CARRIED AWAY: *SUN CAPITAL*, POLITICS, AND THE POTENTIAL FOR A NEW SPIN ON "TRADE OR BUSINESS" IN PRIVATE EQUITY

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INTRODUCTION

Private equity partners have long enjoyed favorable capital gains taxation on returns through their characterization as passive investors. The First Circuit's recent decision addressing a private equity fund's pension withdrawal liability under ERISA, however, has simultaneously sparked concern and enthusiasm that a movement in the United States to end these tax breaks may come to fruition.[1] Both ERISA[2] and the Internal Revenue Code[3] (I.R.C.) share a phrasing of the designation, "trade or business," that private equity has successfully avoided until the recent *Sun Capital* decision.[4] The threat of the cross-application of "trade or business" from the ERISA to the I.R.C. context would mean an end to characterization of the profits of private

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[1] *See* Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund (*Sun Capital*), 724 F.3d 129, 132 (1st Cir. 2013); *see e.g.*, Rufus Rhoades & Alexey Manasuev, *Tax Effects of Sun Capital Partners III, LP for Non-U.S. Private Equity Funds*, 2013 EMERGING ISSUES 7127 (Dec. 13, 2013); Steven Davidoff Solomon, *A Chance to End a Billion-Dollar Tax Break for Private Equity*, N.Y. TIMES DEALBOOK (Oct. 22, 2013, 6:23 PM), http://dealbook.nytimes.com/2013/10/22/chance-to-end-billion-dollar-tax-break-for-private-equity/?_php=true&_type=blogs&_r=0. See *Employment Law—Pension Withdrawal Liability—First Circuit Holds Private Equity Fund Is "Trade or Business" Under Multiemployer Pension Plan Amendments Act.*— Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund, *724 F.3d 129, 132 (1st Cir. 2013)*, 127 HARV. L. REV. 1268 (2014) for a review of the First Circuit's decision and its potential implications to pension fund liability for private equity funds.

[2] Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), Pub. L. No. 96-364, 94 Stat. 1208 (codified as amended in scattered sections of 26 and 29 U.S.C).

[3] *See, e.g.*, I.R.C. § 1221(a)(1) (2012).

[4] 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/?_php=true&_ type=blogs&_r=0.

equity as capital gains, increasing tax rates for industry and impacting the value of the storied "carried interest" that funds use to compensate their general partners.

But could one circuit's decision, held strictly to an ERISA context, impact decades of tax jurisprudence? Perhaps not.[5] This Comment will examine, however, *Sun Capital* in light of notable developments in legal interpretation of the I.R.C. and other applications of "trade or business," as well as the underlying political and economic pressures that may just force the issue. Stemming from the financial crisis of the 2000s and amplified by public debate in the 2012 Presidential election, there appears to be political and public appetite for stripping private equity of its current tax advantages.[6] Furthermore, tax and legal scholars have long offered arguments for restructuring the tax treatment of carried interest,[7] even reassessing the interpretations of the I.R.C. to find that private equity partnerships are engaged in the business of *developing*, not investing.[8] Even Warren Buffet—beneficiary of the increased investment value that favorable capital gains rates provide—wrote a highly publicized opinion piece in the New York Times, pleading for taxation reform that moves away from the current, pro-investor structure.[9] Recent legislation and the President's budget proposals reflect a similar sentiment.[10]

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[5] *See* Ivan Mitev, *Sun Capital: Trade or Business Armageddon Talk*, PRIVATE EQUITY, VENTURE CAPITAL AND HEDGE FUND TAXATION (Aug. 9, 2013), *available at* http://fund-taxation.com/sun-capital-trade-or-business-armageddon-talk; Lee A. Sheppard, *News Analysis: The Sun Capital Decision in Perspective*, 2013 TAX NOTES TODAY 184-1 (Sept. 23, 2013).

[6] *See* Ben Weyl & Katy O'Donnell, *Carried Interest is Early Target for Tax Reformers*, CQ ROLL CALL, Mar. 11, 2014, *available at* 2014 WL 930061; *see also* Eduardo Porter, *The Great American Tax Debate*, N.Y. TIMES (Sept. 18, 2012), http://www.nytimes.com/2012/09/19/business/the-great-american-tax-debate.html; Jonathan Macy, *How Private Equity Works*, WALL ST. J. (Jan. 13, 2012), http://www.wsj.com/articles/SB10001424052970204124204577154521024107002.

[7] *See, e.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 51–55, 59 (2008) (discussing proposed reforms to the tax treatment of private equity funds, including the "Cost-of-Capital Method," and other possible reform strategies).

[8] *See* Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate 'Developers*,' 138 TAX NOTES 361, 361, 366 (2013).

[9] Warren E. Buffet, Op-Ed., *Stop Coddling the Super-Rich*, N.Y. TIMES, Aug. 14, 2011, at A21.

[10] *See* Joseph E. Bachelder III, *Carried Interests: Current Developments*, N.Y. L.J. (Jan. 6, 2014), *reprinted in* HARV. L. SCHOOL F. ON CORP. GOVERNANCE AND FIN. REG. (JAN. 16, 2014, 9:17 AM), https://blogs.law.harvard.edu/corpgov/2014/01/16/carried-interests-current-developments/; *see also* OFFICE OF MGMT. & BUDGET, EXEC.

This swell of criticism and focus on the structure of private equity taxation does not change the reality, however, that many experts remain resolute in their defense of carried interest and its necessity in the private equity industry, which, they argue, benefit the U.S. economy as a whole.[11] Absent capital gains treatment, funds would face increasing difficulty to maintain a return rate commensurate to the high-risk nature of private equity investments.[12] Furthermore, international, tax-exempt, and passive investors may be dissuaded from contributing capital to funds and funnel capital outside of the U.S.[13] Accordingly, the conclusion of this Comment will examine the potential impacts of a change to the structure of private equity, investors and their involvement in the U.S. market, and the policy differences between ERISA and the I.R.C. that make cross-application of the term "trade or business" both unlikely and untenable.

a. Brief Overview of Private Equity and Carried Interest

The tax treatment of private equity returns and carried interest as capital gains has been the source of considerable controversy following the U.S. financial crisis[14] and 2012 Presidential election,[15] and is the focus of the regulatory, political, and legal developments and debate surveyed in this comment. It is important, first, to distinguish private equity from other investment vehicles in order to understand the regulatory framework and markets in which private equity funds operate. Although private equity funds' activities are by nature diverse and vary in regard to the investments in which the funds take part, there are

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OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2016 (2015), *available at* http://www.whitehouse.gov/omb/budget/.

[11] *E.g.*, Pam Hendrickson, *Think Twice Before Raiding Carried Interest*, WALL ST. J. (Apr. 9 2013, 7:24 PM), http://www.wsj.com/articles/SB10001424127887324100904578401171430290446.

[12] JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE & OPERATIONS § 2.02 (2013).

[13] *See 'Sun Capital' Could Affect Both Main Street, Wall Street, Analyst Says*, DAILY TAX REP.: BLOOMBERG BNA (Oct. 2, 2013), http://www.bna.com/sun-capital-affect-n17179877488/.

[14] *See, e.g.*, Macy, *supra* note 6.

[15] *See* Joshua Green, *Jeb Bush Has a Mitt Romney Problem*, BLOOMBERG POL. (Dec. 11, 2014, 5:00 A.M.), http://www.bloomberg.com/politics/features/2014-12-11/jeb-bush-has-a-mitt-romney-problem; Weyl & O'Donnell, *supra* note 6; *see also* Porter, *supra* note 6.

some general realities about private equity that dictate its operation and influence in capital markets.[16] Broadly speaking, private equity funds are "pooled investment vehicles that raise equity capital in the less heavily regulated, private capital markets."[17] These funds acquire other "portfolio" companies—typically underperforming or showing a potential for growth—and invest "capital, time and effort to improve the company's performance and increase its overall value."[18] Private funds target companies at varying stages of development,[19] including, for example, start-ups in which the fund provides venture capital, "management, financial and operational expertise."[20] Finally, there is no set criteria to the types of industry, level of involvement, or size of the company a fund may undertake; funds may pursue investments in "real estate, commodities, derivatives and financial instruments[,]"[21] all managed with the intention to sell at a profit after what is typically a long-term holding period.[22] As its name suggests, the funds' equity investment in a company can only be recouped if the company's performance or value is improved.[23] Investors expect higher returns relative to public market investments in light of the higher risk associated with this form of investment.[24]

Private equity funds are structured as limited partnerships in which investors become limited partners, contribute capital, and defer management of the fund to a general partner.[25] "The

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[16] *See* SCHELL ET AL., *supra* note 12, at § 1.01.

[17] *Id.*

[18] *Education: The Private Equity Investment Model*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/education/ (last visited Feb. 15, 2014).

[19] Steven M. Rosenthal & Andrew W. Needham, *Taxing PE Funds and Their Partners: A Debate on Current Law*, 139 TAX NOTES 1327, 1328 (2013).

[20] SCHELL ET AL, *supra* note 12, at § 1.01; *see generally id.* at § 1.01–1.11 (offering a more comprehensive survey of the different types of private equity funds (hedge funds, leveraged buy-outs, etc.)).

[21] *See id.* at § 1.01.

[22] *See* Fleischer, *supra* note 7, at 9, 14–15, 18; *see also* PRIVATE EQUITY GROWTH CAPITAL COUNCIL, *supra* note 18 ("funds typically invest in companies for three to seven years before selling them, hoping to realize a gain on the sale as a result of the increased value they have created during their period of ownership.").

[23] Macy, *supra* note 6. *But see* James Surowiecki, *Private Inequity*, NEW YORKER (Jan. 30, 2012), http://www.newyorker.com/talk/financial/2012/01/30/120130ta_talk_surowiecki (explaining that some private equity funds have taken advantage of acquired companies' abilities to borrow in order to pay themselves "special dividends").

[24] SCHELL ET AL., *supra* note 12, at § 2.01[1].

[25] *See, e.g.*, Fleischer, *supra* note 7, at 8.

general partner, in turn, creates a wholly owned management company to administer the fund and manage the portfolio company."[26] The management fee paid to the management company (or directly to the general partner[27]) is "usually two percent of the fund's committed capital."[28] The general partner receives a right to share in a set percentage of the funds' profits, commonly twenty percent, referred to as profit interest or "carried interest."[29] The "carry" lies in the fact that managers are not taxed upon receipt of the profit interest,[30] but upon its distribution. Carried interest is paid once the limited partners receive their guaranteed investment return.[31]

Under current tax law, the purchase of a portfolio company represents an investment, making the company a capital asset.[32] Accordingly, gains realized through the sale of a portfolio company are treated as capital, a characterization that is subsequently attributed to the gains received by the fund's partners.[33] Carried interest also receives capital gains treatment,[34] affording the general partner considerable tax advantages in addition to performance incentives—the larger the profit earned by the fund, the greater the value of the carried interest.[35]

b. Capital Gains

A capital gain is a recognized gain from the disposition of a capital asset through the sale or exchange of taxpayer property that is not held for sale to a customer.[36] These gains are distin-

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[26] Steven M. Rosenthal, *Private Equity is a Business: Sun Capital and Beyond*, 140 TAX NOTES 1459, 1461 (Sep. 23, 2013) [hereinafter Rosenthal, *Sun Capital and Beyond*].

[27] See Section II.e. *infra* for discussion of management fee offsets.

[28] Fleischer, *supra* note 7, at 8.

[29] *Id.* The general partner is usually structured as a limited liability company organized and owned by the limited partners. *See* SCHELL ET AL., *supra* note 12, at §1.01.

[30] Rev. Proc. 93-27, 1993-24 I.R.B. 63; *see also* Rev. Proc. 2001-43, 2001-34 I.R.B. 191.

