# I'll Take the Macaroni, But Hold the UBIT, Please

*By: Tony Roda*

## Historical Background

By now most of the NAPPA community has heard the story of New York University's (NYU) famous feeder corporation (no pun intended) in the 1940s called C.F. Mueller Co., which was then the largest producer of macaroni in the nation. The NYU-Mueller relationship has been credited by many, including the tax staff of the U.S. House of Representatives' Committee on Ways and Means, to be the impetus behind enactment of the unrelated business income tax (UBIT) in the Revenue Act of 1950.

Mueller was not NYU's only commercial venture and NYU was not alone among educational institutions or other tax-exempt organizations in running what were essentially private businesses, including some major real estate ventures, with all profits from those businesses being sent to the charitable institution to further its exempt purpose. All of this commercial activity by tax-exempt organizations and the charges by their for-profit competitors of unfair competition caught the eye of news outlets, including the New York Times, the Internal Revenue Service, which failed in the courts in its attempts to tax the monies from these commercial ventures,[1] and the U.S. Congress.[2]


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With an eye toward leveling what they believed had become an un-level playing field, Congress and President Harry Truman enacted the UBIT provision. The rationale for UBIT was that absent such a provision charitable organizations, when they entered into commercial activities, would enjoy a tax-fueled advantage over their taxable competitors. Current Treasury regulations are consistent on this rationale: "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 organizations upon the same tax basis as the nonexempt business endeavors with which they compete."[3] It is also argued that UBIT is necessary to guard against the erosion of the federal tax base.

After further amendments to the UBIT statute, including the addition of specific statutory language to cover state colleges and universities,[4] the design of the law was settled and most practitioners were confident and remain so that state and local governmental pension plans are not subject to UBIT. They use a combination of arguments to explain their rationale.

First, state and local governmental plans are not subject to UBIT because of the legal doctrine of intergovernmental tax immunity, which is also embodied in statute in the federal tax code.[5] The specific statutory language states that, "Gross income does not include – (1) Income derived from…the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) Income accruing to the government of any possession of the United States, or any political subdivision thereof."

The second argument is based on an IRS News Release (IR-1869), which was posted on August 10, 1977. The question posed to the IRS was whether trusts related to governmental plans are subject to income tax. The answer provided by the IRS was that, "Under consideration is whether the trust relating to such 401(a) plans are subject to tax on their income. Pending completion of the review, the IRS will resolve these issues in favor of the taxpayer or governmental unit." Then again in 1997 the IRS stated in a letter to the Florida Retirement System that, "the taxpayer or governmental unit may continue to rely on IR-1869 with respect to unrelated business income tax related to a governmental plan."

## Recent Congressional Interest

A proposal to apply UBIT to certain investment income of state and local governmental pension plans was included in H.R. 1, tax reform legislation introduced in 2014 by then-Ways and Means Committee Chairman Dave Camp (R-MI).[6] The provision was described as a "clarification" of current statutory tax law. This assertion was maintained in the description of the 2017 version of the UBIT proposal.

The clarification argument is based on the interpretation that tax code section 511(a)(2)(A) states that organizations described in section 401(a) are subject to the UBIT tax and should be covered today but for the inappropriate imposition of section 115 (essential governmental function) as a shield to taxation. The language of the House-Senate conference committee on H.R. 1 (115th Congress)[7] in 2017 described the House provision as follows:

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> The provision clarifies that an organization does not fail to be subject to tax on its unrelated business income as an organization exempt from tax under section 501(a) solely because the organization also is exempt, or excludes amounts from gross income, by reason of another provision of the Code. For example, if an organization is described in section 401(a) (and thus is exempt from tax under section 501(a)) and its income also is described in section 115 (relating to the exclusion from gross income of certain income derived from the exercise of an essential governmental function), its status under section 115 does not cause it to be exempt from tax on its unrelated business income.

The clarification language was a dagger through the heart of the statutory-based, intergovernmental tax immunity argument. If enacted, it also would have undercut the second argument, which is based on the IRS's on-going review of current statutory law. Of course, in speaking to some litigators in our community, the enactment of the UBIT provision would have almost certainly led to a test case in the courts based on the ability under the U.S. Constitution for one sovereign to tax another sovereign on its essential governmental functions. For the moment that judicial contest has been put aside.


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### Revenue Analysis

One major difference between 2014 and 2017 was the revenue analysis prepared by Congress's Joint Committee on Taxation (JCT), which is the official arbiter of the revenue impact of statutory changes to the tax code. In 2014, JCT estimated that the UBIT provision would raise $100 million in new revenue over 10 years. In contrast, the 2017 JCT score estimated that the identical UBIT provision would raise $1.1 billion over 10 years. This immediately made it a much more attractive provision for House tax writers, who were trying to live within an aggregate revenue loss of $1.5 trillion over 10 years. One billion in the positive column was, if not too significant, at least something.

There have been no meetings to my knowledge between our community and the JCT to discuss the methodology underlying the revenue analysis and what new data or assumptions led to the over 100 percent increase from 2014 to 2017. This question is something of a dual-edged sword. For instance, if public plans dig deeply into their portfolios and determine with some precision the annual amount of investment income that would be subject to UBIT, those amounts on a national basis could show even the most recent $1.1 billion score to be low. The answer to the question right now is that we just don't know how much investment income would be subject to UBIT on a plan-by-plan basis and that it would take a considerable amount of administrative cost to make such a determination.

