"Trade or Business": The Relevance of a Deceptively Simple Income Tax Phrase to the Labor Code, Federal Statutes, and Private Equity Activity

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"Trade or Business": The Relevance of a Deceptively Simple Income Tax Phrase to the Labor Code, Federal Statutes, and Private Equity Activity

Arthur Acevedo

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INTRODUCTION

Corporate law is premised upon two fundamental principles: the pooling of moneys for investment purposes and the privilege of limited liability. The pooling of money enables promoters and investors to efficiently amass and organize substantial sums for investment purposes. The privilege of limited liability assures investors that personal liability for the underlying invested activity is limited to the moneys invested. Limited liability is a sacrosanct principle and a quintessential investment assumption within the investment community. Private equity firms have successfully exploited these two policies.

However, a decision by the First Circuit Court of Appeal casts a shadow of doubt on the scope of the privilege of limited liability. In Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund ("Sun Capital Partners"), the First Circuit found a private equity fund liable for the 4.5 million dollar withdrawal pension liability of one of its portfolio companies. Under traditional corporate law principles, an investor’s liability is limited to its investment in the venture. What makes Sun Capital Partners unique is that it is the first reported decision holding a private equity fund liable for

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the pension withdrawal liability of its portfolio companies.\(^4\) Predictably, the reaction by the private equity investment community was swift and disapproving of a finding of liability in this case.\(^5\) *Sun Capital Partners* also exposes a deeper problem – the underlying tension between competing federal and state policy objectives.

The *Sun Capital Partners* decision represents a departure from the traditional view that an investor’s liability is limited because two critical factors converged in this case. First, the applicable labor statute imposes liability when an investor’s activity constitutes a “trade or business.” In particular, the labor statute at issue provides that “[t]o 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.”\(^6\) The labor statute cross-references Section 401(c) of the Income Tax Code when defining “trade or business.” Regrettably, Section 401(c) does not define “trade or business,” leaving litigants, regulators, and courts with no guidance as to its meaning. Second, there is substantial evidence in the record demonstrating that the private equity fund was aggressively involved in the daily activities of the portfolio company, thereby exposing itself to the claim that it was engaging in the “trade or business” of operating the portfolio company.\(^7\)

There are over 1,000 references to the phrase “trade or business” in the tax code, each with different policy objectives and implications. The phrase “trade or business” is not defined in the Income Tax Code nor is it defined in the Income Tax Regulations. Three Supreme Court cases address the question of whether the activity at issue constitutes a trade or business. However, the Supreme Court does not define the meaning of “trade or business.”

For income tax purposes, the determination of whether an activity is a trade or business imports a variety of consequences ranging

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4. *Id.* at 132-33 (“This case presents important issues of first impression as to withdrawal liability for the pro rata share of unfunded vested benefits to a multiemployer pension fund of a bankrupt company, here, Scott Brass, Inc. (SBI).”).


7. *Id.* at 134.
from granting a tax benefit, to qualifying tax benefits, to imposing an income tax burden. For instance, Section 162 of the Income Tax Code grants taxpayers the benefit of deducting from gross income “ordinary and necessary” expenses “incurred during the taxable year in carrying on any trade or business.” In contrast, Section 882 burdens foreign taxpayers “engaged in a trade or business” within the United States to report their “effectively connected income” and pay their corresponding U.S.-based income tax liability.

For labor law purposes, the determination of whether an activity is a trade or business under the labor statute imports only one consequence, the imposition of a withdrawal liability. The function of the trade or business requirement in this context is radically different than in the income tax context. This singular policy objective within the labor statute justifies reading “trade or business” differently than when used in the Income Tax Code.

In what sense does Congress intend the use of the phrase “trade or business” when applying the Labor statute? Did Congress intend the phrase “trade or business” to adopt the permissive sense of an “ordinary and necessary” business deduction under section 162? Or, did Congress intend some other sense of the use of the phrase?

This paper explores the meaning of this disputed and elusive term as applied outside of the tax forum. It examines the term within the context of the labor code, its relevance to other federal statutes generally, and its significance to private equity investment activity, specifically. It concludes by advancing two proposals. The first prescribes a definition of the term “trade or business” when applying the contested labor statute. The second is a method of construction already recognized by our courts, but never before applied to this statute. These proposals are especially relevant for use within the context of tiered structures as typically found in private equity investment.

Sun Capital Partners exposes a sharp conflict between competing federal and state policy justifications. The federal government seeks to protect pensions. State governments seek to encourage investment and broaden economic activity in order to benefit an array of

9. Id. at § 162(a).
10. 26 U.S.C. § 882(a) (providing the general rule that “[a] foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11, 55, 59A, or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States”).
constituents. These competing policies present a conflict with broad implications for investors, regulators, and labor.

Part I of this paper analyzes the relevant facts of Sun Capital Partners. Part II examines the business practices of the private equity industry and presents arguments by proponents and critics of private equity investment with a view toward informing the debate regarding when an activity constitutes a “trade or business.” Part III examines the historical significance of the phrase “trade or business,” its application within the labor statute, its habitual deployment by Congress throughout various federal statutes, and its presumed meaning by courts. Finally, Part IV states a proposal and conclusion.

I. SUMMARY OF SUN CAPITAL

In Sun Capital Partners, the New England Teamsters & Trucking Industry Pension Fund (“Teamsters”) challenged the activities of two commonly controlled private equity investment funds. The Teamsters argued that the equity funds were engaged in a trade or business under applicable federal law. As a result, the Teamsters sought a 4.5 million dollar withdrawal pension liability payment from the equity fund on behalf of its members. The “two private equity funds [asserted] they are mere passive investors” in the portfolio company and, therefore, are not engaged in a trade or business as maintained by the Teamsters Pension Fund.


13. The litigant, Sun Capital Partners, Inc., describes itself as “a pioneer in private equity investing, uniquely combining the financial skills and resources of a traditional private equity firm with the insight and expertise of a world class operating team. The firm focuses on market-leading companies that can benefit from our in-house professionals, resources, and expertise in their efforts to materially improve operating performance. Sun Capital affiliates have invested in more than 340 companies worldwide with combined sales in excess of $45 billion since our inception in 1995.” Affiliate of Sun Capital Partners, Inc. Enters into Definitive Agreement to Sell Emerald Performance Materials, 4-TRADERS (June 4, 2014), http://www.4-traders.com/news/Affiliate-of-Sun-Capital-Partners-Inc-Enters-Into-Definitive-Agreement-to-Sell-Emerald-Performance—18545971/; see also About Us, SUN CAPITAL PARTNERS, INC., http://www.suncappart.com/?page_id=10 (last visited Jan. 31, 2016) (“Sun Capital affiliates have invested in more than 340 companies worldwide with combined sales in excess of $45 billion since our inception in 1995. On a consolidated basis, Sun Capital’s affiliated portfolio companies would rank in the top 100 of Fortune Magazine’s listing of the 500 largest companies in the United States.”).


15. Id. at 136-38.

16. See id. at 132.
The equity funds initiated a suit in district court seeking a declaratory judgment establishing that they were not engaged in a trade or business. The district court granted the plaintiff's request for a declaratory judgment. However, on appeal, the Court of Appeals for the First Circuit reversed and rejected the plaintiff's assertion that it was not engaged in a trade or business. The Court of Appeals found that one of the funds, Fund IV, was engaged in a trade or business and, therefore, subject to payment of the pension withdrawal fee. The Court of Appeals remanded the case to the district court for a determination of whether Fund III was likewise engaged in a trade or business. Unfortunately, the First Circuit did not offer a standard of review to aid in determining when an investment activity by an equity fund constitutes a trade or business. The ownership structure of the Sun Funds investment is complicated and multilayered. Several tiers of companies with interlacing ownership interests separate the investors from the target investment. In 2007, Sun Capital Advisors Inc., (“Fund Organizer”), “a private equity firm,” pooled investors’ money and organized two investments funds, Sun Fund III L.P., and Sun Fund IV L.P., (“Funds”). The Funds then created a series of intermediary companies for the purposes of ultimately acquiring the target portfolio company, SBI. In the process, the Funds created SSB-LLC, which in turn created SBHC, which then acquired 100% of the target portfolio company, SBI. Within the chain of entities in this corporate structure, SBI was the operating company and, as such, conducted business operations with customers and suppliers and employed a labor force. SBI operated as “a manufacturer of brass and copper coil for industrial purposes” before “an involuntary Chapter 11 bankruptcy proceeding was brought against [it].”

The problems for the Funds began when market conditions adversely changed in late 2008. The change in conditions caused its portfolio company, SBI, to be in technical breach of its loan covenants. SBI sought relief from its creditors but was denied. Conditions worsened for SBI. It subsequently failed to make a 4.5 million dollar contribution to the New England Teamsters and Trucking Industry

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17. Id. at 132-33.
18. The Court of Appeals could have articulated a standard that would be limited to investor activities in an ERISA context.
Pension Fund. In due course, the Plan asserted its rights against SBI and sought payment. The Plan also asserted its rights against the Funds invoking ERISA’s control group legislation.

The Fund Organizers used a combination of LLCs, limited partnerships, and a holding company to effectuate the investment structure at issue. Each layer in the overall structure was designed to serve a particular purpose, such as limiting liability, securing financing, or holding assets. This complex investment structure, while legally permissible under state law, did not go unnoticed upon the Court of Appeals. The court commented that “[t]hese private equity funds engaged in a particular type of investment approach [that is] to be distinguished from mere stock holding or mutual fund investments.”22 However, despite the complex and multi-layered ownership structure, it bears noting that the ultimate issue is relatively simple and straightforward: namely, whether a private equity fund should be held liable for the withdrawal pension liability of one of its portfolio companies when the private equity fund, directly or indirectly, engages in the operations of the portfolio company.

The artificial separation of the structures, while permitted under state law, would prove to be problematic under federal law. The federal legislation at issue provides that, “under regulations prescribed by the [PBGC],23 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.”24 Predictably, the Funds advanced the argument that they are not engaged in a trade or business and thus are not subject to the mandate of the statute.

A. Operation of the Funds and Control Mechanisms

The Fund Organizers used three key control mechanisms to establish, oversee, and maintain control of the portfolio company’s

22. Id. at 134. “[A] mutual fund is an investment company, which, typically, is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares. Because open-end investment companies will redeem their shares, they must constantly issue securities to prevent shrinkage of assets. In contrast, the capital structure of a closed-end company is similar to that of other corporations; if its shareholders wish to sell, they must do so in the marketplace. Without any obligation to redeem, closed-end companies need not continuously seek new capital.” Bd. of Governors of the Fed. Reserve Sys. v. Inv. Co. Inst., 450 U.S. 46, 51 (1981) (internal quotes omitted).

23. This acronym stands for the Pension Benefit Guaranty Corporation.

operations and policies. Leaving nothing to chance, the legal consequence of these control mechanisms assured the Fund Organizers the right and the power to control the activities and operations of the portfolio company.

