October 7, 2013

Recent Decision of the U.S. Court of Appeals for the First Circuit May Have Significant Implications for Private Equity Funds

In late July of this year, the U.S. Court of Appeals for the First Circuit reversed a Massachusetts District Court, and in a decision of first impression, held that one of Sun Capital Partner's private equity funds was liable for an unfunded pension liability generated by its bankrupt portfolio company, Scott Brass, Inc. While this case arose under the Employment Income Security Act of 1974, as amended ("ERISA"), in reaching its decision, the First Circuit held that: (i) the general partner of the private equity fund was engaged in the "trade or business" of managing the fund (and its portfolio companies); and (ii) that such trade or business could be attributed to the fund itself in order to support imposition of the unfunded pension plan liability.

I. TRADITIONAL PRIVATE EQUITY FUND STRUCTURING AND TAXATION

A. Private Equity Fund Structuring

Virtually all private equity funds are structured as limited partnerships. The general partner ("GP") is usually paid a 2 percent management fee and 20 percent share of the ultimate profits (the so-called "2 and 20 rule"). The limited partners ("LPs") are usually paid a preferred return on their invested equity and (in addition to a return of their invested equity) 80 percent of the back-end profits. The fund's primary economic objective is usually to "invest" in portfolio companies. The LP investors rely on the GP to provide top-end market management and intervention to maximize value and then monetize that value by selling the portfolio company, usually within a five year horizon.

B. Private Equity Fund Taxation

The traditional approach to the taxation of a private equity fund has been to treat the limited partnership as "passively investing" in portfolio company equity investments, thereby ultimately generating dividend income and capital gain—as opposed to engaging in a "trade or business" that would generate ordinary income. Traditional LP investors are attracted to the private equity market because of the high potential for significant economic returns, the bulk of which are taxed at more favorable capital gain rates. Tax-exempt investors are attracted to the private equity market because the investments have traditionally generated income that is not subject to unrelated business taxable income ("UBTI"). Finally, foreign investors are attracted to private equity because the investment-related returns have not been traditionally treated as income that is effectively connected ("ECI") with the conduct of a U.S. trade or business and, therefore, the foreign investors are not subject to taxation within the U.S.

410 17th Street, Suite 2200
Denver, CO 80202

II. THE SUN CAPITAL FACTS

The Sun Capital private equity fund in question was structured, and functioned in all material respects, as a traditional private equity fund. It followed the 2 and 20 rule—the GP had no employees, the GP used an affiliate to provide management expertise and operational input to the portfolio companies, the ERISA investors relied on the venture capital operating company ("VCOC") exception to the plan asset rules and the "good income" exception to the UBTI rules, and foreign investors relied on the position that the fund did not generate ECI from a U.S. trade or business. One of the portfolio investments, Scott Brass, Inc., maintained a pension plan that experienced a $4.5 million unfunded pension liability due to the fact that within two years of the fund investing, it failed economically and sought bankruptcy protection. The New England Teamsters Pension Fund brought suit to recover the unpaid pension liability from several parties including the private equity fund that owned the company. Under ERISA, members of the same "controlled group" are jointly and severally liable for the unfunded pension liability—and therefore demand was made on the fund as well. To be within a controlled group, you must: (1) be under common control; and (2) conduct a trade or business. ERISA does not define what is meant by a trade or business—and the fund defended by saying—we are a passive investor and are not engaged in a trade or business. The First Circuit looked to regular income tax law to define "trade or business" (in particular, the Supreme Court's well-known decision in *Commissioner v. Groetzinger*, 480 US 23 (1987)). In *Groetzinger*, the U.S. Supreme Court held that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and … the taxpayer's primary purpose for engaging in the activity must be for income or profit." In applying the *Groetzinger* test, the First Circuit found that the fund engaged in enough activity to constitute a "trade or business" and held them liable for the pension liability. The trade or business in which the fund engaged was the trade or business of "actively managing and operating the portfolio companies," not investing in them passively.

III. POTENTIAL REPERCUSSIONS OF THE SUN CAPITAL DECISION TO PRIVATE EQUITY

If extended to its ultimate extreme, the holding in Sun Capital could have the following significant repercussions in the private equity space:

<u>A. Indirect Implementation Against a GP of the Proposed "Carried Interest" Legislation</u>
For some time now, the current administration has been advocating adoption of the so-called "carried interest" legislation. If enacted, the carried interest legislation would tax as ordinary income the 20 percent carried interest of the private equity fund GP, as opposed to its traditional taxation as capital gain. So far, Congress has not been able to garner the support to enact "carried interest" legislation. However, the holding in Sun Capital, which relies on already well-accepted tests for establishing the existence of a trade or business in the income tax area, may well provide the opportunity for the IRS to advance the carried interest theory judicially as

opposed to legislatively.

