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In this article, Dougherty and Laurila argue that Congress should enact a provision that would allow private pension funds to avoid incurring unrelated business income tax on investments in hedge funds that use leverage.

Introduction

State and local government pension plans continue to experience a dramatic funding gap. At the end of 2013, the gap between assets and liabilities was more than $1 trillion.[1] Private pension plans face a similar situation, with the funding gap of pension plans sponsored by S&P 1500 companies at $379 million as of July 2015.[2] As they look to boost investment returns to increase plan assets, various pension plan administrators see hedge funds as a critical part of a pension plan's diversified portfolio. However, pension plans investing in funds may be subject to the unrelated business income tax when there is debt-financing in the investment structure. When the UBIT applies, there will be a drag on investment returns unless the investment is properly structured from a tax perspective.

Figure 1 depicts the public pension shortfall over a 17-year period from 1997 to 2013 expressed in trillions of dollars.[3]

Figure 2 depicts the private pension shortfall, with the deficit in dollar terms on the left Y axis and the liability-funded status on the right Y axis expressed in percentages.[4]

The UBIT can apply to investments in hedge funds under section 512(b)(4), which subjects tax-exempt organizations, like pension plans, to federal income tax on income from debt-financed property. This rule extends to the tax-exempt organization's share of income from a partnership that has debt-financed property. Hedge funds regularly use leverage to help increase investment returns, but the UBIT reduces those returns for pension plans and other tax-exempt organizations. Pension plan administrators can strive to avoid UBIT by using offshore corporations in low-tax jurisdictions or specific derivative investments treated as equity and not debt for U.S. federal income tax purposes, but that type of complex tax planning is expensive and available only to wealthy funds and plans.

Moreover, pension plans using those techniques incur tax compliance costs in addition to the expense of tax and legal planning advice. For example, offshore corporations are subject to a dividend withholding tax on U.S.-source dividends, typically 30 percent of the dividend. This rule resulted in about $5.9 billion of withholding tax paid by offshore corporations in 2011 (the latest year for which figures are available).[5] Note that investors in offshore funds typically include both U.S. tax-exempt investors and non-U.S. investors. Industry estimates suggest that about a third of the money invested in offshore funds is attributable to U.S. tax-exempt investors,[6] so it may be reasonable to conclude that those investors lose approximately $2 billion to U.S. withholding taxes annually. Pension plans investing in offshore funds that use specific U.S. equity derivative contracts are subject to a similar withholding tax with the enactment of section 871(m) in 2010 and recently issued Treasury regulations that will broadly expand the scope of

[1] The Pew Charitable Trusts, "The State Pensions Funding Gap: Challenges Persist" (July 2015).

[2] Mercer Investment Consulting Inc., "S&P 1500 Pension Funded Status Drops 1% in July" (Aug. 2015).

[3] The Pew Charitable Trusts, *supra* note 1.

[4] Mercer Investment Consulting, *supra* note 2.

[5] Scott Luttrell, "Foreign Recipients of U.S. Income, 2011," *IRS Statistics of Income Bull.* (Winter 2015).

[6] IBISWorld, "Private Equity, Hedge Funds and Investment Vehicles in the U.S.," industry report 52599 (Nov. 2015).