[31] Hendrickson, *supra* note 11.

[32] *See id.*

[33] Bachelder, *supra* note 10.

[34] *See* Rev. Proc. 2001–43, 2001-34 I.R.B. 191, § 4 (addressing the treatment of carried interests as capital gains); *see also* Rosenthal & Needham, *supra* note 19, at 1328.

[35] *See* Solomon, *supra* note 1; Fleischer, *supra* note 7, at 3.

[36] I.R.C. § 1221 (2012); RABKIN & JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION, § 34.01–02 (Matthew Bender 2015).

guished from ordinary income and taxed at a lower rate; typically fifteen to twenty percent.[37] Investments, such as stocks, are treated as capital assets, and afforded capital gains treatment upon their sale.[38]

Capital gains taxation first appeared in Revenue Act of 1913, which taxed capital gains at rates commensurate to ordinary income until it became apparent that heightened tax rates of World War I were stifling property sales across the country.[39] The Revenue Bill of 1921 applied a flat tax of 12.5% on capital gains (contrasted to ordinary income rates of approximately 70%) in order to encourage the sale of appreciated assets.[40] This initial policy objective remains the cornerstone for the justification of capital gains treatment: incentivizing savings, investment, and economic activity.[41]

The definition of capital asset provided in the I.R.C. is exclusionary, specifically restricting the taxpayer from characterizing gains from the sale of property held for "sale to customers [or use] in the ordinary course of his trade or business."[42] Such gains are instead treated as ordinary income, subject to full taxation rates.[43] Whether an activity constitutes a trade or business is not defined in the tax code, and courts therefore must engage in a factual inquiry in order to make that determination.[44] For those persons for whom investing represents the base of their

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[37] I.R.C. § 1(h); *see* I.R.C. § 1221; Rodney P. Mock & Jeffrey Tolin, *I Should Have Been a Rockstar: Deconstructing Section 1221(A)(3)*, 65 TAX LAW. 47, 50–53 (2011).

[38] *See, e.g.*, DEP'T OF THE TREASURY, I.R.S. PUBLICATION 550, *Investment Income and Expenses (Including Capital Gains and Losses)* (Feb. 12, 2015), *available at* http://irs.gov/pub/irs-pdf/p550.pdf.

[39] Anita Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX J. 12, 14–15 (1949), *available at* http://www.jstor.org/stable/41789799. "The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) . . . ." *Id.* at 15 n.8 (quoting COMM. ON WAYS AND MEANS, REPORT ON REVENUE BILL OF 1921, NO. 67-350, at 10–11 (1921)).

[40] *Id.* at 15; *see also* Van Mayhall, *Capital Gains Taxation*, 41 LA. L. REV. 81, 87 (1980) (providing historical background to the Revenue Bill of 1921).

[41] *Cf.* THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R40411, THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION (2010), *available at* http://www.fas.org/sgp/crs/misc/R40411.pdf (examining historical justifications for capital gains treatment).

[42] I.R.C. § 1221(a)(1)–(2) (2012).

[43] *See* I.R.C. § 1 (listing the applicable tax rates imposed on income derived from various incomes and taxpayers).

[44] Higgins v. Commissioner, 312 U.S. 212, 217 (1941).

income, the question has been presented as to whether or not investing may be considered their "trade or business," specifically in the context of taking business deductions.[45] The following section reviews these decisions in detail.

I. JUDICIAL INTERPRETATIONS OF "TRADE OR BUSINESS" IN THE TAX CODE

> [T]he difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our 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.[46]

The below surveyed cases provide the current United States Supreme Court case law addressing the interpretation of a "trade or business" in investment contexts. This background is particularly relevant to both the arguments concerning capital gains treatment for private equity examined later in this comment and the underlying reasoning for both the PBGC and *Sun Capital* decisions.

a. Higgins v. Commissioner[47]:

In *Higgins*, the question of whether "investing" constituted trade or business for income tax purposes was reviewed by the Supreme Court. The petitioner taxpayer held and managed "extensive investments in real estate, bonds and stocks," hiring employees and renting office space to assist in the management of those investments.[48] The petitioner did not directly or indirectly manage any of the firms or corporations in which he held stock.[49] When the petitioner deducted expenses in connection with the managements of his investments, those deductions were refused by the Commissioner and later the Board of Tax Appeals[50] where both found that the petitioner's investment activities did not constitute a carrying on of a business.[51] On appeal,

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[45] *See id.* at 213–15. *See generally* I.R.C. § 162 (defining allowable business expenses).

[46] Comm'r v. Groetzinger, 480 U.S. 23, 36 (1987).

[47] 312 U.S. 212 (1941).

[48] *Id.* at 213.

[49] *Id.* at 214.

[50] Higgins v. Comm'r, 39 B.T.A. 1005, 1012, 1015 (1939) (citations omitted).

[51] *Higgins*, 312 U.S. at 215.

the Supreme Court examined whether extensive, continuous investment activity, such as that of the petitioner, could be considered a trade or business under the tax code.[52] The Court acknowledged the continuity and regularity of the taxpayer's activities in managing his investments, but ultimately agreed with the tax court that the management of investments could not be considered a trade or business.[53]

This case is widely cited for its proposition that the management of one's own investments, no matter how meticulously attended to by the taxpayer, cannot be considered a trade or business for purposes of business deductions under the tax code.[54] Because the Court explicitly noted that the petitioner in *Higgins* was a passive investor and did not participate in the management of any of the funds in which he owned stock, this decision has also been cited to distinguish precedent and support the treatment of private equity as a trade or business.[55] Both the *Sun Capital*[56] and 2007 PBGC Board private equity decisions distinguish their facts from *Higgins*, as will be discussed below.

b. Whipple v. Commissioner[57]:

Distinct from the passive investor in *Higgins*, *Whipple* required the Court to decide whether a "petitioner's activities in connection with several corporations in which he [held] controlling interests" could be characterized as a trade or business in order to allow the petitioner to deduct debts incurred from the interests as bad debts.[58] Worthless debts other than "nonbusiness debts" were deductible in full under the code.[59] Nonbusiness debt, however, was defined "in part 'as a debt . . . other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business'" was not deductible.[60]

The taxpayer previously worked as a construction superintendent, forming several corporations and participating as a

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[52] Id. at 216–17. "To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case." *Id.* at 217.

[53] *Id.* at 218.

[54] *See*, *e.g.*, Comm'r v. Groetzinger, 480 U.S. 23, 30 (1987).

[55] *See* Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1464–67.

[56] *Sun Capital*, 724 F.3d 129, 145–46 (1st Cir. 2013).

[57] 373 U.S. 193 (1963).

[58] *Id.* at 194–95*; see* I.R.C. § 23(k)(1) (1939) (current version codified at I.R.C. § 166 (2012)).

[59] *Whipple*, 373 U.S. at 194 (citing § 23(k)(1)).

[60] *Id.* at 194 (citing § 23(k)(4)).

member in them.[61] The taxpayer eventually sold those corporations and formed several new corporations, including Mission Orange Bottling Co. of Lubbock, Inc.[62] Additionally, he purchased the assets of a sole proprietorship in the bottling business, which he ran for a short period of time before selling its equipment to Mission Orange Bottling Co.[63] The taxpayer also leased land and made cash advances to Mission Orange Bottling Co., for which he subsequently never received rental payments or loan reimbursements.[64] The taxpayer deducted those debts owed to him by the corporation as bad business debt.[65] The Commissioner assessed deficiencies for those deductions, and subsequent appeals sustained the deficiencies, confirming that the taxpayer "was not in the business of organizing, promoting, managing or financing corporations, of bottling soft drinks or of general financing and money lending."[66]

The Court granted certiorari to resolve a circuit split on the issue of whether if a "taxpayer furnishes regular services to one or many corporations, an independent trade or business of the taxpayer [is] shown."[67] The Court noted that "investing is not a trade or business" and "[d]evoting ones 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."[68] Additionally, "furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business."[69]

Turning to the taxpayer's case, the Court agreed that an investor may also maintain an independent trade or business, but that "care must be taken to distinguish bad debt losses arising from his own business and those . . . peculiar to an investor . . . participating in[] the conduct of the corporate business."[70] The Court found that the taxpayer did not make this distinction, and agreed with the lower courts that the taxpayer's activities were

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[61] *Id.* at 195.
[62] *Id.*
[63] *Id.* at 195–96.
[64] *Id.* at 196.
[65] *Whipple*, 373 U.S. at 196–97.
[66] *Id.* at 197 (citing Whipple v. Comm'r, 301 F.2d 108 (5th Cir. 1962)).
[67] *Id.* at 197, 201–02.
[68] *Id.* at 202.
[69] *Id.* at 203.
[70] *Id.* at 202.

intended to enhance his investment, not to "develop[] the corporations as going business for sale to customers in the ordinary course [of business]."[71] Accordingly, the Court affirmed, holding that the taxpayer's activities conformed with those of an investor and therefore the debts in question were not incurred in the course of a trade or business so as to be deductible.[72]

In the private equity context, *Whipple* is cited to support the proposition that general partners' services represent only investment activity because the general partner's "compensation" for his management and attention to the companies in which the funds invest is simply a percentage return on his investment.[73] *Whipple*, however, has also been used to distinguish private equity general partners from the average, "interested investor." Examined below, commentators stress that the *Whipple* Court's focus on a taxpayer's lack of intent to sell the corporations he managed to a customer in the ordinary course of business is distinguishable from private equity general partners, whose end goal is almost always to effect a profitable sale of the portfolio corporation.[74] Additionally, the *Sun Capital* and 2007 PBGC Board decisions both use the "without more" language in *Whipple* to support their use of an "investment plus" approach to analyzing private equity managers' activity as a trade or business.[75]

c. Corn Products Refining Co. v Commissioner[76]:

In *Corn Products*, the Court examined whether or not commodities futures[77] purchased by a corn product refining company should be considered capital assets for purposes of assessing gains and losses.[78] In the 1930s, droughts in the "corn belt" increased the price of spot corn, threatening Corn Products

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[71] *Whipple*, 373 U.S. at 202–03.

[72] *Id.* at 203.

[73] *See, e.g.*, Dagres v. Comm'r, 136 T.C. 263, 281 (2011) (citing *Whipple,* 373 U.S. at 203) (a "common factor for distinguishing mere investment from conduct of a trade or business has been compensation other than the normal investor's return").

[74] Fleischer, *supra* note 7, at 9; Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1464.

[75] *Sun Capital*, 724 F.3d 129, 146 (1st Cir. 2013) ("It is difficult to see why the *Whipple* 'without more' formulation is inconsistent with an MPPAA 'investment plus' test.").

[76] 350 U.S. 46 (1955).

[77] "A commodity future is a contract to purchase some fixed amount of a commodity at a future date for a fixed price." *Id.* at 47 n.1.

[78] *Id.* at 48–50.