1. Use of Controlling Stake

First, the private equity fund organizer ("Fund Organizer") used its "controlling stakes in portfolio companies . . . to implement restructuring and operational plans, build management teams, become intimately involved in company operations, and otherwise cause growth in the portfolio companies in which [the Funds] invest."\(^{25}\) This ability to use control figured prominently in the "private placement memos to potential investors."\(^{26}\) The Fund Organizer set investor expectation by communicating that the Funds would be able to control the policies and operations of the portfolio company. Specifically, the Fund Organizer stated that the Funds would “ha[ve] direct contractual rights to substantially participate in or substantially influence the management of operating companies . . . and . . . in the ordinary course of [their businesses], actively exercis[e] such management rights with respect to at least one of the operating companies in which [they invest].”\(^{27}\) This level of control is critical to attract investors, to minimize any risk associated with the investment, and to optimize the return on investment upon the disposition of the investment.

2. Use of a Management Company

Next, the Fund Organizer employed the use of a management company.\(^{28}\) The management company structure provided operational, managerial, and oversight services to the Funds and enabled the Funds to engage directly with the portfolio company. The management company employed “about 123 professionals”\(^{29}\) and “acted as a middleman, providing SBI with employees and consultants from SCAI.”\(^{30}\) The management company acted as a conduit between the investors and the portfolio company, providing both parties with information, assess-

\(^{25}\) Sun Capital Partners III, LP, 724 F.3d at 134.
\(^{26}\) Id.
\(^{27}\) Id.
\(^{28}\) It bears noting that, in an independent setting, buyers of management services are free to select from a group of competitors. SBI did not have the opportunity to decide for itself whether it needed a consultant. The consultant was forced upon SBI.
\(^{29}\) Sun Capital Partners III, LP, 724 F.3d at 133.
\(^{30}\) Id. at 136.
ment, and expertise. The management company received a payment directly from the portfolio company in exchange for providing services. As a result of the payment, the Fund Organizer would credit the amount otherwise due from the Funds for investment services provided by the management company to the portfolio company. This crediting feature ensured that there was no duplication of costs between the investors and the portfolio company. Thus, every dollar paid by the portfolio company to the Fund Organizer’s management company resulted in a corresponding credit that the Funds would receive from the Fund Organizer.

3. Participation in Corporate Policy Making and Operational Decisions

Finally, the Fund Organizer actively participated in the policymaking and operations of the portfolio company. The Court of Appeals noted that “[n]umerous individuals with affiliations to various Sun Capital entities . . . exerted substantial operation and managerial control over [the portfolio company].”31 The Court of Appeals cited the following examples as evidence of control and influence by the Fund Organizers: “attend[ing] a ‘Jumpstart Meeting’”; approving “the hiring of three [portfolio company] salesmen”; approving “the hiring of a [computer systems] consultant”; “discussing possible acquisitions, capital expenditures, and working capital levels”; receiving “email chains discussing liquidity, possible mergers, dividend payouts, and concerns about how to drive revenue growth at [the portfolio company]”; and “receiving weekly flash reports [containing] . . . key financial data, market activity, sales opportunities, meeting notes and action items.”32

The heightened level of participation by private equity funds or equity fund organizers in the policy decisions and operations of the portfolio company is a common feature in most private equity investments. One writer notes,

After the acquisition, the general partners in the private equity fund are actively involved in the strategic direction of the portfolio company. They normally have operational control over the company through their control of its board of directors. The general partners act as advisors to the portfolio company’s management and as members of the company’s board of directors, and draw on their expertise in corporate restructurings and their contacts throughout the industry to assist in creating value. However, when needed, the private equity partners can use their control to swiftly alter com-

31. Id.
32. Id.
pany policies, remove underperforming executives, or challenge management to perform better.33

The control mechanisms and the level of participation by the Fund Organizers in *Sun Capital Partners* was part of an intended structural design feature to ensure complete control and domination over the portfolio company. This type of operational engineering and subsequent involvement by private equity fund organizers is atypical within a traditional investor environment. Moreover, this type of operational engineering goes beyond “mere stock holding”34 by an investor, crossing instead well onto the grounds of active participation. The IRS maintains that “mere personal investment activities never constitute carrying on a trade or business, no matter how much of one’s time or of one’s employees’ time they may occupy.”35

At the time the labor statute was enacted, LLC’s were in a nascent stage and LLPs were not in contemplation by state legislators.36 Congress enacted Section 1302, the applicable labor statute, in 1974,37 during a period when traditional investors did not engage in the actual operations of the invested activity. Indeed, one of the key distinguishing features of modern private equity investment from traditional investors is the degree of involvement, direct or indirect, that equity funds exert in most of the daily operational decisions of its portfolio investment company.

Opponents of the *Sun Capital Partners* decision may advance several arguments in support of the position that they are not engaged in a trade or business. First, they may argue these arrangements are legally permissible. Every state has enabling legislation granting investors the privilege of limited liability, so long as statutory minimum requirements are met.38 Second, opponents may argue that substantial economic benefits are realized through private equity activity. Specifi-

38. Many states simply require the filing of a form, which discloses basic information and the payment of a fee in exchange for accessing the privilege of limited liability, be it in the form of a corporation, limited liability company, or a limited liability partnership. See Model Bus. Corp. Act. §§ 1.20-1.24 (2008) (Am. Bar Ass’n, amended 1984); Del. Code Ann.
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cally, they may cite to the positive effects of increased economic and employment activity in support of this position. Finally, opponents may argue that the law prohibiting participation by limited partners was itself explicitly relaxed to allow limited partners to participate in the undertakings of the underlying investment. This last point is a compelling argument that deserves additional attention.

Private equity firms can be expected to cite to the Uniform Limited Partnership Act’s39 “recommended”40 approach to limited liability.41 Specifically, Section 303 provides: “A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.” Admittedly, this is a persuasive argument in that the revised policy merely harmonizes the treatment of LPs with its sister entities, LLPs and LLCs.

Private equity firms will also point to the comments in Section 303. These comments explain the rationale for relaxation in the participation standard for limited partners. Specifically, the comments to Section 303 indicate that the section provides a full, status-based liability shield for each limited partner, “even if the limited partner participates in the management and control of the limited partnership.” The section thus eliminates the so-called “control rule” with respect to personal liability for entity obligations and brings limited partners into parity with LLC members, LLP partners, and corporate shareholders.42

The drafters of the revised Section 303 justify the change in policy by acknowledging that “[i]n a world with LLPs, LLCs, and most importantly, LLLPs, the control rule has become an anachronism. This Act therefore takes the next logical step in the evolution of the limited partner’s liability shield and renders the control rule extinct.”43 Granted, the policy of state legislatures has been one toward relaxation


40. See id.

41. As of January 2015, nineteen jurisdictions have adopted part or all of this model statute, including Section 303, which shields a limited partner from liability “even if the limited partner participates in the management and control of the limited partnership.” Id.; see also 805 ILL. COMP. STAT. 215/303 (2005).

42. See UNIF. LIMITED PARTNERSHIP ACT OF 2001, supra note 39.

43. See id.
and permissiveness of participation by the investor. However, one must exercise caution when distinguishing among the varying policy objectives.

What it means to be an investor for purposes of a limited liability analysis is a fundamentally different question from whether an investor is engaged in an activity constituting a trade or business; and therein lies the difference. Sun Fund’s argument that it is a “mere passive investor”\(^{44}\) confounds state and federal policy objectives. The determination of whether one is an investor under state law principles is designed to furnish to investors the flexibility of pooling capital resources and securing the privilege of limited liability. In contrast, the determination of whether one is an investor for purposes of Title 29, let alone Title 26, is irrelevant and blind to the labels of LLC, LLP, and LP, because the relevant inquiry under the labor statute is not whether one is an investor. Rather, the relevant inquiry is whether the activity engaged in constitutes a “trade or business.”

II. PRIVATE EQUITY

The private equity investment sector is an exclusive and economically significant sector. Private equity is characterized by two broad sectors: the buyout sector and venture capital sector.\(^{45}\) “Virtually all private equity funds are organized as limited partnerships, with private equity firms serving as the general partners (GP) of the funds, and large institutional investors and wealthy individuals providing the bulk of the capital as limited partners (LPs).”\(^{46}\) Unlike ordinary investors who invest directly in the particular enterprise, private equity investors invest in a pooled fund, which then invests and operates the targeted portfolio company.\(^{47}\) Throughout its life cycle, “[a][private eq-


\(^{47}\) SCOTT W. NAIDech, PRACTICAL LAW CO., PRIVATE EQUITY FUND FORMATION 2 (2011), http://www.chadbourne.com/files/Publication/3d5a9a56-734c-4d30-a5e4-0a8c593967ab/Presentation/PublicationAttachment/12de9f6c-964d-4b0e-0d4-c48ee9dd7c2f/Naidech_PrivateEquityFundFormation_Nov11.pdf. It is not uncommon for private equity funds to use a series of related subsidiaries or brother-sister entities as it deploys the moneys received to acquire the target portfolio company. Id.
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uity] fund goes through a number of overlapping stages.”48 In form, the various entities of the equity fund are separated by layers of common ownership to achieve strategic objectives. But in substance, they are collectively organized and operated with the assistance of a professional management team to direct the operations of the targeted portfolio company for the purpose of maximizing investor profitability.49

Two key investment strategies distinguish private equity investing from regular investing – debt and control.

In a typical deal, a private-equity firm buys a company, using some of its own money and some borrowed money. . . . [The private equity investment] model encourages firms to borrow as much as possible, since, just as with a mortgage, the less money you put down, the bigger your potential return on investment.50

The other key investment strategy is control. Private equity firms will secure organizational and operational control, upon acquiring the portfolio company, to enable the firm to make immediate changes as private equity firms seek to control costs while maximizing profitability.51

The role of private equity investment is significant to the economy. “Private equity firms invested $443 billion in more than 2,360 U.S. based companies in 2013. These companies employ approximately 7.5 million people. And the value of PE-backed IPOs since 2001 is well over a trillion dollars.”52 The private equity industry is “an important asset class with over $1 trillion under management, two thirds of

   Organization/Formation (Year 0);
   Fund Raising (Years 0 to 2);
   Deal Sourcing and Investing (Years 1 to 4);
   Portfolio Management (Years 2 to 7); and
   Exiting Investments (Years 3 to 10).
which is managed by BO⁵³ funds. Furthermore, fundraising is growing fast from $5 billion in 1980 to $400 billion in 2006.⁵⁴ However, there is considerable debate concerning the virtues⁵⁵ and the vices⁵⁶ of private equity investment activity. The scholarship is itself fractured and inconclusive.

