The Effects of the New Tax Law UBTI Rules on Tax-Qualified Pension Investments Are Still Unclear, Even after Additional IRS Guidance

By Meredith O’Leary, Esq.*

On December 22, 2017, the 2017 tax act was enacted.1 This law included a number of new sections to the Internal Revenue Code, including a new §512(a)(6), which, effective for years after December 31, 2017, requires tax-exempt organizations to report unrelated business tax income (UBTI) separately for each trade or business.2 This approach is a departure from the previous rule for such organizations, which permitted these entities to essentially lump all UBTI together and reduce their total UBTI by all allowable deductions (this permitted UBTI gains and losses to offset each other on an aggregate basis, with the effect of reducing such entities’ taxable UBTI).3

The implementation of §512(a)(6) appears to have arisen from concerns by the Internal Revenue Service that exempt organizations were not complying with the UBTI rules, specifically concerns that such entities were inappropriately generating large net operating losses (NOLs) to offset UBTI generated by such entities. The new law’s requirement that exempt entities silo, or track and calculate UBTI separately for each trade or business, appears to be an effort to address this concern. The new law also limits the application of carryover NOLs for tax years beginning after December 31, 2017, to UBTI related to the same trade or business that generated such UBTI, although it permits NOLs from previous years to be applied to UBTI related to any trade or business.

These changes are significant for exempt organizations, including tax-qualified pension plans, whose sole job, one could argue, is to invest the assets they hold to generate sufficient funds to pay plan benefits to participants and their beneficiaries. These entities, which manage an estimated $7 trillion in assets,4 frequently invest in alternative investments (such as private equity, hedge funds, managed futures, real estate, commodities, and derivative contracts) that can generate UBTI. Because there is no current definition of a “separate trade or business” (including under the new law), these entities are left without guidance as to how to comply with these new requirements.5 For example, take a situation where a tax-qualified pension fund invests in 20 private equity partnerships, each of which then invests in 15 private equity investments. Is investing in private equity, generally, a separate trade or business? Or is investing in each private equity partnership a separate trade or business? Or, must a plan look through each private equity partnership to each separate investment? If the latter is the case, can a plan aggregate investments across investments that involve a similar trades or businesses? How should a plan handle investments in a fund of funds, a fund that invests in other funds, each of which in turn makes their own investments?

On August 21, 2018, the IRS issued Notice 2018-67, which provided that exempt organizations can use a “reasonable, good-faith interpretation” when identify-

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1 Pub L. No. 115-97.
2 All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.
3 Reg. §1.512(a)-1(a).
4 Brian Chappatta and Edward Bolingbroke, Wall Street Warns of Seismic Pension Fund Shifts into Bonds This Month, Bloomberg (Jan. 25, 2018).
ing different trade or business pending proposed regula-
ations, provided additional guidance and requested
additional comments on how to implement §512(a).
However, further guidance is still sorely needed.

WHAT IS UBTI?

Prior to 1950, the income of exempt organizations
was completely exempt from taxation — including
UBTI. This changed in response to the perception that
exempt organizations were being given an unfair
competitive advantage, most notably characterized
by C.F. Mueller Co. v. Commissioner. In that case,
an exempt organization purchased the C.F. Mueller
pasta company (using a loan), with the tax-free in-
come associated with the investment paid to New
York University Law School. The IRS challenged the
tax-exempt status of the organization, but the U.S.
Court of Appeals for the Third Circuit (on appeal) re-
jected the challenge. As a result, the predecessor to
current §511 was passed, providing for the application
of UBTI to exempt organizations, commencing with
tax years after December 31, 1950. In 1969, UBTI
was expanded to apply to private tax-qualified pen-
sion plans as well.

Definition of UBTI

UBTI is defined as the gross income derived by an
exempt organization from any unrelated trade or busi-
ness that is regularly carried on by the organization,
less expenses and certain adjustments. A “trade or
business” is broadly construed as any activity carried
on for the production of income that otherwise pos-
sess the characteristics required to constitute a trade
or business within the meaning of §162. Whether a
trade or business is unrelated is generally strictly con-
strued. In the case of a tax-qualified retirement plan,
the Code provides that any trade or business is con-
sidered “unrelated.”

Debt-Financed Investments

Generally, proceeds from investments such as
stocks, bonds, and real estate do not constitute UBTI.
This can include interest income, dividends, annuities,
mutable fund distributions, rents from real property,
royalties, and investment gains. Most investments in
a tax-qualified pension plan, absent unusual structures
or investment choices, will qualify as investment in-
come. However, consistent with the C.F. Mueller case
and notwithstanding this general rule, proceeds from
investments financed with debt are subject to UBTI.

Debt-financed property is any property held to pro-
duce income that has “acquisition indebtedness.” “Ac-
quisition indebtedness” is debt incurred (or re-
lated to) acquiring or improving the debt financed
property.

What Is the Result of Generating
UBTI?

The result of generating taxable income in the form
of UBTI in excess of a de minimis amount is, unsur-
prisingly, the taxation of these amounts in the form
of Unrelated Business Income Tax (UBIT). In calcu-
lating the amount of UBIT owed, an exempt organi-
zation can take a deduction against UBTI for ex-
penses, depreciation, charitable contributions, and ex-
penses directly connected to the unrelated trade or
business. Historically, the final amount of income was
taxable to the exempt organization at individual tax
rates and reported in the aggregate to the IRS annu-
ally on Form 990-T. Taxes were required to be paid
quarterly, with the Form 990-T due within three and a
half months following the end of the tax year.

Exempt organizations were also potentially subject
to state filings and taxes. Effective in 2015, tax-
qualified retirement plans also had to report these
amounts on Form 5500-SUP, effectively giving the
IRS notice to look for a corresponding Form 990-T
(as well as the payment of taxes for reported
amounts).

