

## NOTE

### IS A PRIVATE EQUITY FUND A “TRADE OR BUSINESS”? ALTERNATIVES TO THE FIRST CIRCUIT’S APPROACH

JOSEPH CALAVENNA\*

What exactly a private equity firm does can often seem confusing and inaccessible. The private equity industry and the firms within it use capital invested by individuals and institutions to purchase companies that are then held as investments. The companies purchased as investments range in strength from distressed companies to companies with strong operations. In both cases, private equity firms provide services to strengthen portfolio companies with the goal of either selling the company in the future or selling stock in the company in an initial public offering.

In *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, the First Circuit classified a private equity fund as a “trade or business.” But the term “trade or business” is undefined in relevant regulations. Regardless, the First Circuit classified the private equity fund in question as a “trade or business” by relying heavily on an administrative letter and loosely interpreted case law. This Note will explore how the First Circuit made its decision and ultimately conclude that the First Circuit erred in its application of the “trade or business” term as applied to private equity funds.

Introduction .....	538
I. The Confusing World of Private Equity Regulation and Litigation ..	542
A. Regulations at Play .....	542
B. Informative Supreme Court Cases .....	544
C. The Internal Revenue Code and Instructive Tax Cases .....	545
D. The Sun Capital Partners Model of Private Equity .....	546
II. The “Trade or Business” and “Investment Plus” Constructs:	
Letting the Courts Decide .....	548
A. The <i>Groetzing</i> and <i>Whipple</i> Approach to “Trade or Business” .....	548
B. How Tax Cases Define “Trade or Business” and How These Definitions Can Relate to Private Equity Funds .....	551

---

\* J.D. Candidate, University of Wisconsin Law School, 2016; M.B.A. Candidate, Wisconsin School of Business, 2015; B.S., New York University-Stern School of Business, 2010. Thank you to Professor Kenneth B. Davis, Jr. for suggesting this topic and to Professor Deborah Moritz for helping immensely during the editing process. Thank you also to the *Wisconsin Law Review* editors and staff for their tireless work. Finally, a special thanks to my mother for inspiring me to join the *Wisconsin Law Review*, to my father and sister for their endless support, and to my friends for all their encouragement.

C. The “Investment Plus” Approach to “Trade or Business”.....	555
Conclusion.....	556

## INTRODUCTION

It is sometimes hard to see the effect the private equity industry has on the lives of individuals. But the private equity industry is behind many popular companies. Imagine any day for an American family. It could start with lunches packed with Del Monte fruit cups by a mom watching The Weather Channel before the kids are bundled up in Canada Goose down jackets and taken to the bus stop. After work, mom stops at Toys “R” Us to buy a birthday present for her son and at Michaels to pick up supplies for a class project for her daughter. After dinner, she might check movie times at the AMC Theater for her Friday date night with her husband. All of these brands are owned by three of the best-known private equity firms: KKR,<sup>1</sup> the Carlyle Group,<sup>2</sup> and Bain Capital.<sup>3</sup>

Despite how ubiquitous private equity-owned companies are, what a private equity firm actually does is still a mystery to most of the general public.<sup>4</sup> But the actions of private equity firms are fairly easy to understand. Put simply, private equity is an investment vehicle for individual or institutional investors like endowments, foundations, and pension funds.<sup>5</sup> Private equity, like any investment, is one of many alternatives to investing in debt or equity markets like stock markets.

Private equity firms usually invest directly in private companies, often by purchasing the entire private company.<sup>6</sup> Private equity firms can also acquire controlling interests in freestanding public companies and take them private.<sup>7</sup> The term private equity is used because it refers to the

1. KKR owns Del Monte and Toys “R” Us. KKR PORTFOLIO, [http://www.kkr.com/kkr-portfolio?page=Private\\_Equity](http://www.kkr.com/kkr-portfolio?page=Private_Equity) (last visited Mar. 20, 2015).

2. The Carlyle Group owns AMC Entertainment. CARLYLE GROUP PORTFOLIO INVESTMENTS, <http://www.carlyle.com/our-business/portfolio-of-investments> (last visited Jan. 17, 2014).

3. Bain Capital owns The Weather Company, Michaels, and Canada Goose. BAIN CAPITAL PRIVATE EQUITY INVESTMENTS, <http://www.baincapitalprivateequity.com/investments> (last visited Jan. 17, 2014).

4. Steve Odland, *In Support of Private Equity*, FORBES (Jan. 25, 2012, 10:13 AM), <http://www.forbes.com/sites/steveodland/2012/01/25/in-support-of-private-equity/>.

5. DOUGLAS CUMMING, PRIVATE EQUITY: FUND TYPES, RISKS AND RETURNS, AND REGULATION 9 (2010).

6. Odland, *supra* note 4.

7. Susan Chaplinsky & Shikha Khetrepal, *Valuation of Late-Stage Companies and Buyouts*, DARDEN BUS. PUBLISHING, Oct. 2011, at 1, 2.

fact that the equity is not listed and the exchange of the equity is not regulated.<sup>8</sup>

A popular tool of private equity firms for acquiring portfolio companies is the leveraged buyout:

A leveraged buy-out occurs when a group of investors, usually including members of a company’s management team, buy the company under financial arrangements that include little equity and significant new debt. The necessary debt financing typically includes mortgages or high risk/high yield bonds, popularly known as “junk bonds.” Additionally, a portion of this debt is generally secured by the company’s assets. Some of the acquired company’s assets are usually sold after the transaction is completed in order to reduce the debt incurred in the acquisition.<sup>9</sup>

In order to buy companies and build a portfolio of acquired companies, a private equity firm needs to raise capital for investment funds from a variety of investors, including institutional and individual investors.<sup>10</sup> Once the funding goal for a fund is met, the private equity fund will purchase a mix of companies that will then comprise a portfolio of holdings for the private equity fund.<sup>11</sup> Often, once a private equity fund has acquired a company, it will start the process of improving the company’s operations to boost growth.<sup>12</sup> Sometimes the companies that private equity funds acquire are performing poorly and need help strengthening the business.<sup>13</sup> However, private equity also provides an avenue for business owners to exit their businesses when they are ready.<sup>14</sup>

Private equity funds acquire a large variety of different types of companies in a broad range of industries. As a result, the work that private equity firms and their funds do can be important not only to the businesses they acquire but also to the industries they enter.<sup>15</sup> Studies

---

8. CYRIL DEMARIA, INTRODUCTION TO PRIVATE EQUITY 1 (2010).

9. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1505 n.1 (S.D.N.Y. 1989).