Figure 1

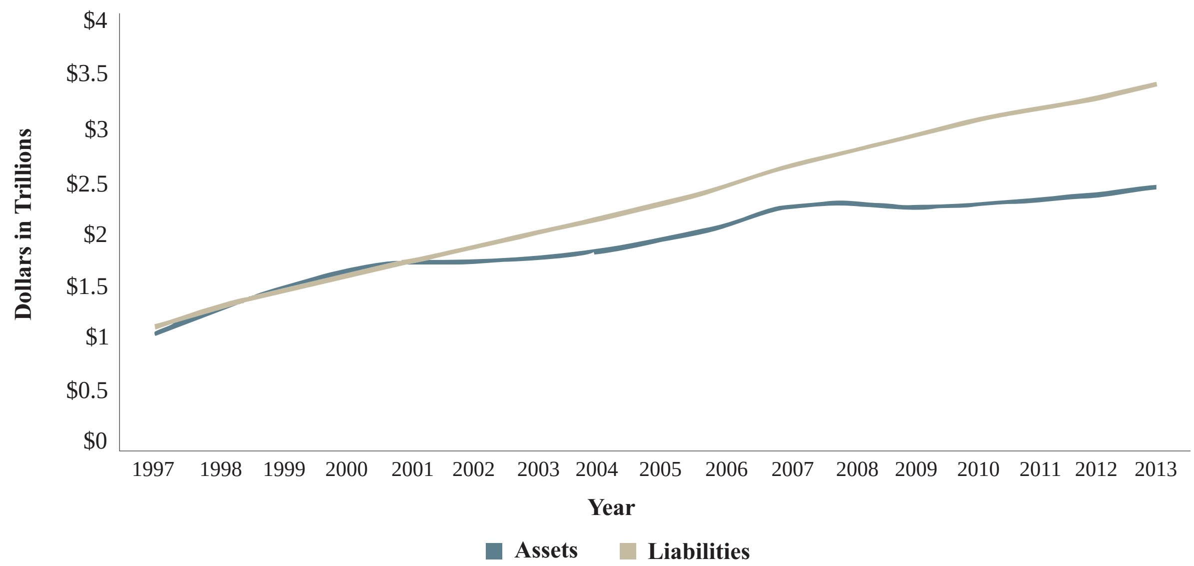
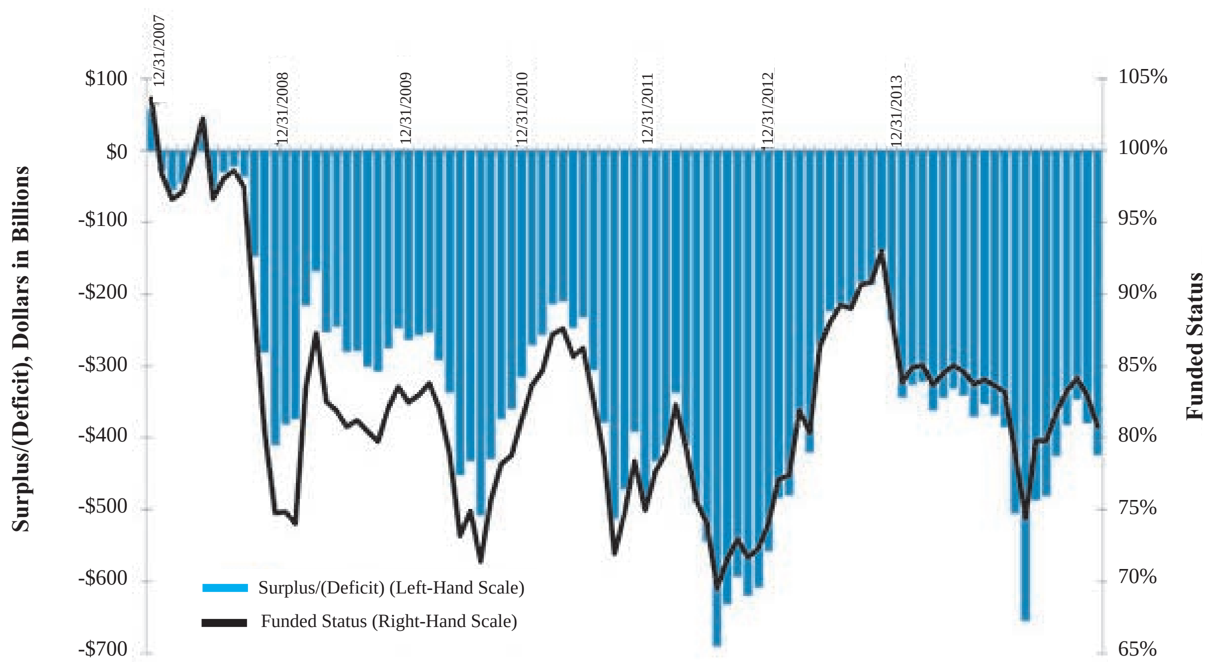


Figure 2



that provision.[7] As a result, the withholding tax cost to U.S. pension plans will likely increase.[8]

There have been several proposals over the years to provide exceptions to the UBIT rule for pension plans. One such proposal, which was passed by

[7]T.D. 9734.

