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Unrelated Taxable Income and Pensions

'Tax Cuts' act raises the tax on funds generating UBTI.

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Plan fiduciaries, plan advisers and investment fund managers may not be aware that the Tax Cuts and Jobs Act of 2017, enacted a year ago December, made major changes to the Internal Revenue Code (IRC) provisions affecting unrelated business taxable income (UBTI). The IRS issued IRS Notice 2018-67 this past August 20, to provide some guidance on how to interpret these changes to the IRC and how to apply them until the Treasury Department issues proposed regulations. Those regulations could have a substantial impact on how tax-qualified retirement plan trusts and voluntary employee benefit associations (VEBAs) invest in funds that generate UBTI and how such funds are structured and managed.

Plan trusts and VEBAs invest in funds—typically organized as partnerships or limited liability companies (LLCs)—that generate UBTI. The trusts and VEBAs are tax-exempt entities under Sections 501(a) and 501(c)(9) of the IRC, and, thus, the federal government generally does not tax them on income unless they generate UBTI. A fund manager generates UBTI if: the manager, on behalf of the fund, purchases or invests in debt-financed property; the fund is actively engaged in a business, such as the management of real estate; or the fund invests in a limited partnership that conducts these activities.

The Employee Retirement Income Security Act (ERISA) does not prohibit investments that generate UBTI. However, ERISA fiduciaries should consider the impact of such income on the plan trust's or VEBA's rate of investment return in light of the fact that plan trusts and VEBAs are otherwise tax-exempt organizations.

Prior to the Tax Cuts and Jobs Act, even if a fund generated UBTI, a plan fiduciary or an adviser could often manage the impact of that income. In accordance with the IRC, the plan or VEBA could net gains or losses generated by one investment fund against the gains or losses generated by another. Additionally, to the extent a fund generated net operating losses (NOLs), the plan or VEBA could carry over those losses to future tax years to deduct against UBTI generated in a subsequent tax year by the same fund or a different fund. As a result, many plan trusts and VEBAs could manage investments in a way that would reduce the impact of UBTI. For example, the trust or VEBA could balance its investments between newly formed funds, which are more likely to generate losses, and mature funds, which are more likely to generate income.

The act amended IRC Section 512(a)(6) in a manner that would substantially change a fiduciary's or adviser's ability to manage UBTI, as described. The tax code now requires that the trust or VEBA calculate gains and losses of each "trade or business." In the absence of regulations or additional guidance from the Treasury Department or the IRS providing otherwise, the IRC now appears to require that a trust or VEBA treat each investment fund as a separate trade or business. Therefore, the ability to calculate gains and losses on a net basis is lost. Further, the trust or VEBA may not use future NOLs generated by one fund to offset gains generated by another fund.

As a plan fiduciary, an adviser to a plan, or a fund manager, you should not underestimate the impact of this development on how you manage plan trusts, VEBAs and investments funds. As noted above, while ERISA certainly does not prohibit a plan trust or VEBA to invest in funds that generate UBTI, plan fiduciaries must consider the impact of that income on investment performance. The inability to aggregate and use NOLs, as described, could result in a substantially higher tax burden and thus may require reconsideration regarding whether certain UBTI-generating investments are appropriate. Alternatively, plan fiduciaries and their advisers may ask managers to structure their funds, or investments in their funds by a trust or VEBA, by, for instance, using "blocker" entities so that any UBTI is not passed through to the trust or VEBA.

The previously mentioned IRS Notice 2018-67 explains how a trust or VEBA may define a trade or business, as well as gives some other helpful guidance. For example, the notice provides that, pending further guidance, the plan trust or VEBA should apply a "reasonable, good faith interpretation" of the term "trade or business." In this regard, the notice provides for a safe harbor if the trust or VEBA uses the six-digit code listed in Section 3.03 of the Northern American Industry Classification System (NAICS).

In summary, the changes to the UBTI provisions of the tax code will have a substantial impact on plan trusts and VEBAs. The IRC and Notice 2018-67 are the only authorities currently available. Fiduciaries, advisers and fund managers should not expect additional guidance prior to the date federal income tax returns are due for tax years beginning in 2018.

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