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What's News in Tax

Analysis That Matters from Washington National Tax

Private Equity Funds Found Liable for Unfunded Pension Liability

In a recent decision, a U.S. district court found that two private equity funds that owned a bankrupt company were treated as being in a single deemed partnership, which was engaged in a trade or business that created common control of the bankrupt company for purposes of imputing liability for unfunded pension obligations. At a minimum, the case has direct implications on the potential exposure of a fund for pension obligations of a portfolio company. However, the court's analysis could be invoked by others, such as the IRS or the courts, to disregard a taxpayer's organizational formalities and create deemed partnerships that could result in unanticipated tax consequences beyond the funding of pension plan liabilities. This article discusses how, unless modified on appeal, the decision may affect future structuring and due diligence for private equity investments.

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Background

In November 2008, an involuntary bankruptcy proceeding was brought against Scott Brass, Inc. ("SBI"), an entity with an unfunded pension obligation. The New England Teamsters and Trucking Industry Pension Fund sought to impose liability for SBI's unfunded pension obligations under ERISA,[1] as modified by the Multiemployer Pension Plan Amendment Act of 1980 ("MPPAA"), on two private equity funds, Sun Fund III and Sun Fund IV, (together, the "Funds") that indirectly owned 30 percent and 70 percent of SBI, respectively. Under the MPPAA, to have liability for SBI's unfunded pension obligations, the Funds must be trades or businesses and have common control of SBI. Under the regulations, control is generally defined as ownership of 80 percent or more of the stock of the business with the unfunded pension obligation.

1 Employee Retirement Income Security Act of 1974.

The Funds had acquired the stock of SBI in early 2007 through an entity formed as a vehicle to invest in SBI—Scott Brass LLC ("SB LLC"). Sun Fund III made a 30 percent investment in SB LLC ($900,000) and Sun Fund IV made a 70 percent investment in SB LLC ($2.1 million). SB LLC then formed Scott Brass Holding Corp. ("SBHC") and transferred the Funds to SBHC in exchange for stock ($1 million) and debt ($2 million). SBHC borrowed an additional $4.8 million and used the funds to purchase all the stock of SBI. (See Appendix A.)

Sun Fund III and Sun Fund IV are limited partnerships that were organized to acquire and undertake management and operation of businesses to make a profit. The limited partners in each of the Funds are largely unrelated investors. The general partners of Sun Fund III and Sun Fund IV are also limited partnerships (each referred to as a "GPLP"). Each of the GPLPs of the Funds is controlled by and operates through a limited partner committee that consists of the same two individuals. Under each of the Funds' agreements, the GPLP is tasked with management and operation of the companies in which each of the Funds invests. To fulfill its responsibilities, the GPLP of each of the Funds entered into a separate management contract with Sun Capital Advisors, Inc. ("SCA"). The co-CEOs of SCA are the individuals who serve on the limited partner committees.

The limited partners and the GPLP of each of the Funds are obligated to make contributions to capital of each fund upon receipt of a capital call. In addition, under the Funds agreements, each general partner is entitled to a management fee equal to two percent of invested capital. The general partner may waive the right to the management fee (the "Waived Fee Amount"). In this situation, the Waived Fee Amount can be used to satisfy the general partner's obligation to contribute future capital. In addition, the management fee can be reduced by certain other fees paid to the general partner (the "Management Fee Offsets") by SBHC, SBI and other entities in the ownership and management structure. When no management fee is owed or the amount of the Management Fee Offsets is greater than the management fee owed, Management Fee Offset carryforwards (the "Carryforwards") are generated, which can be used to offset future management fees owed the general partner of each fund.

Generally, each fund has only investment-type returns from its indirect ownership of the stock of SBI (through SB LLC and SBHC) and incurs expenses to pay interest on debt, costs of administration, and—to the

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

extent not waived or offset—management fees to the general partner. Neither fund has employees or offices. All activities were conducted by the general partners through SCA.

ERISA and Sections 414(b) and 414(c)

Qualified retirement plans must meet certain discrimination rules that require the employer and all related companies to provide nondiscriminatory retirement plan benefits to almost all non-highly compensated employees in the related group of employers. Most qualified defined benefit plans (pension plans) are subject to the IRS qualified plan rules and are also subject to a number of Department of Labor rules and Pension Benefit Guaranty Corporation ("PBGC") rules, including a requirement to pay premiums to the PBGC. All related employers are jointly and severally liable for the funding of a pension plan if it is underfunded. The PBGC has significant power over the related group of employers if there is a risk that the PBGC might end up taking over the plan.

