain after a few years.[29] Because private equity firms typically organize as limited partnerships,[30] investors retaining the status of limited partner are absolved of any liability in excess of their investment.[31] Limited partners are not involved with the

Private Equity And Hedge Fund Chiefs, HUFFINGTON POST, Feb. 22, 2012, http://www.huffingtonpost.com/2012/02/22/obama-tax-plan_n_1294003.html.

25. Rubin & Drucker, *supra* note 24; Alden, *supra* note 24; Levine, *supra* note 24.

26. Solomon, *supra* note 8.

27. *See* Solomon, *supra* note 8; Fleischer, *supra* note 8; Rosenthal, *supra* note 8.

28. *See* Solomon, *supra* note 8.

29. *See* DONALD J. MARPLES, CONG. RESEARCH SERV., RS 22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS (2014) (The CRS report by Donald Marples is referenced heavily because the taxation of private equity funds is a hotly debated political topic, and the Congressional Research Services is a nonpartisan research body. Therefore, this report is referenced to avoid politically biased facts.); *see also* PEGCC, *supra* note 8 (The PEGCC is the advocacy institution for the private equity industry. This source is used throughout for two reasons: (1) because private equity is private (except for a few publically held partnerships), firms typically do not make much information public; and (2) by using the statements on the industry's advocacy organization's website to make arguments, the author aims to prevent opponents from claiming that fact statements herein inaccurately reflect the industry.).

30. MARPLES, *supra* note 29, at 2–3; Fleischer, *supra* note 8.

31. 68 C.J.S. Partnership § 557 (2014).

management of the invested funds or the companies purchased with them.[32] Often, and specifically in the case of the Sun Capital funds, the general partners are organized as partnerships or LLCs, not individuals.[33] Typically, management teams comprised of consultants are hired by the general manager from a parent organization to work on the purchased companies.[34] The parent organization is often organized as a corporation.[35] The general partners also typically contribute capital, but their primary contribution is in managing the fund's investments.[36] This layered entity approach serves to shield the funds' investors from tax, ERISA, and other obligations of the funds.[37]

General partners seek out struggling businesses, purchase them, and then reorganize and guide the businesses' strategies until they are resold for a profit or loss.[38] Often, management teams are assembled and specific strategic plans are designed prior to purchasing a company.[39] After a company is acquired, the management team works to increase the company's value by reorganizing the company's management, operations, and financial structure.[40] In the *Sun Capital* case, the funds' involvement in the investment company encompassed details as small as signing checks and holding meetings with staff to discuss operations, competition, and personnel decisions.[41]

B. The Taxation of Private Equity

Because private equity funds are organized as partnerships, they are not taxed at the entity level; partnerships are not taxable entities.[42] Instead, income or loss flows from the partnership without being taxed, to the partners, while

32. *Id.*

33. Amanda N. Persaud & Adrienne Atkinson, *Private Equity Finds: Legal Analysis of Structural, ERISA, Securities and Other Regulatory Issues*, *in* INVESTMENT ADVISER REGULATION 47-1, 47-10 (Clifford E. Kirsch ed., 3rd ed. 2012), *available at* http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.21704.12.pdf.

34. *See id.* at 47-4, 47-5.

35. *See* Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 133–35 (1st Cir. 2013) for an example of one such fund's structure.

36. Persaud & Atkinson, *supra* note 33, at 47-4, 47-5; MARPLES, *supra* note 29, at 3; Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate Developers*, *in* TAX NOTES 361, 361 (Jan. 21, 2013).

37. *See* Persaud & Atkinson, *supra* note 33, at 47-20, 47-21, 47-22.

38. MARPLES, *supra* note 29, at 1; *see also* Persaud & Atkinson, *supra* note 33, at 47-4.

39. Persaud & Atkinson, *supra* note 33, at 47-4; *see also Sun Capital*, 724 F.3d at 133–35 (explaining the Sun Funds' strategy).

40. MARPLES, *supra* note 29, at 1–2; *see also Sun Capital*, 724 F.3d at 133–35 (explaining the Sun Funds' strategy).

41. *Sun Capital*, 724 F.3d at 142.

42. I.R.C. § 701 (2012) ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.").

retaining its character.[43] This is commonly referred to as flow-through or pass-through treatment.[44] For example, if a partnership generates capital gains as opposed to ordinary income, the income flows to the partners' individual tax returns as capital gains.[45] In the case of private equity, firms purchase the stock of investment companies and then sell that stock a few years later, generating capital gains.[46] Under partnership tax principles, this income is distributed to the limited and general partners, all of whom report it as capital gains.[47]

Private equity funds and their partners save billions by being taxed at the preferential capital gains rate,[48] which of course, requires the sale of a capital asset.[49] In order to be considered a capital asset, stock *must not* be: (1) held by the taxpayer primarily for sale to customers, or (2) in the ordinary course of a trade or business.[50] Therefore, if the IRS applied the First Circuit's reasoning and classified private equity funds as trades or businesses, funds would be one step closer to losing the passive investor status that entitles them to capital gains.[51] The other step would be to treat the stock held by private equity firms as "held primarily for sale to customers."[52] Together, these two steps would end the favorable tax treatment of income generated by private equity funds.

II. THE *SUN CAPITAL* DECISION

A. The Structure of the Sun Capital Private Equity Firm

Sun Capital Advisers, Inc. (SCAI) is a private equity firm led by co-CEOs and sole shareholders Marc Leder and Rodger Krouse.[53] SCAI employs about 123 professionals to find investors and pool their money into funds organized as limited partnerships to purchase companies.[54] SCAI professionals select

43. *See* I.R.C. § 701 (2012); *see also* PEGCC, *supra* note 8 (explaining that income and losses "flow through" to each partner and are taxed at the individual level).

44. PEGCC, *supra* note 8.

45. *See* I.R.C. § 702(b) (2012) (explaining that tax attributes flow from the partnership to the individual partners); *see also* MARPLES, *supra* note 29, at 4.

46. MARPLES, *supra* note 29, at 1–2.

47. *Id.* at 4–5.

48. Solomon, *supra* note 8 (commenting that the heads of private equity firms pay billions of dollars less in taxes because capital gains are taxed at a rate about 20% less than ordinary income).

49. I.R.C §§ 1231 (2012).

50. Rosenthal, *supra* note 36, at 363 (citing I.R.C. § 1221(a)(1) (2012)).

51. *See generally* Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 137–49 (1st Cir. 2013) (explaining the First Circuit's reasoning regarding the meaning of "trade or business"); Rosenthal, *supra* note 36, at 365 ("[P]rivate equity funds are active enough to be in a trade or business.").

52. *See* Rosenthal, *supra* note 36, at 362–63.