10. Cumming, *supra* note 5, at 9–10.

11. *See id.* at 13–16 (providing a more detailed discussion of the structures and strategies of private equity firms).

12. DEMARIA, *supra* note 8, at 12.

13. Odland, *supra* note 4.

14. *See* DEMARIA, *supra* note 8, at 1.

15. Odland, *supra* note 4 (“In [some] cases, without the actions taken by the PE firm, the company would likely go bankrupt or dissolve thereby causing an even greater number of lost jobs than those lost in the turnaround steps taken to save the company.”).

show that the private equity industry neither destroys nor creates a significant number of jobs.<sup>16</sup> Additionally, private equity-acquired businesses do not fail at a rate any higher than similarly situated businesses.<sup>17</sup> Instead, private equity companies can add real value to the companies they acquire through operational improvements and can provide investors with the possibility of high returns.<sup>18</sup>

However, until recently it was unclear if a private equity fund with a controlling stake in a company that withdrew from a multiemployer pension plan would be liable for the unfunded pensions of the acquired company. The risk of unfunded pension plans is serious for private equity funds but more so for the employees of the company with the unfunded pensions who are relying on the existence of their pensions when they retire.

Fortunately, both the Employee Retirement Income Security Act of 1974 (ERISA)<sup>19</sup> and the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA)<sup>20</sup> are designed to protect Americans' pension assets and to govern unfunded pension liability. The MPPAA provides that "all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer and all such trades and businesses as a single employer."<sup>21</sup> "To impose withdrawal liability on an organization other than the one obligated to the [pension] Fund, two conditions must be satisfied: 1) the organization must be under 'common control' with the obligated organization, and 2) the organization must be a trade or business."<sup>22</sup>

In interpreting whether a private equity fund can be held liable for the unfunded pension liabilities of an acquired company one would need a clear idea of what constitutes a "trade or business." For example, if a private equity fund acquired a company that was ailing and that already had unfunded pension liabilities, should the private equity fund be liable for making the pension fund whole, even if it had no part in the shortage of funds?

---

16. Timothy Spangler, *Private Equity's Public Image Issues*, FORBES (Apr. 10, 2013, 8:37 PM), <http://www.forbes.com/sites/timothyspangler/2013/04/10/private-equitys-public-image-issues/>.

17. *Id.*

18. *Id.*

19. 29 U.S.C. § 1001 (2012).

20. *Id.* § 1381.

21. *Id.* § 1301(b)(1).

22. *McDougall v. Pioneer Ranch Ltd. P'ship*, 494 F.3d 571, 577 (7th Cir. 2007) (citing *Cent. States, Se. & Sw. Areas Pension Fund v. Fulkerson*, 238 F.3d 891, 895 (7th Cir. 2001)).

There is no definition of the term “trade or business” in the MPPAA.<sup>23</sup> The term “trade or business” appears many times in the Internal Revenue Code but has been interpreted in many different ways by the courts.<sup>24</sup> In tax cases, a distinction between whether an individual is an investor or a trader has emerged.<sup>25</sup> The different ways the courts have interpreted “trade or business” in the context of the investor versus trader distinction is instructive when attempting to determine if a private equity fund is a “trade or business” for the purposes of pension liability.

In 2007, the Pension Benefit Guaranty Corporation (PBGC)<sup>26</sup> released an appeals letter that attempted to set out a test for determining when a private equity fund qualifies as a “trade or business.”<sup>27</sup> But the test itself was not applied by any court until *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*.<sup>28</sup> In *Sun Capital Partners*, the First Circuit held that Sun Fund IV, an investment fund of Sun Capital Partners, Inc.,<sup>29</sup> was in fact a “trade or business.”<sup>30</sup> The First Circuit reasoned that Sun Fund IV was not a passive investor and instead was actively involved in the management of Scott Brass, Inc., finding this enough to satisfy an “investment plus” standard created by the PBGC.<sup>31</sup>

This Note will examine the First Circuit’s reasoning in *Sun Capital Partners* in light of relevant and instructive regulations and case law, and it will ultimately conclude that the First Circuit erred in its classification of Sun Fund IV as a “trade or business.” Part I overviews the relevant background information, including a discussion of ERISA, the MPPAA, the PBGC, a number of informative Supreme Court cases, instructive tax cases, and a discussion of the *Sun Capital Partners* model of private

---

23. See § 1301(b)(1).

24. Paula Wolff, Annotation, *What Constitutes Trade or Business Under Internal Revenue Code (U.S.C.A. Title 26)*, 161 A.L.R. FED. 245, 245 (2000).

25. This distinction first appeared in *Purvis v. Comm’r*, 530 F.2d 1332, 1333–34 (9th Cir. 1976) (per curiam), and will be discussed in greater detail later.

26. “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 - the kind that typically pay a set monthly amount at retirement.” GENERAL FAQs ABOUT PBGC, <http://www.pbgc.gov/about/faq/pg/general-faqs-about-pbgc.html> (last visited Jan. 17, 2014).

27. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 139–40 (1st Cir. 2013).

28. 724 F.3d 129, 141 (1st Cir. 2013).

29. *Id.* at 129. For purposes of clarity, Sun Capital Advisors, Inc., as the private equity firm is referred to in the case, will hereinafter be referred to as Sun Capital Partners, as appears on the firm’s web site. SUN CAPITAL PARTNERS, INC., <http://www.suncappart.com/> (last visited Feb. 22, 2015).

30. *Sun Capital Partners*, 724 F.3d at 149.

31. *Id.* at 141–43.

equity. Part II analyzes how courts have decided cases involving the definition of “trade or business” and will explore other instructive interpretations of “trade or business” that the First Circuit did not consider in deciding *Sun Capital Partners*.

### I. THE CONFUSING WORLD OF PRIVATE EQUITY REGULATION AND LITIGATION

With respect to private equity funds, there are many cases, regulations, statutes, and administrative letters that are relevant to the definition of a “trade or business.” Individually, these parts are confusing and become more so when considered together. Accordingly, a brief overview of the most important background information on the cases, regulations, statutes, and administrative letters is necessary.

#### *A. Regulations at Play*

Congress enacted ERISA to ensure that employees working for private sector companies receive the pensions their employers promise them.<sup>32</sup> It is a protection to make sure employers make sufficient contributions to pension plans that will meet future pension liabilities.<sup>33</sup> ERISA sets minimum funding requirements for employers to ensure that employers meet their vested pension liabilities.<sup>34</sup> ERISA also mandates termination insurance in the event that an employer goes bankrupt and makes employers that withdraw from pension plans liable for a fair share of the plan’s deficit if the plan becomes insolvent within five years of the employer withdrawal.<sup>35</sup>

The MPPAA was enacted by Congress to fix an unintentional problem created by ERISA;<sup>36</sup> before the enactment of the MPPAA, financial troubles in a pension plan could “trigger a stampede for the exit doors, thereby ensuring the plan’s demise.”<sup>37</sup> This was because ERISA “encouraged an employer to withdraw from a financially shaky plan and risk paying its share if the plan later became insolvent, rather than to remain and (if others withdrew) risk having to bear alone the entire cost of keeping the shaky plan afloat.”<sup>38</sup> Therefore, the MPPAA was created

---

32. *Milwaukee Brewery Workers’ Pension Plan v. Joseph Schlitz Brewing Co.*, 513 U.S. 414, 416 (1995).

33. *Id.*

34. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 903 F. Supp. 2d 107, 112 (D. Mass. 2012).

35. *Id.*

36. *Id.*

37. *Milwaukee Brewery Workers’ Pension Plan*, 513 U.S. at 417.

38. *Id.* at 416–17.

to disincentivize employers from withdrawing from multiemployer pension plans and also to provide a way for employees to recover unfunded pension liabilities.<sup>39</sup> Accordingly, under the MPPAA, an employer withdrawing from a pension fund is liable for their portion of the vested but unfunded pension benefits.<sup>40</sup> An employer withdraws from a pension fund when it permanently ceases covered operations under the pension plan.<sup>41</sup>

While the MPPAA does not provide a definition of “trade or business,” it does state that “all employees of trades or businesses . . . which are under common control shall be treated as employed by a single employer and all such trades and businesses as a single employer.”<sup>42</sup> This means that in order for private equity fund ABC to be held liable for an unfunded pension fund of company XYZ, private equity fund ABC must be classified as a “trade or business.” Additionally, private equity fund ABC must be controlled in common with company XYZ, the company responsible for creating the unfunded pension liability by not maintaining adequate payments to the pension fund. In this scenario, company XYZ withdrew from the pension fund, not private equity fund ABC.

Congress authorizes the PBGC to create regulations that are consistent with current regulations for similar purposes proscribed by the Secretary of the Treasury.<sup>43</sup> Accordingly, the PBGC has since adopted regulations pertaining to the meaning of common control<sup>44</sup> but has not adopted regulations defining or explaining “trade or business.”<sup>45</sup> A regulation issued by the PBGC defining “trade or business” could clear up a great deal of the confusion surrounding the issue. But the scant guidance the PBGC has provided on the interpretation of “trade or business” came in a 2007 PBGC appeals letter.<sup>46</sup> In the letter, the PBGC applied a two-prong test to determine if the private equity fund was a “trade or business”: (1) whether the private equity fund was engaged in an activity with the primary purpose of income or profit and (2) whether it conducted that activity with continuity and regularity.<sup>47</sup> The approach

---

39. *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 720–22 (1984).

40. *See* 29 U.S.C. §§ 1381, 1391 (2012).

41. *Id.* § 1383(a).

42. *Id.* § 1301(b)(1).

43. *Id.*

44. 26 U.S.C. § 414(c) (2012); 29 C.F.R. § 4001.3(a) (2014).

45. *See, e.g.*, 29 C.F.R. § 4001.3.

46. Letter from Charles Vernon, Chair Appeals Bd., Pension Benefit Guaranty Corp., recipient’s identity confidential (Sept. 26, 2007) (on file with the PBGC).

