

Publications

Recent UBIT Change May Impact Benefit Plan Investors

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A pension or welfare benefit plan's investment in a private equity or real estate partnership may give rise to "unrelated business income tax" ("UBIT"). In recent years, this issue has arisen frequently as more plans invest in such vehicles. The new tax cut legislation makes an important change in this area, summarized below.

Background – Under the UBIT rules, a tax-qualified retirement plan (including an IRA) or welfare benefit plan trust (such as a voluntary employees' beneficiary association), may have UBIT merely by investing in a limited partnership that borrows to make one or more investments. Under Code section 514, such "debt-financed income" generally requires that a proportionate share of the income from that investment be subject to UBIT. A longstanding (though complex) provision exempts most debt-financed real estate investments from UBIT for pension plans (though not for welfare benefit plans). IRC § 514(c)(9). Plans have often used foreign "blocker" corporations to shelter other income from UBIT, although the costs and benefits of that approach need to be examined on a case-by-case basis. And even if no debt is used, if a limited partnership invests in an active trade or business (e.g., directly operates a hotel or participates in an operating company), the investor's income will be UBIT. IRC § 512(c).

The calculation of UBIT allows an investor to claim its share of associated expenses against the income, just like any taxpayer. IRC § 512(a)(1). In the case of a trust, the net income is subject to the individual tax rates – 37% starting in 2018 – and reported on IRS Form 990-T. IRC § 511(b). State taxes and filings also may apply.

What Changed? – Effective for tax years beginning after December 31, 2017, benefit plans with two or more unrelated trade or businesses will no longer be able to "net" the income and losses of the businesses when determining the UBIT. Instead, the UBIT for the year is the sum of the UBIT (but not less than \$0) for each trade or business. New IRC § 512(a)(6). The new law also limits the application of the carryover of net operating losses for tax years beginning after December 31, 2017 to the UBIT of the same trade or business in future years. Net operating losses from tax years beginning prior to 2018 can be applied to any trade or business to reduce UBIT.

Where plans have multiple investments that generate UBIT, they commonly net the gains and losses of these investments when determining UBIT. Many investment

funds generate tax losses in early years, and with regular turnover of investments, UBIT can often be deferred for many years. Thus, the potential impact of the law could be significant.

A key area of uncertainty in this area is whether each investment held by the plan would be viewed as a separate “trade or business,” or alternatively, whether the plan can consider all investments of the same “type” (e.g., all private equity funds) as a single trade or business. (In the context of multiemployer plan withdrawal liability, a federal court has ruled that a plan’s investment in a private equity fund is a trade or business. *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 172 F.Supp.3d 447 (D. Mass. 2016); 724 F.3d 129 (1st Cir. 2013), *cert denied*, 134 S. Ct. 1492 (2014).) If each plan investment is viewed as a separate trade or business, the plan would likely have greater UBIT, and possible tax liability. Among still other questions, it is unclear whether this change would apply to a “fund of funds” investment program.

What Should Plan Investors Do Now? – On February 7, the IRS noted this area as one in which it intends to issue guidance in its 2017-2018 priority guidance plan, but the ultimate timing of any guidance is uncertain. Pending IRS guidance, benefit plan investors should evaluate their potential tax exposure, and possible UBIT reduction strategies, including:

- identifying investments that generate UBIT,
- evaluating the structure of those investments that generate UBIT and considering (or re-considering) alternatives, such as use of a “blocker” corporation to avoid UBIT or liquidating the investment, and
- identifying net operating losses before 2018 that can be used to offset UBIT in 2018 and later years. Using such amounts in 2018 can provide additional time for plans to consider their options.