B. Carried Interest on Steroids!

The carried interest legislation has been directed primarily against the GP in the private equity context—and not the LP investors. However, under the First Circuit's analysis and rationale in Sun Capital, the GP was not only found to have been engaged in a trade or business, but also the trade or business of the GP was "attributed to" the entire limited partnership fund. This re-attribution of the trade or business was necessary to attach to the fund itself, liability for the unfunded pension liability under ERISA. However, if this approach were applied to the income generated by the fund itself, the IRS could argue that all income generated was actually ordinary income and not capital gain. This approach would in effect extend "carried interest" treatment to income generated on behalf of passive LP investors and not only the GP whose interest was actually being "carried."

C. Tax-Exempt Investors

Tax-exempt investors are attracted to private equity investments because traditional investment-type income (interest, dividends, royalties and capital gains) is exempt from UBTI. However, it is clear that the typical UBTI exclusions do not extend to income generated in the ordinary course of a trade or business. While some tax-exempt investors may be willing to accept a UBTI tax, the vast majority of such tax-exempt investors would not select a taxable investment if comparable alternative tax-exempt investments are available.

D. Foreign Investors

Foreigners choosing to invest in the U.S. have been traditionally granted an exemption from U.S. tax provided the investment did not generate income that is ECI. Because private equity funds have been traditionally treated and taxed as if they engaged in passive investment activities, the investment income generated by such funds has been attractive to foreign investors because such income did not constitute ECI taxable to such investors in the U.S. However, under the Sun Capital analysis, if the income generated by the partnership was to be tainted by reference to the trade or business conducted by the GP (and also attributed to both the limited partnership and its LP investors), income taxation of the foreign investors would follow with respect to such deemed ECI.

IV. ARGUMENTS FOR LIMITING THE EXTENSION OF THE SUN CAPITAL HOLDING

Since issuance of the Sun Capital decision, several arguments have been advanced that advocate limiting the scope and reach of this decision:

A. The Case Is Unique

There are those who argue the case is unique in that it arose in the context of ERISA and the desire to find a deep pocket to fund a pension liability for union members who would otherwise lose pension benefits while private economic interests escaped responsibility. Others point to the fact that the Teamsters were involved and that the Pension Benefit Guaranty Corporation should not have to bail out a private investment. While politically appealing, these arguments do little to limit the ability of a court to adopt the analysis of the First Circuit.

B. Technical Arguments

One of the best technical arguments to be advanced in favor of limiting the Sun Capital holding is that the impact of the decision was to collapse the entire limited partnership structure and attribute to the passive LP investors the trade or business of the GP that was found to exist by the court. While there is authority in the tax law to attribute an activity undertaken by the partnership itself to its partners, it is an extreme extension of the tax law to attribute the activity of the GP, first to the partnership itself, and then to the LPs. This extension of GP business to the LPs is especially troubling given the fact that as limited partners, they are prohibited by state law from engaging in such activity.

V. FUTURE PLANNING AND STRUCTURING

Given the fact that Sun Capital is now “on the books,” in going forward, we believe the following to be prudent actions to be undertaken:

A. Ignoring the Case Is Dangerous

Just because the case involved ERISA and pension fund liability, we do not think it is prudent to rely on the uniqueness of the facts. At the ABA meeting in San Francisco that just occurred in August of 2013, IRS representatives indicated that they were aware of the opportunities provided to the IRS by the Sun Capital decision. While the IRS representatives indicated that they would proceed cautiously, there is no reason to take comfort from such statements.

B. Pension Plan Due Diligence Is Key

In any acquisition of a portfolio company (or any company for that matter) that maintains an ERISA plan, Sun Capital places a premium on pension plan due diligence and assessment of the underlying liability and its related risks. An ounce of prevention here is critical given the direct holding of the case.

C. Structuring Alternatives

It is critical to examine the manner in which the GP and its affiliated entities provide management expertise to the portfolio company and its management. In addition, the Sun Capital case provides some support for structuring ownership of a portfolio investment to avoid the percentage-driven “common control” test.

If you have any questions about, or would like assistance in analyzing the impact of, the court's decisions on your tax plans, please contact one of the **Brownstein tax group members**.

This document is intended to provide you with general information about tax issues. The contents of this document are not intended to provide specific legal advice. This communication may be considered advertising in some jurisdictions.

Neil M. Goff
Shareholder
ngoff@bhfs.com
T 303.223.1135

Andrew C. Elliott
Shareholder
aelliott@bhfs.com
T 303.223.1154

Nancy A. Strelau
Shareholder
nstrelau@bhfs.com
T 303.223.1135

Gregory W. Berger
Shareholder
gberger@bhfs.com
T 303.223.1158

David Spaulding
Of Counsel
dspaulding@bhfs.com
T 303.223.1158