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Capital Gains

'Sun Capital' Result for Private Equity Gains May Affect Main Street, Practitioner Says

A move by the Internal Revenue Service to use the *Sun Capital Partners* decision as grounds for recharacterizing private equity gains as ordinary income, without targeted legislation from Congress, would have repercussions far beyond the investment management industry, a practitioner recently told Bloomberg BNA.

Without special legislation aimed specifically at private equity companies, such a rationale by the IRS—namely that the activities associated with private equity companies qualify as an active trade or business—''would have to apply equally to any man or woman on Main Street who sells a business that he or she built through personal efforts,'' Travis Blais, principal of the Boston-based Travis Blais & Co., said in e-mailed remarks Sept. 30.

Changing the tax rate on such transactions from capital gains to ordinary income wouldn't seem to make for good tax policy either, Blais said. ''The fact that an individual expends labor in creating value in an asset is not a reason to disqualify the sale of that asset from capital gains treatment,'' he wrote.

Nevertheless, the U.S. First Circuit Court of Appeals came to that conclusion in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, finding that the private equity fund was engaged in a trade or business and was therefore liable for the unpaid pension plan benefits under one of its portfolio companies (155 DTR K-3, 8/12/13).

Although the court took pains to limit its ruling solely to the arena of the Employee Retirement Income Security Act (ERISA), practitioners recently told Bloomberg BNA that even the possibility of that ruling being taken up by the IRS has shaken the industry for a number of reasons.

Foreign Investors. One of the categories of investors that may feel the pinch of an income recategorization would be foreign investors in U.S.-based private equity funds, Martin Allen, a partner in K&L Gates LLP's Boston office, told Bloomberg BNA Aug. 21. Non-U.S. investors are generally encouraged to make passive investments in U.S. businesses through favorable tax treatment. Typically, such investors are only subject to tax on dividends and interest paid, and not subject to capital gains tax, Allen said. While the tax rate on dividends and interest could be as high as 30 percent, it is often reduced by tax treaties, he said.

If non-U.S. investors were found by the IRS to be investing as partners in an active trade or business directly, and not through a corporation, their income could be viewed as effectively connected with a U.S. trade or business and subject to regular corporate or individual income tax rates, Allen said.

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> TRAVIS BLAIS, TAX ATTORNEY

They would also then be subject to withholding, have to file U.S. tax returns and pay regular income tax, he said, a possibility that some foreign investors with an aversion to identifying themselves to U.S. tax authorities may not be keen on.

However, the IRS may not be able to extend that income characterization to foreign investors due to a statutory safe harbor for direct and indirect investments in corporate stock under tax code Section 864(b)(2)(A), Blais said in a separate Sept. 26 interview.

Tax-Exempt Investors. A similar situation could arise for tax-exempt investors such as universities, charities, hospitals or pension plans. These entities typically do not pay tax on dividends, interest and certain other passive income, but do file returns and pay taxes on unrelated business income, Allen said.

The law requires tax-exempt groups to pay tax on profits if they invested in what would otherwise be a commercial business out of concern that tax-exempts would receive a competitive advantage over businesses in the same industry that are subject to tax, he said.

If a charitable organization investing in a private equity fund were to be found to be actively engaged in an unrelated trade or business, it too could be subject to taxes on any gain from the fund's activities, Allen said.

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Some tax-exempt groups may not want to file a return on unrelated business income and attract the IRS's attention for very similar reasons as some foreign investors, Allen said. ''If the IRS audits for that, who knows what else it's going to find,'' he said.

Carried Interest. An additional point of concern could be taxation of carried interest, specifically that the flow-through income to a private equity fund's general partners could lose its favorable tax treatment at the capital gains rate, Allen said.

If found to be an active trade or business for tax purposes, private equity fund managers' carried interest—the compensation they receive for developing the portfolio companies held by the fund—could then be subject to ordinary income taxes.

Cold Comfort. The potential impact of *Sun Capital Partners* being applied in the income tax context is generally negative; however, at least one of its outcomes could be favorable, Allen said.

If private equity funds and other financial management businesses were found to be operating a trade or business, they would be able to deduct what are currently characterized as investment expenses as ordinary business expenses, he said.

Private equity funds generally cannot deduct their management fees, typically 2 percent given to the management company and 20 percent carried interest given to the general partner, he said.

''The funds would love to deduct those fees as ordinary business expenses, because they would pass through to the partners,'' Allen said. U.S. taxable partners would be able to deduct their share of those fees above the line, rather than as a below-the-line itemized deduction, which is subject to limitations and phased out at higher levels of income.

This outcome, however, ''would be the coldest comfort I could possibly imagine'' as a result of *Sun Capital*, Blais said.

Traditional Fund Structure. The First Circuit Court's ruling validates the separation of general partners and management companies found in traditional private equity fund structures, precisely because the structure of the Sun Capital funds departed from the norm, Blais said.

Sun Capital departed from the traditional structure in that the management fees paid by the limited partners in a fund could be offset by the 2 percent annual management fee paid to the general partner.