47. *Id.*

the PBGC took in the 2007 appeals letter had been coined the “investment plus” standard.<sup>48</sup>

### *B. Informative Supreme Court Cases*

Because the term “trade or business” has not yet been defined in the MPPAA, a number of Supreme Court cases are particularly instructive in interpreting the meaning of “trade or business” in the MPPAA as it applies to private equity funds. In 1987, the Supreme Court, in *Commissioner v. Groetzinger*,<sup>49</sup> set out to define “trade or business,” as it had not yet been formally defined in the Internal Revenue Code.<sup>50</sup> Additionally, at the time no “broadly applicable authoritative judicial definition” of “trade or business” had emerged.<sup>51</sup> The absence of “trade or business” from the Internal Revenue Code was significant because *Groetzinger* was a tax case concerning whether “a full-time gambler who makes wagers solely for his own account is engaged in a ‘trade or business,’ within the meaning of” the Internal Revenue Code.<sup>52</sup>

The *Groetzinger* Court concluded that “not every income-producing and profit-making endeavor constitutes a trade or business.”<sup>53</sup> The Court laid down the test that to be engaged in a “trade or business,” one “must be involved in the activity with continuity and regularity,” and that the “primary purpose for engaging in the activity must be for income or profit.”<sup>54</sup> According to *Groetzinger*, a “sporadic activity, a hobby, or an amusement diversion does not qualify.”<sup>55</sup>

In *Whipple v. Commissioner*,<sup>56</sup> the Court analyzed the tax laws and determined from legislative history that “Congress, by providing for the deduction of losses incurred in a trade or business separately from those sustained in other transactions entered into for profit, . . . distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business.”<sup>57</sup> The Court went on to state that “[d]evoting one’s time and energies to the affairs of a corporation is not of itself, and without more, a trade or business.”<sup>58</sup>

---

48. See *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).

49. 480 U.S. 23 (1987).

50. *Id.* at 27.

51. *Id.*

52. *Id.* at 24.

53. *Id.* at 35.

54. *Id.*

55. *Id.*

56. 373 U.S. 193 (1963).

57. *Id.* at 197.

58. *Id.* at 202.

Even if those efforts “produce income, profit 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 individual actor herself.<sup>59</sup>

Finally, the *Higgins v. Commissioner*<sup>60</sup> interpretation of “trade or business” adds more to the assertion that it is not possible to classify a private equity firm like Sun Capital Partners as a “trade or business.” In *Higgins*, the petitioner devoted significant time and energies to managing a large portfolio of securities and sought to deduct expenses as incurred in “trade or business.”<sup>61</sup> However, the Court found that the petitioner’s energies were insufficient to establish that the petitioner was carrying on a “trade or business.”<sup>62</sup> Specifically, the Court asserted that the petitioner collected interest and dividends merely through managerial attention to his investments, and that no matter how continuous or extended the work required may be, actions similar to the petitioner’s cannot be classified as a “trade or business.”<sup>63</sup>

### *C. The Internal Revenue Code and Instructive Tax Cases*

The Internal Revenue Code is also instructive in determining an appropriate interpretation of the term “trade or business.” Specifically, cases dealing with competing interpretations of the Internal Revenue Code are valuable for comparison. “Trade or business” is referenced many times in the Internal Revenue Regulations.<sup>64</sup> In *Purvis v. Commissioner*,<sup>65</sup> the Court of Appeals for the Ninth Circuit identified a distinction between being a trader and an investor for tax purposes in relation to investing activities.<sup>66</sup> The court held that the taxpayer’s investments in securities from 1963 to 1968 did not constitute a “trade or business,” and that the taxpayer was merely an investor and not a trader for tax purposes.<sup>67</sup> This meant the taxpayer could not claim expenses and operating losses as part of investing activities for tax purposes.<sup>68</sup>

---

59. *Id.*  
60. 312 U.S. 212 (1941).  
61. *Id.* at 218.  
62. *Id.*  
63. *Id.*  
64. Wolff, *supra* note 24, at 1.  
65. 530 F.2d 1332 (9th Cir. 1976).  
66. *Id.* at 1333.  
67. *Id.* at 1334.  
68. *Id.* (citing 26 U.S.C. § 162(e) (2012)).

*Purvis* started a trend in tax cases of focusing on the trader versus investor distinction. In *Moller v. United States*,<sup>69</sup> the Court of Appeals for the Federal Circuit adhered to a similar investor versus trader standard.<sup>70</sup> The court found that the taxpayer's investment activities did not classify as a "trade or business" even though the taxpayer had relied primarily on returns from these investments for income since 1965.<sup>71</sup> Because the taxpayer focused on long-term investments the taxpayer could not be a trader and must therefore be an investor, which meant he could not be involved in a "trade or business."<sup>72</sup>

Two more tax cases dealt with the trader versus investor distinction. But both found that the petitioners were engaged in a "trade or business" based on investing activities.<sup>73</sup> Additionally, both involved nonresident aliens engaged in investment activities in the United States,<sup>74</sup> which could have influenced the courts' tax rulings.

#### *D. The Sun Capital Partners Model of Private Equity*

The preceding provides a brief background of the regulations and litigation surrounding the term "trade or business." However, it is helpful to consider the actual workings of a private equity firm when considering whether a private equity fund classifies as a "trade or business." Sun Capital Partners is a great example of a private equity firm because its operations are similar to those of other private equity firms.<sup>75</sup>

Sun Capital Partners is a private equity firm.<sup>76</sup> In conjunction with affiliated entities, it finds investors and creates limited partnerships where investor money is pooled into funds called "Sun Funds" for investment in portfolio companies.<sup>77</sup> Sun Capital Partners recommends investment opportunities and negotiates, structures, and finalizes deals.<sup>78</sup>

---

69. 721 F.2d 810 (Fed. Cir. 1983).

70. *Id.* at 813–14.

71. *Id.* at 811, 813–14.

72. *Id.* at 815.

73. *Comm'r v. Nubar*, 185 F.2d 584, 586 (4th Cir. 1950); *Adda v. Comm'r*, 10 T.C. 273, 277, *aff'd*, 171 F.2d 457, 458 (4th Cir. 1948) (per curiam).

74. *Nubar*, 185 F.2d at 585; *Adda*, 10 T.C. at 273.