How Does UBTI Come Into Play With
Tax-Qualified Pension Plans?

Generally, tax-qualified retirement plans are exempt
from federal and state income taxes under §401(a).
The trusts holding their assets are similarly exempt

6 “The primary objective of adoption of the unrelated business
income tax was to eliminate a source of unfair competition by
placing the unrelated business activities of certain exempt organi-
izations upon the same tax basis as the nonexempt business en-
deavors with which they compete.” Reg. §1.513-1(b).
7 190 F.2d 120 (3d Cir. 1951).
8 §512(a)(1).
9 §513; Reg §1.513-1(b).
10 §513(b).
11 §512(b), under the theory that such investments “are not
likely to result in serious competition for taxable businesses hav-
ing similar businesses” (S. Rep. No. 81-2375, at 30-31 (1950));
and “investment-producing incomes of these types have long
been recognized as a proper source of revenue for [exempt] orga-
nizations and trusts.” Id.
12 §514.
13 There is a narrow exception to debt-financed property for ac-
cquisition indebtedness incurred by a plan in acquiring or impro-
ving any real estate. See §514(c)(9).
14 Currently, $1,000.
15 Up to 37%, starting in 2018.
Dealing With and Avoiding UBTI

Some tax-qualified pension plans have the internal or external tax resources to simply calculate, report, and pay UBIT. Others do not. One method to “cleanse” UBTI for a tax-qualified pension plan is to make an otherwise UBTI-generating investment through a taxable corporation (a blocker), so that the corporation pays tax on the UBTI generating investment, but the amounts that are paid up to the exempt organization constitute investment income that would not constitute UBTI. This method essentially moves the taxable event from the exempt entity to the taxable corporation.

GUIDANCE UNDER NOTICE 2018-67

As described above, prior to the new tax law, exempt organizations, including tax-qualified pension plans, generally aggregated any and all UBTI, netted out all related deductible amounts, and reported and paid UBIT on such amounts. The new tax law changed this approach by requiring exempt organizations to “silo” UBTI (and related deductible amounts) separately for each trade or business, a significant change to how such entities have previously accounted for and reported such amounts.

Separate Trade or Business

Notice 2018-67 recognizes that there is no statutory or regulatory definition for what constitutes a separate trade or business. Notice 2018-67 provides that an exempt organization may rely on a reasonable, good-faith interpretation considering all of the facts and circumstances when identifying separate trades or businesses and points to both the North American Industry Classification System and §513(c) as guides, while also requesting comments as to how to identify separate trades or business.

Specifically, Notice 2018-67 notes that under §513(c), “an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, nor may not, be related to the exempt purposes of an organization.” Further, Notice 2018-67 seems to suggest a look through approach to partnership activities by stating that one “one interpretation of Code Section 512(a)(6) might require an exempt organization to calculate UBTI separately with respect to each unrelated trade or business regularly carried on by the partnership in which the exempt organization is a direct or indirect partner,” providing that if a partner holds multiple partnerships, “the exempt organization may be engaged in multiple separate unrelated trades or businesses through its interest in the partnership.” In taking this approach, the IRS does note the administrative burden in obtaining sufficient information from multi-tiered partnerships and Notice 2018-67 notes that the IRS intends to propose further regulations on investment activities with respect to the new provision.

Transition Rules

Given the lack of clarity as to how exempt organizations should comply §512(a)(6), Notice 2018-67 provides exempt organizations with transition guidance pending publication of proposed regulations. Specifically:

- **De minimis test.** An exempt organization may aggregate its UBTI from a single partnership (including those with multiple trades or businesses) so long as the organization holds no more than 2% of the profits interest or 2% of the capital interest in such partnership.

- **Control test.** An exempt organization may aggregate its UBTI from a single partnership (including those with multiple trades or businesses) so long as the organization holds no more than 20% of the capital interest and does not have control or influence over the partnership. An organization will be deemed to have “control or influence” over the partnership if it may require the partnership to perform any acts or prevent the partnership from performing any act that significantly affects the operations of the partnership or if it has the right to participate in the management of the partnership or conduct the partnership’s business at any time, including to remove any of the partnerships officers, directors, trustees or employees. Plans that have advisory or other board rights with respect to a partnership investment may trigger this test and should look closely at their ownership holdings with respect to such investments.

- **Transition rule.** Notwithstanding the de minimis test and the control test, under a final transition rule, investments acquired prior to August 21, 2018, may treat each partnership interest as compromising a single trade or business.
An exempt organization may rely on the Schedule K-1 received from a partnership in determining its ownership for purposes of the de minimis and control tests.

CONCLUSIONS

As described above, private and public tax-qualified pension plans hold a huge amount of assets, the majority of which is exempt from taxation. The IRS has long been concerned about exempt organizations (including tax-qualified pension plans) complying with the UBTI rules and properly reporting and paying UBIT on these amounts. Therefore, while some have said that increased compliance efforts on existing UBTI and UBIT rules would have been a more appropriate next step, it is not a surprise that the new tax law would focus on these amounts, especially as a potential revenue-generating item.

However, the obvious result of the tax law as currently structured (and guidance issued to date) is that the legal uncertainties and administrative burden in attempting to comply with these new rules may very well outweigh the potential benefits in pursuing investments that generate UBTI, and therefore, require the accounting for and paying of UBIT. If exempt organizations generally, and tax-qualified pension plans specifically, avoid these types of investments going forward, not only will there be less taxable revenue generated by them, but there is a risk that the potentially significant returns associated with such investments may not be attractive to such funds, which could result in less assets available to plan participants and their beneficiaries. This result, one has to assume, was the opposite of what Congress intended when enacting the new tax law.