Refining Company ("the company") with a situation in which it would not be able to purchase sufficient amounts of corn to support its refining operations.[79] The company thus purchased corn futures, selling only when shortages appeared and to the extent required to achieve its spot grinding, often realizing a sizeable profit from its futures dealings.[80] The company argued that the futures were capital assets held for investment, and that its futures trading was separate and apart from its regular refining activities.[81]

The court of appeals disagreed, finding that the futures trading was not a separate investment transaction, but instead "an integral part of [the company's] business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future manufacturing."[82] The company argued that the futures transactions were instead hedging, and the Supreme Court granted certiorari to examine whether or not "transactions in commodity futures which are not 'true hedges' capital asset transactions and thus subject to the limitations of Section 117" or if the gains and losses result in ordinary income.[83]

In its analysis, the Court noted that the company's corn futures were not explicitly listed in I.R.C. § 117 exclusions such as a "stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business."[84] The Court stressed, however, that Congress's purpose in giving preferential treatment to capital asset transactions was not intended to extend to "profits and losses arising from the everyday operation of a business."[85] The Court found that permitting capital gains treatment for the company's futures transactions would thwart this policy objective, as the company's futures transactions were conducted to insure the company's manufacturing supply, inseparable from its everyday operations.[86] The Court noted that to hold otherwise would create a loophole in which a hedger could choose tax treatment of his transactions as desired, taking

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[79] *Id.* at 48.
[80] *Id.* at 48–49.
[81] *Id.* at 49.
[82] *Corn Products*, 350 U.S. at 50.
[83] *Id.* at 47 n.2, 51.
[84] *Id.* at 52.
[85] *Id.*
[86] *See id.* at 52–54.

delivery under the futures contract for ordinary income or selling the future on the market at a capital gain or loss.[87] Therefore, the Court held, "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly" in order "to effectuate the basic congressional purpose."[88]

Although *Corn Products*' holding was narrowed under *Arkansas Best Corp. v. Commissioner*,[89] it remains widely cited for its language supporting broad exclusions of the definition of capital assets and the distinction between holdings that are operative in nature, inseparable from the core business of the taxpayer, and investments separate from the trade or business of the taxpayer.[90]

d. Commissioner v. Groetzinger[91]:

In *Groetzinger*, the Court reviewed whether or not "a full-time gambler," operating for his own benefit, was engaged in a trade or business so as to deduct his expenses under I.R.C. § 162.[92] The taxpayer engaged in gambling activity "6 days a week for 48 weeks in 1978 . . . [and] spent a substantial amount of time studying racing forms, programs, and other materials."[93] This resulted in the taxpayer spending approximately 60–80 hours per week on gambling, with a view to earning his living through gambling winnings.[94] Despite winning $70,000 and betting $72,032 in 1978, the taxpayer did not include his winnings or losses on his tax return, and the Commissioner assessed this activity as income not from a trade or business, asserting a deficiency that the taxpayer later appealed to the Tax Court.[95] The Tax Court held that the taxpayer's gambling constituted a trade or business,[96] the Seventh Circuit affirmed,[97] and the United

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[87] *Id.* at 53–54.

[88] *Corn Products*, 350 U.S. at 52.

[89] 485 U.S. 212, 223 (1988) (approving the broad reading of capital asset exclusions under *Corn Products* that excluded the corn futures deemed an integral part of the refinery's business).

[90] *See, e.g.*, MeadWestvaco Corp. v. Ill. Dep't of Revenue, 553 U.S. 16, 29 (2008).

[91] 480 U.S. 23 (1987).

[92] *Id.* at 24.

[93] *Id.*

[94] *See id.* at 24 n.2, 24–25.

[95] *Id.* at 25–26.

[96] Groetziner v. Comm'r, 82 T.C. 793, 803 (1984).

[97] Groetzinger v. Comm'r, 771 F.2d 269, 277 (7th Cir. 1985).

States Supreme Court granted certiorari to review.[98]

Noting the lack of a defined standard for "trade or business" and giving deference to the factual inquiry called for in *Higgins*, the Court prefaced its holding by stating: "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."[99] Applying those factors to the taxpayer, the Court determined that the taxpayer's gambling was "pursued full time, in good faith, and *with regularity*, to the production of income for a livelihood . . . [, and] it [was] a trade or business."[100]

The reasoning employed in *Groetzinger* is cited as a two-prong test for whether a taxpayer is engaged in a trade or business.[101] Under the *Groetzinger* test, a court reviews 1) whether the taxpayer conducted the activity in question with continuity and regularity, and 2) whether the primary intent of the taxpayer for engaging in the activity at issue was for generating income or profit.[102] The conclusions reached by the 2007 PBGC Appeals Board and the First Circuit in *Sun Capital* both applied this test to private equity funds' general managers in an ERISA context in order to reach their conclusions that the fund was engaged in a trade or business.[103]

The *Groetzinger* test's efficacy in application to private equity, however, remains circumspect as *Groetzinger* specifically noted that its holding would not "cut back on the Court's holding in *Higgins*."[104] The *Groetzinger* Court used its two part test to distinguish whether the taxpayer's gambling rose to the level of a trade or business as opposed to a hobby, an analysis distinct from the *Higgins* inquiry of whether a taxpayer's management of

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[98] *Groetzinger*, 480 U.S. at 26.

[99] *Id.* at 35–36.

[100] *Id.* at 35 (emphasis added).

[101] *See, e.g.*, Cent. States Se. & Sw. Areas Pension Fund v. Messina Prods., LLC, 706 F.3d 874, 878 (7th Cir. 2013). *But cf.* Carpenters Pension Trust Fund for N. Cal. v. Lindquist, 491 F. App'x 830, 831 (9th Cir. 2012) (holding that the *Groetzinger* test was not required to interpret § 1301(b)(1)).

[102] *Messina Prods.*, 706 F.3d at 878.

[103] *See Sun Capital*, 724 F.3d 129, 139, 149 (1st Cir. 2013); Section II.c *infra* (analyzing the PBGC Board decision).

[104] *Groetzinger*, 480 U.S. at 35.

his investments rose to the level of a trade or business.[105] Proponents of current tax treatment of private equity funds' returns find that this distinction leaves the second prong of the *Groetzinger* test maladroit for application to private equity, as under *Higgins*, management of one's investments can never rise to the level of a trade or business, no matter the regularity.[106] The First Circuit's decision in *Sun Capital*, however, dismissed this distinction as overbroad, focused on the fact that *Higgins* involved personal investments and applying *Groetzinger* in its use of the "investment-plus" test, discussed below.[107]

e. Dagres v. Commissioner[108]:

In *Dagres*, the Tax Court reviewed whether a manager general partner of a private equity fund could deduct a loan made to a business colleague as a bad business debt under I.R.C. § 166(a)(1).[109] This inquiry required the court to determine if the taxpayer's venture capital management constituted a trade or business.[110]

The taxpayer engaged in venture capital activities with Battery Ventures, a private equity group consisting of three types: specific limited partnership venture capital funds, LLCs serving as the general partners of the venture fund limited partnerships, and management companies providing management services to the limited and general partners.[111] The taxpayer was a member manager of the general partner, entitled to carried interest, and also a stockholder and salaried employee of the management company Battery Management Co. (BMC).[112]

The court noted that although Battery Ventures' gains were generated through investment activity, this was not dispositive

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[105] Brief for Petitioner at 24, *Sun Capital*, 724 F.3d 129 (1st Cir. 2013) (No. 13-648).

[106] *See* Michelle B. O'Connor, *The Primary Profit Test: An Unworkable Standard?*, 27 LOY. U. CHI. L.J. 491, 512–14 (1996); Glenn P. Schwartz, *How Many Trades Must a Trader Make to Be in the Trading Business?*, 22 VA. TAX REV. 395, 420–29 (2003); *see also* Higgins v. Commissioner, 312 U.S. 212, 218 (1941); Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund, 903 F. Supp. 2d 107, 117 (Mass. Dist. Ct. 2012).

[107] *See* Section II.c.i. *infra*.

[108] 136 T.C. 263 (2011).

[109] *Id.* at 277.

[110] *Id.* at 282–83.

[111] *Id.* at 265–67.

[112] *Id.* at 266–67, 270–71.

of a finding that the fund conducted a trade or business.[113] "Rather, the activity of 'promoting, organizing, financing, and/or dealing in corporations for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business' is a business, as is 'developing corporations.'"[114] The court found that the general partner engaged in a trade or business when it, similar to a stock broker or investment bank, earned compensation through fees and profit interests in exchange for providing management services and developing the target companies of the venture capital limited partnership.[115]

The IRS disputed the treatment of the general partner's activities as a business because the general partner contributed a 1% capital investment to the fund and its returns on that investment were treated as capital gains.[116] The court, too, disagreed with this characterization, noting that it would be "absurd" to find that the 20% carry given in return for the general partner's 1% investment was anything but compensation for management of the fund, and not a return on investment.[117] The court acknowledged that the capital gains treatment of such carried interest created an inconsistency, where the carried interest was compensation for services, but received investment treatment as capital gains due to the 1% investment and return.[118] The court stressed that capital gains treatment is "not necessarily indicative of investment . . . rather than business activity[,]" and that carried interest "is deemed to remain passthrough income with the same character in the hands of the recipient ([the general partner]) as in the hands of the partnership ([the venture fund limited partnership])."[119]

The nature of private equity compensation described in

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[113] *Id.* at 281.

[114] *Dagres*, 136 T.C. at 281 (citing Deely v. Comm'r, 73 T.C. 1081, 1093 (1980) (internal citations omitted); T.C. Memo. 1981-229; Whipple v. Comm'r, 373 U.S. 193, 202–03 (1963)).

[115] *Id.* at 284.

[116] *Id.* at 284–85.

[117] *Id.* at 285–86 ("The 99-percent investors were not looking for a 1-percent coinvestor; they were looking for someone in the business of managing venture capital funds, who could locate attractive investment targets . . . and achieve an attractive return for them; and the General Partner L.L.C. conducted that business.").

[118] *See id.* at 285–87.

[119] *Id.* at 286–87 (citations omitted).

Dagres distinguishes the investor in *Whipple*; although both taxpayers were involved in the management of the corporations in which they invested, the carried interest received by a general partner represents a return very different from that of a "typical" investor.[120] Commentators view *Dagres* as having "stopped short" because of its focus on the activities of the general partner and its ultimate failure to address the activities of the entire private equity fund.[121] This avoidance may stem from the court's comfort with established precedent concerning the treatment of private equity, or instead signal the tax court's unwillingness to address the larger issue of whether the fund itself is engaged in a trade or business.[122] Regardless, *Dagres* is cited as an example of a case in which the Tax Court accepts that private equity fund managers are engaged in the trade or business of managing and developing target companies,[123] lending credence to arguments supporting the trade or business treatment of private equity funds' activities discussed in the following section.

II. BOXING PRIVATE EQUITY INTO A TRADE OR BUSINESS

This section reviews arguments for finding that private equity firms are engaged in a trade or business in both the ERISA and tax contexts.

a. Point of Debate: Taxing Private Equity Funds as a Trade or Business Under a "Developer" Theory

Steven Rosenthal, senior fellow of the Urban-Brookings Tax Policy Center, published articles in 2013 advocating for the application of a "developer theory" to private equity profits.[124] Rosenthal's theory is frequently cited[125] in debates concerning the taxation of private equity, and therefore warrants discussion as a current, cogent argument for the treatment of carried interest as ordinary income. According to Rosenthal, the Treasury Department should reevaluate the current interpretation of pri-

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[120] *See Whipple*, 373 U.S. at 202–03.

[121] Rosenthal, *supra* note 8, at 365.

[122] *See id.* at 365 & n.43.

[123] *See, e.g.*, *id.*

[124] *See* Rosenthal, *supra* note 8, at 361, 366–67.