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

54. *Id.*

investment companies for the funds to purchase and handle the negotiation and finalization of the deals.[55] Once deals are finalized, SCAI contracts with its subsidiary management companies to provide purchased companies with management and consulting services.[56] Like other private equity funds, the goal is to improve the value of the companies, then sell them for a profit.[57]

In *Sun Capital*, two SCAI-affiliated private equity funds (the "Sun Funds" or the "Funds") acquired Scott Brass, Inc. (SBI).[58] The Sun Funds had no offices or employees of their own, and were managed by SCAI-affiliated general partners.[59] The general partners held authority relating to hiring, terminating, and compensating employees and agents of SBI.[60] For their services, the general partners were entitled to an annual management fee equal to 2% of the total capital committed to the Funds.[61] Immediately after acquisition, the general partners managed the Funds using subsidiary management companies that employed SCAI professionals.[62] The management companies and SBI then entered into contracts whereby the subsidiary management companies provided SBI with the SCAI-employed professionals.[63] In return, SBI paid an annual fee to the management companies.[64] One of the Sun Funds received an offset or discount from the fees it owed the general partner in the amount of the fees paid to the management companies by SBI.[65] Therefore, in effect, that Fund received an additional return in the form of free management of its asset.[66]

B. Facts and the Raising of the "Trade or Business" Issue

Pursuant to a collective bargaining agreement, SBI had ongoing obligations to contribute to the New England Trucking and Teamsters Pension Fund (the "TPF")—a multiemployer pension plan.[67] At the time of acquisition, the Sun Funds received a 25% discount on the purchase price of SBI, due to the existence of SBI's unfunded obligations to the plan.[68] SCAI-affiliated consultants were involved in and informed of SBI's decisions regarding

55. *Id.*
56. *See id.* at 134.
57. *Id.* at 142.
58. *Id.* at 133–36.
59. *Sun Capital*, 724 F.3d at 134.
60. *Id.* at 142.
61. *Id.* at 135.
62. *Id.*
63. *Id.* at 136.
64. *Id.* at 135.
65. *Sun Capital*, 724 F.3d at 143 n.19.
66. *See id.* at 142–43.
67. *Id.* at 132, 135.
68. *Id.* at 135.

business operations, personnel, capital expenditures, and financing through 2007 and 2008.[69] In the fall of 2008, inventory write-downs caused SBI to breach its loan covenants.[70] Thereafter, SBI was unable to access the credit it needed to pay its bills, and it stopped making contributions to the TPF.[71] SBI then became liable for its share of the TPF unfunded benefits.[72] An involuntary bankruptcy proceeding was brought against SBI in November 2008, and the Sun Funds asserted that they lost their entire investment in SBI.[73]

In December of 2008, the TPF sent a demand note to the Sun Funds requiring payment from them for the unfunded withdrawal liability owed to it by SBI.[74] "[The] TPF asserted that the Sun Funds had entered into a partnership or joint venture in common control with SBI and were therefore jointly and severally liable for SBI's withdrawal liability under" ERISA.[75] Under the respective statute, "to impose withdrawal liability on an organization other than the one obligated to the pension fund, two conditions must be met: (1) the organization must be under common control with the obligated organization, and (2) the organization must be a trade or business."[76] In June 2010, the Sun Funds filed an action for declaratory judgment seeking declaration that they were not liable for SBI's withdrawal liability.[77] The Funds asserted that they did not meet either condition of the two-part test.[78]

Congress gave the Pension Benefit Guarantee Corporation (PBGC) authority to prescribe regulations as to the meanings of "common control" and "trade or business," but stipulated that any regulations "shall be consistent and coextensive with regulations prescribed for similar purposes [under the Internal Revenue Code]."[79] However, no regulations were adopted to define "trade or business."[80] The Internal Revenue Code also does not define the term "trade or business." Therefore, tax cases are the only related source of interpretation for the terms.[81] The only ERISA-related guidance available was a 2007 PBGC

69. *Id.* at 134–36.

70. *Id.* at 136 (explaining that the write-downs were caused by declining copper prices).

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

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* at 136–37. The specific ERISA provision is 1301(b), but that is not relevant to this discussion.

76. *Id.* at 138.

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

78. *Id.* The Sun Funds first sought to prove that they were not trades or businesses. They were successful at the district court. The TPF appealed bringing the case to the First Circuit.

79. *Id.* at 139. Because the PBGC adopted regulations pertaining to the meaning of "common control," the meaning of that phrase was not an issue.

80. *Id*.

81. *Id.* The phrase "trade or business" is used thousands of times in the Internal Revenue Code. This is likely why the IRS and the courts have refrained from giving it a definitive

appeals letter, which purported to derive its trade or business test from Supreme Court tax precedent.[82] However, the letter was denied validity by the district court.[83]

After its own trade or business analysis, the district court granted SBI's motion for summary judgment on the conclusion that the Funds were not trades or businesses.[84] The court reached that conclusion "relying on the fact that the Sun Funds did not have any offices or employees, and did not make or sell goods or report income other than investment income on their tax returns."[85] Further, the court found that the Sun Funds were not involved in the general partner's management of SBI.[86] The First Circuit reversed the district court's finding on this issue.[87]

C. The First Circuit's Trade or Business Analysis

In reversing the district court, the First Circuit came up with the "investment plus test" to conclude that the general partner was engaged in a trade or business.[88] Then, it applied agency principles to attribute the same conclusion to the limited partners.[89]

Under the court's investment plus approach, finding a trade or business requires continuous and regular activity, the intent to earn a profit, more than managerial attention to investments, and more than investment returns.[90] However, the court declined to provide specific factors for what satisfies the "plus," or how much "more" is required. The test itself is derived from a string of tax cases—*Higgins*, *Whipple*, and *Groetzinger*—all of which contribute to the investment plus test and help inform the inquiry into the "plus" factor.[91]

The test begins by employing principles from *Commissioner v. Groetzinger*, where the Supreme Court adopted a two-prong test to determine whether an activity was a trade or business: (1) the taxpayer must be involved in the activity with continuity and regularity, and (2) the taxpayer's primary

meaning—it may apply differently in different contexts. *See id.* at 137; Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 35 (1987).

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

83. *Id.*

84. *Id.*

85. *Id*. The First Circuit later characterized this reasoning as simplistic.

86. *Id.*

87. *Id.* at 129.

88. *Sun Capital*, 724 F.3d at 143. The court also noted that it would have reached the same conclusion without applying the investment plus test and analogized to a similar approach employed by the Seventh Circuit.

89. *Id.* at 147–48.

90. *Id*. at 144–45.

91. *Id.* at 146. The test was first developed by the PBGC in an appeals letter. *Id.*

purpose for engaging in the activity must be for income or profit.[92] This rule serves as the threshold for the investment plus test.

In *Higgins v. Commissioner*, an individual taxpayer sought to deduct expenses incurred in managing his large personal investment portfolio.[93] The portfolio consisted of permanent investments in real estate, stocks, and bonds.[94] The taxpayer rented offices, hired employees, and spent much of his own time managing the investments.[95] The Supreme Court held that the taxpayer was not engaged in a trade or business, and therefore, Higgins could not deduct his management expenses.[96] The Court ruled that managing one's investments, while collecting interest and dividends, is *not by itself* sufficient to constitute a trade or business. The Court further stipulated that this was true regardless of the size of the investment or the continuous nature of the work required in its management.[97] The *Higgins* Court also cautioned that determining whether or not a taxpayer's activities are a trade or business requires an "examination of the facts in each case."[98] Most importantly, in *Higgins*, the taxpayer *did not participate directly or indirectly in the management of the corporations in which he invested*.[99] Thus, *Higgins* carves out an exception to the *Groetzinger* test for passive investors. That is, those that provide *only* managerial attention to their investments are not engaged in a trade or business.