One paper in support of private equity investment activity advances the claim that “[t]he raw data indicate that employees of firms that get acquired by PE investors are subsequently employed for longer durations than workers employed elsewhere.”⁵⁷ This statement negates claims by opponents of private equity investment activity that such investment activity has a harmful effect on the acquired target company and its employee labor pool. Another paper, touting itself as “the first to take advantage of a new research-quality cash flow data set,”⁵⁸ advances two dramatic conclusions concerning private equity fund investments. First, the authors assert that “it seems likely that buyout funds have outperformed public markets, particularly the S&P

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⁵³. “BO” is an acronym used to describe a buyout fund.
⁵⁵. See Masulis & Thomas, Does Private Equity Create Wealth?, supra note 33, at 260. Among the benefits cited are that “[p]rivate equity offers several attractive benefits to help offset . . . corporate governance problems . . . [by concentrating] share ownership . . . with the creation of a controlling, monitoring blockholder . . . [plac[ing]] control in the hands of directors representing large fractional owners in the firm . . . en[sur[ing]] that these directors are financially sophisticated and strongly motivated to carefully monitor senior managers . . . [and providing] boards at private-equity portfolio companies [with] the power and incentives to discipline and if necessary replace senior management.” Id.
⁵⁶. See Ludovic Phalippou, Beware of Venturing into Private Equity, 23 J. ECON. PERSP. 147, 152-54 (2009) (discussing how investors may not be aware of hidden fees in private equity transactions and suggesting that fees should be computed by reference to alternative performance measures using an “internal rate of return” model and a “multiple” model).
⁵⁸. Robert S. Harris et al., Private Equity Performance: What Do We Know?, (Nat’l Bureau of Econ. Res., Working Paper No. 17874, 2012), http://faculty.chicagobooth.edu/steven.kaplan/research/HJK.pdf. The authors of the paper call into question numerous earlier studies by implicitly stating that the data of many of these earlier studies is stale and outdated. The authors of this study make the following claim: “Our research highlights the importance of high quality data for understanding private equity and the returns it provides to investors. Some of the existing papers in the academic literature have relied upon data whose reliability has recently been questioned. Most previously published papers also have focused on funds raised up until the mid- or late-1990s. The enormous growth in investor allocations to private equity funds since the late 1990s has created a need for a re-evaluation of private equity performance. This paper is the first to take advantage of a new research-quality cash flow data set from Burgiss, using data as of March 2011.” Id.
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500, net of fees and carried interest, in the 1980s, 1990s, and 2000s.”59  
Second, the authors also note that “VC60 funds outperformed public  
markets substantially until the late 1990s.”61  
These claims praise the  
virtues of private equity investment and its positive results on society  
in terms of employment and economic growth.  

One private equity firm engaging in a hypothetical Q&A session  
asked the following question: “How do private equity firms improve  
company performance?”62  
In response, it answered:  
To succeed in improving the performance of a portfolio company a  
private equity firm needs to supply a great deal more than just fi-  
nancial creativity. Developing organic revenue growth is key to  
securing increased value within a company. To further enhance a  
company’s performance it is also crucial to undertake substantial  
operational improvements, cost and waste reductions, improving  
the company’s competitiveness, product repositioning and ability to  
enter new markets, as well as the development and execution of a  
sound business strategy.63  

This response is illuminating. It conveys to readers an active  
involvement by many private equity firms in the operations of their  
target portfolio company. The communication strategy behind state-  
ments such as this one conveys to potential investors both an obvious  
and an understated message. This statement must be analyzed not  
only for its obvious content but also for its persuasive value to potential  
investors.64  
Not only does the statement suggest something more than mere “financial creativity,” it illustrates a communication strategy by  
equity firms to convey to targeted investors the investment, manage-

59.  Id.  
60.  “VC” is an acronym used to describe a buyout fund. It specifically refers to venture capital.  
61.  Harris et al., supra note 58, at 28. The paper goes on to note: “Since 2000, the average VC fund has underperformed public markets by about 5% over the life of the fund.”  
Id.  
63.  Id.  
64.  See Carlo V. di Florio, Director, Office of Compliance Inspections and Examinations, SEC, Speech by SEC Staff: Private Equity International’s Private Fund Compliance (May 3, 2011), 20120418P NYCBAR 43 (discussing potential conflicts during the fund-raising stage); see also William J. Holstein, The Very Big Business of Private Equity, N.Y. TIMES (May 23, 2004), http://www.nytimes.com/2004/05/23/business/office-space-armchair-mba-  
the-very-big-business-of-private-equity.html (“Our investors know as much, if not more,  
about our investments and returns than do public companies’ investors. We have a more  
limited audience, so it’s easier to communicate with them. A firm like ours might have 75 or  
80 investors. That’s a target audience that’s easier to communicate with.”).
rial, and operational philosophies of the respective private equity firms.

Another proponent of private equity writes that “the fundamental reason behind private equity’s growth and high rates of return is something that has received little attention, perhaps because it’s so obvious: the firms’ standard practice of buying businesses and then, after steering them through a transition of rapid performance improvement, selling them.”65 This statement is striking because of its clear admission that businesses are “steered,” thereby conveying an active involvement by the private equity firm in the underlying operational activities of the investment.

A KPMG research study further illustrates the nuances of the “steering” argument. KPMG asked its research subjects the following question: “Should private equity executives have operational or industry sector experience?”66 Predictably, the reported response states, “The results of our research show a high degree of consensus on this topic, with private equity directors’ lack of operational or management experience seen as a weakness in the way they interact with portfolio companies.”67 “Interaction” between private equity firm directors and the underlying portfolio company is a commonplace occurrence in the private equity industry. To the linguistic purist, the word “interact” may not be the equivalent to “steering.” But when viewed through the eyes of a reasonable investor, the word “interact” signals an appropriate level of activity by the private equity firm to justify the risk of the investment to an interested investor.

Private equity firms have also sought to legitimize their economic and social impact by asserting that “[a]cademic studies have shown that private equity investment and leverage has an overall positive impact on the financial performance and efficiency of companies, especially since the transitional capital invested fills a critical gap when capital markets are fragile.”68 They add that, “[u]ltimately, leveraged buy-outs of portfolio companies generate greater productivity, promote employment and salary growth, and have a positive effect on employee relations within the company.”69 They go on to add that

67. Id.
68. Key Facts About Private Equity, supra note 62.
69. Id.
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“[s]uperior returns from private equity investments strengthen pension funds that provide benefits for millions of employees.”

Nevertheless, private equity investment activity is reputed to have destructive and disreputable characteristics. In response to the traditional argument that investors in general, and private equity in particular, help to grow markets and create job opportunities, one author writes:

In recent years, private equity funds have played an increasingly important role in corporate acquisitions. Even though they have no in-house expertise in particular industries, they may, in theory, acquire a company for the long term and hire industry experts as managers and ask them to upgrade its capabilities. However, in practice, these funds usually have no intention to upgrade the acquired company for the long term. They acquire firms with a view to selling them on in three to five years after restructuring them into profitability. Such restructuring, given the time horizon, usually involves cutting costs (especially sacking workers and refraining from long-term investments), rather than raising capabilities. Such restructuring is likely to hurt the long-term prospects of the company by weakening its ability to generate productivity growth. In the worst cases, private equity funds may acquire companies with the explicit intention to engage in asset-stripping, selling the valuable assets of a company without regard to its long-term future.

This statement reinforces the proposition that many private equity funds do not “merely invest” in their companies. Instead, this statement asserts that private equity funds are regularly and substantially engaged in the operational and organizational policies of the underlying portfolio company.

Whether the speaker is a proponent or critic of private equity investment, proponents and critics alike speak with a common voice in the following respect – namely, that many private equity funds are regularly and substantially engaged in many of the activities of the portfolio company.

A. Distinction Between Structural Roles

Another factor contributing to the significance of the private equity sector is its ability to successfully exploit the modernization of business entity statutes. Private equity has seized upon a structural distinction among the various business entity statutes. The distinction

70. Id.
between investors in a corporation and investors in a limited partnership, LLP, or LLC, reflects a fundamental policy change adopted by state legislatures regarding the level of participation and control investors may have in the underlying entity. State laws allow investors to maintain the legal fiction of separate entities despite common ownership while permitting investors to actively manage the activities of such entities through control mechanisms such as contract law, agency law, and corporate law.\footnote{For example, \textit{Model Bus. Corp. Act.} § 3.02 provides that “every corporation . . . has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs,” while \textit{Model Bus. Corp. Act.} § 6.22(b) provides that “a shareholder of a corporation is not personally liable for the acts of debts of the corporation . . . .” In similar fashion, the Revised Uniform Limited Liability Company Act (2006) § 105 provides: “A limited liability company has . . . the power to do all things necessary or convenient to carry on its activities.” While § 304 states that “the . . . liabilities of a limited liability company, whether arising in contract, tort, or otherwise are solely the . . . liabilities of the company [and] do not become the . . . liabilities of a member or manager . . . .”}

One key distinction between investors in a corporation and investors in a limited partnership, LLP, or LLC, is the fact that the organic law of a corporation prohibits shareholders from actively engaging in the management, oversight, and operations of the corporation. Historically, investors were not involved in the managerial or operational activities of the invested companies. Corporate investors remain structurally prohibited from engaging in the management or operations of the corporation. MBCA Section 8.01(b) provides, “All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors.”\footnote{\textit{Model Bus. Corp. Act.} § 8.01(b) (Am. Bar Ass’n, amended 1984).} Rejecting a shareholder’s desire to participate in a liquidation proceeding, one court noted, “When a statute provides that powers granted to a corporation shall be exercised by any set of officers or any particular agents, such powers can be exercised only by such officers or agents.”\footnote{Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85, 86 (1880).} With the notable exceptions of \textit{Clark v. Dodge},\footnote{199 N.E. 641 (N.Y. 1936).} and \textit{Galler v. Galler},\footnote{203 N.E.2d 577 (Ill. 1964).} corporate shareholders, both public and closely-held, remain prohibited from managing or overseeing the corporation.

In contrast, the organic laws of LLPs, LLCs, and now LPs, allow for active participation by investors. The change in the structural rules reflects the policy change by state legislatures regarding the level of participation and control investors may exert in the entity. While state laws allow investors the flexibility of maintaining a separate legal fic-
tion among the entities, state laws should not promote the idea that separation in form promotes separation in substance, especially when doing so would frustrate public policy.

III. Analysis of Trade or Business

The labor statute at issue in *Sun Capital Partners* provides: “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.”77 Therefore, determining what is “common control”78 and what is a “trade or business” is indispensable to establishing liability.

The phrase “common control” is not defined by the labor code. Instead, readers are instructed to traverse through a dizzying array of statutes and regulations before concluding that a clear definition is not indicated.79 In the end, one arrives at the conclusion that common control means the common relationships existing between trades or businesses that have parent-subsidiary relationships, brother-sister relationships, or a combination of the two. The determination of “common control” is further complicated when one searches for a definition for non-corporate entities, such as LLPs and LLCs. In this case, the applicable statute contemplates that the determination of “common control” is to be made “on principles similar to” corporate entities. There is no case law either defining the scope or illustrating the application of this particular clause. However, in *McDougall v. Pioneer Ranch Ltd. Partnership*, the Court of Appeals for the Seventh Circuit stated that “the organization must be under ‘common control’ with the obligated organization”80 before a finding of liability can be made.

Similarly, the phrase “trade or business” is also not defined by the labor code. Instead, the labor code instructs readers to look to Section 414(c) of the income tax code when establishing whether an

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78. A complete analysis of “common control” is beyond the scope of this paper and will be the topic of a future paper.
79. *But see* 29 C.F.R. § 779.221 (2011), which defines the phrase “common control” for purposes of the Fair Labor Standards Act as Applied to Retailers of Goods or Services by splitting this phrase into its component parts and defining “control... as the act of fact of controlling and ‘common’... as includ[ing] the sharing of control and it is not limited to sole control or complete control by one person or corporation.” *Id.*
organization is a “trade or business” for purposes of the labor statute.81 Regrettably, the Internal Revenue Code itself does not define the term “trade or business” for purposes of Section 414(c). Moreover, the phrase “trade or business” as used within Section 414(c) itself has yet to be interpreted by any court.