[125] *See, e.g.*, *Sun Capital*, 724 F.3d 129, 148 n.30 (1st Cir. 2013); DONALD J. MARPLES, CONG. RESEARCH SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 6 n.25 (2014), *available at* https://www.fas.org/sgp/crs/misc/RS22689.pdf; Mitev, *supra* note 5.

vate equity funds' activities; issue regulations to clarify that private equity funds are corporate *developers* that hold their property primarily for sale to customers; and tax private equity gains accordingly.[126] He bases this theory on the fact that private equity funds' day to day operations involve regular, substantial efforts to raise capital, acquire, develop, and sell businesses in the near term for a profit.[127]

Rosenthal notes that under the current tax framework, buyers and sellers of stock are classified under three different types of categories with different tax implications: dealers, traders, and investors.[128] Dealers are merchants of securities, engaged in a trade or business through holding stock as inventory for the consistent purchase and resale to customers for profit, taxed as ordinary gains.[129] Traders also purchase and resell stocks for profit on a regular and continuous basis at the level of a trade or business, but their gains are treated as capital because their sale of stocks is speculative and market dependent, not held for sale as inventory to customers.[130] And finally, investors are those who manage their own investments for personal profit, devoting "managerial attention" and receiving capital gains treatment on gains and losses.[131] According to Rosenthal, private equity firms do not fit neatly into any of these three categories, despite their historical treatment as investors.[132] He argues, instead, that private equity funds are a type of developer; they "buy, develop, and resell companies in the course of their trade or business [and the IRS should treat] their companies . . . as held for sale to customers."[133]

This position stems from Rosenthal's analysis of historical treatment of the tax code, focusing on case precedent and the 1934 amendments excluding "'property held primarily for sale *to customers* in the ordinary course of a trade or business.'"[134] The initial intent of capital gains treatment was to encourage the sale

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[126] *See* Rosenthal, *supra* note 8, at 366 (emphasis added).

[127] *Id.* at 364–65.

[128] *Id.* at 363 (citing Comm'r v. Groetzinger, 480 U.S. 23, 28–29 (1987); Higgins v. Comm'r, 312 U.S. 212, 218 (1941); Schaefer v. Helvering, 299 U.S. 171, 174 (1936)).

[129] Rosenthal, *supra* note 8, at 363.

[130] *Id.*

[131] *Id.*

[132] *Id.* at 363–64.

[133] *Id.* at 363–64.

[134] *Id.* at 363 (quoting H.R. REP. NO. 73-1385, at 22 (1934)).

of appreciated property. The addition of the language "'to customers'" was intended to block speculators, or traders, from selectively deducting their losses as ordinary.[135] Furthermore, in adding the "to customers" wording, the IRS did not intend to focus on only a regular, consistent vendor-vendee relationship, but instead to characterize and distinguish the type of business engaged in by the taxpayer from those of a stock speculator—profits generated from the "every day operation of a business."[136] A determination of every day operations of a business requires that the business' activity be profit-oriented,[137] continuous and substantial,[138] and that a shareholder "establish his own trade or business, separate from the trade or business of the corporation whose shares he owns."[139]

To illustrate his "developer" theory, Rosenthal provides the analogy of the business of real estate development in which an entity invests in a property, pays to develop it, sells the property to a "customer" with the intent to make a profit, and is accordingly taxed at ordinary income rates.[140] Rosenthal analogizes that private equity funds, through the actions of their general agent, also "acquire, develop, and sell property."[141] "'[T]he activity "of promoting, organizing, financing, and/or dealing in corporations . . . for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary

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[135] Rosenthal, *supra* note 8, at 363 (citing H.R. REP. NO. 73-1385, at 22).

[136] *Id.* at 364–65.

[137] Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1465; *see* Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

[138] Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1465; *see Groetzinger*, 480 U.S. at 35.

[139] Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1465; *see* Whipple v. Comm'r, 373 U.S. 193, 202 (1963).

[140] *See* Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1465 & n.74, 1467 & n.87.

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

Id. at 1467.

[141] *Id.* at 1467 (citing N. Gregory Mankiw, *Capital Gains, Ordinary Income and Shades of Gray*, N.Y. TIMES (Mar. 3. 2012), http://www.nytimes.com/2012/03/04/business/capital-gains-vs-ordinary-income-economic-view.html?_r=0).

course of that business" is a business.'"[142] According to Rosenthal, that near-term, dedicated focus on resale of the corporation at a profit distinguishes private equity funds from business owners selling their own companies at a profit.[143] Furthermore, as discussed in *Sun Capital*, the fact that the day to day management operations of a portfolio company are carried out by an agent of the fund does not preserve a passive investor designation and shield the limited partnership from characterization of engaging in "developing."[144] "One may conduct a business through others, his agents, representatives, or employees[,]"[145] and "the actions of an agent on behalf of the principal are attributed to the principal to determine whether the principal is engaged in a trade or business."[146] Whether these actions are carried out through the structure of a corporation or limited partnership should make no difference under attribution principles.[147]

Thus, Rosenthal advocates that the IRS issue regulations to "clarify that developers, including private equity funds, hold their property primarily for sale to customers[,]" and specify the nature of customers and level of involvement contemplated by this definition.[148] Such regulations would be entitled to *Chevron* deference,[149] and would represent a more targeted and immediate change to tax treatment of private equity as compared to current legislative efforts or case law development.[150] Regardless of

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[142] Rosenthal, *supra* note 8, at 365 (quoting Dagres v. Comm'r, 136 T.C. 236, 281 (2011) (citations omitted)).

[143] *See id.* at 366 ("Small business owners and executives might acquire and develop a business for a variety of reasons . . . , but they do not buy and develop a business intending to resell it in the near term.").

[144] Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1465 ("The taxpayer cannot insulate himself from the acts of those persons whose efforts are combined with his in a mutual endeavor to make a profit, no matter how the endeavor is denominated." (quoting 4 MERTENS LAW OF FEDERAL INCOME TAXATION § 22A:98 (updated Sept. 2013) (citations omitted), *available at* WestlawNext MERTENS)); *see* Rosenthal, *supra* note 8; *see also* Section II.d. *infra* (examining *Sun Capital*'s discussion).

[145] *Sun Capital*, 724 F.3d 129, 147 (1st Cir. 2013) (citations omitted).

[146] Rosenthal, *supra* note 8, at 365 n.43 (citing Comm'r v. Boeing, 106 F.2d 305, 309 (9th Cir. 1939)).

[147] *See* Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1467.

[148] Rosenthal, *supra* note 8, at 366.

[149] *See* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 53–56 (2011) (noting in a unanimous opinion that "[t]he principles underlying our decision in *Chevron* apply with full force in the tax context"); Rosenthal, *supra* note 8, at 367.

[150] *See* Rosenthal, *supra* note 8, at 366–67; Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1470.

whether Rosenthal's recommendation is followed by the Treasury, his theories have influenced the conversation in the taxation of private equity profits in ordinary income and have been cited in opinions finding private equity to be a trade or business.[151]

b. Trade or Business Under ERISA:

Whether an agency is engaged in a trade or business is an inquiry that is not unique to tax law, but one that is also found in other federal laws and regulations. Under ERISA,[152] the MPPAA requires organizations withdrawing from multiemployer pension funds to pay their proportionate share of unfunded but vested pension fund benefits.[153] When determining whether an organization qualifies as an "employer" obligated to the fund, a broad definition of employer requires only that the organization is "under 'common control' with the obligated organization, and . . . a *trade or business*."[154] Section 1301(b)(1) authorizes the Pension Benefit Guarantee Corporation (PBGC)[155] to promulgate regulations that "shall be consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under Section 414(c) of Title 26" of the I.R.C.[156] The PBGC has not issued any formal guidance or regulations defining "trade or business" as used in § 1301(b)(1), and—as previously discussed—neither the Treasury nor the Supreme Court of the United States have definitively interpreted the term in the I.R.C.[157] In 2007, however, the PBGC issued an

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[151] *See, e.g.*, *Sun Capital*, 724 F.3d 129, 134 (1st Cir. 2013).

[152] Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), Pub. L. No. 96-364, 94 Stat. 1208 (codified as amended in scattered sections of 26 and 29 U.S.C).

[153] 29 U.S.C. § 1381 (2012).

[154] *Sun Capital*, 724 F.3d at 138 (emphasis added) (quoting McDougall v. Pioneer Ranch Ltd. P'ship, 494 F.3d 571, 577 (7th Cir. 2007)).

[155] 29 U.S.C. § 1302 (2012). The PBGC is a federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to protect pension benefits in private-sector defined benefit plans. *General FAQs about PBGC*, PENSION BENEFIT GUARANTEE CORPORATION, http://pbgc.gov/about/faq/pg/general-faqs-about-pbgc.html (last visited Feb. 14, 2015).

[156] 29 U.S.C. § 1301(b)(1); *Sun Capital*, 724 F.3d at 138–39.

[157] *E.g.*, *Sun Capital*, 724 F.3d at 139 (citing Comm'r v. Groetzinger, 480 U.S. 23, 27 (1987) (noting that "the Code has never contained a definition of the words 'trade or business' for general application, and no regulation has been issued expounding its meaning for all purposes")).

opinion letter in an informal adjudication that held a private equity fund was engaged in a trade or business.[158]

c. PBGC Opinion Letter (2007)

The PBGC has not published any official guidance on the definition of trade or business, but its interpretation of the term with regard to private equity fund activities was made apparent in a 2007 response to an appeal, referred to hereinafter as the "PBGC Letter." The private equity fund at issue in the decision ("the Fund") was structured as a typical fund, with a limited liability partnership, general partner, and management company hired to manage the funds' investments.[159] The appeal concerned the Fund's termination liability for unfunded pension benefits under ERISA,[160] requiring analysis of whether the Fund was 1) under common control with the obligated organization and 2) a trade or business.[161] The Appeals Board both applied and distinguished tax precedent in its decision, finding that the fund was engaged in a trade or business and ultimately liable under ERISA.[162]

i. The Test for a Trade or Business: "Investment Plus"

The Appeals Board applied the *Groetzinger* test to the Fund to determine whether it was engaged in a trade or business.[163] The first prong, a subjective inquiry into the fund's intent to create income or profit, was satisfied by reference to the Fund's tax return, partnership agreement, and appeal, which stated that the Fund was created for the purpose of creating gains from investment, "'including . . . the general buying, selling, holding, and otherwise investing in securities of every kind and nature.'"[164] The Appeals Board next addressed the second prong of *Groetzinger*, observing that the Fund's general manager provided management and advisory services and received 20% of

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[158] Letter from Pension Benefit Guar. Corp. (Sept. 26, 2007) 1, 14, *available at* http://www.pbgc.gov/documents/apbletter/decision—(liability%20within%20a%20group%20 of%20companies)%202007-09-26.pdf [hereinafter PBGC Letter].

[159] *See id.* at 4, 9–10.

[160] ERISA § 4062(a) [hereinafter 29 U.S.C. § 1362(a) (2012)]; PBGC Letter, *supra* note 158, at 2.

[161] PBGC Letter, *supra* note 158, at 6.

[162] *Id.* at 14–15.

[163] *Id.* at 10.

[164] *Id.* at 10–11 (quoting the Partnership Agreement, Sec. 1.3).

net profits "in exchange for its services and that its acts were attributable to the fund as the fund's agent."[165] Next, the Appeals Board reviewed both the size and scope of the Fund's portfolio, fees paid, and the profits generated, summarily concluding that these factors demonstrated that "management of the fund's investments [were] conducted with regularity and thus the Fund, through activities of its agent [the general partner,] meets the second prong of the *Groetzinger* test."[166] This application of *Groetzinger* is referred to as the "investment plus" standard,[167] and was applied in the First Circuit's *Sun Capital* decision.[168]

ii. The Agency Argument

The Appeals Board's characterization of the Fund's activities as a trade or business relied heavily on a determination that the general partner was operating as the Fund's agent under Delaware partnership law,[169] therefore making "all of [the general partner's] acts within the scope of such agency . . . attributable to the fund."[170] The Appeals Board applied the Delaware Revised Uniform Partnership Act ("DRUP Act") in its agency analysis,[171] noting that under the act "each partner is an agent of the partnership for the purpose of its business, purposes or activities"[172] and that the general partner has "the rights and powers to manage and control the business and affairs of the limited partnership subject to the DRUP Act and partnership agreement."[173] The partnership agreement at issue also delegated "full control over the business and affairs of the partnership" to the general partner.[174]

As previously discussed, the activities of the general partner are typically categorized as passive investment through the legal fiction that only the management company conducts the day to

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[165] *Sun Capital*, 724 F.3d 129, 139–40 (1st Cir. 2013) (discussing the PBGC decision and the "investment plus" standard).