In *Whipple*, an individual taxpayer sought to deduct a bad debt that he made to one of his corporations as a business expense.[100] The taxpayer argued that because he furnished regular services to the corporation, he was engaged in a trade or business separate from that of the corporation.[101] The Supreme Court explained 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. . . . When 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 since investing is not a trade or business and the return to the taxpayer, though

92. *Id.* at 139; Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 35 (1987).
93. Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475, 478 (1941).
94. *Id.* at 476.
95. *Id.*
96. *Id.* at 478.
97. *Id.*
98. *Id.*
99. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 145 (1st Cir. 2013); *see Higgins*, 61 S.Ct. at 476.
100. Whipple v. Comm'r of Internal Revenue, 83 S.Ct. 1168, 1171 (1963).
101. *Id.* at 1174.

> substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.[102]

The *Sun Capital* court interpreted *Whipple* to require that profits must be distinct from those that a normal investor would receive in order to find a trade or business.[103]

In its analysis, the *Sun Capital* court first noted that the Sun Funds made investments in portfolio companies with the intent to earn a profit.[104] The court then identified several factors or activities, which in sum satisfied the "plus" in the investment plus test.[105] Much like the tax cases it purported to follow, the court cautioned that its analysis was very fact-specific[106] and that no specific factor was dispositive.[107] The relevant factors included: (1) the stated intent of the Sun Funds to seek out portfolio companies "that are in need of extensive intervention with respect to their management and operations, to provide such intervention, and then to sell the companies;"[108] (2) the broad powers given to the general partners to manage the portfolio companies, including hiring, terminating, and compensating the companies' agents;[109] (3) the Sun Funds' controlling interest in SBI, which allowed them to control the board by placing SCAI employees in two of the three board positions;[110] and (4) the discount or "offset" for the management fees that one of the Funds (Sun Fund IV) owed the general partner's management company.[111] The offset was equal to 50% of the fees Scott Brass owed the management company.[112] Notably, the court only found the Fund that received the fee offset to be a trade or business.[113] The

102. *Id.*

103. *Sun Capital*, 724 F.3d at 146. The court likely interpreted *Whipple* too narrowly. *See* discussion *infra.*

104. *Id.* at 141 ("Profits [were] made from the sale of stock at higher prices than the purchase price and through dividends.").

105. *See id.* at 141–43.

106. *Id.* at 141; *see also* Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 36 (1987) ("We adhere to the general position of the *Higgins* Court, taken 46 years ago, that resolution of this issue 'requires an examination of the facts in each case'" (citing Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475, 478 (1941))).

107. *Sun Capital*, 724 F.3d at 141.

108. *Id.* at 142.

109. *Id.*

110. *Id.* at 142–43 (noting that the intimate involvement in the management and operations of the company "goes well beyond that of a passive shareholder" and supports a conclusion that an organization is a "trade or business").

111. *Id.* at 143.

112. *Id*.

113. *Sun Capital*, 724 F.3d at 143.

court reasoned that the offset constituted a direct economic benefit that an ordinary, passive investor would not receive.[114]

The First Circuit then analogized to a Seventh Circuit case that employed similar factors, including "the stated intent in the creation of the enterprise," "the enterprise's legal form," its tax treatment, and the fact that the entity in question was a "for-profit" organization.[115] In fortifying its opinion, the court acknowledged that the Seventh Circuit's analysis would have provided the same outcome as the investment plus approach.[116]

The Sun Funds first argued that finding them to be trades or businesses would be inconsistent with *Higgins* and *Whipple*.[117] In rejecting the Funds' argument, the court relied partly on the *Groetzinger* Court's hesitancy to express a uniform definition of the phrase "trade or business" within the IRC.[118] The First Circuit also noted that the phrase is not required to be interpreted uniformly, only coextensively for ERISA and tax purposes.[119]

Next, the Funds argued that because the investment plus test relied on *Groetzinger*, which stated that it was consistent with *Higgins*, they cannot be trades or businesses, because that interpretation would be inconsistent with *Higgins* and its progeny.[120] The court denied the presence of such inconsistency, and distinguished the Sun Funds from both *Higgins* and *Whipple*, neither of which provided *per se* rules.[121]

The First Circuit distinguished *Higgins* primarily based on the Sun Funds' substantial participation in the management of SBI.[122] The court distinguished *Whipple* based on the management fees the funds channeled to the general partner, and subsequent offset received by Sun Fund IV.[123] The court emphasized the significance of the offset or discount, noting that Fund IV would otherwise have paid those fees to its general partner.[124] Thus, the

114. *Id.* (explaining that the fee offset saved Sun Fund IV $186,368 in management fees it otherwise would have paid its general partner for managing the investment in SBI).

115. *Id.* at 143–44.

116. *Id.* at 143.

117. *Id.* at 144.

118. *Id.* at 145 ("We are particularly convinced this is this is the case because the Supreme Court has been hesitant to express a uniform definition even within the code itself.") (citing Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23 (1987)).

119. *Sun Capital*, 724 F.3d at 145.

120. *Id.* at 144; *see also* Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23 (1987).

121. *Sun Capital*, 724 F.3d at 145; *see also Groetzinger*, 480 U.S. 23 (following *Higgins* to require a fact specific inquiry); *see also* Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475 (1941) (requiring a fact-specific inquiry).

122. *Sun Capital*, 724 F.3d at 145 (distinguishing the Sun Funds from *Higgins* based on the fact that the taxpayer in *Higgins* was operating under a different section of the tax code, and on the Sun Funds' participation in the management of the corporations they owned).

123. *Id.* at 146.

124. *Id.*

discount was an economic benefit that a normal investor would not receive.[125] This benefit seemed to convince the court that *Whipple*'s "without more" hurdle was cleared, and thus separated Fund IV from passive investor status.

The First Circuit concluded its investment plus analysis by noting that it is consistent with the test established in the line of tax cases—*Higgins*, *Whipple*, and *Groetzinger*.[126] According to the First Circuit's analysis, those cases collectively say that each case requires an examination of the facts, and providing *mere* managerial attention while receiving *only* investment returns, *without more* does not constitute a trade or business, even if the activity is engaged in for profit, and continuous and regular.[127] In *Sun Capital*, the court's investment plus test, simply put, found *more*.[128] The Funds provided greater management of the investment than in *Higgins*, and one Fund received returns that investors do not, thus satisfying *Whipple*.

D. The Court's Agency Analysis

Instead of stopping at the general partner level, the *Sun Capital* court took the issue a step further by applying agency principles to attribute the acts of the general partners in managing the Sun Funds to the Funds themselves.[129] The court did so by first applying Delaware partnership law, which makes the acts of one partner attributable to the partnership, if completed while carrying on in the ordinary course of the partnership's business.[130] Next, the court pointed to the Sun Funds' limited partnership agreements, which provided the general partners with exclusive and broad authority to manage and effectuate the Funds' purposes.[131] The court also noted that even without applying partnership law, the general partners' agreements create actual authority for the

125. *See id.*

126. *Id.*

127. Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475, 478 (1941) ("To determine whether the activities of a taxpayer are carrying on a business requires an examination of the facts in each case. . . . The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No 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 . . ."); Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 35 (1987) ("We accept the fact 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."); Whipple v. Comm'r of Internal Revenue, 83 S.Ct. 1168, 1174 (1963) ("Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged.").