75. The Sun Capital Partners web site provides a detailed description of the firm's investment strategy and focus. See *About Us*, SUN CAPITAL PARTNERS, INC., [http://www.suncappart.com/?page\\_id=10](http://www.suncappart.com/?page_id=10) (last visited Feb. 22, 2015).

76. *Id.*

77. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 133 (1st Cir. 2013).

78. *Id.*

Sun Capital Advisors, Inc. also provides management services to portfolio companies.<sup>79</sup>

When Sun Capital Partners raises enough investor money, it creates an investment fund; the money pooled in each Sun Fund will then be used to invest in portfolio companies.<sup>80</sup> At the time of the case, Sun Capital Advisors, Inc. had three such investment funds.<sup>81</sup> The stated purpose of such funds is to invest in “underperforming but market-leading companies at below intrinsic value.”<sup>82</sup> The hope is that after a private equity fund purchases and aids in the operational improvements of a portfolio company, the private equity fund can later sell the portfolio company for a profit.<sup>83</sup> The goal of each Sun Fund is to sell the hopefully newly successful portfolio company within two to five years at the earliest.<sup>84</sup>

In 2007, two Sun Funds—Sun Fund III, LP and Sun Fund IV, LP—completed a transaction to purchase Scott Brass, Inc.<sup>85</sup> The purchase price reflected a 25 percent discount because Scott Brass, Inc. had unfunded pension liabilities that were known at the time of the transaction.<sup>86</sup> After the acquisition, Scott Brass, Inc. continued to manufacture metal products while Sun Capital Partners provided management services to Scott Brass, Inc., consistent with the Sun Capital Partners model.<sup>87</sup> Part of these management services meant that Sun Capital Advisors, Inc. received weekly reports from Scott Brass, Inc. containing information about revenue, key financial data, market activity, sales opportunities, meeting notes, and action plans.<sup>88</sup>

This Note will analyze how and why *Sun Capital Partners* reached the decision it did. It will expound upon why private equity funds should not be classified as “trades or businesses.” It will do this by drawing from both *Groetzinger* and *Whipple* and from the many tax cases that explored the interpretation of “trade or business.” This Note will ultimately conclude that the First Circuit erred in its classification of Sun Capital Partners private equity fund as a “trade or business.”

---

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 134.

83. *Id.*

84. *Id.*

85. *Id.* at 136.

86. *Id.* at 135.

87. *Id.* at 136. Management services were pursuant to an agreement signed by the general partner of Sun Fund IV. *Id.*

88. *Id.*

## II. THE “TRADE OR BUSINESS” AND “INVESTMENT PLUS” CONSTRUCTS: LETTING THE COURTS DECIDE

This Part will explore and evaluate the limited number of cases that have analyzed and interpreted the “trade or business” classification. First, it will more deeply explore two important Supreme Court cases, *Groetzing* and *Whipple*, distinguished by the First Circuit. Then, this Part will explore a number of tax cases that analyzed the “trade or business” classification with respect to investment activities similar to private equity. Finally, it will examine the First Circuit’s use of the PBGC “investment plus” classification. Combined, these Sections will highlight an alternative way to apply the “trade or business” classification and explore why private equity funds do not fit that classification.

### A. *The Groetzing and Whipple Approach to “Trade or Business”*

At the time *Groetzing* was decided, no “authoritative judicial definition” of “trade or business” existed.<sup>89</sup> Although *Groetzing* is a tax case, the tax focus of *Groetzing* is less significant than the Supreme Court’s interpretation of how to define and apply the “trade or business” framework. It is also telling that the term “trade or business” was left undefined in the MPPAA, which was completed many years after *Groetzing* was decided.<sup>90</sup> The Supreme Court’s attempt to create a rule for classifying an activity as a “trade or business” in *Groetzing* remains informative today in determining what the term means in the context of a multi-employer pension fund and will prove instructive in considering the First Circuit’s decision in *Sun Capital Partners*.

As early as 1911, the Supreme Court had defined business as a “very comprehensive term” that “embraces everything about which a person can be employed”<sup>91</sup> and “[t]hat which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.”<sup>92</sup> However, in the context of *Groetzing*, this interpretation was too broad and unwieldy to be useful.<sup>93</sup> Instead, the Supreme Court offered that “not every income-producing and profit-making endeavor” could constitute a

---

89. *Comm’r v. Groetzing*, 480 U.S. 23, 27 (1987). This also included the Internal Revenue Code, and *Groetzing* was a tax case dealing with whether a full-time gambler could be engaged in a “trade or business” under the Internal Revenue Code. *Id.* at 24.

90. 29 U.S.C. § 1301(b)(1) (2012); *Groetzing*, 480 U.S. at 23.

91. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911).

92. *Id.* (quoting 1 BOUVIER’S LAW DICTIONARY 273 (1st ed. 1892)).

93. *Groetzing*, 480 U.S. at 31–32.

“trade or business,”<sup>94</sup> going against the formulation of income tax law from the beginning.<sup>95</sup> A “trade or business” requires involvement “in the activity with continuity and regularity,”<sup>96</sup> and the primary purpose of the activity must be for income.<sup>97</sup> Sporadic activities do not qualify.<sup>98</sup>

Accordingly, any activity that does not involve regular and continuous involvement cannot be classified as a “trade or business.” In the context of *Groetzinger*, the Supreme Court found gambling was a “trade or business” because Groetzinger gambled full time with “constant and large-scale effort” and he did it for a livelihood.<sup>99</sup> Contrast this with the activities of the Sun Capital Partners private equity Sun Fund IV, which invests money pooled from investors to purchase companies as investments. Private equity firms, like Sun Capital Partners, are not in the business of running the businesses they purchase as investments; they are in the business of making sound investments to better ensure returns for their investors.<sup>100</sup> Furthermore, even when a private equity fund provides management services, these services do not rise to the level of “[c]onstant and large-scale effort”<sup>101</sup> displayed in *Groetzinger* and cannot reasonably rise to that level considering the many other companies the funds are invested in.<sup>102</sup>