A dilemma thus arises: what is the intended meaning of the phrase “trade or business” when not one, but two cross-referencing federal statutes invoke its use but are silent as to its meaning? And, does the interpretation by a court of the phrase “trade or business” in one context, income tax law in this case, mandate the same interpretation in a labor law context?

To begin, there are over 1,000 references to the phrase trade or business in the Internal Revenue Code. The intended meaning of “trade or business” itself within Section 414(c) is undefined by the statute, by the underlying regulations, or by the common law. “The interplay among the relevant Code sections does not permit, in this context, an interpretation that harmonizes all and leaves no loose ends.”82 Regulators and litigants alike will be forced to examine ancillary interpretations and common law precedents to inform their inquiry and their judgment.

Three Supreme Court cases have considered the question of what constitutes a trade or business for purposes of business deductions under the Income Tax Code. Admittedly, the individuals in all three cases sought to access the benefit of a tax deduction instead of avoiding the burden of a pension liability. Nonetheless, the analysis of the three cases can be instructive in identifying elements necessary to determine if a trade or business activity exists, and if so, to what extent these elements are determinative to the finding of a trade or business.

81. 29 U.S.C. §1301(b)(1) (2012) instructs that “[t]he regulations prescribed under the preceding sentence shall be consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c) of Title 26.”
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A. Proposition No. 1: “Carrying on a Trade or Business Requires an Active and Influential Involvement in the Portfolio Company and Excludes Merely Recording and Monitoring the Activities of the Portfolio Company”

In Higgins v. Commissioner,83 the Supreme Court examined for the first time the question of whether a taxpayer was engaged in a trade or business. The taxpayer sought to deduct investment expenses incurred in producing investment income for the year under examination. The issue in this case was whether the taxpayer was carrying on a trade or business and thus eligible to deduct the investment expenses against his income. The applicable tax statute at the time provided that “[i]n computing net income there shall be allowed as deductions . . . [a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”84

The taxpayer in Higgins is an investor of substantial means with “a fortune of $35,000,000 or more, part of it in real estate and part in stocks and bonds.”85 The Supreme Court describes him as a “taxpayer . . . devot[ing] a considerable portion of his time to the oversight of his interests and hir[ing] others to assist him in offices rented for that purpose.”86 The Supreme Court noted that the taxpayer “did not participate directly or indirectly in the management of the corporations in which he held stock or bonds.”87 The Court further noted that the taxpayer “merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.”88

The taxpayer in Higgins argued that he was engaged in carrying on a trade or business and therefore eligible to deduct his investment expenses. The IRS rejected this argument, stating that mere investment activities do not constitute a trade or business.89 In analyzing the facts in Higgins, the Supreme Court distinguished between an investor who “merely” manages, without more, one’s

83. 312 U.S. 212 (1941).
84. Id. at 214.
85. Higgins v. Comm’r, 111 F.2d 795, 796 (2nd Cir. 1940). The Second Circuit’s description reduces the level of abstraction and gives context to the issue in dispute. Id. at 796. The Second Circuit concluded that the taxpayer “is not engaged in any business, unless the management of his fortune be deemed a business.” Id.
86. 312 U.S. at 213.
87. Id. at 214.
88. Id. at 218.
89. Id. at 216.
investments from an investor who is actively engaged in managing the underlying trade or business activity.

The Supreme Court held that the taxpayer was not involved in a trade or business as that phrase was used in a tax context, and thus, did not qualify for a tax deduction. The Supreme Court, noting the variants and complexities that individual circumstances may present, stated, “To determine whether the activities of a taxpayer are ‘carrying on a business’ requires an examination of the facts in each case.”

Congress enacted I.R.C. § 212 in 1942 in response to the Supreme Court’s holding in Higgins denying investors a deduction for investment related expenses. Section 212 authorizes income tax deductions for individuals who incur expenses in the production of income. Unlike Section 162, which authorizes deductions incurred by a taxpayer engaged in a trade or business, Congress eliminated any requirement for a “trade or business” in the newly enacted I.R.C. § 212. By doing so, Congress expressly recognizes and distinguishes between the conduct of active and passive taxpayers. This distinction in the statutory framework between Section 162 and Section 212 remains today. The history and jurisprudence of Section 162 contemplates taxpayers actively “carrying on a trade or business.” In contrast, the history and jurisprudence of Section 212 contemplates only that taxpayers “produce, collect, or maintain property for the production of income,” thereby eliminating the need for any active conduct by the taxpayer in the underlying activity.

The income tax code further distinguishes deductions between investors, traders, and dealers. Investors “are not eligible for IRC section 162’s trade or business deductions and . . . will deduct most of their investment expenses under IRC section 212 as ‘below the line’ itemized deductions.” In contrast, traders and brokers can deduct, “under IRC section 162 for ‘all the ordinary and necessary expenses

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90. Id. at 217.
92. 26 U.S.C. § 212 captioned “Expenses for production of income” provides that “[i]n the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.”
paid or incurred during the taxable year in carrying on any trade or business.' IRC section 162 deductions . . . are 'above the line' deductions that reduce adjusted gross income.\textsuperscript{96}

B. Proposition No. 2: Something More Than Simply an Investment
Return is Required – A Plus Factor

In a second case, Whipple \textit{v. Commissioner}, the Supreme Court once again examined the question of whether a taxpayer was engaged in a trade or business. This time, the court examined the question in context to determine whether a shareholder who advanced loans to his controlled company was entitled to a bad debt deduction when the loans became worthless.\textsuperscript{97}

The statute at issue\textsuperscript{98} allows a deduction for bad debts incurred by the taxpayer. However, the statute contemplates two different income tax treatments for bad debts depending on whether the debt is classified as a business bad debt or a nonbusiness bad debt. Business

\textsuperscript{96} Id. at 1019.

\textsuperscript{97} Whipple \textit{v. Comm'r}, 373 U.S. 193, 194-95 (1963). The taxpayer advanced the argument that he was engaged in three separate activities – organizing, financing, and operating. \textit{Id.}

\textsuperscript{98} See 26 U.S.C. § 23(k)(1) (1952) (providing “[d]ebts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection. In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, the reasonable addition to a reserve for bad debts shall be determined with due regard to the amount of the taxpayer’s surplus or bad debt reserves existing at the close of December 31, 1951. In the case of a taxpayer described in the preceding sentence, the reasonable addition to a reserve for bad debts for any taxable year shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this sentence shall not be greater than the lesser of (A) the amount of its net income for the taxable year, computed without regard to this subsection, or (B) the amount by which 12 per centum of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.”); see also 26 U.S.C. § 23(k)(4) (1952) (stating, “(4) Non-business debts. In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term “non-business debt” means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business.”).
bad debts are granted favorable treatment and deductible in full, provided they were incurred in a trade or business. In contrast, nonbusiness bad debts are accorded less favorable treatment by being subject to statutory deduction limitations.

Over a period of three years, from 1949 to 1952, the taxpayer created fifteen different corporations, one of which, Mission Orange, is the corporation at issue. The taxpayer “made sizeable cash advances to Mission Orange in 1952 and 1953.” An outstanding debt of $56,975 eventually “became worthless in 1953 and is in issue here.”

The taxpayer in Whipple claimed a bad debt deduction for the outstanding debt, arguing that he “was in the business of organizing, promoting, managing and financing corporations, general financing and lending of money, operating a bottling business, or all three.” The taxpayer advanced the argument that, as a result of these activities, he was engaged in a trade or business and thus entitled to deduct the loans as a business bad debt. The IRS countered, arguing that the taxpayer was not engaged in a trade or business. According to the IRS, the loans are a nonbusiness bad debt and the deduction is limited.

The Supreme Court reviewed the case and held for the Commissioner. The Supreme Court reasoned:

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 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

100. Id.
101. Id. “Prior to 1941 petitioner was a construction superintendent and an estimator for a lumber company but during that year and over the next several ones he was instrumental in forming and was a member of a series of partnerships engaged in the construction or construction supply business. In 1949 and 1950 he was an original incorporator of seven corporations, some of which were successors to the partnerships, and in 1951 he sold his interest in the corporations along with his equity in five others in the rental and construction business, the profit on the sales being reported as long-term capital gains. In 1951 and 1952 he formed eight new corporations, one of which was Mission Orange Bottling Co. of Lubbock, Inc., bought the stock of a corporation known as Mason Root Beer 3 and acquired an interest in a related vending machine business. From 1951 to 1953 he also bought and sold land, acquired and disposed of a restaurant and participated in several oil ventures.”
102. Id.
103. Id.
104. Id. at 196-97.
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.

The Supreme Court noted that, “absent substantial additional evidence, furnishing management and other services to corporations for a reward not different from that flowing to an investor in those corporations is not a trade or business under s23(k)(4).”

In light of Whipple, a reasonable argument may be advanced that the pecuniary rewards private equity investment is designed to generate provide private equity firms with financial returns beyond the mere appreciation in the investment. Specifically, private equity firms charge four principal fees: management fees, transaction fees, monitoring fees, and carried interest. Three of these fees – management fees, transaction fees, and monitoring fees – represent payments for something more than the mere appreciation in the investment. Only carried interest is based on the performance level of the asset and represents a payment for the appreciation of the investment. Carried interest is generally only paid to the Fund Organizer after a specified hurdle rate has been satisfied. The payment of the fixed fees to the Fund Organizer represents a payment for “something more” than the appreciation in the value of the investment. Ordinary investors do not enjoy the advantage of a payment of fixed fees (regardless of whether the portfolio company is profitable or not). Ordinary investors only receive a payment in the event of appreciation.

One court observed:

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106. In contrast, private equity has a return plus component. The plus being the 2% fee and the 8% hurdle rate. To earn these amounts, the private equity firms must be active in the business, thus they are in a trade or business.
108. Id. at 203.
110. Proponents contend that this aligns the interests of the money managers with their clients. Lawrence Delevingne, CNBC Explains: Carried Interest, CNBC (Mar 4, 2014), http://www.cnbc.com/2014/03/04/cnbc-explains-carried-interest.html.
111. Metrick & Yasuda, supra note 46, at 2312.
[A] rational investor would not make an investment with a negative expected rate of return, or an expected rate of return materially below the rate they could earn elsewhere with the same risk. A rational investor would consider, among other things, all fees and costs associated with a proposed business or investment transaction in order to determine whether there was a reasonable possibility of profit.113

This statement by the court is consistent with portfolio investment theory, which recognizes, “[i]n a standard model of the portfolio choice, . . . a security is rationally purchased by an investor only if its returns co-vary positively with the investor’s marginal utility.”114 According to investment theory, rational investors are not prone to make payments without expecting a return on investment. That return is the private equity engaging in the management of the underlying investment. Thus, a finding of a trade or business is justified whenever a private equity firm engages in the operations of the underlying portfolio company in exchange for a fixed fee beyond the mere appreciation of the investment.

C. Proposition No. 3: A Direct and Active Involvement is Required by the Taxpayer in the Underlying Activity115

In a third case, Commissioner v. Groetzinger,116 the Supreme Court examined, yet again, the question of whether a taxpayer was engaged in a trade or business. This time, however, the Court examined the question in a gambling context. Specifically, the issue in Groetzinger was “whether a full-time gambler who makes wagers solely for his own account is engaged in a ‘trade or business,’ within the meaning of [Section] 162.”117 Hanging in the balance for the taxpayer was a deduction for gambling losses incurred by the taxpayer.