128. *See Sun Capital*, 724 F.3d at 146; *Higgins*, 61 S.Ct. at 476 ("[Taxpayer] did not participate directly or indirectly in the management of the corporations in which he held stock or bonds.").

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

130. *Id.* at 147.

131. *Id.*

general partners to act on behalf of the portfolio companies.[132] The Sun Funds argued that the general partner entered into service agreements with SBI on its own behalf, and not as an agent of the Funds.[133] The court found that argument unpersuasive for two reasons.[134] First, the court noted that it was within the general partner's authority as a partner in the Funds' limited partnership to provide management services to SBI.[135] Second, because providing the management services was done on behalf of, and for the benefit of, the Sun Funds, the requisite principal-agent relationship was established, and the acts of the general partners as agents were attributable to the Funds.[136] This was true because the Funds had no employees of their own. Therefore, their stated purposes could only be achieved by the acts of agents.[137] Hence, the reason for the signing of the service contract between the management company and SBI immediately after SBI's acquisition was that the Funds simply could not act without hiring agents.[138] Additionally, the fee offset received by one of the Funds provided an economic benefit by reducing its expenses.[139] The court noted, "[t]he services paid for by SBI were the same services that the Sun Funds would otherwise have paid for themselves to implement and oversee an operating strategy at SBI."[140]

E. The First Circuit's Holding in Sun Capital

Because under Section 1301(b)(1) an employer must be a trade or business, the First Circuit reversed the district court's entry of summary judgment in favor of Sun Fund IV—the Fund that received the fee offset.[141] The court vacated the entry of summary judgment in favor of Sun Fund III and remanded for a determination of whether the Fund received any economic benefit from an offset that a typical investor would not.[142] Therefore, the court only determined that Sun Fund IV was a trade or business.[143] The court also acknowledged that its investment plus test leaves grey area as to where the line should be drawn between a passive investor and a trade or business.[144]

132. *Id.*
133. *Id.*
134. *Id.*
135. *Sun Capital*, 724 F.3d at 147.
136. *Id.* at 147–48.
137. *Id.* at 148.
138. *Id.*
139. *Id.*
140. *Id.*
141. *Sun Capital*, 724 F.3d at 148.
142. *Id.* at 148–49.
143. *Id.* at 149.
144. *Id.* at 148.

III. APPLYING *SUN CAPITAL* TO TAX LAW: PRIVATE EQUITY FUNDS ARE TRADES OR BUSINESSES FOR TAX PURPOSES

Although not a tax case, *Sun Capital* is significant in the tax context. First, by basing its reasoning on established tax law, the First Circuit laid a foundation of how such law can be applied to determine that private equity is a business. Second, because *Sun Capital* does not create tax precedent, future courts addressing the issue in tax contexts are free to adjust the reasoning. Finally, in keeping with the spirit of *Groetzinger*, the First Circuit's reasoning aligns with common sense. Private equity funds search for and acquire a controlling interest in struggling companies, and then rework the companies from the inside out in order to sell them for a profit. The fact that they use complex organizational structures and arrange for subsidiaries and other agents to actually do the work does not change that. Private equity funds *are in the trade or business* of developing corporations for profit. Yet, they avoid the classification of trade or business because the industry has been successful in masking the simple reality of what they do through sophisticated structuring. Much of this intricacy aims to prevent tax and other liability.[145] Meanwhile, the tax code and tax courts routinely assess situations by employing a substance-over-form approach.[146] The following argument outlines how courts should follow *Sun Capital*'s lead and apply common sense to parse through the complexity and classify businesses that make billions of dollars per year as businesses for tax purposes.

A. *The Tax Law*

Sun Capital correctly began its inquiry with the test provided in *Groetzinger*. To be deemed a trade or business, a taxpayer must be engaged in the activity with continuity and regularity, and with the intent to earn a profit.[147] In *Groetzinger*, the taxpayer gambled on dog races for sixty to eighty hours per week with a goal of earning a living.[148] When he netted a gambling loss for the year he sought to attribute it to a trade or business.[149] The Supreme Court allowed the deduction, and stated that it was applying a *common sense*

145. Rosenthal, *supra* note 8.

146. 26 U.S.C. § 7701(o) (2012) (The "economic substance doctrine" is the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.).

147. *Sun Capital*, 724 F.3d at 139; Comm'r of Internal Revenue v. Groetzinger, 480 U.S. 23, 35 (1987).

148. *Groetzinger*, 480 U.S. at 23.

149. *Id.*

approach to determining what is a trade or business.[150] It reasoned that the activity required skill, which the taxpayer applied in a constant and large-scale effort for the purpose of earning a living.[151] The *Groetzinger* Court also cautioned that it was not overruling or cutting back on *Higgins*.[152] In fact, the Court reinforced the *Higgins* requirement that a trade or business inquiry "requires an examination of the facts in each case."[153]

In a rather bare-bones opinion, the *Higgins*[154] Court refrained from setting forth elements, in addition to profit motive and regularity, that are required to render an activity a trade or business.[155] Instead, the Court deferred to the Bureau of Internal Revenue to determine what is carrying on a business.[156] The commissioner argued "that mere [personal] investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy."[157] Without engaging in its own analysis, the Supreme Court held that "[n]o matter how large the [estate] or how continuous or extended the work required may be, such facts are not sufficient [to constitute a trade or business]."[158] Notably, in *Groetzinger*, which relied on *Higgins*, the issue was again personal.[159] Therefore, *Higgins* should only apply in cases where the investments are of a personal nature to an individual taxpayer. Most importantly, Eugene Higgins *did not* participate directly or indirectly in the management of the corporations in which he invested.[160] The managerial attention referred to in the *Higgins* case was applied to his portfolio in general. Moreover, the repeated judicial direction to conduct a fact-specific inquiry shows that courts are hesitant to establish a broad rule. This is likely because they believe their outcomes would vary with even slight factual differences. For example, in the case of private equity, the entity in question is not an individual investing on his or her own behalf, but on the behalf of other individuals, funds, and businesses.

In *Whipple*, the taxpayer promoted and maintained several corporations. A.J. Whipple claimed to be in the trade or business of serving his corporations for the purpose of deriving future income through those corporations' trades or

150. *Id.* at 35.
151. *Id.* at 36.
152. *Id.* at 35.
153. *Id.* at 36 (citing Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475 (1941)).
154. *See* discussion of facts *supra* text accompanying notes 93–99.
155. *Groetzinger*, 480 U.S. at 29–30 (1987) (discussing Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475, 477–78 (1941)).
156. Higgins v. Comm'r of Internal Revenue, 61 S.Ct. 475, 478 (1941).
157. *Id.* at 477.
158. *Id.* at 478.
159. *See Groetzinger*, 480 U.S. 23.
160. *Higgins*, 61 S.Ct. at 476.

businesses.[161] The Supreme Court found that he did not engage in a trade or business of his own, and denied his claimed bad-debt deduction for a loan made to one of his corporations.[162] The Court held that Whipple's intent to derive income based on the future success of his corporations was *not* a trade or business distinct from that of the corporations.[163] Instead, the Court classified Whipple as an investor, which does not rise to the level of trade or business. In other words, *Whipple* distinguishes the activity of developing corporations to derive long-term[164] income from developing corporations to derive income from their sale.[165] The *Whipple* Court also hinted that the presence of more than one corporation might support a finding of a trade or business.[166] Therefore, according to *Whipple*, absent additional evidence, furnishing management and other services to corporations for income akin to that of an investor is not a trade or business.[167] However, the intent to earn a profit on the *sale* of corporations, and the presence of multiple corporations, in addition to providing management and other services, might provide this additional evidence.

