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The First Circuit's Sun Capital Decision: Much Ado About Nothing?

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The First Circuit's much-discussed decision in ***Sun Capital Partners III, LP, et al. v. New England Teamsters & Trucking Industry Pension Fund*** *et al.,* No. 12-2312 (1st Cir. 2013) has forced many practitioners and commentators (and, perhaps, tax policymakers) to take another step back and assess the appropriate **tax treatment of pooled investment vehicles** (in particular, **private equity funds**). The ultimate holding of the case, however, is far less foreboding for tax purposes than some have made it out to be. In fact, the most relevant aspect of the case from a federal tax perspective may just be a footnote buried near the end of the court's opinion.

In *Sun Capital*, the First Circuit held that a private equity fund entity was jointly liable for an ERISA withdrawal liability of one of its portfolio companies that was in bankruptcy. Under ERISA, this legal determination was based on the court's finding that the fund was engaged in a "trade or business." Appealing to notions of agency, the court emphasized the fact that the fund was not a passive investor, but was "actively," "extensively" and "intimately" involved in the management, operation and supervision of the portfolio company. Essentially, the fund was in the very trade or business of the portfolio company itself (in this case, metal production). The court quoted a commentator who had stated, "it is one thing to manage one's investments in businesses. It is another to manage the businesses in which one invests."

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The court pointed out that its holding, while not *based* on Supreme Court tax precedent, was not inconsistent with such precedent. However, for tax purposes, it would be contrary to well-established thinking to conclude that a fund (set up as a Delaware limited partnership) was engaged in the very business of its portfolio company (treated as a corporation for tax purposes). While the tax law does acknowledge the attribution of "trade or business" activity through partnerships, it does not apply these attribution principles to investments in corporations. And the relevant case law defining "trade or business" for tax purposes acknowledges that in the absence of exceptional facts, investment-oriented activities vis-à-vis corporations are not to be conflated with the trade or business of the corporations themselves.

Based on the above, it would be rather dramatic for a court to hold that a private equity fund is in the trade or business of its portfolio company for tax purposes. Features of investment funds such as management fee offsets (on which the *Sun Capital* court focused heavily) should not cause the fund's investment-oriented conduct to instead be treated as something else. In the wake of the court's decision, many commentators sounded the alarm bells, describing the sweeping implications the decision could have on the taxation of fund managers. In reality, however, the court's direct holding would be largely inapposite as applied to settled tax precedent.

If one were to accept the proposition that a fund is not engaged in the businesses of its portfolio companies, the question then becomes whether they are engaged in a different business. As a general matter, market-oriented activities have traditionally been characterized as falling along a spectrum consisting of three categories: investing, trading and dealing. “Trader” status may be the golden ticket for investment funds, as it would allow above-the-line deduction of management fees while still preserving capital gains treatment on investment gains. However, courts have set a relatively high bar for “trader” status. A recent case, *Nelson v. Commissioner*, T.C. Memo. 2013-259 (11/13/13), held that even as many as 535 trades in a year was not enough to establish “trader” status under the facts of that particular case. Accordingly, private equity funds are unlikely to be treated as traders. Dealer status, on the other hand, typically requires the presence of “customers,” a feature that is arguably lacking in the context of private equity fund sponsors. That leaves “investor” status, which delivers the fund managers their capital gains treatment with respect to their carried interest.

One argument that has started to gain some traction, however, is that the private equity fund sponsors are best treated as “developers.” In other words, their constant buying and selling of companies makes them look like real estate developers who “flip” properties and do not enjoy capital gains treatment on their gain. This approach has been championed most prominently by Steve Rosenthal, a visiting fellow at the Urban-Brookings Tax Policy Center. In his influential article, “Taxing Private Equity Funds as Corporate Developers,” *Tax Notes* Jan. 21, 2013, Rosenthal argues that private equity funds tend to “slip through the cracks” of the investor/trader/dealer framework, and should actually be taxed as developers who sell companies as a type of “inventory.” This treatment would take their gains out of the definition of “capital asset” under Section 1221 of the Code. Although that provision seems to require “customers” as well, Rosenthal argues that the “customer” requirement serves a different purpose and shouldn’t be an impediment to ordinary treatment of private equity gains.

The *Sun Capital* court, in footnote 26, informed us that the teamsters actually raised this “developing business enterprises for resale” theory, but that the argument was raised too late. Although the “developer” theory is similar to treating these funds as dealers, it represents a different conceptualization of fund activity and it would be interesting to see how a court would address it.

There is no shortage of academic commentary dealing with the normative question of how investment fund managers should be taxed on their economic income. Most of these discussions point in one of two directions: (1) some form of carried interest legislation should be passed, recharacterizing some or all of the manager’s carried interest as compensation, or (2) such legislation is not warranted, since the taxation of fund managers is consistent with the principles of U.S. tax laws applicable to partnerships and to sweat equity. The developer theory, however, would maintain that even in the absence of a legislative change, private equity sponsors should be taxed on their carried interest at ordinary income rates. Therefore, while the *Sun Capital* decision shouldn’t be viewed as a harbinger of drastic change to fund sponsor taxation, it should force the industry to think about the appropriate responses to some of the harder questions that are sure to come.

On November 21, 2013, Sun Capital filed a certiorari petition with the Supreme Court challenging the First Circuit Court. In its petition, the fund argued that the First Circuit “obliterated [the Supreme Court’s] clear line between an investor and a ‘trade or business.’”