The actions of private equity firms like Sun Capital Partners are much closer to investing in stocks and bonds than they are to running and managing a business full time, which is required to meet the “trade or business” framework of *Groetzinger*. Take, for example, *Snyder v. Commissioner*.<sup>103</sup> In *Snyder*, the Supreme Court held that an investor seeking to increase holdings was not engaged in a “trade or business.”<sup>104</sup> The petitioner in *Snyder* was a salaried secretary of an insurance company, but in his free time he made many purchases and sales of a gas company on margin and earned capital gains.<sup>105</sup> Similarly, private equity is concerned with gaining a return on investment, or a capital gain, for the investors in the private equity funds.<sup>106</sup> Thus, the goal of private

---

94. *Id.* at 35.

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.* at 36.

100. *Cf. Cumming*, *supra* note 5, at 9.

101. *Groetzinger*, 480 U.S. at 36.

102. *See, e.g., Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 133–34 (1st Cir. 2013).

103. 295 U.S. 134, 135 (1935).

104. *Id.* at 138–39.

105. *Id.* at 135–36.

106. *See supra* note 18 and accompanying text.

equity is analogous to what the salaried secretary in *Snyder* was hoping to achieve: returns rather than control. This is further borne out by the Sun Funds' policy of selling successful portfolio companies in two to five years.<sup>107</sup> Accordingly, the goal of Sun Capital Partners was the same as that of *Snyder*—to ensure returns for its investors—not to wield control over portfolio companies.

The circumstances in *Whipple* are even more analogous to the private equity industry than *Groetzing*. The question in *Whipple* was whether a petitioner's activities in connection with several corporations in which the petitioner held controlling interests could be classified as a "trade or business."<sup>108</sup> This situation closely matches the standard model in private equity funds—like Sun Fund IV—of holding a controlling stake in multiple companies, which comprise a portfolio of investments. This is especially true because private equity funds will often take a guiding, but not controlling, approach in helping to ensure that the companies in which they own stakes increase in value to better ensure a return on investment for investors.<sup>109</sup>

Additionally, even if a private equity fund does devote time and energy to a portfolio company, that fact alone does not make the private equity fund a "trade or business." In *Whipple*, the Supreme Court determined that "[d]evoting 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."<sup>110</sup> Even if the activities dedicated to the corporation by Sun Fund IV "produce income, profit 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."<sup>111</sup>

The profits generated from the successful operation of a private equity portfolio company are distinguishable from those profits that a private equity fund like Sun Fund IV makes and eventually passes on to investors because the profits from the sale of a company are not directly related to any regular activities performed for the portfolio company by the private equity fund.<sup>112</sup> *Whipple* even went one step further when it declared that "[i]f full-time service to one corporation does not alone amount to a trade or business, which it does not, it is difficult to understand how the same service to many corporations would suffice."<sup>113</sup>

---

107. *Sun Capital Partners*, 724 F.3d at 134.

108. *Whipple v. Comm'r*, 373 U.S. 193, 195 (1963).

109. See Odland, *supra* note 4.

110. *Whipple*, 373 U.S. at 202.

111. *Id.*

112. See *id.*

113. *Id.*

Finally, in *Higgins*, the Court asserted that the petitioner collected interest and dividends merely through managerial attention to his investments.<sup>114</sup> No matter how continuous or extended the work required may be, managerial actions similar to the petitioner’s cannot be classified as a “trade or business.”<sup>115</sup> If that is the case, then how could a private equity fund, like Sun Fund IV, that merely performs the managerial guidance of portfolio companies possibly be classified as a “trade or business” when extended effort and time spent managing investments does not constitute a “trade or business” for tax purposes? This raises the question of whether the IRS and courts have cleverly used the classification of “trade or business” to ensure that tax bills remain high.

The First Circuit distinguished *Higgins*, *Whipple*, and *Groetzinger* based on a factual interpretation of each case, finding that the cases were not analogous.<sup>116</sup> The First Circuit focused heavily on the active involvement Sun Capital Partners had with Scott Brass, Inc. to classify Sun Fund IV as a “trade or business.”<sup>117</sup> However, considering the foregoing analysis, it appears that the three cases together provide a persuasive basis to find that active involvement alone does not create a “trade or business.”

*B. How Tax Cases Define “Trade or Business” and How These Definitions Can Relate to Private Equity Funds*

The Internal Revenue Code and cases arising from different interpretations of it are instructive in narrowing and determining the appropriate interpretation of the term “trade or business.” The Internal Revenue Code and the Internal Revenue Regulations contain many references to the term “trade or business.”<sup>118</sup> The determination of whether a taxpayer is classified as a “trade or business” is very important.<sup>119</sup> It often determines whether the taxpayer is entitled to certain advantages, like tax deductions, or disadvantages, like taxation.<sup>120</sup> Accordingly, an analysis of how courts have interpreted the term “trade or business” in a tax context is instructive in determining how the term can be applied more broadly with respect to private equity related interpretations.

---

114. *Higgins v. Comm’r*, 312 U.S. 212, 218 (1941).

115. *Id.*

116. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 144–49 (1st Cir. 2013).