The *Whipple* Court specifically distinguished *Giblin v. Commissioner* to arrive at its decision, distinguishing sales income from investment income. In *Giblin*, the taxpayer claimed to be in the business of seeking out businesses, promoting them, and investing both capital and time in them before selling them for a profit or loss. The Fifth Circuit found Vincent Giblin to be engaged in a trade or business.[168]

Courts take *Giblin* and *Whipple* together to provide the rule for determining whether a taxpayer is engaged in the trade or business of promoting, organizing, financing, and/or dealing in corporations.[169] That is, to qualify as a separate business, apart from the corporation itself, the activity must be conducted for a fee or commission, or with the immediate intent to sell the corporation at a profit in the ordinary course of that business.[170] *Deely v.*

161. Whipple v. Comm'r of Internal Revenue, 83 S.Ct. 1168, 1174 (1963).

162. *Id.* at 1168 (denying his attempt to deduct a bad loan made to one of his corporations).

163. *Id.* at 1174.

164. *See id.* (considering long-term income based on the success of a corporation as *investment* income, which is distinguished from sales income).

165. *Id.*

166. *See id.* ("To be sure, the presence of more than one corporation might lend support to a finding that the taxpayer was engaged in a regular course of promoting corporations for a fee or commission, [*or for a profit on their sale*,] but in such cases there is compensation other than the normal investor's return, income received directly for his own services rather than indirectly through the corporate enterprise.").

167. *Whipple*, 83 S.Ct. at 1174.

168. *Id.*; Giblin v. Comm'r of Internal Revenue, 227 F.2d 692, 696 (5th Cir. 1955).

169. Deely v. Comm'r of Internal Revenue, 73 T.C. 1081, 1093 (1980); *see also* Millsap v. Comm'r of Internal Revenue, 46 T.C. 751 (1966).

170. *Deely*, 73 T.C. at 1094.

Commissioner provided an example of a sale that was not immediate enough to qualify as income different from investment income. To constitute a trade or business, *Deely* required the taxpayer to show that the entities were developed with a view to a quick and profitable sale after each business had become established, rather than with a view to long-range investment gains.[171] The taxpayer asserted that his activities were in the trade or business of promoting, organizing, financing, and/or dealing in corporations.[172] However, he held only one of his sixteen profitable entities for less than six years, while holding the rest for periods between seventeen and thirty-nine years.[173] The court denied his bad-debt deduction based on its finding that he did not engage in the trade or business of dealing in corporations.[174] The court reasoned that an early resale shows that the profit is income received directly from services to the business.[175] On the other hand, an interest held for longer periods (like Deely's) shows that it is serving as an investment, with the returns tied to the success of the business.[176] The court reasoned that Deely only sold the unprofitable businesses that would not serve as successful long-term investments, and held on to the profitable businesses that would.[177] The *Deely* court took a very fact-specific approach as it looked past the taxpayer's actions to the intent underlying those actions.

B. Analysis: The Tax Law Applied to Private Equity

Private equity funds meet the *Groetzinger* test of being engaged in the activity with continuity and regularity with intent to earn a profit. Funds apply constant and large-scale efforts evidenced by the industry's enormous profits.[178] Fund managers and their agents work to improve the value of their companies in order to sell them for the production of income.[179] The IRS and future courts should follow *Groetzinger*'s common sense, fact-specific approach in determining whether private equity funds are trades or businesses.

Higgins should not shield private equity funds from common sense. Private equity funds are not personal investments. They are comprised of numerous investors, many of which are businesses and other types of institutional

171. *Id.* at 1094–95.
172. *Id.* at 1093.
173. *Id.* at 1094.
174. *Id.* at 1096.
175. *Id.* at 1093.
176. *Deely*, 73 T.C. at 1093–94.
177. *Id.*
178. *Performance Update: Private Equity Beats S&P 500 Over Long-Term*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/newsroom/in-the-news/pegcc-performance-update-private-equity-beats-sp-500-over-long-term/ (last visited Jan. 16, 2014).
179. PEGCC, *supra* note 8.

funds.[180] Therefore, they should not be protected by the *Higgins* exclusion for personal investments. Moreover, the *Sun Capital* court distinguished Higgins's lack of participation in the corporations he invested in from the Sun Funds' material participation in SBI. The IRS and future courts should likewise distinguish the material and substantial work private equity funds engage in to restructure their businesses. The managerial attention referred to in *Higgins* should be thought of as applying to his portfolio in general, while private equity funds actually manage the companies they invest in. Courts should apply *Groetzinger*'s common sense approach with *Higgins*'s fact-specific inquiry. If they did, like *Sun Capital*, they would find that because private equity funds are paid to develop corporations for other individuals and businesses, they are different from a single individual managing his or her estate.

Private equity funds engage in the trade or business of developing corporations under the rule prescribed by *Whipple*, *Giblin*, and *Deely*. Earning a fee, commission, or revenue from the sale of a corporation distinguishes those engaged in the business of developing corporations from mere investors. To be considered a sale, as opposed to an investment, the holding period must be short. The presence of multiple corporations also cuts towards finding a trade or business. Therefore, by requiring a fee or commission to find that Sun Fund IV was a trade or business,[181] the *Sun Capital* court read *Whipple* too narrowly. *Whipple* also stated income in the form of "profit on their sale" could show compensation other than normal investor returns.[182] Both Sun Funds invested in multiple corporations that they intended to sell in the short term. Industry wide, private equity firms invest in companies with the intent to resell their investments for a profit within three to seven years.[183] During the investment period, private equity firms place strategies and management teams in companies in order to improve their performance.[184] Moreover, funds invest in several companies simultaneously. Therefore, in a fact-specific inquiry, private equity funds satisfy *Whipple*, *Giblin*, and *Deely*, because they contribute substantial work to develop multiple corporations for a profit on their sale, in the short term.

180. *Value Creation*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/education/value-creation/ (last visited Jan. 25, 2015).

181. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 141 (1st Cir. 2013).

182. Whipple v. Comm'r of Internal Revenue, 83 S.Ct. 1168, 1174 (1963).

183. *Education*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/education/ (last visited Jan. 25, 2015).

