Offshore Funds: Implications of the Appellate Court Ruling Against Sun Capital

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Selected US Tax Developments

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OFFSHORE FUNDS: IMPLICATIONS OF THE APPELLATE COURT RULING AGAINST SUN CAPITAL

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This article examines the implications of the *Sun Capital* case for the US federal income tax treatment of foreign taxable and section 892 exempt governmental investors in US private equity funds.

KEYWORDS: FOREIGN ■ FOREIGN INVESTORS ■ FUNDS ■ GOVERNMENTS ■ PENSION PLANS ■ US

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INTRODUCTION

In a recent decision involving two private equity funds managed by the Florida-based Sun Capital investment adviser group ("the Sun funds"),[1] the First Circuit Court of Appeals held that at least one of those funds, Sun Capital Partners IV, LP ("Fund IV"), was a "trade or business" on which pension withdrawal liability may be imposed under the Employee Retirement Income Security Act of 1974 (ERISA).[2] Although the issue in the *Sun Capital* case was not a tax issue, the characterization

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1 *Sun Capital Partners III, LP; Sun Capital Partners III QP, LP; Sun Capital Partners IV, LP v. New England Teamsters & Trucking Industry Pension Fund*, docket no. 12-2312 (1st Cir., July 24, 2013).

2 29 USC section 1001 et seq.

of a private equity fund as a trade or business could potentially be relevant to the US federal tax treatment of foreign investors in US private equity funds or their offshore feeder funds. The case could also have implications for foreign governmental investors that qualify for the section 892 exemption under the Internal Revenue Code.[3] This article explores the implications of *Sun Capital* for foreign investors in such funds and attempts to assess whether it would be prudent for such investors to take any steps to mitigate tax risks arising from the court's holding.

FACTUAL BACKGROUND

Scott Brass, Inc. ("SBI"), a leading producer of high-quality brass, copper, and other metals, was acquired by Fund IV together with its sister fund, Sun Capital Partners III ("Fund III," which was also managed by the Sun Capital adviser group).[4] SBI was a participating employer in a multi-employer pension fund known as the New England Teamsters and Trucking Industry Pension Fund ("TPF"), and until 2008 SBI made contributions to the TPF on behalf of its employees pursuant to a collective bargaining agreement. In 2008 SBI ceased making contributions to the TPF, and shortly thereafter SBI entered a chapter 11 bankruptcy. The TPF filed a lawsuit against SBI under ERISA section 1381. That section provides that if an employer withdraws from a multi-employer pension plan, the employer is liable to the plan for the employer's allocable share of the unfunded vested benefits accrued under the plan (subject to certain adjustments). The TPF also sued Fund III and Fund IV, claiming that they were also liable for SBI's pension withdrawal liability. The claim against those funds was based not merely on their ownership of SBI, but rather on a special rule contained in ERISA section 1301 pursuant to which trades or businesses under common control are treated as a single employer upon which pension withdrawal liability can be imposed.[5] In order for this rule to apply, the TPF had to show that Fund III and Fund IV each constituted a "trade or business."

The District Court held that the two funds were not trades or businesses and that the management activities of the funds' general partner could not be attributed to the Sun funds.[6] However, the First Circuit Court of Appeals reversed the District Court on the trade or business issue and concluded that Fund IV's activities (or at least the activities of its general partner) were sufficient for Fund IV to be treated as a "trade or business" for the purposes of ERISA section 1301.[7] The court applied a

3 Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

4 Sun Fund III actually comprises two different partnerships, Sun Capital Partners III, LP and Sun Capital Partners III QP, LP. The court described these as "parallel funds" and treated them as a single fund.

5 ERISA section 1301(b)(1).

6 *Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107 (Dist. Ct. MA 2012).

7 The court did not reach a conclusion on whether Fund IV was under common control with SBI and remanded the case back to the District Court for a conclusion on that issue.

standard that has come to be known as the "investment plus" test, which was first advanced by the agency charged with enforcing ERISA (the federal Pension Benefit Guaranty Corporation, or PBGC) in a 2007 ruling involving a private equity fund that foreshadowed the *Sun Capital* case.[8]