The taxpayer “worked for 20 years . . . when his position was terminated in February 1978. During the remainder of that year, the taxpayer busied himself with parimutuel wagering, primarily on greyhound races.”118 The record indicates that the taxpayer “went to the

115. See Comm’r v. Groetzinger, 480 U.S. 23, 27 n.6 (1987) (“Some sections of the Code, however, do define the term [‘trade or business’] for limited purposes. See . . . §§ 502(b) and 513(b), 26 U.S.C. §§ 502(b) and 513(b) (exempt organizations).”)
116. Id. at 23.
117. Id. at 24.
118. Id.
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track 6 days a week for 48 weeks [during] 1978, [spending] a substantial amount of time studying racing forms, programs, and other materials. The taxpayer devoted from 60 to 80 hours each week to these gambling-related endeavors... gambling solely for his own account. He had no other profession or type of employment.”

As a result of his gambling activities, the taxpayer incurred a net gambling loss of $2,032, earning $70,000 in gambling winnings, and sustaining $72,032 in gambling losses. However, the taxpayer reported, but never claimed the $2,032 gambling loss as a deduction on his income tax return. On audit, the IRS determined that the taxpayer’s gambling winnings of $70,000 were a tax preference item for AMT purposes and included the winnings in income for AMT purposes, thereby triggering a total tax deficiency of $2,522. However, the IRS did not allow the taxpayer to claim a deduction of $72,032 in gambling losses on the theory that the gambling losses were not incurred in a trade or business. The taxpayer disagreed with the IRS, sued and prevailed in Tax Court and again in the Court of Appeals.

The Supreme Court accepted certiorari to resolve a split in the circuits. The Supreme Court began its analysis by noting that “the phrase “trade or business” has been in [Section] 162(a) and in that section’s predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations.”

The Supreme Court recognized that “[t]he concept thus has a well-known and almost constant presence on our tax-law terrain [and] despite this, the Code has never contained a definition of the words “trade or business” for general application, and no regulation has been issued expounding its meaning for all purposes.”

The Supreme Court examined carefully the facts in Groetzinger, noting in particular the substantial time, financial commitment, research conducted, and the decision process undertaken by the taxpayer. In a critical passage, the Supreme Court writes “that if one’s gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere

119. Id.
120. Groetzinger reported the loss on Schedule E, but never carried the loss amount to the face of Form 1040 to be claimed as a loss deduction.
121. Implicit in the IRS’s argument is its contention that the gambling losses were nondeductible personal expenses under 26 U.S.C. § 262. Section 262 reads, “Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.”
123. Id.
hobby, it is a trade or business within the meaning of the statutes with which we are here concerned.” 124 Without explicitly declaring a standard for analysis for determining the presence of a “trade or business,” the Supreme Court’s dicta offered guidance to future litigants. The Supreme Court added that a combination of “[c]onstant and large-scale effort . . . [s]kill . . . [and] livelihood” elevates an activity from a mere hobby to a trade or business.125

In the end, the Supreme Court held for the taxpayer, reasoning that he was engaged in a trade or business. The Supreme Court noted the limitation in interpreting the clause, “trade or business” by stating that “[o]ur task in this case is to ascertain the meaning of the phrase as it appears in the sections of the Code with which we are here concerned.”126 The Supreme Court expressly rejected a reading of the phrase “trade or business” that limited it to the provision of goods or services reasoning that “[i]n any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.”127

Groetzinger is significant because it demonstrates the Court’s acceptance of a direct and personal involvement by the taxpayer in a trade or business. The Supreme Court noted,

We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.128

Applying this reasoning to private equity firms leads to the reasonable conclusion that private equity firms are engaged in a trade or business. For instance, private equity firms are involved with “continuity and regularity” in the operations of the portfolio company. Additionally, the private equity firm’s primary, if not sole, purpose for engaging in the activity is for the production of “income or profit.” And finally, it is beyond any reasonable contemplation that private equity investing amounts to “[a] sporadic activity, a hobby, or an amusement.” On the contrary, $443 billion in more than 2,360 U.S. companies is a far cry from a hobby. Applying Groetzinger, these factors support the conclusion that private equity firms are engaged in a trade or business when

124. Id. at 35.
125. Id. at 36.
126. Id. at 27.
127. Id. at 34.
they provide expertise, consulting, financial engineering, or assistance to the target portfolio company.

D. Synthesis of the Three Supreme Court Cases

Each one of the three Supreme Court cases interpreting the phrase “trade or business” advances important propositions that are acutely relevant to private equity investment activity.

*Higgins* advances the proposition that merely recording and monitoring the activities of the portfolio company, without more, does not amount to a trade or business activity. *Groetzinger* advances the proposition that active conduct satisfies the trade or business standard when the activity is pursued with “continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”129 Taken together, these two cases require individuals who seek to invoke the benefits of a trade or business to have a direct, active, and substantial engagement in the underlying activity.

Unlike ordinary investors, private equity firms are directly involved in the target investment. In this regard, private equity fund organizers are different from ordinary investors. Ordinary investors do not engage in the policy and decision-making function of the invested activity. In contrast, private equity fund organizers are active in the policy and decision-making function of the target investment. Ordinary investors do not make hiring or firing decisions on behalf of the target investment, nor do they attend “jump-start meetings.” As noted by one study, “Private equity investors provide valuable services (time, contacts, reputation) in addition to their cash investments.”130 The relentless participation by many private equity funds in establishing the policies, managing the operations, and even in lending reputational credence to the portfolio company, are all activities yielding to the conclusion that private equity firms are engaged in a trade or business.

*Whipple* advances the proposition that *something more than simply an investment return* is required for an activity to constitute a trade or business.131 In this regard, it bears noting that ordinary investors earn a return through two sources: dividend income and investment growth. In contrast, private equity firms earn “something more than simply an investment return.” In addition to any dividend income they may receive while holding the investment and any gains they may realize upon disposing of the investment, private equity

129. Id.
firms charge four principal fees: management fees, carried interest, transaction fees, and monitoring fees.132 Three of these fees are fixed fees and are paid to the Equity Fund regardless of the portfolio company’s performance.133 Only one fee, carried interest, is a variable fee and is subject to payment based on performance standards. The design and structure of the three fixed fees are calculated to provide private equity firms with a guaranteed return, regardless of the performance of the underlying investment - a luxury ordinary investors simply do not enjoy.

E. Invoking Not-for-Profit Analysis as a Guide in Determining Whether an Activity is a Trade or Business

Examining the not-for-profit literature provides valuable insight when seeking additional guidance as to how courts evaluate when an activity constitutes a trade or business. Section 501(a) of the income tax code exempts qualifying not-for-profit organizations from income taxation.134 However, when a not-for-profit organization engages in a trade or business activity, then the activity itself is subject to income tax. Specifically, the income tax code imposes an unrelated business income tax on the earnings “derived by any organization from any unrelated trade or business . . . [which is] regularly carried on” by the not-for-profit organization.135

The income tax code defines “‘unrelated trade or business’ [to] mean[] . . . any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption . . . .”136 The income tax regulations indicate that, “[i]n determining whether trade or business from which a particular amount of gross income derives is regularly carried on . . . regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.”137 Moreover, the policy objective declared in the income tax regulations state, “The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair

132. Metrick & Yasuda, supra note 46, at 2315.
133. The three fees that are fixed and paid independent of the funds performance are management fees, transaction fees, and monitoring fees.
137. 26 C.F.R. § 1.513-1(c) (2013).
competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”

Two cases offer an interesting study in contrasting how courts examine the issue of a trade or business within the not-for-profit context. In one case, United States v. American Bar Endowment, the actions taken by the tax-exempt organization resulted in a finding of a trade or business. In the second case, National Association of Postal Supervisors v. United States, the lack of action taken by the tax-exempt organization resulted in a finding of a trade or business.

In United States v. American Bar Endowment, the Supreme Court considered “whether income that a tax-exempt charitable organization derives from offering group insurance to its members constitutes ‘unrelated business income’ subject to tax.” The “American Bar Endowment (ABE) is a corporation exempt from taxation under § 501(c)(3) of the Code.” “ABE’s primary purposes are to advance legal research and to promote the administration of justice . . . .” However, “ABE [also] raises money for its charitable work by providing group insurance policies, underwritten by major insurance companies, to its members.”

“Critical to ABE’s fundraising efforts is the fact that ABE requires its members to agree, as a condition of participating in the group insurance program, that they will permit ABE to keep all of the dividends rather than distributing them pro rata to the insured members.” ABE charges participating members a competitive rate. Because ABE insures a favorable risk pool, its costs of insuring are less than the premiums it collects from its members. As a result, ABE receives a refund of premiums paid at the end of each period that ABE uses to fund its charitable activities. “In 1980 the Internal Revenue Service advised ABE that it considered ABE’s insurance plan an ‘unre-

138. Id. at § 1.513-1(b).
139. 477 U.S. 105, 106 (1986).
140. 21 Cl. Ct. 310 (1990).
142. Id. at 107.
143. Id.
144. Id.
145. Id. at 105.
146. Id.
148. Id.
lated trade or business’ and that the profits thereon were subject to tax under §§ 511 [through] 513.”149 The IRS audited ABE’s tax returns for 1979 and 1980 and assessed a tax deficiency on ABE’s net revenues from the insurance program.150 ABE successfully challenged the IRS’s determination and assessment of income tax deficiency and prevailed in the Claims Court.151 The Court of Appeals for the Federal Circuit affirmed the decision of the Claims Court.152 However, the Supreme Court reversed the Court of Appeals holding that ABE was engaged in a trade or business and therefore subject to the unrelated business corporation tax.153

The Supreme Court found that “ABE’s insurance program falls within the literal language”154 of the statutory definition of an “unrelated trade or business.”155 The Supreme Court scrutinized the activities of the taxpayer. Two factors proved critical to the Supreme Court’s analysis. First, the Court found that ABE’s activities of “assembling . . . a group of better-than-average insurance risks, negotiating on [the insureds] behalf with insurance companies, and administering a group policy are activities that can be-and are-provided by private commercial entities in order to make a profit.”156 The Court determined these activities constituted activities beyond the scope of ABE’s approved exemption from income tax.