184. *Id.*

IV. WHY *SUN CAPITAL MATTERS: A POLICY DISCUSSION*

As previously noted, the current treatment of private equity's income as capital gains is a significant tax advantage. Classifying private equity firms as trades or businesses would likely cause the industry to lose this treatment. Opponents of the treatment have lauded the First Circuit for its finding in *Sun Capital*, and now point to the IRS and the Obama administration to make the next move.[185] Proponents of private equity have downplayed the decision, highlighting the fact that it is an ERISA case that cannot be implicated to change "settled" tax law.[186]

Examining the policy arguments over private equity's tax treatment sheds light on why opponents are pointing to *Sun Capital* as a turning point, while the private equity industry simultaneously downplays its relevance. It is important to note, however, that the *Sun Capital* court somewhat blurred a fundamental distinction. That is, the difference between finding a fund's general partner versus an entire fund to be a trade or business. In *Sun Capital*, the pervasive control exerted over the funds by the general partners played a large part in finding the Funds, instead of just the general partners, to be trades or businesses. To reach its conclusion, the court comingled the acts of the general partners and the Funds themselves through agency principles. In policy terms, this comingling elevates the debate from the taxation of carried interest[187] to the taxation of entire private equity funds. Politicians, courts, and the press often criticize the treatment of carried interest as capital gains, but few have echoed the complaint in reference to the returns of limited partners.[188] Opponents of the tax break point to common sense, congressional intent, and fairness.[189] Proponents of private equity cite settled tax law, corporate formalities, and investment incentive.[190] The next sections assess the corresponding arguments presented by both sides.

A. Common Sense v. Settled Tax Law

Because the taxation of private equity relies on the funds being classified as passive investors, opponents of this classification argue that it simply defies common sense.[191] As previously discussed, the relevant tax precedent suggests that if a taxpayer has a profit motive, engages in the activity with continuity and regularity, provides more than managerial attention, and earns more than

185. Davidoff, *supra* note 8; Rosenthal, *supra* note 8, at 1466.

186. Judge, *supra* note 8.

187. Carried interest is the general partner's share of partnership profits. For a discussion of the taxation of carried interest *see generally* Fleischer, *supra* note 24.

188. *See generally* Fleischer, *supra* note 24.

189. Solomon, *supra* note 8; Rosenthal, *supra* note 8, at 1467.

190. Judge, *supra* note 8.

191. Rosenthal, *supra* note 8, at 1467.

normal investment returns, then he or she is more than a passive investor and engages in a trade or business.[192] Private equity's own lobbying organization states that "[c]arried interest is provided to the general partner in recognition of the *substantial* and *material work* required to restructure and direct the investments of the fund."[193] On its face, this language, as a general characterization of the industry, suggests that private equity funds provide more than mere managerial attention like that of a passive investor—they also conduct substantial and material work to improve the value of the companies. Therefore, opponents argue that treating private equity firms like passive investors for tax purposes runs contrary to common sense, and provides an undeserved tax windfall to an industry comprised of billionaires.[194] In fact, even some private equity managers have admitted that they cannot justify the favorable treatment. For example, Peter Peterson, cofounder of the Blackstone Group, one of the world's most profitable private equity funds, stated:

> I think if you make an investment with cash and you get a return, that should be capital gains. If you're a hedge fund and a private equity fund and you get your carried interest taxed at capital gains, I can't justify that, because it's a payment for services, and it ought to be taxed as income tax.[195]

Defenders of private equity's taxation, namely Steve Judge, president and chief executive of the Private Equity Growth Capital Council, dismissed the relevance of *Sun Capital*, saying "[t]he notion that a case involving [ERISA] could be interpreted as a tax case to change settled carried-interest tax law requires . . . many leaps of faith (and logic) that run counter to several important facts."[196] In his dismissal, Judge first seems to suggest that by limiting the holding to ERISA, the First Circuit barred other courts and the IRS from applying its reasoning. While the court did confine its holding to ERISA, the very tax cases underlying the court's reasoning initially applied only to tax law.[197] Thus, in citing *Groetzinger*, *Whipple*, and *Higgins*, the *Sun Capital* court illustrates how courts routinely use parallel reasoning when faced with the same or similar issues under varying areas of law. While Judge is correct

192. *See* discussion *supra* Part III.A.

193. *Tax Policy: Carried Interest*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/issues/private-equity-and-tax-policy/carried-interest/ (last visited Jan. 25, 2015).

194. Solomon, *supra* note 8; Victor Fleischer, *The Top 10 Private Equity Loopholes*, N.Y. TIMES, Apr. 15, 2013, http://dealbook.nytimes.com/2013/04/15/the-top-10-private-equity-loopholes/?_php=true&_type=blogs&_r=0; Rosenthal, *supra* note 8, at 1467.

195. Peter Lattman, *Peterson's Public Break From Private Equity's Line on Taxes*, N.Y. TIMES DEALBOOK, Nov. 29, 2010, http://dealbook.nytimes.com/2010/11/29/petersons-public-break-from-private-equitys-line-on-taxes/.

196. Judge, *supra* note 8.

197. *See* Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 146 (1st Cir. 2013) (citing *Groetzinger*, *Higgins*, and *Whipple*).

that *Sun Capital* is not binding tax law, that fact is certainly not a bar to applying the court's reasoning in other contexts, including future private equity tax cases, Treasury Regulations, or congressional enactments. After all, the same exact phrase—trade or business—is used in both contexts, and the ERISA legislation references the tax code's use of the phrase.

Judge later states that private equity "appropriately" treats the income derived from selling the stock of improved companies as capital gains.[198] He supports this conclusion by stating that the stock is a capital asset.[199] However, Judge stops short of explaining the appropriateness of this capital asset treatment. Instead, Judge skips this step, and asserts that "the income tax code has appropriately recognized since its inception, the sale of a capital asset creates a capital gain or loss, and that treatment flows through to the partners in the firm."[200] While accurate, Judge's statement is incomplete. It is helpful, however, at illustrating two weak points in private equity's argument. Most importantly, the explanation that Judge skipped would, of course, center on the definition of a capital asset, a discussion the industry is hoping to avoid, especially after *Sun Capital*. Second, Judge and other proponents of private equity's capital asset classification reason that because the law has allowed the classification, it must be correct and should continue. However, the classification has rarely been tested.[201] Due to limited IRS resources and the large size of private equity partnerships, funds are seldomly audited. The fact that an ERISA case revived a tax policy debate[202] shows that in a rare challenge, private equity's stance may not be as sure as the industry proclaims.

B. Congressional Intent v. Agency Principles

Another thing Steve Judge's *Dealbook* article did not do was assert that the tax code has, since its inception, consistently defined the term capital asset. That is not the case. Legislative history and Congressional intent illustrate that Congress did not intend to create a tax advantage for private equity funds. The preference for capital gains was initially added to encourage the sale of capital assets in order to raise tax revenue.[203] Without the preference, taxpayers were discouraged from selling assets they had owned for long periods, because they

198. Judge, *supra* note 8.

199. *Id.*

200. *Id.*; *see also Tax Policy: Partnership Taxation*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/issues/private-equity-and-tax-policy/private-equity-partnership-taxation/ (last visited Jan. 25, 2015).

201. Rosenthal, *supra* note 8, at 1460. Steven Rosenthal is a visiting fellow at the Urban Brookings Tax Policy Center and an expert on the taxation of private equity funds. His article, *Taking Private Equity Funds as Corporate Developers*, was cited by the First Circuit in *Sun Capital*.

