STROOCK
SPECIAL BULLETIN

"Mind Your Own (Unrelated) Business!!"

What Public Pension Plans (and Those That Transact with Them) May Say About UBTI Related Provisions of the House Majority Tax Bill

November 7, 2017

I. Introduction

On November 6, 2017, House Ways and Means Committee Chairman Kevin Brady (R-TX) introduced the Tax Cuts and Jobs Act, the long-awaited Republican-sponsored tax bill (the "House Bill"). The House Bill proposes a significant overhaul to the Internal Revenue Code of 1986, as amended (the "Code").

This *Stroock Special Bulletin* calls attention to a provision in the House Bill that may dramatically alter the investment calculus of state and municipal government public sector retirement plans. Consequently, many financial service providers – including investment managers, investment banks, and derivatives counterparties – should carefully monitor developments with respect to the proposed House Bill.

II. Background

Employee benefit plans subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") are generally exempt from U.S. Federal income tax on investment income under Section 501(a) of the Code. However, such plans ("Plans") are subject to taxation under Sections 511-514 under the Code for so-called unrelated business taxable income ("UBTI"). UBTI generally comes in two varieties: income from a trade or business that is regularly carried on by a Plan, and income derived by the Plan from investments acquired or maintained with the use of acquisition indebtedness.

UBTI is designed to impose a "toll" on a tax-exempt entity that engages in a trade or business that is unrelated to its tax-exempt purpose. The policy behind UBTI is to promote competitive fairness. Were it not for UBTI, certain non tax-exempt (*i.e.*, for profit) investors might be placed at an unfair competitive disadvantage with respect to investing in a particular trade or business, because tax-exempts might be willing to pay higher prices for such investments because they would not have the burden of paying income tax associated with gains on the investments.

Where the tax-exempt entity uses debt to finance its acquisition, it can leverage an equity base that is comparatively larger than that of a non tax-exempt. Without debt financed UBTI, the tax-exempt might be able to secure greater amounts to acquire the asset, compared to the amounts a taxable entity would be able to secure. These potential pricing distortions are the basis for the debt financed UBTI regime.

Notwithstanding the broad policy considerations in favor of UBTI for tax-exempt entities, certain

governmental pension funds (not subject to ERISA) often argue that they are exempt from UBTI under Section 115 of the Code. That provision permits entities to escape taxation if they are providing an "essential governmental function."

However, this argument has been open to interpretation as applied to governmental plans, and there are a number of different possible views. The Ways and Committee Report to the House Bill notes, in fact, that

> It is unclear, however, whether certain State and local entities (such as public pension plans) that are exempt under Code section 115(l) as government-sponsored entities as well as section 501(a) are subject to the UBTI rules.

Some governmental plans have insisted that their investments be structured "as if" they were subject to UBTI, without necessarily conceding that they in fact are. Some others may do so in more limited or targeted circumstances. Obviously, any given governmental plan's position may differ dramatically from any other's.

III. House Bill

The House Bill includes a proposal that would clarify the treatment of governmental retirement plans for purposes of Section 115 of the Code. Specifically, the House Bill would deny the ability of such governmental plans to claim an exemption from UBTI under that provision, meaning that UBTI-sensitive structures could generate previously unplanned for tax.

Obviously, the House Bill is only the first salvo in the current cycle of tax reform, and there is no telling at this point whether such a provision will find its way into any finally-enacted tax reform, and if it does, what form it will take. Indeed, it is uncertain at this time whether any tax reform will be enacted in 2017.

Nevertheless, given the potential dramatic impact for governmental plans, and for those financial market participants that provide investment related services to such plans, we would recommend that clients and friends pay careful attention to the evolution of this provision in the coming days and weeks. For example, investment managers, private equity and real estate fund managers, financial intermediaries such as broker-dealers, swap counterparties, securities lending agents, and banks, along with governmental pension plans themselves, could be affected by this provision. We continue to stand ready to answer questions regarding the potential implications of this provision, and the proposed tax reform generally, as the situation moves forward.

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