The ERISA has four titles that govern qualified retirement plan issues and are interrelated. Title II provides the IRS Code rules that apply to qualified retirement plans (such as sections 414(b) and (c)). Title IV provides the PBGC rules and the PBGC power over defined benefit plans. Thus, when the PBGC rules "borrow" the controlled group rules from sections 414(b) and (c) of the Code, they are essentially borrowing within another part of the same enabling legislation, though many of the qualified plan rules were in use before ERISA.

Sections 414(b) and (c) (and later sections 414(m) and (o)) were enacted to require employers to treat related entities as a single employer for most retirement benefit purposes, in order to prevent companies from having "better" plans for more highly paid related entities and "worse" plans for the less highly paid parts of the related entities.

Court Decisions

In its first decision, the district court granted the Funds' motions for summary judgment,[2] holding that the Funds were not trades or businesses subject to unfunded pension liability under the MPPAA. The court also held that the decision by the Funds to invest in a 70/30 ratio was not a transaction intended to evade or avoid withdrawal liability.

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2 903 F.Supp. 2d 107 (D. Massachusetts 2012).

On appeal, the First Circuit agreed with the district court that the transaction was not intended to avoid or evade pension obligations, but disagreed with the district court's finding that the Funds were not in trades or businesses for purposes of finding liability under the MPPAA.[3] The First Circuit determined that Sun Fund IV was in a trade or business based on a number of factors, including the purpose of Sun Fund IV, as stated in its prospectus, and the activities of its general partner under an "investment plus" approach. The court imputed the business activities of its general partner and its agent, SCA, to Sun Fund IV and found that the fund had an economic return or benefit that differed from that of a pure investor because Sun Fund IV benefited from the Management Fee Offset arrangements. The court remanded the case to the district court to determine whether Sun Fund III was in a trade or business within the parameters of its analysis.

On remand, the district court determined that both Funds were in a trade or business based on the activities of their general partners and based on the purposes of the Funds as stated in the prospectus. Moreover, the district court re-examined the facts and determined that the Management Fee Offsets as well as the Carryforwards benefited both Funds and that the benefit was unlike that of an ordinary investor. Finally, the district court found that the Funds formed a deemed partnership-in-fact (the "Partnership-in-Fact") that owned 100 percent of SBI and exercised common control. Although not specifically stated, the Partnership-In-Fact presumably created a partnership under which the Funds (or the Partnership-in-Fact) were treated as related to SBI and thus would be liable for the unfunded pension obligations of SBI under the MPPAA.

Discussion

The Funds had argued that, under Supreme Court precedent established by *Higgins v. Commissioner*[4] and *Whipple v. Commissioner*,[5] an investor cannot be in a trade or business of managing its investments when the investor earns only an investment return. As the Supreme Court put it:

> 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, profit or

[3] 724 F.3d 129 (1st Cir. 2013).

[4] 312 U.S. 212 (1941).

[5] 373 U.S. 193 (1963).

> 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.[6]

In its opinion, the First Circuit determined that the facts of this case were distinguishable from this Supreme Court precedent and were a type of "investment plus" activity. The circuit court found that the Funds did not simply devote time and energy to SBI, but also funnelled management and consulting fees to Fund IV's general partner.[7] Importantly, the circuit court noted that the general partner's trade or business activities in operating SBI were attributable to the Funds because, under Delaware law, the partner was "the agent of the partnership for the purpose of its business, purposes and activities."[8]

The district court expanded on the First Circuit's "investment plus" analysis and, after having rejected the agency argument in its original opinion,[9] adopted the circuit court's formulation of the agency relationship on remand.[10] The district court attributed all the general partner's investment and business decisions, as well as the active management of the portfolio companies by SCA, to the Funds. Moreover, the district court corrected the First Circuit's factual findings on the Management Fee

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6 *Whipple* at 202.

7 The First Circuit stated:

> But the Sun Funds did not simply devote time and energy to SBI, 'without more.' Rather they were able to funnel management and consulting fees to Sun Fund IV's general partner and its subsidiary. Most significantly, Sun Fund IV received a direct economic benefit in the form of offsets against the fees it would otherwise have paid its general partner. 724 F.3d at 146.

8 724 F.3d at 146, citing Delaware law.

9 "The trade or business of an agent does not transfer to the principle." 903 F. Supp. 2d 107, 115-6.

