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External Release
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Sun Capital Partners: Further consideration of the trade or business and common control issues in pension case

Affects: Private equity (PE) Funds and investors in PE Funds

Situation presented:

On March 28, 2016, the federal district court in Massachusetts (the "District Court"), issued a decision (2016 U.S. Dist. LEXIS 40254) in Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund, 2013 U.S. App. LEXIS 15190 (1st Cir. 2013) ("Sun Capital"), holding that, for purposes of pension withdrawal liability under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA), two private equity funds were engaged in a trade or business and that they were under "common control" with the portfolio company such that they were jointly and severally liable for its pension withdrawal liability. While Sun Capital is not a tax case, some commentators have suggested that the principles of the case, if extended to the tax arena, could have broad implications for the tax treatment of the income and activities of PE Funds and their investors.

The District Court's decision followed remand of the case from the United States Court of Appeals for the First Circuit (the "First Circuit") pursuant to a July 24, 2013, decision, which addressed whether the private equity partnership litigants in the case were engaged in "trades or businesses" for purposes of the MPPAA. Reversing a decision by the District Court, the First Circuit held that one of the investing funds was more than a mere passive investor and therefore was engaged in a trade or business for purposes of ERISA. The First Circuit remanded for additional fact finding with respect to the second fund as well as whether the two funds were under "common control" with the bankrupt portfolio company under section 4001(b)(1) of ERISA, thereby making the funds jointly and severally liable for the portfolio company's pension withdrawal liability.

The District Circuit's holding in the case addressed only provisions of ERISA. The definition of "trades or businesses...under common control" under ERISA effectively cross-references the definition in the Treasury Regulations under section 414(c) of the Internal Revenue Code (the "Code"). Many PE Funds and similarly situated taxpayers have historically relied on certain tax authorities, including United States Supreme Court cases, to support the position that they are not engaged in a "trade or business" for federal income tax purposes.

Issue – Background

The relevant facts of *Sun Capital* are as follows:

Two private equity partnerships, Sun Fund III and Sun Fund IV, both of which were managed by their general partners, invested (through a holding company) in Scott Brass Inc. (SBI), a troubled business with an obligation to contribute to the New England Teamsters Fund (the "Teamsters Fund"). One partnership held 70% of the holding company shares and the other partnership held 30%. The general partner of one of the Sun Funds (the "Sun GP") also owned a subsidiary management company that provided management

services to SBI. Within two years of the Sun Funds' purchase of SBI, SBI was bankrupt and liable for over $4 million in withdrawal liability (greater than the total Sun Funds' cash investment). The Teamsters Fund sought the unpaid withdrawal liability from the Sun Funds under the MPPAA.

The MPPAA imposes liability on an organization, other than the one obligated to the pension fund, when two conditions are satisfied: the organization is engaged in a "trade or business," and the organization is under "common control" with the organization obligated to the pension fund. Congress authorized the Pension Benefit Guaranty Corporation (PBGC) to prescribe regulations consistent and coextensive with regulations prescribed by the Secretary of Treasury under section 414(c), and the PBCG regulations effectively cross-reference the Treasury Regulations under section 414(c).

Trade or Business

The First Circuit decision in *Sun Capital* articulated an "investment plus" standard for determining whether an organization is engaged in a trade or business. It concluded that Sun Fund IV was engaged in a trade or business but remanded to the District Court for additional factual findings for Sun Fund III. The specific focus was on whether Sun Fund III had management fee offsets or other economic benefits similar to those that the First Circuit believed existed for Sun Fund IV but that a passive investor ordinarily would not obtain. It appears there was a misunderstanding of the facts—that Sun Fund III was actually the one with the management fee offset during the relevant years and Sun Fund IV was only entitled to management fee offset carryforwards for future use. The District Court concluded that these carryforwards nevertheless were a valuable benefit accruing to the funds as a result of their management activities with respect to SBI and thus Sun Fund IV also satisfied the First Circuit's "investment plus" standard.

Common Control

The District Court then turned to the second issue: whether the funds were under "common control" with SBI. The court began its analysis of this issue by observing that the "brightline ownership-based test" used in the Treasury regulations "is in some tension with the purposive approach of the MPAA" and suggesting "that the relevant political actors should consider whether their enactments can be better harmonized by statute and/or regulation." The Court did conclude the funds are under common control with SBI but only after determining the Sun Fund III and Sun Fund IV owned a partnership-in fact to hold SBI and certain other shared portfolio investments.

Partnership-in-Fact

Sun Fund III and Sun Fund IV formed Sun Scott Brass, LLC to invest in the Scott Brass business. The two funds also co-invested in several other entities using a similar structure. Sun Fund III owned 30% of the investment holding company and Sun Fund IV owned the remaining 70%. Each fund also invested in other assets that were not owned either in the same proportion or not owned by the other fund at all. The District Court concluded after considering cases such as *Commissioner v. Culbertson 337 U.S. 733 (1949)* and *Luna v.*

Commissioner, 42 T.C. 1067 (1964), and substance over form, that the funds were deemed to form a partnership to hold all investments held in the same structure with the same ownership. Thus, Sun Fund III and Sun Fund IV formed a partnership. That partnership owns 100% of Sun Scott Brass, LLC, which owns the Scott Brass businesses.

The District Court then concluded that this partnership-in-fact was both engaged in a trade or business and under common control with SBI, thereby making the two funds jointly and severally liable for SBI's withdrawal liability.

Significance of Sun Capital

Sun Capital specifically involves the provisions of ERISA. Accordingly, Sun Capital is potentially significant to investors who are considering purchasing a business with substantial withdrawal liability exposure or substantially underfunded single employer plans. The specific ERISA provision at issue in Sun Capital

essentially imports the Treasury Regulations under section 414(c), suggesting that the District Court's holding may be extended beyond Title IV of ERISA to various nondiscrimination rules and other provisions of the Code that also cross-reference section 414(c).

It is important to consider how this case impacts how the term "trade or business" is generally defined for purposes of the Code. One may expect many PE Funds and PE investors to continue to take the position, based on Whipple v. Commissioner, 373 U.S. 193 (1963), Higgins v. Commissioner, 312 U.S. 212 (1941), and similar authorities, that they are not engaged in a "trade or business" for federal income tax purposes. It is also critical to consider when and to what extent separate partnerships should be treated as one partnership and when tax partnerships might exist when none legally exist. Interested parties should continue to monitor future developments in this area of the law.

Potential discussion items:

- Are any PE investments structured to address potential PBGC or other ERISA liabilities?
- Could portfolio companies be treated as a single employer under section 414(c), and what implications would this have on their employee benefit plans (e.g., coverage requirements, nondiscrimination requirements)?
- Could arrangements be restructured to reduce the risk of being classified as a trade or business, or the adverse impact from such a classification? Note that considerations may differ depending on whether application of the provision in question is triggered merely by the existence of a trade or business, or only by the existence of trades or businesses under common control.
- If a fund were found to be engaged in a trade or business for tax purposes, that could potentially impact tax issues including (but not limited to):
    - Whether expenses are deductible under section 162 versus section 212
    - Whether there is effectively connected income under section 864
    - Whether a sovereign wealth fund's investments in a fund are subject to US tax
    - Whether a tax-exempt investor has unrelated business taxable income under section 512
    - How the income is taxed at the state level (for example, whether the income is subject to apportionment rules that apply to trade or business income).

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