Second, the Supreme Court also noted that “ABE has a unique asset—its access to the ABA’s members and their highly favorable mortality and morbidity rates—and it has chosen to appropriate for itself all of the profit possible from that asset, rather than sharing any with its members.”157 This unique asset allowed ABE to charge its members a competitive rate and realize an economic benefit in the form of a premium refund. ABE successfully exploited its competitive advantage by unabashedly overcharging its low risk insurance pool and requiring members to forfeit a claim for refund.158

Exploitation of a unique asset proved troublesome for ABE. The Supreme Court remarked, “Lacking a factual basis for concluding that

149. Id. at 108.
150. Id. at 105.
151. Id.
152. Id.
154. Id. at 110-11.
157. Id. at 113.
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Generosity is at the core of ABE’s success, we can easily view this case as a standard example of monopoly pricing.”159 In fact, monopoly pricing is the objective of asset exploitation. The whole body of intellectual property law is founded on this premise – the exploitation of a unique asset160 to the exclusion of others,161 to reward one’s risk of engaging in the activity and allow for a recovery of costs.162 By directing the focus of analysis to the exploitation of a unique asset, the Supreme Court recognized the activity as one of the hallmarks of a trade or business activity.163

In National Association of Postal Supervisors v. United States, the United States Claims Court examined whether the activities of a tax-exempt labor organization constituted a trade or business.164 The plaintiff, National Association of Postal Supervisors (NAPS), “is a tax-exempt labor organization that sponsors a health plan.”165 “NAPS’s [tax-exempt] purpose was the ‘social and economic advancement of postal supervisors and improvement of the postal service.’”166

Prior to 1980, NAPS offered three classes of membership levels: active, honorary, and associate. Membership in these three classes was limited to postal supervisors. In 1980, NAPS amended its constitution and bylaws to provide a fourth class of membership: the “limited benefit” membership.167 The creation of a fourth class allowed “non-postal federal employees [to become] limited benefit members, but only ‘for

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161. Yonatan Even, Appropriability and Property, 58 Am. U. L. Rev. 1417, 1432 (2009) (“Exclusionary rights promote exclusive use of assets and prevent tragedies of the commons. Such rights also ensure that those exploiting the assets are free from the threat of poachers, thereby enabling transactions with others for access to the fruits of their labor. Thus, it is not surprising that Blackstone, Bentham, and many subsequent commentators have identified the right to exclude as the central right at the core of property regimes.”).
162. Malcom Gladwell, In the Air: Who Says Big Ideas Are Rare?, The New Yorker (May 12, 2008), http://www.newyorker.com/magazine/2008/05/12/in-the-air. Intellectual property is justified, “[t]his phenomenon of simultaneous discovery—what science historians call “multiples”—turns out to be extremely common. One of the first comprehensive lists of multiples was put together by William Ogburn and Dorothy Thomas, in 1922, and they found a hundred and forty-eight major scientific discoveries that fit the multiple pattern.” Id.
163. See generally Am. Bar Endowment, 477 U.S. at 110.
165. Id. at 311
166. Id. at 312.
167. Id.
the sole purpose’ of obtaining insurance” under the plan.\textsuperscript{168} Limited benefit members paid $25 in dues.\textsuperscript{169}

The change in policy by NAPS to expand the membership proved fruitful. “From 1981 through 1984, NAPS experienced a substantial increase in limited benefit membership.”\textsuperscript{170} During this period, limited benefit membership grew dramatically from “149 limited benefit members”\textsuperscript{171} to “almost 33,000 federal employees.”\textsuperscript{172} During the same period, “[l]imited benefit member dues generated substantial income”\textsuperscript{173} for NAPS. During 1983 and 1984, NAPS collected “over $580,000” and “nearly $850,000” in limited benefit membership dues.\textsuperscript{174} These amounts represented “sixty-four percent” and “sixty one percent of NAPS’s total net operating revenues” for 1983 and 1984, respectively.\textsuperscript{175} Upon audit, the IRS “determined that NAPS’s collection of membership dues in return for health insurance was a trade or business activity unrelated to the organization’s tax-exempt purpose.”\textsuperscript{176} NAPS paid the tax and filed suit seeking a refund for payment of the tax.\textsuperscript{177}

The Claims Court found that the limited benefit membership differed substantially from the other levels of membership. For example, the evidence disclosed that “[u]pon joining NAPS, active and associate members received a membership kit,”\textsuperscript{178} whereas “limited benefit members received only the health plan brochure, the insurance underwriter’s pamphlet, and a cover letter from NAPS.”\textsuperscript{179} The brazen distinction in service levels between membership tiers continued. “NAPS perform[ed] many other services for its active and associate members”\textsuperscript{180} that it did not perform for the limited benefit members. For example, NAPS lobbied on behalf of its active and associate members; NAPS had “the right to consult about pay issues, fringe benefits,
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and other programs affecting its postal supervisors,”181 and “NAPS testified before Congress” on behalf of its postal membership. The evidence did indicate that NAPS offered all members training and education programs. “NAPS made no specific effort, however, to inform limited benefit members of [available] training and education programs.”182 The distinction in service levels was all too apparent to ignore.

In 1984, NAPS adopted a resolution granting to limited benefit members the right “to participate in meetings, to serve on committees and to offer technical advice.”183 NAPS sought to blunt the risk created in providing minimal and disparate benefits to the limited benefit members. The Chairman of NAPS explained the reason for the resolution by stating:

The reason this resolution is here because, one, these people184 are getting nothing for their $25-you know, they are paying the premium on the health benefits also in full-but, second, and more important, this was at the urgency and suggestion of our attorneys and legal people because we could be in serious trouble if we left this $25 as simply a fee and gave the people no participating rights for it.185

The Claims Court concluded that the activity of providing limited membership benefits constituted a trade or business and held for the IRS. NAPS appealed the judgment of the Claims Court.

On Appeal, the United States Court of Appeals, Federal Circuit, affirmed the judgment of the Claims Court. The Federal Circuit reasoned that:

While earning a profit may not have been NAPS's only motive in offering insurance to federal employees who were not postal supervisors, it was one of the primary reasons the union installed and kept the $25.00 membership fee. The Claims Court found that “NAPS knew before setting the limited benefit member dues that each individual would cost the organization less than $25.00,” and that the “Executive Committee set the $25.00 dues with knowledge that this rate would generate profits.”186

181. Id.
183. Id.
184. In this context, the clause “these people” refers to the limited benefit members. Id. at 321.
185. Id. at 314.
The following factors, outlined by the Claims Court, proved critical to the Court of Appeals decision:

First, the activity must "benefit . . . membership as a group, rather than in their individual capacities." Second . . . court[s] should ascertain whether the fees charged by the organization are directly proportional to the benefits that individuals receive. . . . Third, an activity is less likely to be substantially related to an organization's tax-exempt purpose if "the service provided . . . is one commonly provided by for-profit entities."187

The disparity in service levels among the different membership levels, coupled with the intent to generate a profit, resulted in a finding that NAPS's activity of providing insurance to its nonmembers constituted a trade or business, subject to the unrelated business income tax.188 In the end, NAPS failed to demonstrate that its activities satisfied the basis for its income tax exemption triggering exposure to the corporate income tax.189

F. Other Federal Statutes with Trade or Business Implications

The phrase "trade or business" is not solely limited to use in the income tax code. The phrase courses throughout the United States Code, touching a diverse range of federal statutes, reflecting Congressional policies in areas such as, production and sale of handicraft items by native American tribes,190 the regulation of firearms,191 structuring transactions to evade the reporting of monetary instrument transactions,192 extending trade benefits to certain Sub-Saharan associations,193 determining who is eligible to receive federal grants to reduce the production of methamphetamine,194 and protecting Alaskan land leases.195

At present, forty-seven non-tax federal statutes employ the phrase "trade or business."196 The frequency and use of this particular

187. Nat'l Ass'n of Postal Supervisors, 21 Cl. Ct. at 324.
188. Id. at 324-26.
189. Id. at 326.
phrase outside of the income tax code is striking. However, the meaning of the term “trade or business” is undefined in these non-tax statutes. Only two of the aforementioned federal statutes make a scant attempt at a definition by making a passing reference to Section 162 of the income tax code. Congress undoubtedly intended the adoption of a general and undefined term. Therefore, courts are left with no legislative guidance as to the meaning of this term. Presumably, the courts will look to how the phrase has been used in the income tax statutes for guidance.

What then is the intended meaning of the phrase “trade or business” when used in a non-tax context? One must be mindful of the “fundamental canon of statutory construction [which] is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.” Should the interpretation of non-tax statutes import a tax meaning when interpreting the phrase? The range of federal statutes adopting this phrase beseeches an expansive application of the term to fulfill Congress’ policy objectives.

For example, The Ethics in Government Act requires certain federal officers and individuals to “file a report containing . . . [t]he source, type, and amount or value of income . . . from any source” including, “[t]he identity and category of value of any interest in property held during the preceding calendar year in a trade or business, or for investment or the production of income, which has a fair market

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197. See 42 U.S.C. § 411(c) (2015) (relaying the definitions relating to self-employment, which provides in relevant part that “[t]he term “trade or business,” when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 of the Internal Revenue Code of 1986”); 42 U.S.C. § 403(k) (2015) (relating to certain reductions of insurance benefits for activity outside the United States, which provides in relevant part that the term “trade or business” shall have the same meaning as when used in section 162 of the Internal Revenue Code of 1986”).

198. Perrin v. United States, 444 U.S. 37, 42 (1979). See also Schindler Elevator Corp. v. United States, 563 U.S. 401 (2011) (“When terms used in a statute are undefined, we give them their ordinary meaning.”).


200. Id. at § 101(f) (The list of enumerated individuals required to file a report include the “President, the Vice President, each officer or employee in the executive branch . . . who occupies a position classified above GS-15 . . . Member(s) of Congress . . . [including] officer[s] or employee[s] of the Congress . . . judicial officer[s], and judicial employee[s].”).

201. See id. at § 102.
value which exceeds $1,000."202 The policy for this statute is to ensure integrity and establish accountability among federal workers.

Another federal statute prohibits the Secretary of Homeland Security from “enter[ing] into any contract with a foreign incorporated entity” if the foreign entity acquires “substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership.”203 The policy reason behind this statute is to discourage U.S.-based businesses from reorganizing with foreign ownership and, thereby, avoid paying U.S. taxation, while simultaneously reaping the benefits of entering into a contract with the United States. Congress was concerned with the high incidence of corporate inversion transactions, that were essentially mere paper transactions costing the U.S. treasury millions of dollars in lost tax revenue. This statute was enacted in response to the foreign reincorporation of an entity, where the substance of the managerial and operational control remained within the same group of American individuals.204 The policy justification for this requirement is described by one writer as an “‘alternative sanction’ . . . to the traditional civil and criminal sanctions that is used to stop a perceived abuse of tax law.”205

Yet another federal statute, an immigration statute, invokes the phrase “trade or business” when determining whether individuals from the countries of Cuba or Nicaragua have satisfied the conditions to adjust their immigration status. Specifically, Title 8, Section 1255 of the United States Code provides that, “for purposes of establishing that the period of continuous physical presence” has been satisfied, the individual must demonstrate that she “performed service, or engaged in a trade or business, within the United States.”206

202. Id. at § 102(a)(3).
204. See Michael S. Kirsch, Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy, 89 IOWA L. REV. 863, 867 (2004) (“Another recent example of alternative sanctions arises in the context of corporate inversions, whereby a company organized under the laws of the United States changes its place of incorporation to a foreign country, such as Bermuda or the Cayman Islands, in order to reduce its future United States tax liability. In response to this recent phenomenon, Congress enacted, as part of the Homeland Security Act of 2002, an alternative sanction purporting to ban these former United States corporations from entering into future contracts with the Department of Homeland Security.”).
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One final example, the Federal Hazardous Substances Act (“FHSA”), brings certain private equity firms directly into the crosshairs of the trade or business debate. Specifically, Section 1278 of the FHSA requires that certain toys intended for use by children contain a cautionary statement. The purpose of this statute is to provide consumers with a warning about the hazards of small parts and balloons. The statute applies to manufacturers, distributors, retailers, importers, and private labelers. The statute exempts “an individual whose selling activity is intermittent and does not constitute a trade or business.”