[166] PBGC Letter, *supra* note 158, at 11.

[167] *See, e.g.*, Bd. of Trs., Sheet Metal Workers' Nat'l Pension Fund v. Palladium Equity Partners, LLC, 722 F. Supp. 2d 854, 869 (E.D. Mich. 2010).

[168] *Sun Capital*, 724 F.3d at 141–42.

[169] *See* Delaware Revised Uniform Partnership Act ("DRUP Act"), DEL. CODE ANN. tit. 6, § 15-301 (West 2015).

[170] PBGC Letter, *supra* note 158, at 9–10.

[171] *Id.* at 9.

[172] *Id.* (quoting DEL. CODE ANN. tit. 6 § 15-301 (West 2015)).

[173] *Id.* (citing DRUP Act at § 17-403).

[174] *Id.* (quoting from the Partnership Agreement).

day operations of the fund. The Appeals Board's analysis refused to accept that fiction, instead finding that where the management agreement did not relinquish the management rights and responsibilities of the general partner,[175] the management company was only hired to assist the general partner in its management function.[176] Accordingly, the Appeals Board reasoned that the general partner actively participated in the Fund's investment activities, received compensation for its services in carried interest, and those acts were attributable to the Fund as the principal.[177] Thus, the Appeals Board's inquiry into whether the fund engaged in a trade or business was prefaced by its attribution of "investment activities"—in place of passive investment—to the Fund.[178]

iii. Distinguishing Tax Precedent

The Fund cited tax precedent from *Higgins*, *Whipple*, and *Zink* to argue that the Fund could not be classified as a trade or business, because "investment activities do not constitute a trade or business."[179] The Appeals Board analyzed each case, distinguishing their holdings from the Funds' facts and noted:

> Although those cases do not generally characterize passive investment activities as a trade or business, such characterizations, when read in context with the facts of each case, refer to individuals managing their own personal investments rather than to partnerships, like the Fund, whose purpose is to acquire, hold, and sell securities and other investment interests in United States industrial businesses.[180]

Accordingly, the Appeals Board distinguished *Higgins* from a private equity fund in that the Fund was not simply a taxpayer

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[175] *See id.* The Partnership Agreement stated, "The appointment of a Management Agent shall not in any way relieve the General Partner of its responsibilities and authority vested pursuant to Section 6.1 or relieve the General Partner of any of its fiduciary duties to the Partnership and its Partners." PBGC Letter, *supra* note 158, at 9.

[176] *Id.* at 10.

[177] *Id.*

[178] *See id.* at 10–14.

[179] *Id.* at 11–12. In *Zink*, the Fifth Circuit Court of Appeals disallowed the deduction of aircraft component R&D expenses where the taxpayers did not participate in the actual R&D, but rather were investors in the aircraft component business and "their activities in connection with . . . [such] products never surpassed those of investors." Zink v. United States, 929 F.3d 1015, 1023 (5th Cir. 1991).

[180] PBGC Letter, *supra* note 158, at 12–13.

managing personal investments and receiving typical investment returns.[181] Rather, the Fund was regularly involved in "investment activities of a much more active nature," reflected by the responsibilities of the general partner, "who: (i) provides investment advisory and management services to others (i.e., its partners); (ii) hires a third party . . . to assist in selecting and purchasing potential investments . . . and (iii) receives compensation for such services (e.g., 20% of all realized profits from the Fund's investments)."[182]

In *Whipple*, the Appeals Board noted that the taxpayer's debt could not be related to a trade or business because "the taxpayer 'was not engaged in the business of money lending, of financing corporations, of bottling soft drinks, or any combination of the three.'"[183] The Appeals Board failed to find a parallel in private equity, noting that "the Fund . . . was directly and substantially involved in a recognized business activity (i.e., providing investment advisory and management services) for the benefit of several other entities (i.e., its general and limited partners)."[184] Furthermore, the returns realized by the general partner were a form of compensation for services, not a typical investment return.[185]

Finally, the Appeals Board noted that the Fund's purpose was not simply to contribute investment funds to the activities of a company like the taxpayers in *Zink*, but actually to participate in and control the acquisition and management of investment companies on behalf of its partners.[186] The Appeals Board concluded its analysis by reiterating that Fund's level of activity in managing its investments was distinguishable from the cited tax precedent and that "delegation of many of its management functions to other entities . . . does not establish that the Fund was merely a 'passive investor.'"[187]

iv. Judicial Deference to the PBGC's Decision

The amount of deference owed the PBGC's letter dictates how its characterizations of private equity funds will be treated

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[181] *Id.* at 12.
[182] *Id.*
[183] *Id.* (quoting Whipple v. Comm'r, 373 U.S. 193, 203–04 (1963)).
[184] *Id.* at 13.
[185] *See id.*
[186] PBGC Letter, *supra* note 158, at 13.
[187] *Id.* at 14.

by later courts interpreting liability under the MPPAA and ERISA. In its amicus brief in *Sun Capital*, the PBGC claimed that its 2007 letter was entitled to deference under *Auer v. Robbins*.[188] The PBGC noted that because "trade or business" appears in the MPPAA, a statute it is authorized to interpret, "the court must defer to that interpretation unless plainly erroneous or inconsistent with its own regulations."[189]

This argument was rejected both at the trial and appellate levels of *Sun Capital*; both courts concurred that only *Skidmore* deference was appropriate where "interpretations contained in formats such as opinion letters are entitled to respect . . . only to the extent that those interpretations have the power to persuade."[190] The First Circuit additionally noted that "such deference is inappropriate where significant monetary liability would be imposed on a party for conduct that took place at a time when the party lacked fair notice of the interpretation at issue[,]" as was the case with the Sun Funds which made their investments prior to the PBGC's publishing of the 2007 opinion letter.[191] Furthermore, an agency does not "acquire special authority to interpret its own words" when instead of promulgating a clear definition or regulation, it only paraphrases the term.[192] Accordingly, the PBGC is afforded only *Skidmore* deference, entitling the decision to deference only to the extent that it has the "power to persuade."[193]

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[188] Brief of Amicus Curiae Pension Benefit Guaranty Corp. in Support of Appellant Requesting Reversal, *Sun Capital*, 724 F.3d 129 (1st Cir. 2013) (No. 12-2312), 2013 WL 656571, at *6 n.1616; *see also* Auer v. Robbins, 519 U.S. 452, 461 (1997) (courts must defer to an agency's interpretation of its own ambiguous regulation unless it is inconsistent with the regulation or "plainly erroneous").

[189] *Sun Capital*, 724 F.3d 129, 138–40 (1st Cir. 2013) (citing *Auer*, 519 U.S. at 461).

[190] *Id.* at 140; Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 903 F. Supp. 2d 107, 115 (D. Mass. 2012) (quoting Christensen v. Harris Cnty., 529 U.S. 576, 587 (2000) (quoting Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944))).

[191] *Sun Capital*, 724 F.3d at 140–41 (citing Christopher v. SmithKline Beecham Corp., 132 S. Ct. 2156, 2167 (2012)).

[192] *Id.* at 141 (quoting Gonzales v. Oregon, 546 U.S. 243, 257 (2006)).

[193] *Id.* (citing *Skidmore*, 323 U.S. at 130 ("the 'weight' of an agency's determination 'depend[s] upon the thoroughness evident in [the agency's] consideration, validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade.'")); Bd. of Trs., Sheet Metal Workers' Nat'l Pension Fund v. Palladium Equity Partners, LLC, 722 F. Supp. 2d 854, 869 (E.D. Mich. 2010).

d. Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund (1st Cir. 2013)

In July 2013, the Court of Appeals for the First Circuit held that a private equity fund was engaged in a trade or business for the purposes of pension liability under the ERISA.[194] The case was initiated by two related funds[195] (the "Sun Funds") that sought declaratory judgment to avoid withdrawal liability for payments allegedly owed to the New England Teamsters and Trucking Industry Pension Fund (the "Pension Fund") "stemming from the bankruptcy of Scott Brass, Inc., [(SBI), a portfolio company] in which the Sun Funds invested."[196] The Sun Funds argued that, as passive investors in SBI, they did not meet the requirements under ERISA to establish pension fund liability: common control with the obligated organization and conducting a trade or business.[197] As noted in the PBGC Board decision, no definition for "trade or business" existed in the relevant statutes or administrative guidance from either the PBGC or the Treasury, requiring the court to engage in a factual inquiry as to the status of the Sun Funds' activities.[198] This inquiry led the First Circuit to turn to relevant tax and partnership case law on the issue of whether or not private equity is engaged in a trade or business in its analysis.[199] The court also found the "investment plus" approach used in the PBGC Board decision persuasive, noting that it was both an appropriate test to apply to the trade or business prong of Section 1301 (b)(1) and consistent with the applicable tax precedent.[200]

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[194] *Sun Capital*, 724 F.3d at 141.

[195] Sun Capital Partners III, LP and Sun Capital QP, LP (Sun Fund III) and Sun Capital Partners IV, LP (Sun Fund IV) are investment funds of Sun Capital Advisors, Inc., "a private investment firm founded by Marc Leder and Rodger Krouse specializing in leveraged buyouts and other investments in underperforming, market-leading companies." *Sun Capital Partners III, LP*, 903 F. Supp. 2d at 108–09.

[196] *Id.*

[197] *See Sun Capital*, 724 F.3d at 137.

[198] *Id.* at 139, 141. The court noted, further, that interpretations of trade or business found in the Internal Revenue Code were not determinative for ERISA purposes. *Id.* at 144–45 (citing United Steelworkers of Am., AFL-CIO & Its Local 4805 v. Harris & Sons Steel Co., 706 F.2d 1289, 1299 (3d Cir. 1983) (noting that a term used for tax purposes does not necessarily have the same meaning under ERISA)).

[199] *See id.* at 145–49.

[200] *Id.* at 143–46 ("The 'investment plus' test as we have construed it in this opinion is thus consistent with the *Groetzinger*, *Higgins*, and *Whipple* line of cases."). *See* Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1462 n.36 ("The [Sun Capital] court analogized the 'plus' factor as 'perfectly consistent with' the 'without more'

i. Facts Specific to the Trade or Business Analysis

Sun Capital Advisors, Inc. is a private equity firm that creates limited partnerships to pool investor funds and finds, recommends, and executes investments in certain portfolio companies.[201] Sun Fund III and IV ("the Sun Funds")[202] were examples of these limited partnerships.[203] They were "overseen by general partners" and empowered by their limited partnership agreements to exclusively manage and supervise the partnership and all incidental activities deemed necessary carry out its objectives.[204] These partners were compensated for their management services with a 2% management fee and a carried interest from the Sun Funds' profits from investments.[205]

In 2006, the Sun Funds set out to purchase 100% of SBI.[206] Sun Fund III[207] held a 30% investment and Sun Fund IV held a 70% investment.[208] Additionally, the Sun Funds general partners each held subsidiary management companies that contracted with the funds to provide management services, employees, and consultants to SBI.[209] SBI then paid management fees directly to those management companies, which in turn offset the fees owed to the general partner by the Sun Funds.[210] The court noted that the general partners of the Sun Funds exercised "substantial operational and management control over SBI."[211]

ii. The "Investment Plus" Analysis

The court's application of the "investment plus" test to determine whether or not the Sun Funds were engaged in a trade or business appeared to be a reaction to the facts of the Sun

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directive from *Whipple*.").

