# Whiteford, Taylor & Preston L.L.P.
# Memorandum

**TO:** Howard County Police and Fire Employees Retirement Plan
Howard County Retirement Plan

**FROM:** Paul W. Madden ***PWM***

**DATE:** November 30, 2017

**RE:** **Application of UBIT to State and Local Governmental Plans**

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Background

Organizations, such as public charities, that are exempt from federal income taxes under Section 501 of the Internal Revenue Code are subject to federal income taxes on their "unrelated business taxable income" and "unrelated debt financed income" under Section 511 of the Code. Unrelated business taxable income and unrelated debt financed income are commonly referred to as UBIT. One purpose of UBIT is to level the playing field when tax-exempt organizations operate a business (like a grocery store) that competes with for-profit entities. Because operating a grocery store is not intrinsic to the mission of the tax-exempt organization, it is treated as an unrelated business and the income generated by the business is treated as unrelated business income (or UBIT).

The partnerships formed by alternative investment managers can produce UBIT in two ways.

- Some partnership investments generate ordinary trade or business income. Such income is likely to be taxable to the tax exempt partner/investor.

- Many investment partnerships use debt to acquire their investments. The presence of that debt may lead to unrelated debt financed income.

To avoid the obligation to file federal tax returns, tax exempt investors (like foundations associated with private not-for-profit universities) will typically invest in investment partnerships through a "blocker corporation." When the blocker corporation is properly structured, the blocker corporation will pay the tax on UBIT. The shareholders in the blocker corporation will not need to file income tax returns or pay taxes directly on their share of the UBIT.

Historically, most state and local governmental pension plans have taken the position that, because income of their related trusts is exempt from federal income taxes under Section 115 of the Code as well as Section 501(a), their trusts are not subject to UBIT under Section 511. The Howard County Master Trust has consistently taken this position.

While there is limited guidance addressing this position, to date, the IRS has not challenged governmental plans on this point.

Tax Reform Proposal on UBIT

Section 5001 of the Tax Cuts and Jobs Act (H.R.1) would amend Code section 511 to specifically provide that an organization or trust exempt from taxation under Code section 501(a) (such as a 401(a) plan trust) will not be exempt from UBIT solely because it excludes amounts from gross income under another Code provision. Therefore, under Section 5001, state and local governmental plans would likely be subject to UBIT under Section 511 regardless of the provisions of Section 115. This provision would be effective for taxable years beginning after 2017.

The Senate Bill, as currently written, does not include a provision that would subject governmental plans to UBIT. However, (1) the Senate Bill could be amended to include such a provision or (2) Section 5001 of H.R. 1 could be in the final bill through the reconciliation process.

If Section 5001 of H.R. 1, is enacted into law as currently written, it will create an issue for the Master Trust and for any governmental plan that has private equity investments. Potentially, the Master Trust may be required to file income tax returns and to pay tax on UBIT.

For future investments, the Master Trust may elect to use a blocker corporation set up by the private equity manager to avoid having to file federal income tax returns. For current investment, the Master Trust can ask if the investment can be restructured. It is unclear whether alternative investment managers would respond favorably to a request to restructure. In addition, it is difficult to see how the Master Trust could avoid the obligation to file tax returns for 2018.

Lobbying Efforts

NCPERS, NASRA, NCTR and some large state-wide pension systems have been lobbying Congress on this issue and have developed the following talking points:

- This is a **NEW** tax on state and local government retirement systems, not a clarification of existing law, and overturns a 40-year-old position by the IRS to not apply UBIT to public pension trusts.

- It sets a dangerous precedent regarding federal taxation of state agencies, eroding the Constitutional immunity states and the federal government each enjoy from taxation by the other.

- Since the Great Recession, every state has made changes to one or more of its pension plans to strengthen their financial condition. Public pension plans have NOT sought any type of assistance from Congress, but expect Congress to avoid imposing adverse tax changes, particularly without any formal consideration of the impact on the funds and the affected investments (including economic development, real estate and infrastructure).

- If Congress wants public pension funds to exit the types of investments that would be subject to UBIT, they should, at a minimum, apply UBIT to new investments only, not ones that were entered into in good faith based on the long-standing understanding that UBIT did not expressly apply.

- Existing public plan investments will be treated far worse than private investments that use a corporate blocker, which under tax reform would give them a nearly 20 percent lower tax rate than trusts that do not have such blockers in place.

- In summary: Application of UBIT to public pension plans is a NEW tax, it sets a dangerous precedent with regard to federal taxation of state agencies, it overturns IRS' 40 year-old position to not apply UBIT to state and local government retirement systems, and existing public plan investments will be treated far worse than private plans that choose to use blockers.

We are continuing to monitor the progress of this legislation.

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