10 Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund, No. 1:10-CV-10921 -DPW, 2016 WL 1239918, at *5 (D. Mass. Mar. 28, 2016).

Offset[11] and found that both Funds derived an economic benefit from the Management Fee Offsets and Carryforwards unlike that of an ordinary investor.

In an interesting and potentially significant addition to the analysis, the district court determined that Sun Fund III and Sun Fund IV had formed a deemed partnership, the Partnership-in-Fact, above SBI LLC, through which the Funds were related under the section 414(c) common control rules and thus related to SBI, which apparently created liability for the Funds as partners for the Partnership-in-Fact's obligations. The court looked to traditional partnership cases[12] in finding the deemed partnership. Despite having separate organizational structures and books and records and despite having filed separate partnership returns, the Funds were deemed to have formed an additional Partnership-in-Fact on top of SB LLC because of the following:

- The Funds formed a joint venture, evidenced by use of the same organizational structure, to look for and invest in its other investments between 2005 and 2008;
- Joint activity of the Funds was necessary for the structuring of the co-investment in SBI through SB LLC and to split their ownership of SB LLC 70/30; and
- There was no evidence of actual independence in the Funds' co-investments and business activities.

Although noting that the record is not clear on the precise scope of the partnership, the court determined that the Partnership-in-Fact controlled and operated SBI and constituted a trade or business that was involved in the active management of its portfolio company investments. The court also determined that the Partnership-in-Fact passed-on the economic benefit of its activities to its partners (the Funds) and that the profits from the restructuring and operation of SBI constituted an economic return that was more than that of a passive investor.

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[11] In fact, Sun Fund III had a Fee Offset Amount and Sun Fund IV did not. Nevertheless, because of the potential benefit of the Fee Offset Carryforwards, the district court found that both Funds derived an economic benefit from the investment in SBI unlike that of a simple investor.

[12] *See, e.g.*, Commissioner v. Tower, 327 U.S. 280 (1946), Commissioner v. Culbertson, 337 U.S. 733 (1949), and Luna v. Commissioner, 42 T.C. 1067 (1964).

Thus, the court concluded that the conditions for liability under the MPPAA were satisfied and the Funds were found to be jointly and severally responsible for the unfunded pension liability of SBI.

Potential Implications

Although it is possible to argue with the holdings for which certain authorities are cited and the conclusions of the district court on a number of levels, and while the opinion may be appealed and modified by the First Circuit, the district court's opinion raises issues that should be considered in performing due diligence for, and the structuring of, private equity investments. At a minimum, the case has direct implications on the potential exposure under the MPPAA for pension obligations of a portfolio company. However, the court's analysis could be invoked by others, such as the IRS or the courts, to disregard a taxpayer's organizational formalities and create deemed partnerships that could result in unanticipated consequences beyond the funding of pension plan liabilities.

On their face, these decisions can affect the determination of pension liability under ERISA and the MPPAA for an acquiring private equity fund. Private equity funds should carefully consider the courts' decisions and any future court-related holdings in these matters and whether the use of parallel fund structures could cause a fund to be obligated for unfunded pension liabilities. In addition, funds interested in acquiring companies in order to improve the acquired company's profitability may be deterred because of the imputation of control in circumstances in which they can actually control the business but have structured the acquisition so that the 80 percent ownership test of the MPPAA regulations has not been satisfied. It is unclear that the policy results of imputing pension liability to investors who devote considerable resources to attempting to make the businesses profitable are what Congress intended in creating the MPPAA. Funds may well be deterred from investing in, or may more deeply discount the price paid for, businesses with unfunded pension obligations in the future.

Furthermore, the insertion of a deemed Partnership-in-Fact above the actual partnership formed by the Funds (SB LLC) results in an economic and legal arrangement that is considerably different from the form adopted by the Funds. The use of the limited liability company would appear to have been intended both to eliminate "control" under the MPPAA as well as to interpose limited liability between the investment and the Funds.