[201] *Sun Capital*, 724 F.3d at 133.

[202] The court groups its discussion of the "Sun Funds" generally throughout its opinion, and this work will therefore only note the difference between the two where relevant in the court's analysis.

[203] *See Sun Capital*, 724 F.3d at 133–34.

[204] *Id.* at 134–35.

[205] *Id.* at 135.

[206] *Id.*

[207] The court vacated and remanded the claim against Sun Fund III to determine whether or not Sun Fund III received such offset fees from SBI and the question of common control. *Id.* at 148–49.

[208] *Id.* at 135.

[209] *Sun Capital*, 724 F.3d at 135.

[210] *Id.*

[211] *Id.* at 136.

Funds' case, and not necessarily a requirement for all ERISA cases.[212] In undertaking its "investment plus" approach, the court stated that although the 2007 PBGC Board decision's use of the test only warranted *Skidmore* deference, the court would have "reach[ed] the same result through independent analysis."[213] Furthermore, the court did not enumerate a set list of factors considered under the "plus" of the test, stating that it saw "no need to set forth general guidelines for what the 'plus' is," and cautioning that the factors it used in its analysis were not dispositive for determining whether an entity was engaged in a trade or business.[214]

The court began its application of the investment plus test by tracking *Whipple*, stating that "a mere investment made to make a profit, *without more*, does not itself make an investor a trade or business."[215] The court found that "more" in its review of the Sun Funds' structures and their active involvement in the management of SBI.[216] The Sun Funds' own characterizations of their activities were factors taken under specific consideration, as "an entity's own statements about its goals, purposes, and intentions are 'highly relevant, because [they] constitute [ ] . . . declaration[s] against interest.'"[217] The stated purpose of each of the funds was to make a profit by "seek[ing] out potential 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."[218] Next, the court stressed the level of detail the general partners of the funds engaged in when supervising the funds, the Sun Funds' controlling stake in SBI, and the fact that these two circumstances combined

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[212] *See id.* at 141–43, 144–45 (explaining that using the test articulated in *Groetzinger* is not required for interpretation of "trade or business" in application to § 1301 (b)(1)).

[213] *Id.* at 141 (citing as example of similar independent analysis of the issue Cent. States, Se. & Sw. Areas Pension Fund v. Messina Prods., LLC, 706 F.3d 874 (7th Cir. 2013)).

[214] *Id.*

[215] *Sun Capital*, 724 F.3d at 141–42 (emphasis added) (citations omitted).

[216] *See id.* at 142.

[217] *Id.* at 142 (citing McDougall v. Pioneer Ranch Ltd. P'ship, 494 F.3d 571, 577–78 (quoting Connors v. Incoal, Inc., 995 F.2d 245, 254 (D.C. Cir. 1993))).

[218] *Id.* (citing the Sun Funds private placement memos). Although the argument was raised too late to be considered by the court in this case, the court's stress on the funds' intent to resell the companies in a short time period is part of the "developer theory" advanced by Rosenthal, whom the court cites in its opinion. *See* Section II.a. *supra*.

"provided a direct economic benefit . . . that an ordinary, passive investor would not derive: an offset against the management fees it otherwise would have paid its general partner for managing the investment in SBI."[219] All of these factors combined "satisf[ied] the 'plus' in the 'investment plus' test[,]" and supported the court's finding that the Sun Funds' management of SBI constituted a trade or business for the purposes of pension fund liability under ERISA.[220]

iii. Distinguishing Tax Precedent

The Sun Funds' arguments relied on tax and partnership case law to contend that the funds were passive investors and not engaged in a trade or business—that *Whipple* and *Higgins* preclude any finding that an entity managing investments is engaged in a trade or business; that applying the investment plus test to a private equity fund is inconsistent with *Groetzinger*'s preservation of *Higgins*;[221] and that the activities of the general partner and management company cannot be attributed to the Sun Funds.[222] Reviewed in the followings sections, the First Circuit rejected each of these contentions.

A. The Investors in Whipple *and* Higgins *Are Distinguishable From Private Equity Funds.*

The court found the facts of *Higgins* to be easily distinguishable in a private equity context where the "'petitioner [in *Higgins*] merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.'"[223] Furthermore, the taxpayer in *Higgins* "'did not participate directly or indirectly in the management of the corporations in which he held stock or bonds[,]'"[224] and, contrariwise, "the Sun Funds *did* participate in the management of SBI."[225]

In reviewing *Whipple*, the court addressed the Supreme Court's holding that the management of a corporation in which

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[219] *Sun Capital*, 724 F.3d at 135, 142–43 ("When portfolio companies pay fees to the management companies, the Sun Funds receive an offset to the fees owed to the general partner.").

[220] *Id.* at 143.

[221] *Id.* at 144.

[222] *Id.* at 146.

[223] *Id.* at 145 (quoting Higgins v. Comm'r, 312 U.S. 212, 218 (1941)).

[224] *Id.* (quoting *Higgin*s, 312 U.S. at 214).

[225] *Sun Capital*, 724 F.3d at 145 (emphasis added) (acknowledging that the management was performed through affiliated entities).

one has invested "without more"—only receiving profits consistent with returns of an investor—does not constitute a trade or business.[226] The Sun Funds argued that because their only income from SBI came in the form of dividends and capital gains, their activities did not raise to the level of a trade or business under *Whipple*.[227] The court disagreed, stating "the Sun Funds did not simply devote time and energy to SBI, 'without more.'"[228] The court pointed out that the Sun Funds were actively and intimately involved in the management of SBI, and "were able to funnel management and consulting fees to [the] general partner and its subsidiary . . . [and] received a direct economic benefit in the form of offsets."[229] The court, reviewing the "without more" formulation in *Whipple*, found it consistent with its investment plus test.[230] Accordingly, the First Circuit concluded that its findings under the investment plus test of a trade or business were consistent with *Whipple*, *Higgins*, and *Groetzinger*.[231]

B. Funds Act Through Their General Partners.

The court dismissed the Sun Funds' argument that the business of an agent may not be attributed to its principal,[232] explaining that under Delaware Partnership law:

> [A] partner "is an agent of the partnership for the purpose of its business, purposes or activities," and an act of a partner "for apparently carrying on in the ordinary course the partnership's business, purposes or activities or business, purposes or activities of the kind carried on by the partnership binds the partnership." To determine what is "carrying on in the ordinary course" of the partnership's business, we may consider the partnership's stated purpose.[233]

The court determined that the general partner of the Sun Funds, "in providing management services to SBI, was acting as

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[226] *Id.* at 145–46 (quoting *Whipple*, 373 U.S. 193, 202 (1963)).

[227] *Id.* at 146.

[228] *Id.*

[229] *Id.* at 142, 146.

[230] *Id.* at 146.

[231] *Sun Capital*, 724 F.3d at 146.

[232] *See id.* at 146–47 (citing DEL. CODE ANN. tit. 6, § 15-301(1) (West 2015); Comm'r v. Boeing, 106 F.2d 305, 309 (9th Cir. 1939) ("One may conduct a business through others, his agents, representatives, or employees."); Rudnitsky v. Rudnitsky, No. 17446, 2000 WL 1724234, at *6 (Del. Ch. Nov. 14, 2000)).

[233] *Id.*

an agent of the Fund."[234] The court noted that the limited partnership agreements entered into by Sun Capital Advisors, Inc. gave the Sun Funds' general partners "authority to act on behalf of the limited partnerships" as necessary to carry out the purpose of the limited partnerships.[235] Accordingly, the management services provided to SBI were both within the authority of the general partner under the limited partnership agreement, and "on behalf of and for the benefit of the Sun Funds."[236]

e. What Implications Does Sun Capital Have for Private Equity Under the Internal Revenue Code?

None, some would say.[237] The First Circuit's interpretation of trade or business was limited explicitly to applications in the ERISA pension liability context, and does not address questions necessary to interpretation of the I.R.C.[238] Nevertheless, the First Circuit derived its decision from tax precedent, citing *Groetzinger* and *Dagres* in its application of the investment plus test and distinguishing private equity funds from the investors in *Higgins* and *Whipple*.[239] Moreover, its attribution of the trade or business of the general partner to the larger funds themselves was an interpretation of Delaware partnership law,[240] distinct from any administrative interpretations for purposes of the I.R.C. or ERISA.[241] Accordingly, the decision provides reasoning that a tax court could conceivably apply to private equity funds in order to find that they engage in a trade or business.

The crux of the First Circuit's differentiation from *Whipple*, however, was the fact that the management company was able to pass on fee offsets to the limited partnership through the compensation of its general partners.[242] The ownership arrangement of the Sun Funds—in which the general partners owned all of the management company—created a *direct* offset that is not typical of private equity funds; SBI paid management fees di-

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[234] *Id.* at 147.
[235] *Id.*
[236] *Id.* at 147–48.
[237] *See* Sheppard, *supra* note 5, at 3.
[238] *See Sun Capital*, 724 F.3d at 141.
[239] *Id.* at 145–46.
[240] *See also* I.R.C. § 702(b) (2012); Rosenthal, *supra* note 8, at 365 n.43.
[241] *See Sun Capital*, 724 F.3d at 144, 146–47.
[242] Sheppard, *supra* note 5, at 9.

rectly to the general partner, whereas portfolio companies typically pay fees to the management company.[243] However, equivalent management fee offsets are common in "rebate" funds. Under this fee structure the entire management fee is rebated to the limited partners when the portfolio company pays its "monitoring fee" for being managed.[244] *Sun Capital* exposes these arrangements[245] where the limited partner investors essentially receive a portion of monitoring fees—income for services—as providing the limited partners "more" than a typical investor's return in the receipt of ordinary income.[246] Because such offset arrangements are contractual in nature, however, they can be altered in the event that *Sun Capital*'s holding appears likely to be applied in a tax context.[247] Such economic maneuvering would likely be "difficult for the industry"[248]—especially in light of the increasing popularity of rebates in private equity—but needed to protect private equity compensation balances.[249]

Importantly, even if a tax court were to follow *Sun Capital*'s line of reasoning to distinguish a rebate fund from *Whipple*, whether *all* gains from the sale of the portfolio company would be considered ordinary income or only those gains attributable to the offset monitoring fees remains a question that *Sun Capital* did not directly address.[250] Accordingly, the opinion's dependence on the receipt of a non-investor return through management fee offsets limits the application of *Sun Capital* to characterizing only private equity funds that engage in such offset arrangements as a trade or business.[251]

At the time of this writing, it does not appear that *Sun Capital* presents any immediate risk that private equity funds will be subjected to a trade or business designation under the I.R.C. The decision does, however, present questions and reasoning

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[243] Fleischer, *supra* note 7; *see* Sheppard, *supra* note 5, at 3. Traditional private equity funds separate the general partner and management companies, incurring some overlap but not direct ownership. *Id.*

[244] Sheppard, *supra* note 5, at 9.

[245] "The people in this industry have known for years that there's a risk with the management fee offset." Amy S. Elliot, *Panelists Agree on Fee Offsets, But Disagree on Sun Capital*, 141 TAX NOTES 1, 19 (Oct. 7, 2013).

[246] *See* Sheppard, *supra* note 5, at 9.

[247] *See* Elliot, *supra* note 245, at 18.

[248] *Id.* at 19.

[249] *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/.