202. *See* Rosenthal, *supra* note 8 and accompanying text.

203. H.R. REP. NO. 67–350, at 10–11 (1921).

would owe tax on the entire appreciation in value in the year of disposition.[204] Part of Congress's impetus in the reduced rate was, in fact, to collect revenue by encouraging the sale of assets.[205] Initially, any property held for profit or investment, with the exception of inventory, was a capital asset.[206] However, this definition was too broad, and taxpayers took advantage of the preference. For example, the sale of real estate, which was not inventory, but was often held in a business, was taxed as capital gain.[207] To tighten the requirements for an asset to qualify as capital, Congress added an exclusion from the definition of a capital asset for "[property] held primarily for sale in the course of a trade or business."[208] However, the addition of this broad exclusion from the definition of capital asset meant property held in a trade or business was taxed at ordinary rates.[209] This allowed traders engaged in the business of buying and selling stocks and bonds to deduct losses sustained in the markets from ordinary sources of income like salaries and rents.[210] For example, Wall Street bankers could deduct trading losses from their salaries. Because the effect on tax revenue was substantial, Congress added the words "to customers" after "property held primarily for sale."[211] Again, Congress changed the law of capital gains based on tax revenue concerns, not to incentivize private equity funds to invest.

The current definition of capital asset under section 1221(a)(1) excludes property held by the taxpayer for sale to customers in the ordinary course of his trade or business.[212] Because private equity funds do not consider the stock of investment companies held for sale to customers, and do not consider funds to be trades or businesses, they enjoy a substantial tax advantage.

To arrive at the conclusion that the Sun Funds were engaged in a trade or business, the First Circuit applied agency law to attribute the acts of a general partner to the funds.[213] This would also be required in a tax context. To find that the stock held by the funds is not a capital asset because it is held for sale to customers in a trade or business would require a court to attribute the acts of the general partner and management companies hired by the general partner to the funds. Defenders of private equity argue that such an application of agency

204. *Id.*
205. *Id.*
206. 136 I.R.A. §206(a)(6) (1921).
207. Rosenthal, *supra* note 36, at 362.
208. *Id.* at 363.
209. *Id.* at 362.
210. H.R. REP. NO. 72-708, at 12–13 (1932).
211. *Id.*; *see also* I.R.C. § 1221 (2012).
212. *See* I.R.C. § 1221 (2012).
213. Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 148 (1st Cir. 2013).

law is flawed and requires one to ignore corporate formalities.[214] However, as Rosenthal explains, "fund structures . . . are complicated, with layers and layers of entities, domestic and foreign, without apparent purpose, apart from tax and regulatory avoidance."[215] Moreover, courts evaluating tax questions often see through comparable confusion by applying a substance-over-form approach.[216] For example, the *Sun Capital* court focused heavily on the fact that the Funds did not have *any* employees, and therefore, *could not act*, except for through an agent. Further, in tax cases, courts have held that "activities performed on behalf of a principal by an independent contractor must be attributed to the principal even if there is no actual agent."[217] Even those who have downplayed *Sun Capital*'s applicability to tax law recognize that the attribution of a general partner's acts to the funds themselves is a thorny issue.[218] For example, Lee Sheppard, in his *Tax Notes* article, admitted,

> the tax law has no good explanation of what should be the treatment of active investors who get their hands dirty running portfolio companies and accept fees for services, but do not become employees of those companies. They wear a lot of hats, which make their investors vulnerable to agency arguments.[219]

In the end, despite its trial and error, Congress's original intent in taxing capital gains at a preferable rate was to raise revenue. The definition of capital asset has been revised several times in order to limit unintended loopholes and means by which taxpayers have discovered to lower their tax bills. Therefore, private equity should not be able to form hollow entities and contract around

214. Appellee's Response Brief at 33, Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312) ("At bottom, the Teamsters' legal theory amounts to little more than mushing together every entity that had 'Sun' in its name (or had someone from a Sun Entity acting on its behalf) and hoping that confusion will lead the Court to attribute every action of every Sun entity to the Sun Funds.").

215. Rosenthal, *supra* note 8, at 1459.

216. James S. Halpern, *Putting the Cart Before the Horse: Determining Economic Substance Independent of the Language of the Code*, 30 VA. TAX REV. 327, 328 (2010) ("The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.") (citing Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006)).

217. Brief of Amicus Curiae Pension Benefit Guaranty Corporation in Support of Appellant Requesting Reversal, Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312).

218. Sheppard, *supra* note 8, at 13 ("The bottom line is that Sun Capital does not put private equity investors in a trade or business for tax purposes.").

219. *Id.*

the actual substance of their businesses in order to enjoy lower tax rates than average, working-class Americans.[220]

C. Fairness v. Incentive to Invest

Opponents of private equity's income classification see this tax windfall as unfair. The subject of private equity's tax break made headlines during the 2012 presidential election when the public discovered that billionaire presidential candidate Mitt Romney's 2011 effective tax rate was 14.1%.[221] Like other private equity managers, Romney enjoys a tax rate lower than most middle-class Americans because his work—managing multibillion-dollar investment funds—is characterized as passive, and given favorable treatment as capital gains under the tax code's current classification.[222]

The fairness argument requires deciding whether it is a good idea to provide tax incentives to induce investment. The current legislative regime answers generally, yes. This is one reason why capital gains receive favorable treatment under the tax code. However, the general favor granted to capital gains can be distinguished from its use by private equity funds. "Private equity is just that: private."[223] That is, private equity is an exclusive investment vehicle for extremely wealthy individuals, businesses, and other funds such as endowments and pension plans. While working-class Americans may see indirect benefits of private equity investing, they are generally denied access to the lucrative investment opportunity. Considering that private equity has outpaced the S&P Index by 6.9% over the last ten years, the privilege of investing in private equity is substantial. [224]

To decide whether providing private equity with a tax incentive to invest merits favorable treatment, it is insightful to look at the recent trends in United States income inequality. Over the last thirty years, income inequality and, more importantly, wealth inequality in the United States has grown

220. *Compare Sun Capital*, 724 F.3d at 148 (noting that the Sun Funds had no employees, but claimed the general partner was not acting as their agent), *with Tax Policy: Carried Interest*, *supra* note 193 ("Carried interest is provided to the general partner in recognition of the substantial and material work required to restructure and direct the investments of the fund."). The PEGCC is the advocacy institution for the private equity industry. It is difficult to reconcile the Sun Funds and private equity's argument that the general partners are not substantively acting as agents of the funds. The *Sun Capital* court correctly rejected this contention.

221. Philip Rucker, Jia Lynn Yang & Steven Mufson, *Mitt Romney releases tax return for 2011, showing he paid 14.1 percent tax rate*, WASHINGTON POST, Sept. 21, 2012, http://www.washingtonpost.com/politics/decision2012/romney-earned-nearly-14-million-in-2011-paid-141-percent-tax-rate-campaign-says/2012/09/21/e62e5096-0417-11e2-91e7-2962c74e7738_story.html.

222. *Id.*; *see* I.R.C § 1(a)–(e) (2012).

