

Tax Reform Threatens UBIT Exemption: How to Minimize the Impact of UBIT on Public Pension Plans

Background / Current Status

Currently, tax exempt organizations under Internal Revenue Code ("Code") sections 401(a) and 501(c) are subject to unrelated business income taxation ("UBIT").[note]Unrelated business income tax (UBIT) is imposed on a tax exempt organization's income from a trade or business, regularly carried on, that is not substantially related to the purpose that is the basis of the organization's exemption. Historically, governmental pension plans have been exempt from UBIT. UBIT generally applies to income received from an unrelated trade or business, derived in connection with debt financed property, or received on a pass through basis from a limited partnership or LLC in which the tax exempt organization invests (which would include investments in a private equity fund that acquires an interest in an LLC, for example).[/note] Tax exempt organizations include a long list of entities, such as charities, civic groups, religious groups, foundations and public pension plans. However, public pension plans may claim an *additional* exemption not available to other tax exempt organizations: Code section 115 specifies that public pension plans may exclude income derived in the performance of an essential governmental function. Therefore, many public pension plans rely on Code section 115 to avoid UBIT. Being exempt from UBIT enhances public plans' investment returns, and consequently their ability to fund benefit obligations.

Draft Legislation UBIT to Public Pension Plans

The version of tax reform legislation that passed the House of Representatives on November 16, 2017 would potentially subject public pension plans to UBIT. Section 5001 of H.R.1 would amend Code section 511, effective January 1, 2018, to specify that tax exempt entities under Code sections 401(a) and 501(c) will be subject to Code section 511, even if they can claim an exemption under another section of the Code.

"[A]n organization or trust shall not fail to be treated as exempt from

POSTED:

Dec 11, 2017

RELATED PRACTICES:

[Employee Benefits](https://www.reinhartlaw.com/practices/employee-benefits)

<https://www.reinhartlaw.com/practices/employee-benefits>

[Tax](https://www.reinhartlaw.com/practices/tax)

<https://www.reinhartlaw.com/practices/tax>

[Institutional Investor Services](https://www.reinhartlaw.com/practices/institutional-investor-services)

<https://www.reinhartlaw.com/practices/institutional-investor-services>

RELATED SERVICES:

[Tax-Exempt Organizations](https://www.reinhartlaw.com/services/tax-exempt-organizations)

<https://www.reinhartlaw.com/services/tax-exempt-organizations>

[Fiduciary Review](https://www.reinhartlaw.com/services/fiduciary-review)

<https://www.reinhartlaw.com/services/fiduciary-review>

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.*"

If this version of the tax legislation becomes law, public pension plans will no longer be able to rely on Code section 115 with respect to UBIT. While it is unclear whether H.R.1 will be adopted or whether the Senate's more favorable version of the Tax Cuts and Jobs Act will become law, it will be important for public pension plans to adopt strategies to minimize UBIT for investments currently underway, and develop policies and procedures to minimize UBIT going forward. Perhaps even more important, public pension plans could develop lobbying strategies to ensure that future tax laws do not contain similar threats to the UBIT exemption.

Minimizing UBIT in Private Equity Investments

As noted above, if H.R.1 is adopted, it will become effective January 1, which means that public pension plans will have to identify and report on income subject to UBIT, regardless of when the transaction generating the income subject to UBIT originally closed. This is particularly relevant for private equity investments that may have closed years ago but are only now generating returns. However, there are steps that public pension plans can take now to try to minimize the impact of UBIT going forward.

- Public pension plan investors may contact their investment managers to understand their UBIT exposure in a particular investment. Many public pension plans are facing this issue, and investment managers may need to be flexible to accommodate their clients' changing tax profiles.
- For private equity investments that have already closed, public pension plans may contact their investment managers and request the right to transfer their limited partnership interest to a parallel fund or to a wholly owned affiliate organized as a corporation. Many private equity funds already have these parallel funds structured as corporate "blockers" to prevent UBIT sensitive investors from receiving income subject to tax. Instead, these UBIT sensitive investors would receive dividends and gains not subject to UBIT, though the corporation would pay corporate taxes. While corporate blockers add costs, both House and Senate versions of the tax bill would decrease the corporate tax rate to 20%, which may make corporate blockers more attractive tools to

avoid UBIT.

- For private equity investments that are being negotiated, public pension plans may request a side letter provision that requires the general partner to provide notice of investment transactions likely to generate UBIT and use commercially reasonable efforts to structure the transaction so as to minimize the impact of UBIT through a corporate blocker. Public pension plans may also request the right to assign their interest to a parallel fund or a subsidiary organized as a corporation, as described above.

Planning for the Future

If the House version of the tax reform legislation is ultimately made law, then public pension plans will need to determine the availability of any other exemptions from UBIT. If none are available, then public pension plans will need to file tax returns on Form 990 T. This requirement is particularly burdensome for public pension plans, as they typically take the position that they are exempt from any federal income tax and often do not file any federal income tax returns.

In addition, public pension plans may choose to rely on other Constitutional grounds, such as the doctrine of intergovernmental immunity, to continue to claim exemption from UBIT. While the applicability of such doctrines in the UBIT context is unsettled, and may result in litigation with the IRS, some comfort can be taken from the fact that the IRS has acknowledged and relied on intergovernmental immunity in other contexts. [note]For example, IRS Private Letter Ruling 200126032.[/note]

Lastly, even if the UBIT exemption is not impacted by the final law, the House version of the tax reform legislation warns about the possibility that a similar measure may become law in the future. Public pension plans may wish to anticipate these changes by developing lobbying strategies to ensure that future tax laws do not contain similar threats to the UBIT exemption.

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.