[250] *See id.*

[251] *See Sun Capital*, 724 F.3d at 143.

that may be influential to that end in the future.[252] Craig Gerson, advisor to the Treasury's Office of Tax Legislative Counsel, "said that 'there's a recognition that the [Sun Capital] decision may give us an opportunity to reassess what "trade or business" means[,]'" but also noted "that he did not think there would 'be any rush to issue guidance.'"[253] The opinion, in reality, has little to do with capital gains treatment or carried interest beyond the interpretation of a common term within tax and ERISA statutes.[254] For example, *Sun Capital* does not address whether private equity funds hold portfolio companies for sale to *customers* or other similar inquiries necessary to exclude capital gains treatment for private equity profits under the I.R.C. It does, however, provide legislators cogent logic that may put private equity "into the box of having a trade or business."[255] In the current political climate, having that logic to employ against carried interest may be the step needed to effect major legislative changes to the I.R.C.[256]

III. LEGISLATIVE PROPOSALS TARGETING PRIVATE EQUITY'S TAX TREATMENT

Discussed in the following sections, several proposals have surfaced following the U.S. financial crisis that seek to address private equity taxation—either in a direct approach or as part of a sweeping reform.

a. Carried Interest Legislation

In June 2007, during the U.S. Financial Crisis, Representative Sander Levin introduced a bill that would treat certain types

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[252] *See, e.g.*, Solomon, *supra* note 1.

[253] *Id.*

[254] *See Transcript Available of Tax Analysts' Forum on Implications of Sun Capital*, 2013 TAX NOTES TODAY 190 (2013), *available at* http://www.taxanalysts.com/www/features.nsf/Features/879FF396A916DFDC85257BF70043F439?OpenDocument [hereinafter *Implications of Sun Capital*]; *see also* Solomon, *supra* note 1.

[255] *Implications of Sun Capital*, *supra* note 255.

[256] *See* Amy S. Elliot, *Supreme Court Won't Hear* Sun Capital *Private Equity Trade or Business Case*, 2014 TAX NOTES TODAY 42-1 (Mar. 4, 2014) (noting general similarities between Congressman Dave Camp's proposal to tax private equity partners' income as ordinary and the reasoning in the *Sun Capital* decision).

of carried interests as ordinary income.[257] Similar bills have continued to surface,[258] a most recent of its type introduced by Senator Carl Levin in February 2013 and subtly entitled the "Cut Unjustified Tax Loopholes Act."[259] These proposed bills all "reflect[] the view that to the extent a carried interest holder receives an allocation of the fund's income and gains in excess of what he would receive based on his own capital contributions, the excess . . . should be treated as . . . compensation for . . . services."[260]

To illustrate, S. 268 Proposed Section 710[261] would treat the income of a partner in a private equity fund providing certain services to the fund as ordinary income.[262] The section focuses on the restructuring of partnership interests into "investment partnerships," defined as partnerships whose assets are substantially all "real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing"[263] or where "more than half of the capital of the partnership is attributable to qualified capital interests which . . . constitute property not held in connection with a trade or business."[264] The proposed section would characterize carried interest as income from a trade or business, defined in Proposed Code section 710(c)(2) to include:

> (A) Advising as to the advisability of investing in, purchasing, or selling any specified asset.
>
> (B) Managing, acquiring, or disposing of any specified asset.
>
> (C) Arranging financing with respect to acquiring specified assets.[265]

Beyond its potential economic impacts, concerns over this proposed legislation include the sheer complexity of its potential administration.[266] The Proposed Section 710, in one iteration,

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[257] H.R. 2834, 110th Cong. (2007).

[258] *See, e.g.*, H.R. 1935, 111th Cong. (2009); S. 3793, 111th Cong. (2010).

[259] S. 268, 133d Cong. (2013).

[260] Bachelder, *supra* note 10.

[261] S. 268, 113th Cong. (2013).

[262] Heather M. Field, *The Real Problem with Carried Interests*, 65 HASTINGS L.J. 405, 415 n.34 (2014) (noting that several proposed legislations have contained a Proposed Section 710 with a consistent "core objective").

[263] S. 268, 113th Cong. (2013) (Proposed § 701(c)(4)); *see* Bachelder, *supra* note 10.

[264] S. 268, 113th Cong. (2013) (Proposed § 710(c)(3)(A)(ii)).

[265] *Id.* at Proposed § 710(c)(2).

[266] *See* Peter J. Reilly, *Left Should Challenge Obama, Not Romney, on Carried Interest*,

adds approximately 3,000 words to an already massive I.R.C. and introduces new concepts foreign to established tax law.[267] Furthermore, the scope of the legislation also appears unwieldy, as unintended impacts of Proposed Section 710 may include application to other entities besides fund managers such as non-grantor trusts and small businesses.[268]

b. The Effects of Carried Interest Legislation

Whether or not any of the recently proposed carried interest legislation achieves a discernible policy objective also plagues the viability of this legislation in its current form.[269] The majority of carried interest legislation targets profits from the private equity industry without justification beyond the fact that tax loopholes for fund managers appear *unfair*.[270] In her 2014 article examining the various criticisms of carried interest, Professor Heather Field points out that the risks one might typically associate with a tenable policy objective—protection of industry or the public from an equity compensation structure that fails to align manager-owner incentives or encourages unreasonable risk-taking by general partners—is not achieved by a narrow legislative focus on carried interest alone.[271] Exclusive targeting of carried interest may only incentivize funds to negotiate different compensation arrangements and do little to influence fund managers' behavior or risk-taking.[272] Furthermore, even if the policy objectives espoused by these proposed bills are simply to shift

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FORBES (Jan. 20, 2012), http://www.forbes.com/sites/peterjreilly/2012/01/20/blame-obama-for-carried-interest-not-romney/.

[267] *See id.*

[268] Letter from Charles H. Egerton, Am. Bar Ass'n Section of Taxation, to Senator Max S. Baucus, Senator Charles E. Grassley, Chairman & Ranking Member of the Comm. on Fin., Representative Sander M. Levin, Representative Dave Camp, Chairman & Ranking Member of the Comm. on Ways & Means, *Comments on Carried Interest Proposals in Senate Amendment 4386 to H.R. 4213* (Nov. 5, 2010), *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/110510comments.authcheckdam.pdf.

[269] *See id.* at 3 n.6.

[270] *See* Representative Sander M. Levin, Floor Statement on Cut Unjustified Tax Loopholes Act (2013), *available at* http://www.levin.senate.gov/newsroom/speeches/speech/levin-floor-statement-on-cut-unjustified-tax-loopholes-act. Another proposed carried interest bill—H.R. 4016, 112th Cong. (2012)—was even given the name "Carried Interest Fairness Act of 2012."

[271] Field, *supra* note 262, at 418–20.

[272] *See id.* at 420.

additional tax burden onto fund managers, "contractual and behavioral changes can shift the incidence of the . . . increased tax burden to fund investors (and possibly others)."[273]

In sum, the current proposed carried interest legislation appears poised to impose a complicated set of new regulations that may not have any significant effect on tax burdens for fund managers. Finally, projections estimate the tax revenue generated from the proposals to eliminate only $13.5 billion over 10 years[274]—a relatively small return when administration of the complex tax regulations proposed are considered.

c. The Camp Proposal

On February 26, 2014, Dave Camp, the Republican Chairman of the House Ways and Means Committee, released his plans for a major overhaul of the U.S. tax code,[275] including a new take on private equity taxation.[276] This proposal addresses taxation of carried interest by requiring that "partnership interests held in connection with the performance of services" be characterized as ordinary income.[277] Partnership interests would include those "interest[s] transferred directly or indirectly . . . in connection with the performance of services . . . [including]: (1) raising or returning capital, (2) identifying, investing in, or disposing of other trades or businesses, and (3) developing such trades or businesses."[278] The draft proposal cites a need for consistency in application of the tax code to similarly situated taxpayers where "[a] partnership (e.g., private equity fund) 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. The businesses bought

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[273] *Id.* at 437 (citing Heather M. Field, *The Return-Reducing Ripple Effects of the "Carried Interest" Tax Proposals*, 13 FLA. TAX REV. 1, 11–12 (2012) (explaining that fund managers may not bear the economic burden of the reform because of the design of their contractual agreements with fund investors)).

[274] Steven Sloan & Kelsey Snell, *The 'Carried Interest' Debate*, POLITICO (Feb. 6, 2013), http://dyn.politico.com/printstory.cfm?uuid=544EAD7C-A25E-47F2-B1AF-FF1EE665BE69.

[275] *Tax Reform Act of 2014, Discussion Draft*, COMMITTEE ON WAYS AND MEANS (2014), *available at* http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

[276] *See* Dan Primack, *Dave Camp's Confusing (and Understated) Private Equity Tax Plan*, FORTUNE (Feb. 27, 2014), http://finance.fortune.cnn.com/2014/02/27/dave-camps-confusing-and-understated-private-equity-tax-plan/.

[277] COMMITTEE ON WAYS AND MEANS, *supra* note 275, at 120–21.

[278] *Id.* at 121.

and sold by the partnership are its inventory."[279] These definitions and policy arguments echo the reasoning laid out in *Sun Capital*, and address its missing elements needed to place general partners, statutorily, in the box of conducting a trade or business. Accordingly, instead of a blind political focus on "unfair" tax loopholes, the proposal provides what could logically be construed as a clarification to the current tax code.

However, instead of *just* taxing carried interest as ordinary at the proposed 35% top income rate, Representative Camp's proposal creates a blended effective tax rate for carried interest, determined through an elaborate "calculation [that] includes such variables as carry-over taxes from past years, the amount of capital contributed by fund partners[,] and federal long-term interest rates."[280] The proposal is still in its draft stages at the time of this writing, and faces the same challenges described above in regard to its complexity and commercial efficacy.[281] Importantly, however, the proposal potentially represents a shift in the political approach to the issue of carried interest taxation, showing a more dynamic and bipartisan[282] legislative focus on removing preferential treatment for carried interest.

d. The Obama Administration

President Obama's 2012 re-election campaign focused heavily on raising tax rates for wealthier Americans, and benefitted from the polarization of his opponent, Mitt Romney, a private equity executive.[283] President Obama has "repeatedly criticized the [carried interest] tax break as unfair[,]"[284] but has been unsuccessful in passing a measure to end carried interest's tax treatment in budget negotiations despite the fact that every budget proposed by President Obama attempted to tax carried

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[279] *Id.*

[280] Primack, *supra* note 276.

[281] *See* Rosenthal, *supra* note 8, at 366 (noting that after several years of proposed legislation targeted at carried interest, private equity managers have engaged in various forms of tax planning that suggests "sophisticated taxpayers are outpacing our lawmakers again").

[282] *See* Richard Rubin, *Camp Hits Carried Interest in Tax Plan Focused on Finance*, BLOOMBERG POL. (Feb 27, 2014), http://www.bloomberg.com/news/2014-02-26/camp-hits-carried-interest-in-tax-plan-focused-on-finance.html.

[283] *See Obama Questions 'Carried Interest' Tax Break*, CNBC POL. (Feb. 3, 2013), http://www.cnbc.com/id/100429960.

[284] *Id.*

interest as ordinary income.[285] President Obama has also advocated the removal of carried interest through other avenues, such as the Jobs Act,[286] but has similarly been unsuccessful in passing that measure.[287]

The opportunity to address public sentiment against partnership taxation through the designation of private equity as a trade or business on the heels of the *Sun Capital* decision appears to be a logical step for the Obama Administration to take in order to achieve the tax reform championed by the President.[288] Craig Gerson, Adviser in the Department of the Treasury's Office of Tax Legislative counsel, acknowledged shortly after the decision that the arguments in *Sun Capital* were noticed by the Treasury, stating "there's a recognition that the court's decision may give us an opportunity to reassess what 'trade or business' means."[289]

But is that how the Obama Administration intended its fight against carried interest to conclude, by redefining trade or business in the I.R.C.? Although both the legislative and budget approaches have the same effect of stripping capital gains treatment for fund managers' carried interests, issuance of a rule characterizing the activity of private equity funds as a trade or business would achieve removal of carried interest capital gains taxation via an indiscriminate characterization of all the private equity fund partnerships' profits as ordinary income. As discussed below, the impacts of such a shift in tax policy would be wide reaching—impacting foreign, passive, and institutional investors, not just the fund manager. Furthermore, an issuance of

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[285] OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2014 (2013) at 18; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2013 (2012) at 40; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2012 (2011) at 186; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2011 (2010) at 39; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2010 (2009) at 122.