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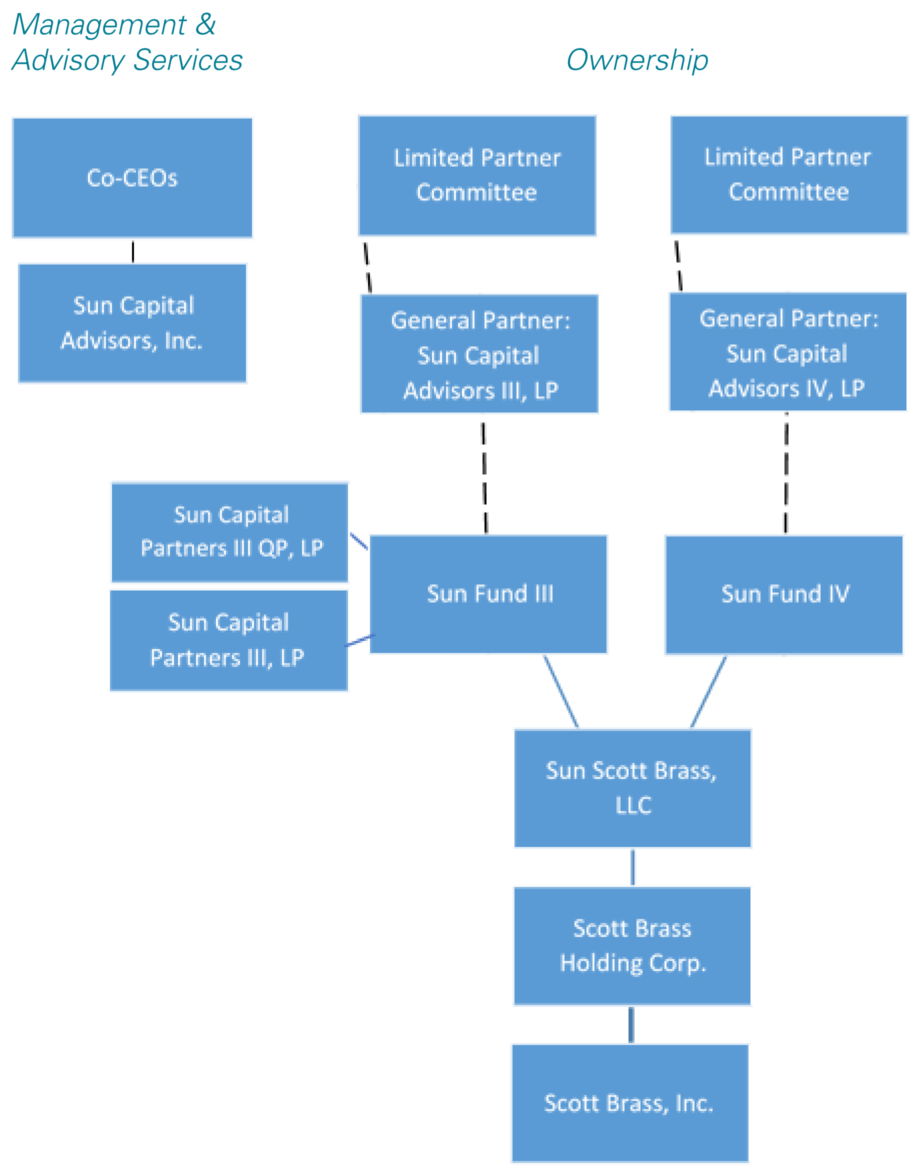
The court's creation of a deemed general partnership above SB LLC changes both results. While it is unclear that this finding would survive an appeal, taxpayers should consider the type of cooperation and planning for joint investment that might cause a court to disregard the form chosen and to create a deemed joint venture with broad liability.

Lastly, although it is unclear whether the First Circuit's and the second opinion of the district court's "investment plus" analysis applies to impute trade or business activities to an investment partnership apart from the analysis required under ERISA and the MPPAA, the analysis raises the question of whether partnerships that receive only "investment-type" returns are simply investors in circumstances in which their general partners are actively managing an investment. The question of which activities of a general partner can be potentially attributed to the partnership is one that should be examined carefully in future planning. Moreover, if the general partner is properly treated as an agent of the partnership and is active in the trade or business of managing businesses, the question arises as to whether profits intended to be treated as capital gains may be recharacterized as trade or business income, at least to some extent.[13] While this seems unlikely at present, the *Sun Fund* opinions stand with *Dagres*[14] to raise a possibility that should be kept in mind.

[13] 724 F.3d at 146, note 2; *see, e.g.,* the Circuit Court's mention of Deely v. Commissioner, 73 T.C. 1081 (1980), Farrar v. Commissioner, T.C. Memo. 1988-385, and Dagres v. Commissioner, 136 T.C. 263 (2011).

[14] Dagres v. Commissioner, 136 T.C. 263 (2011).

APPENDIX A



Solid line: ownership
Dotted line: managerial control