Private equity firms have taken a dominant investment position in the toy industry. For example, “Toys’R’Us, Inc. . . . the world’s leading dedicated toy and baby products retailer . . . , operated as a public company [until] . . . an investment group consisting of affiliates of Bain Capital Partners LLC, Kohlberg Kravis Roberts & Co. (KKR) and Vornado Realty Trust completed an acquisition of Toys’R’Us, Inc. for $6.6 billion” in 2005. In still another private equity transaction, the “Transom Capital Group [] sold Uncle Milton Industries Inc., a . . . maker of ant farms and other science toys for children, to KCB Management” for an undisclosed sum.

Private equity firms will undoubtedly argue that they are not engaged in the trade or business of selling toys. Predictably, they will raise the time-honored defenses that separate corporate identities and limited liability for investors justify holding only the operating company liable. However, fair questions arise when one considers whether a private equity firm that provides consulting services, facilitates distribution, enables manufacturing alliances, or otherwise engages in actions affecting the operations of the toy company is engaged in an “activity” that constitutes a “trade or business” for purposes of this statute. The debate is brought into full relief when one considers the competing policy implications between the states’ economic development interests and the federal government’s objective of regulating an activity which directly affects the most innocent and unsuspecting members of the population – our children.

209. See About Toys”R”Us, Inc., Toys“R”Us, http://www.toysrusinc.com/about-us/ (last visited Apr. 1, 2016). “The acquisition encompassed all worldwide operations of Toys”R”Us, Inc., including the Toys”R”Us and Babies”R”Us businesses. With the completion of this transaction, each of the investors owns an equal stake in Toys”R”Us, Inc.” Id.
G. Common Law Uses of the Phrase Trade or Business Illustrating a Common, Plain and Ordinary Understanding of Such Phrase

The phrase “trade or business” is also a common tool of analysis conveying meaning beyond its statutory framework. Courts have invoked this phrase when identifying a litigant’s protectable property interest despite the absence of a statutory mandate compelling the presence of a trade or business.

In Caraway v. Ford Motor Company, the plaintiff sought to invoke the federal court’s jurisdiction by alleging that defendants violated “provisions of the Sherman Anti-Trust Act and the Clayton Act, Title 15 U.S.C.A. §§ 1-7, 12 et seq.” The court stated that “[a] person who has been injured in his trade or business by the activities of an unlawful monopoly, combination or restraint is entitled to recover damages in an action at law for the loss suffered, recovery being sustainable both at common law and under the federal anti-trust statutes.”

In Old Dearborn Distributing Co. v. Seagram-Distillers Corporation, the United States Supreme Court “upheld the Illinois Fair Trade Act . . . as affording ‘a legitimate remedy for an injury to the good will which results from the use of trade-marks, brands or names.’” In upholding the statute, the Supreme Court affirmed “good will is property in a very real sense, injury to which, like injury to any other species of property, is a proper subject for legislation.” The Court’s analysis recognized

[i]t is well settled that the proprietor of the good will “is entitled to protection as against one who attempts to deprive him of the benefits resulting from the same, by using his labels and trade-mark without his consent and authority.” “Courts afford redress or relief upon the ground that a party has a valuable interest in the good-will of his trade or business, and in the trade-marks adopted to maintain and extend it.”

“In Kewanee, the [United States] Supreme Court held that Ohio’s law of trade secrets, which, . . . granted monopoly protection to processes

216. Id. at 194-95 (citation omitted).
and manufacturing techniques that had been in commercial use for over one year but were otherwise patentable, was not preempted by the federal Patent Act.”

The plaintiffs in *Kewanee* sought a permanent injunction to prohibit former employees from disclosing certain trade secrets. In upholding the Ohio statute, the Court recognized that “[t]he subject of a trade secret must be secret, and must not be of public knowledge or of a general knowledge in the trade or business.”

Taken together, these cases help illustrate the common gloss that the phrase “trade or business” has now acquired in American jurisprudence.

**H. Competing Policy Interests**

*Sun Capital Partners* raises significant issues of importance in tax law, pension law, and corporate law. Its holding creates broad policy implications for regulators, investors, and laborers concerning the twin doctrines of preserving entity integrity and promoting limited liability.

Economic history amply documents the evolution of investment opportunities, investment strategies, and investment vehicles since the early days of the joint-stock company in the sixteenth century. Initially, investment opportunities were simple and direct, and they exposed investors to unlimited liability. With the advancement of economic and social progress, investors insisted on greater legal protections and legislators responded by creating the limited partnership. The concept of limited liability took on greater significance with the proliferation of corporate entities and the advent of limited partnerships in the nineteenth century. Legislation tending to impose a burden of responsibility on corporations fell in favor of lax regulation during the charter race of the nineteenth century. The desire for limited liability continued unabated throughout the nine-

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219. *Id.* at 475.

220. *See*, e.g., Clowes v. Brettell, (1843) 152 Eng. Rep. 885, 886 (Eng.) (finding that the plaintiffs can look beyond the company to the shareholders for payment of debt).

221. *See* Limited Liability Act 1855, 18 & 19 Vict. c. 133 (Eng.) (providing limited liability to companies with 25 or more shareholders); *see also* Joint Stock Companies Act 1856, 19 & 20 Vict. c.47 (Eng.) (extending limited liability protection to companies with seven or more shareholders).

222. *See* The Rise of Big Business: The Corporate Revolution, *Digital History*, http://www.digitalhistory.uh.edu/disp_textbook.cfm?smtid=2&psid=3165 (last visited Apr. 6, 2016) (pointing out that although some viewed this time period as the golden age of free enterprise, working conditions were appalling and labor conflict was intense).
teenth century and well into the twentieth century as investors sought participation rights in the businesses they owned while preserving the privilege of limited liability. State legislators responded late in the twentieth century, enacting legislation allowing for the creation of LLC, LLP, and LLLP entities. These entities perfected the concept of limited liability by permitting investors to participate directly in the entity while maintaining the privilege of limited liability. In the midst of the investors’ quest for expanded participation and liability privileges, Congress enacted federal legislation designed to protect workers’ pensions and to prevent abuse through permissible corporate structuring.

Federal law has made it clear that it will not tolerate legal fictions to avoid liability. Unlike state laws, where legislation grants to investors great flexibility in separating and structuring investment activities, federal law has expounded a standard of liability for certain investment activities under prescribed circumstances. Federal law explicitly anticipated the need to consolidate entities under particular circumstances. Therefore, the fictional separation of an entity’s activities by investors that is permissible under state law principles is irrelevant to the determination of liability under certain federal law principles.

There is a noticeable trend afoot in finding private equity firms responsible for the actions of their portfolio companies. The result of finding a private equity firm liable as demonstrated in Sun Capital Partners is no longer atypical. Federal regulators are aggressively enforcing statutes where enabling legislation is in place. The question is not whether private equity funds should be held liable; rather, the question is when should private equity funds be held liable. To this end, Congress has spoken and enacted federal legislation providing that “all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed

224. See id. at 455-56.
226. 29 U.S.C. § 1301(b)(1) (“[A]ll 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.”).
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by a single employer and all such trades and businesses as a single employer.”228 Still, the question remains, what constitutes a trade or business for purposes of the labor statute?

To date, neither Congress nor the Supreme Court has articulated a definitive standard for determining whether an activity amounts to a trade or business. The cross-references between the relevant labor statute and the tax statute on this point are both incomplete.229 Congress has chosen instead to leave this determination to the courts and the regulators. Determining whether a particular activity constitutes a “trade or business” involves evaluating a myriad of factors. Some factors, such as incurring rental expenses230 or salary expenses,231 are ubiquitous and can make the inquiry into identifying the underlying trade or business uncomplicated and predictable. Other factors, such as incurring legal fees232 or uniform expenses233, may be unique to a particular activity, thus making the inquiry into identifying a trade or business challenging and thought provoking.

Three Supreme Court cases have considered the question of what constitutes a trade or business for purposes of business deductions under the income tax code. The Supreme Court declined the opportunity to consider what constitutes a trade or business under the Labor Code.234 And, unfortunately, the Court of Appeals for the First Circuit did not provide a standard of analysis in Sun Capital when it declared one of the two equity funds to be a trade or business. Both the labor code and the tax code use the phrase “trade or business.” None-

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229. “[T]rade or business” in 29 U.S.C. § 1301 cross references to 26 U.S.C. § 514, which itself cross references to Section 162 where “trade or business” is statutorily undefined. Moreover, the Supreme Court’s analysis of the phrase “trade or business” is limited in Groetzinger.
230. In Quinlivan v. Comm’r, 599 F.2d 269, 272 (8th Cir. 1979), the United States Court of Appeals for the Eighth Circuit stated that “Congress has expressly provided for the deduction of rental expenses where: (1) the payments are required to be made for the continued use or possession of the property; (2) the continued use or possession of the property is for purposes of the trade or business; (3) the taxpayer has not taken and is not taking title to the property; and (4) the taxpayer has no equity in the property.”
231. Brewer Quality Homes, Inc. v. Comm’r, 86 T.C.M. (CCH) 29 (T.C. 2003), aff’d, 122 F. App’x 88 (5th Cir. 2004).
233. Pevsner v. Comm’r, 628 F.2d 467, 469 (5th Cir. 1980) (“[C]ost of clothing is deductible as a business expense only if: (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general usage as ordinary clothing, and (3) it is not so worn.”).
theless, the question remains: “What is a trade or business?” And equally important for purposes of the labor statute is the following question: “Is there a difference in meaning when applying the phrase “trade or business” in the labor code from applying the identical phrase in the tax code?” Specifically, should a reading of the phrase “trade or business” for purposes of the labor statute yield a different result from a reading of the phrase “trade or business” in the tax code? This question has not been addressed by Congress, the courts, or academic commentators.

Sun Capital Partners offers a prime opportunity to examine how the distinction in interpretation and application of the subject phrase operates.

IV. TWO PROPOSALS

Several approaches can be articulated to address the uncertainty raised by the employment of identical terms in these federal statutes. Possibilities abound to resolving the statutory ambiguity such as the one “trade or business” raises. I propose two.

The first approach proposes the adoption of a definition of trade or business for purposes of the labor statute. Thus far, Congress and the courts have been reluctant to define the phrase “trade or business.” However, a limited definition of the phrase “trade or business” is warranted in light of Congress’ objective of protecting a wide base of workers’ pensions, and given the protective posture of the phrase. Providing a limited definition of the phrase “trade or business” is without precedent. For instance, the income tax regulations provide that “for purposes of section 513 the term trade or business has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.”

The labor statute at issue in Sun Capital Partners presently provides that “all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as em-

235. See supra note 196 and accompanying text listing 47 different federal statutes.
236. The income tax regulations at 26 C.F.R. § 1.513-1(b) (2013) provide in relevant part, “any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute trade or business within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term trade or business has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.”
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ployed by a single employer and all such trades and businesses as a single employer.” I propose adding the following definition to clarify the meaning of the statute:

For purposes of Section 1301(b)(1), the phrase “trade or business” includes (1) any business activity organized and operated on a regular, continuous, or substantial basis in a profit motivated transaction with another party under common control involving any exchange at fair market value, or (2) any undertaking conducted by any person engaging in a regular, significant or meaningful manner in the operations, management, or policy making decisions of another person under common control.