[8]Although beyond the scope of this article, it could be argued that the UBIT rules themselves caused offshore funds to engage in derivative transactions to avoid U.S. withholding taxes, and

(Footnote continued in next column.)

section 871(m) was enacted to shut down those transactions. In other words, if not for the UBIT rule on debt financing, section 871(m) would have been unnecessary.

Congress in 1980, provides an exception for debt-financed real property for some qualified organizations, including pension plans. Other proposals to reduce the UBIT burden on pension plans have not been successful. An exception similar to the real property exception, extended to pension plans, may be warranted to increase a plan's investment options and reduce the tax drag — ultimately helping to close the plans' funding gaps.

History of the UBIT Rules

Section 512 generally subjects a tax-exempt organization to federal income tax on the organization's unrelated business taxable income. Section 512(b)(4) includes gross income from debt-financed property in that definition. Debt-financed property, defined in section 514, includes any property held to produce income and to which there is acquisition indebtedness (indebtedness incurred in acquiring or improving property). That definition includes leverage regularly used by hedge funds.

Section 514, as expanded by Congress in 1969, was a response to tax-exempt organizations participating in particular abusive sale-leaseback transactions with taxable parties to acquire properties and generate tax benefits for those parties. The language of the statute, however, reaches far beyond the specific types of sale-leaseback transactions that the law was originally intended to address. Since 1969, Congress has indicated an interest in reconsidering parts of this rule. Most notably, in 1980 Congress enacted section 514(c)(9), which provides an exception to acquisition indebtedness incurred by a qualified organization, including pension plans, in acquiring or improving real property. Through this exception, pension plans are allowed to receive debt-financed income for a specific type of investment (real property) but are still not permitted to receive debt-financed income from most other types of investments.

More recently, congressional proposals have introduced potential changes to section 514. A 2007 House bill would have modified the UBIT rules to allow tax-exempt entities to directly invest in hedge funds, and in other investment funds that use leverage, without incurring UBIT.[9] Income from debt-financed property would not have been subjected to UBIT when the tax-exempt organization had limited liability in a partnership and the partnership incurred or continued debt in purchasing or continuing a qualified security or commodity. A 2009 House bill contained similar language.[10] Neither bill was enacted.

The proposals have not always been favorable for pension plans. A proposal published in 2014 by then-House Ways and Means Committee Chair Dave Camp would have extended the scope of the UBIT rules to address some state and local pension plans that rely on an exception to the definition of gross income provided in section 115 for income derived from performing an essential government function. Those pension plans may not be paying UBIT on debt-financed property in the same way as private pension plans. The Camp proposal would have subjected the governmental pension plans to UBIT by providing that the UBIT rules apply to a tax-exempt organization even though the organization has an exemption from gross income in section 115. That proposal was also not enacted.

Avoiding UBIT

Pension plans have some potential options to avoid paying tax on debt-financed UBTI, although they might not be easily applied or the plans might be unable to fully avoid paying UBIT.

Pensions can rely on various exceptions already included in section 514. To apply the real property exception discussed above, pensions may have to address limitations like the fractions rule in section 514(c)(9)(E), which applies when a tax-exempt organization is a partner in a partnership with a taxable organization. There are also other limited exceptions for obligations to pay an annuity and for payments on specific loans. However, no broad exception exists.