[286] The American Jobs Act of 2011, S. 1549, 112th Cong. (2011).

[287] *See* Sandy Presant & Richard Petkun, *Heavier Taxation of Carried Interest Proposed Again—Both in the Jobs Bill and by Rep. Levin*, DERIVATIVES: FIN. PRODS. REPORT (WG&L/Thomas Reuters, Carrollton, Tex.), Mar. 2012, at *1, 2011 WL 11562339.

[288] *See Obama Questions 'Carried Interest' Tax Break*, *supra* note 283.

[289] Solomon, *supra* note 1.

such a regulation or position would be contested heavily by private equity firms, resulting in costly, complicated litigation.[290]

IV. POTENTIAL IMPACTS OF A CHANGE TO THE TRADE OR BUSINESS DESIGNATION

a. Domestic Investment

Private equity plays an important role in capital markets in the U.S.[291] Private equity, as an industry, has grown "exponentially,"[292] raising approximately $4.1 trillion between 2000–2010.[293] In 2014, there were 11,130 U.S. headquartered companies backed by private equity and approximately 7.5 million people employed by private equity in the U.S.[294] Despite the common media characterization and focus on leveraged buy-outs (LBOs) or "rip, strip, and flip" funds,[295] private equity provides an investment vehicle that has the ability to inject capital and create value in companies that are otherwise capital-starved in the United States.[296] As an investment vehicle, these funds are entrusted to create stable returns for charitable organizations, universities, and pension funds.[297] A change to the characterization of private equity fund managers' activities as a trade or business could have unintended impacts on the structure of private equity, affecting investors and the economy as a whole.[298]

From a policy perspective, there is a potentially disparate impact between the amounts of revenue that taxation of carried interest as ordinary income will generate for the treasury and the

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[290] *See* Solomon, *supra* note 1; Rosenthal, *supra* note 8, at 366.

[291] *See* SCHELL ET AL., *supra* note 12, at §1.01.

[292] *See* Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1459.

[293] *See* SCHELL ET AL., *supra* note 12, at §1.01.

[294] *PE by the Numbers*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, *available at* http://www.pegcc.org/education/pe-by-the-numbers/ (last visited Mar. 9, 2014).

[295] *See* Sheppard, *supra* note 5.

[296] *See Private Equity Creates Value for Millions of Americans*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL, http://www.pegcc.org/wordpress/wp-content/uploads/Value-Creation-Fact-Sheet.pdf (last visited Mar. 9, 2014).

[297] Steve Forbes, *Private Equity, Public Benefits*, WALL ST. J. (July 25, 2007, 12:01 AM), http://online.wsj.com/news/articles/SB118532670875877067.

[298] *See* James M. Thomas, *The Impact of H.R. 4213 on Private Equity Investment and Employment*, PRIVATE EQUITY GROWTH CAPITAL COUNCIL 1, 8–9 (June 10, 2010), *available at* http://www.pegcc.org/wordpress/wp-content/uploads/Tax-Impact-Study-06-08-10.pdf.

aggregate reduction of U.S. investments.[299] Capital gains treatment of private equity funds is integral for maintaining "after-tax returns competitive to those associated with investors' [other] direct investments."[300] Accordingly, without higher returns, the risk of pooled capital investing may bar previously viable investments, or conversely cause fund managers to engage in riskier behavior at the expense of investors.[301] Focusing on taxation of general partners alone, it is estimated that a one percentage point increase in the effective tax rate for private equity funds "is associated with a 1.07% decrease in annual private equity investment[,] . . . translat[ing] to a $525 million reduction in investment for every one percentage point increase in the tax rate" at 2009 investment levels.[302] This decrease means less venture capital available for financing start-up companies or restructuring failing companies and more investments moving offshore, taking investment capital out of the U.S. and raising relatively insignificant tax revenues in their stead.[303]

b. Tax Exempt Investors

Characterizing private equity as a trade or business could impact foreign and other tax exempt investors such as pension funds, charities, universities, and hospitals,[304] comprising of approximately 68% of all global private equity investors.[305] These entities are not taxed on their passive investments, such as income currently derived from investments in private equity funds, but they are potentially liable for income arising from invested in an active trade or business.[306]

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[299] *See* Diana Furchgott-Roth, *Taxing Carried Interest Discourages Investment*, MARKET WATCH: WALL ST. J. (Mar. 7, 2014, 6:30 AM), http://www.marketwatch.com/story/carried-interest-discourages-investment-2014-03-07.

[300] *See* SCHELL ET AL., *supra* note 12, at §2.02.

[301] *See* Field, *supra* note 262, at 420.

[302] Thomas, *supra* note 298, at 1.

[303] *See* Furchgott-Roth, *supra* note 299.

[304] BLOOMBERG BNA, *supra* note 13.

[305] Thomas, *supra* note 298, at 8.

[306] BLOOMBERG BNA, *supra* note 13.

c. Charities and Other Domestic Tax Exempt Investors

Under I.R.C. § 512 the Treasury requires that charitable organizations[307] pay taxes on ordinary income derived from unrelated businesses, referred to as unrelated business taxable income (UBTI).[308] Section 512 was enacted to address unfair competition of charitable organizations that were able to "use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes."[309] Accordingly, gains from "property held primarily for sale to customers in the ordinary course of the trade or business" are subject to the UBTI,[310] and passive investments are tax exempt.[311]

The definitions for capital gains exclusion and UBTI are identical.[312] Accordingly, in the event that the reasoning in *Sun Capital* is extended to classify private equity funds as engaging in a trade or business in a tax context, exempt organizations, such as limited partner investors,[313] would also be subject to UBTI and lose their tax exemptions, greatly reducing returns on their investments.[314] This would potentially have a significant adverse effect on the value of investments for these entities, as well as encourage them to move capital out of markets into less risky and more tax friendly traditional investments.

d. Foreign Investors

A similar exemption exists for foreign investors, whose investments are protected from U.S. income tax under a statutory safe harbor.[315] Income derived from U.S. trade or businesses, however, is taxed generally "in the same manner and at the same graduated rate as the income of a U.S. corporation."[316] Similar to tax exempt organizations discussed above, if *Sun Capital*'s rea-

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[307] See I.R.C. § 511 (2012) for the definitions of "chartable, etc. organization" subject to UBTI.

[308] *See* I.R.C. § 512.

[309] S. Rep. No. 81-2375 (1950).

[310] I.R.C. § 512(b)(5)(B).

[311] BLOOMBERG BNA, *supra* note 13.

[312] *Compare* I.R.C. § 512(b)(5)(B) *with* I.R.C. § 1221(a)(1).

[313] *See* Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1469 n.108 ("The unrelated trade or business activities of a partnership are attributed to the partners under § 512(c)(1).").

[314] *See id.*

[315] *See* I.R.C. § 864(b)(2).

[316] Rosenthal, *Sun Capital and Beyond*, *supra* note 26, at 1469.

soning and partnership attribution applies to private equity, foreign investors will be subject to U.S. income tax and reporting requirements.[317] As foreign investors typically select private equity investments for their favorable tax treatment and subsequently high returns, losing their tax exempt status would likely compress foreign investment and greatly reduce the amount of foreign capital in the United States.[318]

e. Carried Interest Legislation

Legislative proposals focused solely on carried interest may intend to circumvent the above discussed adverse impacts for limited partner investors.[319] However, simply shielding these investors from ordinary income tax does not mean that they may avoid adverse effects by such a change.[320] This assumes that "supply of private equity investment opportunities is inelastic with respect to the tax rate."[321] Beyond a decrease in investment opportunities, an increased tax on carried interest could cause funds to change their structure in order to redistribute these costs, pass them on via lower investment returns, or engage in riskier investment behavior.[322]

V. CONCLUSION

> Opening up the tax code for special-treatment tinkering isn't a game, and it shouldn't be treated like one.[323]

The various legislative, judicial, political, and scholarly pressures examined in this work all point to one similar conclusion: private equity, and specifically carried interest, are targets for increased taxation. The policy objective behind capital gains treatment in private equity seems lost in the current political economic debate, facing large deficits and calls for "fairness" in the tax code.[324] Accordingly, with proposed legislation such as the Levin bills and the Obama Administration's consistent targeting of carried interests in its budget and legislative proposals,

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[317] BLOOMBERG BNA, *supra* note 13.

[318] *See id.*

[319] *See* Randal Dodd, *Tax Breaks for Billionaires*, ECON. POL'Y INST. (July 24, 2007), http://www.epi.org/publication/pm120/.

[320] *See, e.g.*, Thomas, *supra* note 298, at 8; Furchgott-Roth, *supra* note 299.

[321] Thomas, *supra* note 298, at 8.

[322] *See* Field, *supra* note 262, at 420.

[323] Forbes, *supra* note 297.

[324] *See* Furchgott-Roth, *supra* note 299; Hendrickson, *supra* note 11.

the political climate appears set on an increase in the tax rate for private equity funds, "defy[ing] long-settled partnership tax law to treat a critical investment model in a punitive manner and undermine an engine of economic growth."[325]

Decisions such as *Sun Capital* and *Dagres* bring the "trade or business" of private equity into question, providing a potential for regulators to construe narrowly the capital gains exception and box private equity into ordinary income taxation. This reasoning, however, thwarts a century of tax law concerning capital gains treatment established with the purpose of supporting investment in the United States. If tax analysts are able to analogize private equity funds with real estate developers, do we allow the analogy to dictate regulatory change despite the significant effect on the economy? While political forces may successfully roust carried interests from their current capital gains treatment, private contracting and market forces will likely redistribute funds' returns at the expense of the government and economy. Accordingly, regulators must consider what policy objective would such a shift in carried interest taxation ultimately achieve?[326]

Whatever the case, *Sun Capital* is unlikely to have any immediate impact on the taxation of private equity due to the decision's limitation to the ERISA context.[327] It has added deference to the debate for treating private equity as a trade or business, and provides a logical path for future tax courts or the Treasury to follow in interpretations of the I.R.C. Additionally, legislators now have more legal analysis to apply to their focus on carried interest. Increases in taxation on private equity, however, will adversely affect investment in the United States, and the negative net effect of raising additional revenue through decreasing investment by removing the "billionaire tax break" should be appreciated by legislators supporting such change. Private equity funds, in the meantime, will likely assess their structures in order to insulate themselves from the offset issue presented in *Sun Capital*[328] and consider new, restructured general partner compen-

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[325] Hendrickson, *supra* note 11.

[326] *See generally* David A. Weisbach, *The Taxation of Carried Interest in Private Equity*, 94 VA. L. REV 715, 718 (2008) (discussing policy objectives and classification problems associated with carried interest).

[327] Fleischer, *supra* note 4.

[328] *See* BLOOMBERG BNA, *supra* note 13.

sation agreements to preserve their returns and outrun the legislature's unwieldy pursuit.[329] None of these developments appear positive for the economy, and "[i]f Congress is serious about closing perceived loopholes or bringing more fairness to the tax system, then it's time to look at overall reform . . . and not just an easy target."[330]

[329] *See* Rosenthal, *supra* note 8, at 366.
[330] Forbes, *supra* note 297.