US TAX TREATMENT OF FOREIGN INVESTORS IN PRIVATE EQUITY FUNDS

The issue addressed in the *Sun Capital* case is potentially significant from a US tax perspective for foreign investors in private equity funds, since the determination of whether income that is effectively connected to an activity is subject to US federal income tax depends on the characterization of the activity as a trade or business conducted in the United States. More generally, a foreign investor may be subject to US federal income taxation under one of two regimes. One regime applies to fixed, determinable, and periodic (FDAP) income from US sources.[9] Such income is subject to a 30 percent gross tax, which is enforced through withholding at source. The second regime, relevant here, imposes tax on a net basis at the same rates applicable to US taxpayers and applies to income that is effectively connected to a US trade or business.[10] The term "trade or business" is not defined in the Code, and does not necessarily have the same meaning each time it appears within the Code, but is frequently defined in the manner adopted by the US Supreme Court in *Commissioner v. Groetzinger*[11] as including any activity that is (1) engaged in for the primary purpose of profit and (2) conducted with sufficient continuity and regularity. Under longstanding and well-established authorities commencing with *Higgins v. Commissioner*,[12] a taxpayer whose activities are limited to acting as a passive investor is not treated as being engaged in a trade or business. Consistent with those authorities, the courts and the Internal Revenue Service (IRS) have ruled that a foreign taxpayer that invests in securities is not treated as being engaged in a US trade or business, no matter how extensive the investment activities and regardless whether the activities are conducted through a US office.[13] At one time, the courts distinguished foreign taxpayers that engaged in active and regular securities trading activities from passive investors and held that traders are engaged in a US trade or business.[14] However, the Code was subsequently amended to specifically exempt securities traders from such treatment.[15]

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8 PBGC Appeals Board Decision, September 26, 2007.

9 Code sections 871(a) and 881.

10 Code sections 871(b) and 882.

11 480 US 23 (1987).

12 312 US 212 (1941).

13 *Scottish American Investment Co., Ltd.*, 12 TC 49 (1949); and Rev. rul. 55-182, 1955-1 CB 77.

14 *Chiang Hsiao Liang*, 23 TC 1040, at 1042 (1955); acq., 1995-1 CB 4.

15 Code section 864(b)(2).

Private equity funds commonly undertake to their foreign investors that they will apply best efforts to ensure that they are not engaged in a US trade or business. Such funds typically acquire investments with an intent to hold them for extended periods of time, and they generally do not trade with sufficient frequency to be characterized as traders. Accordingly, in *Sun Capital*, the court did not entertain the characterization of the Sun funds as traders.[16] Rather, the *Sun Capital* case focused on a different issue, namely, whether the activities of a fund's general partner with respect to managing corporations in which the fund invests can cause the fund to be treated as being engaged in a trade or business of "corporate management." Prior to *Sun Capital*, most tax practitioners thought that this issue had been favourably put to rest by the US Supreme Court in *Whipple v. Commissioner*, where the court stated:

> Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profits or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.[17]

THE APPELLATE COURT'S DISCUSSION OF THE TRADE OR BUSINESS ISSUE

In its analysis of the trade or business issue, the appellate court in *Sun Capital* discussed both *Higgins* and *Whipple*. Although the court indicated that its holding was addressed to the ERISA definition of a trade or business and that it was therefore not required to conclude that Fund IV's activities were sufficient for the fund to be treated as being engaged in a trade or business for tax purposes, the court nevertheless insisted that its conclusions were consistent with *Higgins* and *Whipple*. Indeed, the PBGC ruling that developed the investment plus standard applied by the court was itself based on the *Groetzinger* case, which was a tax case. The *Sun Capital* case

16 A footnote to the court's opinion indicates that the TPF argued that the Sun funds should also be viewed as trades or businesses because they are engaged in the development, promotion, and sale of companies. Such "promoters" have been held to be engaged in a trade or business for tax purposes. See *Carroll L. Deely*, 73 TC 1081 (1980); *Frank L. Farrar*, 55 TCM 1628 (1988); and *Todd A. Dagres*, 136 TC 263 (2011) (which involved the slightly different issue of whether the general partner of a venture capital fund is engaged in a trade or business by reason of its management of the fund). However, none of those cases considered whether a promoter who is otherwise engaged in a trade or business can nevertheless rely on the Code section 864(b)(2) securities trading exemption to avoid being treated as engaged in a US trade or business for the purposes of determining the taxability of the promoter. The answer to this question probably depends on whether the promoter is acting as a "dealer" with regard to the activity.