One way that pension plans commonly avoid UBIT is by investing in hedge funds through a non-U.S. corporation, referred to as a foreign blocker. While a domestic corporation would pay tax on all income at the corporate tax rate, a foreign blocker is taxable only on income effectively connected with the conduct of a trade or business in the United States. A broad exception to the term "trade or business in the United States" is found in the section 864(b)(2) safe harbor, which provides that trading in securities or commodities for a taxpayer's own account is not included in that definition. The IRS has privately ruled that this exception extends to a tax-exempt organization that holds all the stock in a foreign corporation when the foreign corporation is invested in a leveraged U.S. partnership.[11] Although private letter rulings cannot be used by taxpayers as precedent, the safe harbor is widely applied in a manner consistent with the letter ruling, allowing foreign blockers to invest in hedge

[9] H.R. 3996, 110th Cong., 1st Session (2007).
[10] H.R. 3497, 111th Cong., 1st Session (2009).

[11] LTR 199952086.

funds that use leverage without incurring federal income tax on the income generated from the hedge fund.

While the foreign blocker uses the securities trading safe harbor to avoid income tax, the foreign blocker will be subject to withholding tax on dividend income generated by the hedge fund from investments in U.S. corporations. The statutory withholding rate of 30 percent can be reduced by a tax treaty. However, most foreign blockers are organized in jurisdictions where there is no tax treaty with the United States, subjecting the foreign blocker to tax withholding that is not recoverable.

Some foreign blockers have been using equity derivatives to avoid the withholding tax on U.S.-source dividends. These dividend-equivalent payments may now be subject to withholding tax with the enactment of section 871(m) in 2010. Recently published final regulations will apply broadly to equity derivative transactions starting in 2017. Effectively, this will eliminate the ability of foreign blockers to avoid withholding tax on U.S. dividend-equivalent payments by using derivatives. Note that the use of leverage is implicit in the use of derivatives, which generally are not subject to UBIT. Thus, derivative transactions conducted by the U.S. pension plan itself would not be subject to UBIT or dividend withholding tax, but derivative transactions entered into by the foreign blocker will now be subject to the withholding tax.

For its part, the foreign blocker will make distributions to the pension plan that are not subject to U.S. federal tax because they are treated as dividends from an investment in a corporation as opposed to income from debt-financed property. This is achieved because the foreign blocker is respected as a corporation separate from its owners (pension plans and other blocked investors). However, these distributions could already be after-tax distributions because of dividend withholding tax.

To avoid UBIT, the pension plan or the fund must engage in the complex tax planning and legal advice that are required to establish the foreign blocker and appropriate structure. Entire communities of advisers and service providers have developed in the offshore jurisdictions where hedge funds (and private equity funds) are domiciled. EVestmentResearch estimates that 32.8 percent of the $2.3 trillion U.S. hedge fund industry is domiciled in offshore jurisdictions, representing approximately $754.4 billion of assets.[12] Using an estimate of 34 percent of the hedge fund industry composed of pension funds,[13] this would represent approximately $256.5 billion of assets attributable to investing by tax-exempt organizations such as pension plans. It would be reasonable to conclude that in the absence of the UBIT rules, many pension plans would have invested in U.S. funds directly, and the offshore fund community would be much smaller than it is today.

Conclusion

The original purpose for the debt-financed UBIT rules (the sale-leaseback transactions and then later, as part of the Tax Reform Act of 1969, most debt-financed investment assets) should not apply to today's investing in hedge funds by pension plans. The current UBIT rules force pension plans to either pay UBIT or engage tax advisers to create foreign blockers to avoid paying UBIT while suffering the dividend withholding tax. Both approaches harm investment returns for pension plans that are simply carrying out their tax-exempt purpose by investing on behalf of plan beneficiaries. This UBIT rule does not benefit pension plan beneficiaries, and the resulting planning and structuring costs represent a further drag on pension plan investment returns.

Congress should make it easier, not harder, for pension plans to increase plan assets and close the funding gap between assets and liabilities. Every dollar of U.S. withholding tax imposed indirectly on U.S. pension plans goes to the U.S. government. The UBIT rule is actually contributing to the pension plan liability gap in a meaningful way. The rationale that led to the creation of the real property exception in 1980 should be applied to investments by pension plans in hedge funds that use leverage. Enactment of a proposal similar to the ones introduced in 2007 and 2009 would be a welcome solution.

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[12]Data obtained directly from EVestmentResearch.

[13]IBISWorld, *supra* note 6.