



## Might the UBIT Bite a Bit? You Bet.

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The recent tax reform bill (Tax Cuts and Jobs Act, H.R. 1), which the House Ways and Means Committee introduced November 2, would subject public pension plans to unrelated business income tax (**UBIT**) on their pre-packaged fund investments starting in 2018. Though the legislation is in its early stages and may not be enacted in its current form (if at all), public pension plans should consider it now in evaluating their new investments and negotiating side letters.

### What is UBIT?

Tax-exempt entities under Internal Revenue Code (**Code**) section 501(a) (a broad category that includes, for example, Code section 501(c)(3) charities and retirement plans qualified under Code section 401(a)) may pay UBIT, at for profit corporation rates, on unrelated trade or business income (Code section 511). Unrelated business taxable income generally does not include (Code section 512(b)) passive investment income such as interest, dividends, royalties, rents, and gains. (Under the foregoing rule, the typical IRA or 401(k) which invests in mutual funds does not owe UBIT.) Unrelated business taxable income does, however, include the following:

- First, unrelated business taxable income can include (Code section 512(a)) net income from a trade or business that the exempt organization operates in a manner comparable to that of a for-profit venture, unless the same is closely related to the organization's exempt purposes.
- Second, unrelated business taxable income can include (Code section 514) net income from debt-financed property. For example, if a 501(c)(3) organization finances a purchase of property 80% with debt, then 80% of rent and gain may be subject to UBIT (there are exceptions as discussed below).

Unrelated business taxable income can arise from an activity or property that an exempt entity owns or conducts itself, or on a pass-through basis from a limited partnership or LLC in which the entity invests. The latter pass-through treatment is the reason that many pre-packaged funds structure their investments so as not to generate unrelated business taxable income to their exempt investors. For example, a fund might invest only in corporations or REITs which generate dividends and gains not subject to UBIT, or give tax-

exempt investors the opportunity to invest through blockers (essentially, corporate intermediaries that transform what would otherwise be unrelated business taxable income from the partnership or LLC into dividends and gains not subject to UBIT, albeit at the cost of possible corporate taxes at the blocker level).

**We are a public pension plan with an IRS determination letter that we are qualified under Code section 401(a). So, aren't we subject to UBIT anyway?**

Effectively no, because public pension plans generally take the position (which private retirement plans cannot) that they come under Code section 115 which provides that gross income subject to tax does not include income derived from ... the exercise of any essential governmental function and accruing to a State or any political subdivision thereof. The IRS has never officially confirmed this position but also has not challenged it (probably because of the legal and political cost of doing so). Also, Congress did not challenge this treatment except in 2014, when House Ways and Means Committee then-Chair David Camp (R.-MI) released a draft of a tax reform bill that would have done away with (in a way similar to that in the current HR 1) the informal section 115 UBIT exemption.

(There may also be an intergovernmental immunity argument under the U.S. Constitution, apart from section 115, that the U.S. federal government cannot tax a public pension plan as an integral part of a state or political subdivision of a state. The IRS has sometimes relied on this doctrine independently of section 115 in concluding that certain state instrumentalities were not subject to tax, albeit outside the context of public pension plans – for example, in Private Letter Ruling 200238001, Private Letter Ruling 200227023, Technical Advice Memorandum 200126032, and Private Letter Ruling 200017018.)

Based on the silence is golden approach from the IRS and Congress, public pension plans generally have taken the position that they are not subject to UBIT and, as a result, have not availed themselves of blockers and are indifferent to the complex tax allocation provisions in fund agreements or turgid PPM tax consequence disclosures.

**So what does the proposed legislation say?**

Section 5001 of the bill would amend Code section 511 to provide that for UBIT purposes an organization or trust shall not fail to be treated as exempt from taxation under this subtitle by reason of section 501(a) solely because such organization is also so exempt, or excludes amounts from gross income, by reason of any other provision of this title. This language, which is deceptively simple for a tax statute, means that if a pension plan is exempt under section 501(a), the fact that its income may also be exempt under section 115 does not take it out of the UBIT scheme. The change would be effective for taxable years beginning after 2017 – there is no grandfathering.