The first definition focuses the inquiry on exchanges at fair market value and is consistent with the theory that rational individuals seek to optimize their exchanges. The second definition focuses the inquiry on “engaging in” activities that do not require an exchange at fair market value but nonetheless indicate the presence of a trade or business activity. The advantage to this approach is that it respects the separate entity structure of LLCs, LLPs, and corporations under state law, while providing liability in the event that a higher-tiered individual usurps the policy, managerial, and operational control of the portfolio company under federal law.

In the absence of a defined term, establishing a consistent definition of the term “trade or business” will continue to be a challenge. Regulatory guidance will clarify the present ambiguity, thereby promoting enforcement and compliance with the statute. When invoking the labor statute, the need for a fixed definition of the phrase “trade or business” is warranted to fill the statutory gap left open by Congress.

Three factors converge to justify providing a definition of a trade or business. First, the modernization of the corporate laws allowing for investor involvement in the underlying entity must be recognized. Second, in addition to earning the traditional dividends and appreciation, private equity firms now earn something more: they earn management fees, transaction fees, and monitoring fees. Finally, the difference in posture between invoking a benefit or imposing a burden when invoking the phrase “trade or business” must be recognized and applied by litigants.

A. Administrative Guidance Warranted?

It is unlikely that Congress is willing to act and adopt language defining a trade or business for purposes of Title 29. This is especially

true given that Congress has already authorized the PBGC to “pre-
scribe” regulations with the only limitation that they be “consistent
and coextensive with regulations prescribed for similar purposes by
the Secretary of the Treasury under section 414(c) of Title 26.” What
remains, therefore, is for the PBGC to issue regulatory guidance defin-
ing a trade or business for purposes of the labor statute.

Regulatory guidance can take various forms, ranging from a for-
mal interpretive regulation to an informal administrative
pronouncement. The following question arises: whether such adminis-
trative guidance would be binding on a reviewing court. The answer
depends on the level of administrative action taken. Courts observe
three deference doctrines when evaluating administrative actions –
Chevron deference, Skidmore deference, and Auer deference each
named after the principal case.

In a Chevron-type analysis, a reviewing court evaluates formal
administrative pronouncements interpreting a particular statute. The
formal administrative pronouncement is almost always a regulation.
The court must determine “whether Congress has directly spoken to
the precise question at issue.” If Congress has directly spoken and
has “unambiguously expressed” its intention regarding the applicable
legislation, then the reviewing court is bound to follow Congress’ ex-
pressed intention. “If, however, the court determines Congress has
not directly addressed the precise question at issue, the court does not
simply impose its own construction on the statute, as would be neces-
sary in the absence of an administrative interpretation. Rather, if the
statute is silent or ambiguous with respect to the specific issue, the
question for the court is whether the agency’s answer is based on a
permissible construction of the statute.” Naturally, the debate will
often center on what is the meaning of “the precise question at issue.”

In a Skidmore-type analysis, a reviewing court evaluates infor-
mal administrative pronouncements such as “rulings, interpretations

238. Id.
240. Id. at 843.
241. Id. at 842-43 (“When a court reviews an agency’s construction of the statute which
it administers, it is confronted with two questions. First, always, is the question whether
Congress has directly spoken to the precise question at issue. If the intent of Congress is
clear, that is the end of the matter; for the court, as well as the agency, must give effect to
the unambiguously expressed intent of Congress. If, however, the court determines Con-
gress has not directly addressed the precise question at issue, the court does not simply
impose its own construction on the statute, as would be necessary in the absence of an
administrative interpretation. Rather, if the statute is silent or ambiguous with respect to
the specific issue, the question for the court is whether the agency’s answer is based on a
permissible construction of the statute.”).
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and opinions of the Administrator" 242 that interpret the application of a particular statute. The Supreme Court has indicated that “[t]he weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.” 243 Nonetheless, a reviewing court “may properly resort [to these items] for guidance.” 244 One commentator notes, “Skidmore deference is premised on practicality—a recognition that agencies are institutionally superior to the courts with respect to the interpretation of their statutes.” 245

In an Auer-type analysis, a court is reviewing an administrative interpretation of an administrative action. For example, “[a]n administrative rule interpreting the issuing agency’s own ambiguous regulation may receive substantial deference.” 246 However, the Supreme Court cautions that “[a]n agency does not acquire special authority to interpret its own words when, instead of using its expertise and experience to formulate a regulation, it has elected merely to paraphrase the statutory language.” 247

The course of action taken by the administrative agency, if any, will determine the level of judicial deference ultimately given by the courts. If the administrative agency pursues formal regulations in accordance with the APA provisions, then the resulting regulation receives Chevron-type deference. However, if the administrative agency pursues informal pronouncements, thereby bypassing applicable APA provisions, then the resulting regulations receive Skidmore-type deference. Finally, if the administrative agency issues informal pronouncements such as additional or clarifying announcements, then the resulting administrative guidance will receive Auer-type deference.

B. The Dual Posture of “Trade or Business” - Accessing a Benefit or Imposing a Burden

The second approach to address the uncertainty raised by the employment of identical terms in these federal statutes proposes a

243. Id.
244. Id.
247. Id.
method of interpretation that unfortunately was not recognized by the litigants nor the court in *Sun Capital Partners*. This approach requires that litigants and courts first recognize the fundamental distinction in the policy objectives between the income tax code and the labor statute when invoking the subject phrase “trade or business.” Although not initially apparent, there exists a fundamental difference in policy objectives between the income tax code and the labor statute, despite the fact that both employ the identical phrase “trade or business.” The policy objective of the phrase “trade or business” in the income tax code generally seeks to grant to individuals a statutory benefit. In contrast, the policy objective of the phrase “trade or business” in the labor statute at issue seeks to impose on individuals a statutory burden. Capturing this distinction in policy objectives within these statutes is central to a proper understanding and application of the phrase “trade or business.” Next, litigants and parties are to interpret the subject phrase according to whether the statute grants a benefit or imposes a burden. This is likely because statutes that grant a benefit are to be narrowly construed, whereas statutes imposing a burden are to be broadly construed. Recognizing the distinction between benefit and burden justifies the difference when interpreting the phrase “trade or business.”

When a statute grants a benefit, as in the case of an income tax statute, the statute should be narrowly construed to promote the Congressional objective. Courts have repeatedly held that income tax benefits are matters of legislative grace and, therefore, must be narrowly construed. As a matter of statutory construction, the Supreme Court iterated “the ‘familiar rule’ that ‘an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.’” Invoking the phrase “trade or business” for purposes of accessing an income tax benefit requires taxpayers to demonstrate a direct link between the activity and the claimed income tax benefit.

In contrast, when a statute imposes a burden, the statute should be broadly construed to recognize Congress’ full power to legis-
late, and to mandate. This means granting the presumption of enforceability to the statute enacted by Congress, and requiring challengers to demonstrate why the particular statute is invalid. This approach is consistent with the theory that protective\textsuperscript{251} and remedial\textsuperscript{252} statutes are broadly construed to give full effect to Congressional intent. A broad construction ensures compliance by individuals and enforcement by regulators alike. In tax law, the Supreme Court has recognized this principle of broad construction when the Court upheld “the full measure of [Congress'] taxing power.”\textsuperscript{253} In labor law, the Supreme Court has likewise recognized this principle of broad construction when the court stated, “Traditionally, the Supreme Court and the circuit courts have noted that the FLSA should be broadly construed by 'look[ing] to its animating spirit.'”\textsuperscript{254} Other areas of federal law such as healthcare law,\textsuperscript{255} environmental law,\textsuperscript{256} and antitrust law have adopted a similar rationale when imposing burdens of responsibility. A broad approach is therefore justified by federal policy objectives and by courts that have repeatedly held that legal fictions should not frustrate public policy.

A critical distinction must be drawn between the three Supreme Court cases that have examined the question of “trade or business” and the argument advanced by the plaintiff in \textit{Sun Capital Partners} that it is not engaged in a trade or business. The plaintiff’s reliance on the Supreme Court precedents is misplaced. In each of the three Supreme Court cases\textsuperscript{257} examining the applicability of a “trade or business,” the taxpayer sought to access a benefit. In contrast, the equity funds in \textit{Sun Capital Partners} sought to avoid a burden by relying on a narrow application of the phrase “trade or business” when, in fact, a broader interpretation is suitable. Understanding the distinction in posture and interpreting the phrase accordingly (be it narrowly or broadly) promotes efficiency, reduces conflicts, and provides litigants and regulators alike with a degree of certainty and uniformity.

\begin{itemize}
\item \textsuperscript{251} Avila v. A. Sam & Sons, 856 F. Supp. 763, 769 (W.D.N.Y. 1994) (“As general principle, the [Migrant and Seasonal Agricultural Worker Protection Act] is to be broadly construed to protect migrant agricultural workers.”).
\item \textsuperscript{252} Marshall v. Coastal Growers Ass'n, 598 F.2d 521, 525 (9th Cir. 1979) (“The Farm Labor Contractor Registration Act is remedial and should be broadly construed.”).
\item \textsuperscript{253} Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 476 (1955).
\item \textsuperscript{254} Bartis v. John Bommarito Oldsmobile-Cadillac, Inc., 626 F. Supp. 2d 994, 998 (E.D. Mo. 2009).
\item \textsuperscript{255} See Good Samaritan Hosp. v. Shalala, 508 U.S. 402 (1993).
\item \textsuperscript{256} See United States v. Riverside Bayview Homes, 474 U.S. 121, 133 (1985); Leslie Salt Co. v. United States, 55 F.3d 1388, 1388 (9th Cir. 1995).
\end{itemize}
CONCLUSION

The determination as to whether an activity amounts to a trade or business is a challenging, daunting, and problematic inquiry. The analysis itself requires working with legal standards that are imprecise and inexact. Congress and the Supreme Court have both refused to articulate a definitive standard, preferring instead to leave it to the courts to examine the facts and circumstances of each case before deciding. This approach has proven to be a wise course of action when considering the differing policy objectives that the phrase “trade or business” is intended to promote.

Establishing what constitutes a trade or business inevitably involves examining and balancing factors deemed critical to the operation of a particular activity. For example, relevant factors may include considerations such as the provision of goods and services,\(^{258}\) the active participation by the proprietor, managerial oversight by the board of directors, instituting policy making decisions in the firm, making operational decisions in the organization, requiring prior approval for capital expenditures, approving marketing plans for the firm, or hiring and firing firm personnel. In short, engaging in something more than an occasional or insignificant involvement in the operations, management, or policy-making decisions of the firm is required. The phrase “trade or business” is an amorphous standard: an elusive and slippery concept incapable of a definitive description and yet elastic and flexible to provide the necessary coverage to promote Congressional policy objectives. Whatever the underlying circumstance, whenever a search for the meaning of a “trade or business” is launched, we must be mindful of the words of Justice Cardozo, who so eloquently captured the essence of legal analysis when he wrote:

\begin{quote}
Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.\(^{259}\)
\end{quote}

\(^{258}\) The Frankfurter approach of requiring exclusive goods or services was rejected by the Supreme Court in Groetzinger. Groetzinger, 480 U.S. at 32 (“We must regard the Frankfurter gloss merely as a two-Justice pronouncement in a passing moment and, while entitled to respect, as never having achieved the status of a Court ruling.”).

\(^{259}\) Welch v. Helvering, 290 U.S. 111 (1933) (Cardozo, J.).