17 373 US 193, at 202 (1963).

thus represents a challenge to foreign investors in private equity funds who rely on the *Higgins* and *Whipple* cases and their progeny for the position that such funds are not engaged in a US trade or business.

The court in *Sun Capital* referred to several facts that supported the conclusion that Fund IV was a trade or business. These facts included

1. statements made in the Sun funds' private placement memorandums to the effect that each fund would be actively involved in the management and operation of the companies in which it invested;
2. similar statements appearing in the Sun funds' partnership agreements, which also empowered the general partner of each fund to make decisions about hiring, terminating, and compensating agents and employees of the fund and its portfolio companies; and
3. actions taken by the Sun funds to replace directors and provide consultants who were immersed in details involving the management and operation of the bankrupt portfolio company.

However, the fact to which the court seems to have attached the most weight was that management fees paid by Fund IV's portfolio companies to its general partner entitled Fund IV to an offset against the management fees that it would otherwise have been obligated to pay to its general partner. The court considered this fact to be so significant that it declined to hold that Fund III was a trade or business absent a finding that Fund III had received a benefit similar to the benefit received by Fund IV from the offset of the management fees paid to its general partner by the bankrupt portfolio company; instead, the court remanded the case to the lower court for a determination on that factual point. In addition, the court found that this fee offset represented a significant difference between the facts in the case before it and those addressed by the tax cases on the trade or business issue. In the court's view, the fact that Fund IV derived an economic benefit from the management activities of its general partner in the form of the fee offset meant that the general partner was performing those management activities as an agent of the private equity fund.[18]

ANALYSIS

Sun Capital is troubling in part because most private equity funds provide for an offset of fees that the manager earns from the portfolio companies against the fund's proportionate share of the general partner's management fee. However, the relevance of this fact to the issue of whether the fund is engaged in a trade or business seems questionable. From an economic perspective, the offset can be justified as compensating

18 Interestingly, in a rehearing petition subsequently filed by the Sun funds (which petition was denied by the court), Fund IV asserted that it had in fact waived its right to benefit from the fee offset during the years at issue and that the offset should therefore not have been given any weight by the court. It may be that the court believed that the mere existence of a right to claim the offset was sufficient to support its agency finding.

the funds for the cost to the general partner of devoting some of its resources to an activity other than managing the fund itself; or, putting it differently, the general partner is compensating the fund for providing the general partner with the opportunity to earn fees from the management company. The court thus seems to have got it backward. In effect, the court seems to be treating what is in substance a payment *by the general partner* to the fund (in the form of a fee offset) as if it were a payment *by the fund* to the general partner for acting as the fund's agent. Furthermore and perhaps more importantly, as a technical matter the fee offset should not cause recognition of gross income to the fund at all, so the attribution of the management fees to the fund lacks any sound basis in the tax law. One can only hope that the latter point will serve to dissuade courts and the IRS from concluding that a private equity fund should be treated as being engaged in a trade or business for tax purposes by reason of its entitlement to a general partner management fee offset.

The *Sun Capital* case also has potential implications for foreign governmental investors that rely on the Code section 892 governmental exemption.[19] The section 892 exemption is not available for income derived from a partnership that is engaged in a commercial activity. In addition, an otherwise exempt subsidiary (or "controlled entity") of a foreign government may be disqualified entirely from the section 892 exemption if it is viewed as being indirectly engaged in a commercial activity through a partnership. The same logic that led the First Circuit court to conclude that Fund IV was a trade or business could potentially support an argument that the fund was engaged in a commercial activity within the meaning of section 892. Proposed regulations under section 892 would protect a governmental entity from being disqualified by reason of engaging in a commercial activity inadvertently or as a result of an investment in a partnership as a limited partner if the governmental entity does not have rights to participate in the management and conduct of the partnership's business.[20] However, the income earned from such an investment is still not eligible for the section 892 exemption.

CONCLUSION

It appears unlikely that the *Sun Capital* case will cause any changes in the operation of the industry, but in the event that the decision is viewed as changing the legal landscape, then consideration should be given to the use of special-purpose blocker corporations for investments in private equity funds, especially if the fund features a general partner management fee offset like the one present in *Sun Capital*. While fund investors probably will not complain about management fee offsets, from which they benefit, it is possible that concern about the trade or business risk could lead to resistance to general partners and their affiliates earning management fees directly from portfolio companies.

19 Code section 892.

20 Prop. reg. sections 1.892-5(a)(2) and (b)(5)(1)(iii).