**So if this legislation passes are we subject to UBIT on everything?**

Not necessarily: The legislation does not completely eliminate all UBIT exemptions for public pension plans, but rather places them on the same footing as private retirement plans. Therefore, the same UBIT exemptions that apply to 401(a) plans in general would continue to apply to public pension plans. For example:

- If a 401(a) plan has a direct ownership in debt-financed property (e.g., as fee simple or as a tenant-in-common) then (under Code section 514(c)(9)) the income and gains from that property generally are not subject to UBIT. To reduce liability a retirement plan often will hold such interests through a corporation or LLC that is an exempt

section 501(c)(25) title-holding company.

- If a 401(a) plan enters into a joint venture with a developer or other for-profit entity and that venture owns debt-financed property, then under Code section 514(c)(9) the plan should still avoid UBIT if the venture agreement complies with the so-called **fractions** rule. The fractions rule, which is to tax law what advanced general relativity is to physics, basically says that the exempt owner must always share in losses according to the same percentage it shares in profits (so that the for-profit cannot over-allocate beneficial losses to itself and corresponding taxable profits to the exempt venture).

What the proposed legislation *would* change is the UBIT treatment for pre-packaged funds. While public pension plans can structure their own real estate investments and joint ventures as to avoid UBIT, they cannot do so in pre-packaged funds. Further, fractions rule compliance by pre-packaged funds is essentially impossible given the practicalities of how these funds are organized and operate. Also, Code section 514(c)(9) offers exemption only from the debt-financed income rules; it does not exempt UBIT from a trade or business. Thus, if a private equity fund invests in a start-up venture (that is a partnership or LLC and not a corporation), income from that start-up passed through to an investor may generate UBIT and Code section 501(c)(9) is of no help.

### **So what do we do as a practical matter?**

Even though the legislation may not pass in its current form (if at all), public pension plans should consider the proposed change *now* in evaluating new investments in pre-packaged funds. There is no grandfathering, so that even if a plan invests in a fund before the end of this year, income in 2018 and later may still be subject to UBIT. Relevant questions might include:

- ***Will the fund generate unrelated business taxable income?*** If the fund is unlikely to generate the same (for example, because it is a buy and hold investor in REITs, corporations, bonds, and other securities that do not generate unrelated business taxable income), then there should be no UBIT issue.
- ***If the fund may generate unrelated business taxable income, is an intermediate blocker available?*** A public plan investor may want to consider, more seriously than they have done before, investing through a blocker while weighing the benefits of doing so (to be certain to avoid UBIT) against the drawbacks (corporate taxes and additional expenses at the blocker level, and an inability to exit the blocker if the proposed legislation does not pass).
- ***If the fund may acquire investments that might otherwise generate unrelated business taxable income, does the fund commit to try to structure such investments to avoid the same?*** Some funds so commit in the fund agreements; otherwise, a plan investor might want to try to obtain this commitment in a side letter.
- ***If the fund may generate unrelated business taxable income, does the fund commit to distribute enough cash per year to enable the plan investor to pay the taxes?*** Fund documents usually, but not always, contain such tax distribution commitments. If they do not, a side letter may be necessary.
- ***If the fund may generate unrelated business taxable income, does the fund commit to get K-1 schedules timely to the investors?*** If the fund agreements do not contain a firm commitment to get K-1s and other tax information out in a timely manner, a side letter may be necessary. Remember that even if the tax legislation is enacted it will remain unclear what returns might be required, or when.

Regarding *existing* fund investments, public fund investors may be stuck because, again, there is no grandfathering even if a plan invests in a fund before the end of 2017. We can be sure that funds are monitoring the situation and evaluating strategies if the legislation passes. These strategies may include a variety of the above approaches (e.g., structuring investments to avoid unrelated business taxable income, making tax distributions, and/or giving plan investors the opportunity to move into blockers). We anticipate that investors will be receiving communications from their funds on these issues.

Even if Congress effectively repeals the section 115 UBIT exemption, the intergovernmental immunity argument remains under the U.S. Constitution that the U.S. federal government cannot tax a public pension plan as an integral part of a political subdivision of a state or political subdivision of a state. Were a court to uphold this conclusion, then HR 1's UBIT section 115 repeal would be academic because it is much easier to amend the Internal Revenue Code than the U.S. Constitution. However, it would be unwise for public pension plans to rely solely on this argument in lieu of taking proactive steps to limit their UBIT exposure if HR 1 is enacted.

### **How can Nossaman help?**

Nossaman attorneys have extensive experience in advising public fund clients in their investments, both through pre-packaged funds, 501(c)(25) holding companies, and fractions joint ventures. Please contact us if you have questions about the proposed legislation, its progress, or how the legislation might affect your investments.