''That offset isn't always found in private equity deals,'' but is a feature in some funds, in order to eliminate what is seen as double-dipping on management fees, Allen said.

The First Circuit Court found that the fee offset structure present in *Sun Capital Partners* provides a direct economic benefit to the fund, leading to the conclusion that the fund was a trade or business.

''While *Sun Capital* adds to the danger of using your general partner as the management company, that danger was always there,'' Blais said.

This danger was particular present with respect to the New York City unincorporated business tax (UBT), Blais said.

One key reason to separate the fund and the general partner has nothing to do with federal income tax rules; rather, it is due to the UBT in New York City, where most of the private equity funds are traditionally located, Blais said.

The UBT applies to the income of all passthrough entities or any unincorporated businesses in the city. Although private equity firms could theoretically be taxed at the ordinary rate if *Sun Capital* were to apply, ''the risk of UBT is not theoretical at all'' to a general partner's carried interest income if the general partner was found to be actively involved in a trade or business by carrying on the management activities for the fund, he said.

''Its 20 percent would definitely be taxed by the UBT'' in that situation, Blais said.

Possible Outcomes. The risks posed by a potential application of *Sun Capital Partners* to the income tax realm could result in a restructuring of private equity firms, Allen said.

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MARTIN ALLEN, K&L GATES LLP, BOSTON

Funds located outside of the First Circuit's jurisdiction might particularly be interested in such action, he said. The court's decision, insofar as it applies in the ERISA context, at least applies in tax courts and district courts whose decisions are appealable to the First Circuit, he said.

Hedge funds might also cast a wary eye toward the First Circuit Court's decision, due to their similar compensation structure with private equity funds, Allen said. However, ''they typically do not buy controlling interests in portfolio companies and don't get into the day-to-day management of them,'' minimizing the risk that they could also be found to be a trade or business, he said.

''I would think they'd be treated differently and not open to this risk, but I don't know if the analysis that will develop out of this case may be such that it's broad enough to pick up targets that should not be targets of this conclusion,'' Allen said.

Worst-Case Effects. The worst-case scenario, in which the IRS recharacterized private equity passive investment income into ordinary income, could affect a fund's purchase price, reduce the fund's after-tax yield and have an adverse impact on the amount of capital the funds are able to raise, Karl Fryzel, a tax partner in Edwards Wildman Palmer LLP's Boston office, told Bloomberg BNA Aug. 30.

The repercussions of that hypothetical recharacterization could also affect the purchase price of the companies held within the private equity portfolios, he said.

Fund managers would also face higher taxes on their carried interest income, a prospect that has garnered more attention from the Obama administration and Congress in recent years, Fryzel said.

Democrats have sought since 2007 to tax carried interest as ordinary income, up to 39.6 percent. The Obama administration's 2014 budget request proposed such a change, estimating that ordinary income tax on carried interest could bring in $16 billion over the next decade.

Such a law has never succeeding in making its way through both chambers, but the *Sun Capital Partners* case ''could shed more unfavorable light'' on that prospect, Allen said.

''If this *Sun Capital* theory really caught on and was applied in an income tax context, it's not inconceivable that it could solve Congress's problem in passing carried interest legislation,'' Fryzel said.

Prospects at IRS. While the worst possible outcomes of the case are reason for concern, ''it's too soon to worry'' about them, Fryzel said. One prior Tax Court case to look to for an example of the IRS's possible unwillingness to get involved in such issues is *Dagres v. Commissioner*, he said (60 DTR K-4, 3/29/11).

In *Dagres*, a venture capital fund manager was allowed to deduct a $3.6 million bad business debt loss in connection with his venture capital fund and was found to be in a trade or business. The court did not attribute the activities of the general partner to the limited partners of the fund, and the government conceded that the fund itself was not engaged in a trade or business, Fryzel said.

''I personally read into that that when those cases go out into the fields and get litigated, many times the national office refuses those cases,'' out of wariness for the broad ramifications the trade or business characterization could have, he said.

The chances are remote that a ''rogue'' IRS agent will use the *Sun Capital* case as applied in the ERISA arena to private equity income and manage to ''proceed all the way to litigation without the national office stepping in,'' Fryzel said.

''When you look at the long history in the income tax field of whether someone is in the trade or business of holding securities or corporate stock or business entities for sale to customers, they really would have a hard time making that conclusion in the income tax area,'' Fryzel said.

Such a conclusion would demand ''serious reflection'' within the national office, he said.

A Treasury Department official recently acknowledged the agency was aware of the ruling, but spoke of the case in cautious tones (184 DTR G-4, 9/23/13).

The case could provide the Treasury with ''an opportunity to reassess what 'trade or business' means,'' Craig Gerson, attorney-adviser in Treasury's Office of Tax Legislative Counsel, said at a recent American Bar Association Section of Taxation conference in San Francisco.

Nevertheless, the administration would ''not be in any rush to issue guidance'' related to the *Sun Capital* decision, Gerson said.

''If they did decide to treat these funds as being in a trade or business, it's such a dramatic change in the law I think they'd put out new guidance that would be prospective,'' Fryzel said.

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