223. Rosenthal, *supra* note 8, at 1459.

224. *Education: Fact and Fiction*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/education/fact-and-fiction/ (last visited Feb. 17, 2014).

dramatically.[225] The government, through both tax and monetary policy, has contributed to the widening gap between the nation's wealthiest individuals and everyone else.[226] The policy of providing favorable tax treatment to income derived from the sale of a capital asset, namely stock, provides a larger benefit to the wealthiest Americans, because they hold the overwhelming majority of stock.[227] Because the Federal Reserve's recent monetary policy has substantially bolstered equity markets, the two policies should be considered in concert when assessing their effects on inequality, and whether or not private equity should retain its favorable treatment.

In short, through asset inflation, the monetary policy has increased the value of stocks—which are held predominately by the rich—and the tax policy allows income from the sale of stock to be taxed at lower rates than wages earned by the majority of Americans. By holding interest rates low and conducting quantitative easing, the Federal Reserve has decreased the purchasing power of wage-earning Americans and increased the income of the wealthy.[228] The Fed's goal is to spur steady inflation by providing the economy with means to grow. Low interest rates make it cheap for businesses to borrow money, and quantitative easing or bond buying provides the economy with capital to expand. In a perfect world, businesses would expand in ways that decrease the unemployment rate and cause both wage and asset inflation. However, in reality, wages have not increased. In fact, real income, adjusted for inflation,[229] has declined since 2008. On the other hand, asset inflation (primarily in stock) has occurred. In 2013 the stock market underwent record gains.[230] The Fed's policy, as intended, has also caused modest, yet steady, inflation in consumer goods.[231] However, consumer price increases outpaced wage increases by 6.8 percentage points from 2007 to 2012.[232] Therefore, businesses are not employing capital in ways that increase employee wages, but are employing capital to inflate the value of stock, and thus the returns to those who sell inflated stock. Monetary economist Milton Freidman once said,

---

225. Mohamed El-Erian, *Inequality: America's Great Destroyer*, CNN MONEY, Jan. 29, 2014, http://finance.fortune.cnn.com/tag/income-gap/; THOMAS L. HUNGERFORD, CON. RESEARCH SERV., CHANGES IN THE DISTRIBUTION OF INCOME AMONG TAX FILERS BETWEEN 1996 AND 2006: THE ROLE OF LABOR INCOME, CAPITAL INCOME, AND TAX POLICY 1 (Dec. 29, 2011), *available at* http://fas.org/sgp/crs/misc/R42131.pdf.

226. El-Erian, *supra* note 225; Sheila Bair & Preston Cooper, *Why Low Inflation Hurts the 99%*, CNN MONEY, Jan. 29, 2014, http://finance.fortune.cnn.com/2014/01/29/inflation-fed/?iid=HP_LN.

227. Bair & Cooper, *supra* note 226.

228. *Id.*; El-Erian, *supra* note 225.

229. Bair & Cooper, *supra* note 226 (showing as measured by the Consumer Price Index).

230. Ben Rooney, *Stocks: Stellar year ends on a high note*, CNN MONEY, Dec. 31, 2013, http://money.cnn.com/2013/12/31/investing/stocks-markets/.

231. Bair & Cooper, *supra* note 226.

232. *Id.*

"inflation is taxation without legislation."[233] Taken literally, that proposition is holding true for the majority of Americans, excluding the wealthiest, which is also the group benefiting from private equity's tax break.

Still, those that consider private equity's tax break unfair must also recognize the benefits of providing incentives for investing. Private equity invested $87 billion in the United States during the third quarter of 2013 alone.[234] Almost 18,000 companies backed by private equity employ 7.5 million employees in the United States.[235] While opponents also cite the negative impacts some private equity funds inflict on the economy, there is no denying that the industry generates excellent returns for investors.

Many of those investors are tax-exempt entities, government pension plans, and employee retirement investment funds.[236] The private equity industry and its defenders insist that taxing the income of private equity funds as ordinary would decrease the returns to those investors.[237] While this is true to some extent, it is not contrary to congressional intent. For example, Steven Rosenthal explains that Congress added Unrelated Business Income Tax (UBIT) to charitable organizations in order to place them on equal footing with their for-profit counterparts.[238] In doing so, Congress excluded dividends and other revenues from UBIT, but subjected gains or losses from the sale of property primarily held for sale to customers in the ordinary course of a trade or business to UBIT.[239] Rosenthal, in his *Tax Notes* article, provides a more extensive discussion on the subject, as well as the effect a change in treatment would have on foreign investors. At bottom, Congress did not intend for nonprofit entities to obtain an advantage over private businesses in areas that are not specific to their purpose.

Much of the reason private equity has outpaced other investment vehicles can likely be attributed to the tax advantage the industry has over similar businesses.[240] Income from similar businesses taxed as corporations is taxed twice by the time their investor's receive it: first at the business's level, and second at the individual investor's level as dividends. While the single taxation of partnerships is a primary reason businesses (of all industries) organize as partnerships, private equity also has a tax advantage over other partnerships. Income from other partnerships engaged in trade or businesses are taxed at

233. *Id.*

234. *Education: PE by the Numbers*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/education/pe-by-the-numbers/ (last visited Feb. 17, 2014).

235. *Id.*

236. *Education: Value Creation*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/education/value-creation/ (last visited Feb. 17, 2014).

237. *Id.*

238. Rosenthal, *supra* note 8, at 1469.

239. *Id.*

240. *See* Fleischer, *supra* note 24, at 17.

ordinary levels. Because private equity is not considered a trade or business, its income is taxed at capital gains rates. However if private equity investing is truly as valuable as the industry portrays, returns should still be substantial, even if it were to lose this tax advantage.[241]

V. CONCLUSION

Currently, private equity enjoys a significant tax benefit because funds have been successful at employing *Higgins* as a shield to trade or business status, and courts have not often been called to weigh in on the issue. Given the opportunity, the *Sun Capital* court took a step in the right direction and distinguished the Sun Funds from the individual investor in *Higgins*. *Sun Capital* provides the IRS with support to change its stance on what is a trade or business. Private equity would undoubtedly challenge any such change. Like *Sun Capital*, future courts should start the analysis with *Groetzinger*, and then distinguish private equity funds from *Higgins*. However, they should also apply *Whipple*, *Giblin*, and *Deely* to classify funds that develop corporations for the purposes of earning a profit on the sale thereof as trades or businesses.

As noted above, stripping private equity of its capital gains treatment would also require a second step. The IRS would also need to classify the stock they hold to be held for sale to customers. This could be done through Treasury Regulations.

Congress never intended to provide private equity with a tax break. Further, while the Fed did not intend for its monetary policy to provide private equity with an advantage over average Americans, quantitative easing has had that effect. The Fed is currently tapering off quantitative easing. The IRS and courts should play their respective roles and classify private equity as trades or businesses to prevent the industry from enjoying an unfair advantage. Following *Groetzinger*'s common sense approach, private equity operates like a business, earns revenue like a business, and should also be taxed like a business.

RICHARD BAILEY*

241. James Surowiecki, *Private Inequity*, NEW YORKER, Jan. 30, 2012, http://www.newyorker.com/talk/financial/2012/01/30/120130ta_talk_surowiecki.

* Juris Doctor, Saint Louis University School of Law, expected May 2015.