

# Client Alert

Current Issues Relevant to Our Clients

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## Camp Proposal Would Tax Many State and Local Pension Investments

*Legislative proposals by House Ways and Means Committee Chair Dave Camp would expand the scope of the unrelated business taxable income rules so that state and local pension funds would be subject to tax on certain investment income, including, in some instances, income from investment funds.*

*After several months of hearings on comprehensive tax reform, on February 26, 2014, Representative Camp released a proposal referred to as the Tax Reform Act of 2014. The following is a summary of certain proposed changes that would affect state and local pension fund investments. We have also prepared summaries of other provisions of the proposal relevant to other topical areas — please check our website for additional summaries. Although the Tax Reform Act of 2014 has not yet been formally introduced as a bill, and its prospects for passage are uncertain at this point, given the significant nature of the proposed reforms, we will monitor progress of the proposals and provide updates as warranted.*

### Current Law — Sections 501 and 115

Organizations described in Code § 401(a), including most governmental and non-governmental pension plans, are exempt from federal income tax under Code § 501(a). Under current law, income derived from a trade or business regularly carried on by an organization exempt from tax under Code § 501(a) that is not substantially related to the performance of the organization's tax-exempt functions is subject to a tax on unrelated business taxable income (UBTI). The highest corporate tax rate applies to UBTI. A college or university that is an agency or instrumentality of a state government (or political subdivision) generally is also subject to tax on UBTI. The UBTI rules do not expressly apply, however, to income described in Code § 115(1), which is income accruing to certain state and local entities (such as governmental pension plans) in the exercise of an essential governmental function. As a result, there may be an ambiguity as to whether a state or local entity is subject to the tax on UBTI if the relevant income is otherwise exempt under Code § 115(1) or other general tax principles.

Certain passive income from an unrelated trade or business is excluded from UBTI and is not subject to tax unless the passive income is attributable to property that is acquired with debt financing. These types of passive income include dividends, interest and capital gains.

### The Proposal — Organizations Exempt under Section 501(a)

The proposed legislation would change Code § 511 to provide that an organization exempt from tax under Code § 501(a) will be subject to the tax on UBTI even if the organization is also exempt from tax, or excludes amounts from gross income, by reason of any other provision of the Code.

This change will be of particular concern to state and local governmental pension plans that are described in Code §§ 401(a), 501(a) and 115 that have historically taken the position that income excluded under Code § 115 is not subject to tax on UBTI unless earned by a state college or university.

### The Proposal — Trade or Business of Investing

A second proposed change that becomes significant to state and local governmental pension plans if the first change is made to Code § 511 is as a result of proposed changes to the treatment of carried interests. While state and local governmental pension plans might not initially be interested in the tax treatment of carried interest (*i.e.* an interest in a partnership's profits granted in exchange for services provided to the partnership), there is commentary in legislative summaries of the proposal that suggests the impact of these changes may reach beyond the recipients of carried interests.

According to the proposed statutory language, raising capital, investing in trades or businesses and developing trades or businesses would be considered activities that constitute a trade or business for purposes of the carried interest rules. The summary of the proposal prepared by the Ways and Means Tax Staff adds color to the statutory language by providing that, if the intent of a partnership (e.g., a private equity fund) is to eventually sell the businesses in which it holds interests (e.g., portfolio companies), the businesses should be treated as inventory by the partnership. Unlike capital gain, gain from the sale of inventory is not excluded from UBTI. Therefore, the proposed change to carried interests could have the effect of also increasing the UBTI of a governmental pension plan (if the change to Code § 511 described above is adopted).

The commentary in the summary appears to be a reaction to the *Sun Capital Partner* case decided last year in which a court held that a fund was in a trade or business because it provided management support to the portfolio companies. This result is not dissimilar from the results in *Estate of Smith* decided in the 1960s in a hedge fund context.

## What to Do Now

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No one knows how likely it is that the Camp proposals will become law. However, the Joint Committee on Taxation revenue estimates that accompany the proposals may provide some insight of the likely impact if these changes are enacted into law. The revenue estimates indicate that the change to Code § 511 would raise \$100 million in total revenue over 10 years, and the change to the carried interest provisions would raise \$3.1 billion in aggregate revenue over 10 years. It is very interesting how little in revenue the Joint Committee on Taxation estimates would be raised by the change to Code § 511. A state or local pension plan concerned about the proposed changes has several options, the benefits of which will depend on the nature of the underlying investment activity, including negotiation of a provision that allows for the restructuring of an investment if adverse tax consequences result from a change in law.

## For More Information

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