Potential Treaty Issues Arise in the ‘Trade or Business’ Landscape

By Lori McMillan

The concept of a “trade or business” seems so basic, it almost should not need definition. However, in a potentially game-changing approach, the United States Court of Appeals for the First Circuit in Sun Capital Partners v. New England Teamsters & Trucking Industry Pension Fund, No. 12-2312 (1st Cir. 2013), has drastically altered the “trade or business” landscape by finding that a private equity fund was engaged in a trade or business, in the context of pension liability in bankruptcy. Despite the context, this has significant potential implications for tax treaties and for tax practitioners, as the courts’ interpretations of “trade or business” cuts across statutes and are applicable to areas in which the definition has been previously addressed.

For tax purposes, “trade or business” has a variety of uses, but it is not defined anywhere in the Internal Revenue Code or in any comprehensive regulation. Commissioner v. Groetzinger, 480 U.S. 23 (1987), is commonly cited to define a trade or business as existing when (1) the taxpayer is engaged in an activity with the primary purpose of income or profit, and (2) that activity is conducted with continuity and regularity. The court in Sun Capital rejected the robotic application of Groetzinger and distinguished the oft-cited precedents Higgins v. Commissioner, 312 U.S. 212 (1941), and Whipple v. Commissioner, 373 U.S. 193 (1963), on the facts, narrowing the tests arising in those two cases.

In Higgins, the taxpayer was denied a deduction for expenses incurred in managing his own extensive investments, on the grounds he was not engaged in a trade or business. To distinguish this case, the court noted that the taxpayer in Higgins did not manage the corporations in which he held an interest, directly or indirectly, in any way. This was not so in Sun Funds: “the Sun Funds did participate in the management of (the bankrupt business), albeit through affiliated entities” (at 33). Whipple was distinguished as well, as “when the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating he is engaged in a trade or business.” Sun Funds channeled management and consulting fees to more than one of their general partners and related entities, and in doing so “received a direct economic benefit in the form of offsets against the fees it would otherwise have paid its general partner.” In accordance with those distinguishing facts, the court saw no inconsistency with prior case law in determining that at least one of the private equity funds was engaged in a trade or business. Using the law of agency, as well as partnership law, the court attributed the acts of the general partner to the limited partners, and it had no difficulty doing so, stating, “The investment strategy of Sun Funds could only be achieved by the active management through an agent, since the Sun Funds themselves had no employees” (at 38).

The result is that an entity with no offices or employees of its own, and which had only ever declared passive investment income on its tax returns, was found to be engaged in a trade or business. While the funds invested in multiple businesses and provided significant assistance and management to those businesses, they did so not directly but through various agreements with related entities to provide those services and employees. This can have far-reaching effects in the tax world, the most basic of which involves the issues surrounding effectively connected income.

If a foreign business has a U.S. trade or business, the ECI of that business is taxable in the United States. While tax treaties can, and do, modify this basic threshold of U.S. taxation for foreign businesses through the permanent establishment article in those treaties, something previously thought to be a non-starter now has become a potential treaty issue. Now seemingly passive entities are no longer safe from being a trade or business merely because they manage their corporate family to outsource the “real” work. Substance matters more than form. The court has allowed the attribution of activity...
through agency law, and this should concern practitioners with foreign clients who previously thought that their activities through an investment vehicle, such as a private equity fund, automatically escaped the trade or business threshold. Private equity funds, and other funds such as mutual funds, hedge funds, and the like, must take into account the facts and circumstances of their operation, to determine how truly passive their activities really are. Those that follow an “investment plus” model of business are potentially affected by this ruling, and it is not clear that the impact of the ruling will be limited to the ERISA area. It remains to be seen how aggressive the IRS will get with this, if at all, but the court has fired a shot across the bow, and only the unwary will ignore it.