117. *Id.*

118. Wolff, *supra* note 24, at 245.

119. *Id.*

120. *Id.*

In *Purvis*, the Court of Appeals for the Ninth Circuit made a distinction between being a trader and an investor.<sup>121</sup> According to the court's tests, an investor holds securities for the purpose of collecting capital gains and does not make short-term investment decisions based on developments in the markets.<sup>122</sup> In contrast, a trader buys and sells securities frequently hoping to make profits on short-term swings in the market.<sup>123</sup> Under this test, a trader is engaged in a "trade or business," an investor is not.<sup>124</sup> To put this into perspective, most of the taxpayer's shares in question in *Purvis* had been held for three or more years.<sup>125</sup>

Under this metric set by the Ninth Circuit in *Purvis*, any entity that holds onto an investment for more than three years is classified as an investor and therefore not a "trade or business."<sup>126</sup> Now compare this with the regular operations of a private equity fund. Private equity funds typically hold investments in portfolio companies for at least four years.<sup>127</sup> The hope is that the company, after the holding period, will demand a higher price on the market;<sup>128</sup> this means that a company with synergistic compatibilities in the same or an adjacent industry or another private equity fund will acquire the portfolio company at a higher price.<sup>129</sup>

Furthermore, the Court of Appeals for the Federal Circuit in *Moller* adhered to a similar investor versus trader standard. The court found that the investment activities of the taxpayer in question did not classify as a "trade or business."<sup>130</sup> The court explained that many factors were important in determining the investment intent of a taxpayer, including the nature, frequency, extent, and regularity of the income earned.<sup>131</sup> In *Moller*, the court emphasized that although the taxpayer was active in investing, meaning the investing activities were continuous, regular, and extensive, the taxpayer could not be a trader because the taxpayer focused on long-term investments.<sup>132</sup> By extension, this also means that the taxpayer could not be involved in a "trade or business."<sup>133</sup>

121. *Purvis v. Comm'r.*, 530 F.2d 1332, 1333–34 (9th Cir. 1976) (per curiam).

122. *Id.* at 1334.

123. *Id.*

124. *Id.*

125. *Id.*

126. *See generally id.* at 1333–34.

127. DEMARIA, *supra* note 8, at 16 (“[A] private equity investment is usually held for four to seven years.”).

128. *Id.*

129. *See id.* at 16–17 for a fairly detailed definition of private equity.

130. *Moller v. United States*, 721 F.2d 810, 811–15 (Fed. Cir. 1983).

131. *Id.* at 813.

132. *Id.* at 815.

133. *Id.*

Therefore, according to *Moller*, no matter how much time a private equity fund spends working with a portfolio company in the form of management services, the “trade or business” classification is not appropriate unless the private equity fund intends to hold the portfolio companies only as short-term investments. However, this goes against the whole purpose of investing in a private equity fund because “a private equity investment is usually held for four to seven years.”<sup>134</sup> Accordingly, it does not follow to classify a private equity fund as a “trade or business” based on the rulings in these relevant and instructive tax cases.

Even cases that have classified investment activities as a “trade or business” provide little support for classifying a private equity fund as a “trade or business.” There are two federal cases that found the petitioner was engaged in a “trade or business” while engaged in investing activities; however, both cases involved nonresident aliens engaged in investment activities in the United States.<sup>135</sup> This calls into question whether the courts classified the investment activity as a “trade or business” because the investment activity met an articulated test or instead to capture tax payments from these otherwise non-taxable investment activities.

In *Commissioner v. Nubar*,<sup>136</sup> the Fourth Circuit Court of Appeals found that the petitioner was a nonresident alien and that he was engaged in a business and therefore had to pay taxes on his investments.<sup>137</sup> The petitioner was an Egyptian citizen in the United States from 1939 to 1945.<sup>138</sup> During that time he made a substantial amount of money trading stocks and commodities on American exchanges.<sup>139</sup> The court determined that the taxation exemption for aliens was intended only for those who were in the United States for a short period of time, and that the petitioner had made a lot of profit over a long period of time in the United States and therefore should be subject to taxation.<sup>140</sup>

What is most significant about *Nubar* are the grounds on which the Fourth Circuit made its decision. It relied almost entirely on an analysis of whether the petitioner was an alien, rather than determining what exactly about the petitioner’s investment activities made them a “trade or business.”<sup>141</sup> This lack of analysis and explanation is telling of the Fourth

---

134. DEMARIA, *supra* note 8, at 16.

135. *Comm’r v. Nubar*, 185 F.2d 584, 585 (4th Cir. 1950); *Adda v. Comm’r*, 10 T.C. 273, 273, *aff’d*, 171 F.2d 457 (4th Cir. 1948) (per curiam).

136. 185 F.2d 584 (4th Cir. 1950).

137. *Id.* at 589.

138. *Id.* at 585.

139. *Id.*

140. *Id.* at 589.

141. *Id.* at 586–87.

Circuit's intentions in deciding the case the way it did. It appears that the Fourth Circuit was more interested in capturing taxes from the petitioner and applied the "trade or business" standard as it saw fit to reach that end.

Similarly, in *Adda v. Commissioner*,<sup>142</sup> the Fourth Circuit held that the nonresident alien petitioner's investment activities constituted a "trade or business."<sup>143</sup> The court determined that the trades made on American commodities markets by the petitioner were made for the petitioner's benefit.<sup>144</sup> In this case, the trades were not actually executed by the petitioner himself but by his brother.<sup>145</sup> But this did not sway the court, which determined that the trades were made on behalf of and authorized by the petitioner who was out of the country at the time.<sup>146</sup> Despite that the actual number of transactions was never revealed, the court decided that many transactions executed through different brokers resulting in substantial gains and losses constituted a "trade or business."<sup>147</sup>

As in *Nubar*, the Fourth Circuit's decision in *Adda* hinged on the determination of how to tax a nonresident alien making investments in the United States. It again raises the question of whether the Fourth Circuit was motivated to determine that the petitioner was engaged in a "trade or business" based on an articulated test, or whether the Fourth Circuit was instead using the term because it was conveniently undefined<sup>148</sup> and therefore a more efficient vehicle for the collection of taxes from the petitioners.