### UBIT's Reach

While section 512(a)(3) of the tax code might otherwise appear to subject all gross income of an exempt organization to UBIT, section 512(b) provides specific exclusions for most types of passive investment income, unless the income is debt-financed. Dividends, interest, royalties, capital gains, and most rents from real property are excluded.

For pass-through entities—partnerships and LLCs—the characterization of income is made at the entity level and passes through to the investor (e.g., the limited partner) on its allocable share of the income. The investments most typical of a public pension fund that would generate UBIT-covered income are hedge funds, private equity, limited partnerships and certain other flow-through entities (partnerships/LLCs) that hold operating assets or have incurred debt-financing. Debt-financing engaged in by a fund to acquire investment assets is a key factor because income-producing assets that would generally not produce UBIT-covered income (e.g., a stock portfolio) will generally be covered by UBIT to the extent the property's acquisition was financed by borrowing. Thus, limited partnerships that own debt-financed property, which is commonly referred to as acquisition indebtedness, or situations where the limited partner borrows to fund its investment, will generally be covered, although there is an exception in section 514(c)(9) for most debt-financed real property investments.[8]

### The Effort to Stop the UBIT Tax

Inclusion of the UBIT provision in the 2017 version of H.R. 1 kicked off a frenzied six-week period in which state and local governmental pension plans from around the country emailed, telephoned and met directly with key staff and members of the House Ways and Means Committee, Senate Finance Committee

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and House and Senate Leadership. The three national groups—National Conference on Public Employee Retirement Systems, National Association of State Retirement Administrators and National Council on Teacher Retirement—coordinated strategies and tactics through emails and phone calls every day.

The House moved with such speed that it was not possible to modify or remove the UBIT provision. The legislation was introduced on November 2 and approved by the Ways and Means Committee just 11 days later; the full House approved the Committee-reported bill without a single amendment only three days after that. Moreover, we were fighting a steep uphill battle because the Ways and Means Committee's tax staff firmly believes that the provision is a simple clarification of existing law and that UBIT should be applied to state and local pension plans.


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In the Senate the focus shifted to keeping the provision out of its version of the bill. This effort proved successful. That set up a House-Senate conference committee. The UBIT provision could have emerged from the conference in one of three ways: (1) the original House provision; (2) the House provision modified to provide a so-called soft landing (e.g., grandfathering existing investments, delaying the effective date and/or applying UBIT to only a very narrow set of investments); or (3) no provision.

In the final days the national groups and individual pension funds again contacted all of the key Congressional offices. The message was consistent. Our position was option three. Keep the UBIT provision entirely out of the final bill. On Friday, December 15, the conference report was released and the public pension community was relieved to see that the UBIT provision was not included in the final tax reform legislation, which is now Public Law 115-97.

This remarkable victory was made possible only because of the coordination of the national groups and the timely contacts made by representatives of state and local plans to key members of Congress. Geography played an important role and some key Congressional offices, including Speaker Paul Ryan (R-WI), House Ways and Means Committee Chairman Kevin Brady (R-TX) and Senate Finance Committee Chairman Orrin Hatch (R-UT), were visited in person by their public pension plans. It was a real team effort and one from which we should learn lessons and replicate when serious challenges to public plans present themselves at the federal level.

Given the view held by the tax staff of the Ways and Means Committee, UBIT could reappear during debate on future tax legislation. This year Congress may take action on Senator Hatch's Retirement Enhancement and Savings Act. This bill is aimed at private sector, defined contribution plans, but could carry with it other pension-related legislation. In addition, Congress recently established a Joint Select Committee on Multi-employer Pension Plans. The Joint Committee is required to report its recommendations to the House and Senate by November 30, 2018. Again, while not aimed at public pension plans, the legislation that ultimately emerges from this Committee could include other pension-related items. In fact, I was warned recently by one House tax staffer to pay attention to the multi-employer committee.

The NAPPA list serve was a great tool in my efforts to alert state and local governmental pension plans to the seriousness of the UBIT provision. Please be assured that as future events warrant I will continue to keep our community apprised of these types of issues, whether positive or negative.

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### ENDNOTES:

[1] *See* Trinidad v. Sagrada Orden, 263 U.S. 578 (1924), Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2nd Cir. 1938) and C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951).
[2] A *tour de force* on the historical backdrop is found at Michael S. Knoll, The UBIT: Leveling an Uneven Playing Field or Tilting a Level One, 76 Fordham Law Review, 857, 860-864 (2007).
[3] Treas. Reg. § 1.513-1(b) (2017).
[4] Internal Revenue Code §511(a)(2)(B).
[5] Internal Revenue Code §115.
[6] H.R. 1, §5001, 113th Congress.
[7] How did tax reform legislation both in 2014 and 2017 receive the designation H.R. 1? Coincidence? No, at the beginning of each Congress the leadership of the majority party reserves certain bill numbers, usually H.R. 1 through H.R. 10 and S. 1 through S. 10 in the Senate, for their future legislative priorities.
[8] Fellow NAPPA member Luke Bailey (Strasburger) provided technical assistance with this section.