Either way, neither *Nubar* nor *Adda* provide convincing support for a classification of a private equity fund as a "trade or business." Instead, they highlight the confusion surrounding the term in the courts. Although the presented tax cases are not perfectly analogous to the circumstances in *Sun Capital Partners*, they illustrate alternative and persuasive ways the First Circuit could have dealt with the "trade or business" issue. In sum, these cases favor not classifying a private equity fund as a "trade or business."

---

142. 10 T.C. 273, *aff'd*, 171 F.2d 457 (4th Cir. 1948) (per curiam).

143. *Id.* at 279.

144. *Id.* at 278–79.

145. *Id.* at 274.

146. *Id.* at 274–77.

147. *Id.* at 277–79.

148. The Tax Court of the United States attempted to use the lack of a definition for "trade or business" as an explanation of the term itself: "[u]nder section 211(b) the phrase 'engaged in trade or business within the United States' does not include the effecting of transactions in the United States in commodities through a resident broker." *Id.* at 276 (footnote omitted). The term "trade or business" remained undefined when the most recent version of the MPPAA was released in 2006. 29 U.S.C. § 1301(b)(1) (2012).

C. The “Investment Plus” Approach to “Trade or Business”

The First Circuit, in addition to analyzing whether or not Sun Fund IV was a “trade or business,” used an “investment plus” standard from a PBGC appeals letter to decide whether Sun Fund IV was a “trade or business.”<sup>149</sup> Specifically, the PBGC test applied in the 2007 appeals letter questioned whether the private equity fund involved in the 2007 dispute was engaged in an activity with the primary purpose of income or profit, and whether the private equity fund conducted that activity with continuity and regularity.<sup>150</sup> The First Circuit correctly afforded the PBGC letter *Skidmore*<sup>151</sup> deference; the letter had “no more deference than the power to persuade.”<sup>152</sup> Even so, the First Circuit relied heavily on the PBGC “investment plus” approach in determining that Sun Fund IV was a “trade or business.”<sup>153</sup>

However, using an “investment plus” approach to determine that Sun Fund IV was a trade or business is less persuasive when considered in light of the tax cases discussed previously. First, the First Circuit refused to define what the “plus” meant with even general guidelines but instead only stated that the “undisputed facts of th[e] case” proved that Sun Capital Partners was a “trade or business.”<sup>154</sup> In the absence of a clear definition of “trade or business,” it is hard to accept this lack of analysis.

Second, the First Circuit failed to consider *Purvis* and *Moller* in its “investment plus” analysis of whether Sun Fund IV conducted an activity with the primary purpose of income or profit with continuity and with regularity. Both cases made a distinction between a trader and an investor for purposes of assigning the term “trade or business.”<sup>155</sup> Both determined that no matter how much time an entity spends managing investments, the entity is not classified as a “trade or business” if it is not making regular trades in reaction to the market.<sup>156</sup>

Contrast this with the activities of Sun Capital Partners and Sun Fund IV in the investment in Scott Brass, Inc. Sun Fund IV purchased Scott Brass, Inc. as an addition to its investment portfolio, which holds

---

149. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 139–40 (1st Cir. 2013).

150. *Id.* at 139.

151. *See Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

152. *Sun Capital Partners*, 724 F.3d at 140.

153. *Id.* at 141.

154. *Id.*

155. *See Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983); *Purvis v. Comm’r*, 530 F.2d 1332, 1333 (9th Cir. 1976) (per curiam).

156. *See Moller*, 721 F.2d at 815; *Purvis*, 530 F.2d at 1334.

companies for two to five years at a minimum.<sup>157</sup> Sun Fund IV did not buy Scott Brass, Inc. as a short-term investment it intended to liquidate quickly in reaction to market fluctuations. Instead, Sun Fund IV made its investment decision in Scott Brass, Inc. much like any other private equity fund would, based on the potential profits for the fund when the portfolio company is eventually sold four to seven years in the future.<sup>158</sup>

In essence, the “investment plus” conception is another way to get at the “trade or business” classification. However, in the absence of a clear definition of the term “trade or business,” it is hard to say with confidence whether a private equity fund is a “trade or business.” Accordingly, it appears the First Circuit may have been hasty in its application of the “trade or business” designation to Sun Fund IV.

#### CONCLUSION

Based on the foregoing analysis, it appears the First Circuit may have erred in classifying Sun Fund IV as a “trade or business.” However, the intent of this analysis is not to downplay or belittle the importance of assigning unfunded pension liabilities appropriately. The results of an unfunded pension fund are devastating for the employees who are counting on the funds for retirement. Accordingly, the assignment of unfunded pension liabilities is critical.

*Sun Capital Partners* is a unique case because it is the first time a court has attempted to determine whether a private equity fund can be held liable for the unfunded pension liabilities of one of its portfolio companies. Sun Capital Partners, in investing in Scott Brass, Inc. through Sun Fund IV, knew that Scott Brass, Inc. had unfunded pension liabilities.<sup>159</sup> However, those liabilities were a result of the mismanagement of Scott Brass, Inc.

It is impossible given the constraints of this Note to determine what would have happened to Scott Brass, Inc. if Sun Fund IV had not acquired it. But it is possible to analyze the application of the term “trade or business.” The issue laid out in this Note can be easily fixed by adding a definition of “trade or business” to the MPPAA. It is important to protect the pension funds of hard-working Americans, but until there is a clear conception of how and to whom unfunded pension liabilities are applied, the courts will be left to artfully interpret terms in the interest of achieving an equitable result. A clear definition of “trade or business” is needed to ensure that this does not happen. It is up to the Supreme Court or Congress to define it.

---

157. *Sun Capital Partners*, 724 F.3d at 134.

158. DEMARIA, *supra* note 8, at 16.

159. *See supra* note 86 and accompanying text.