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The Shelf Project

Revenue-Raising Proposals
to Defend the Tax Base

UBIT to the Defense! ESOPs and Government Entities

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UBIT to the Defense! ESOPs and Government Entities

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The unrelated business income tax is imposed on otherwise exempt organizations to prevent the shifting of business assets to exempt entities. Entities that are exempt (or believe they are exempt) from UBIT have recently acted as accommodation parties in transactions, allowing high-rate taxpayers to avoid tax on economic income that those taxpayers own in substance. This proposal would end the UBIT exemption for employee stock ownership plans, governmental pension funds, and other governmental affiliates.

This proposal is made as a part of the Shelf Project, a product of collaboration among tax professionals to develop and perfect proposals to raise revenue. An inventory of past projects is found at "Two Years of the Shelf Project," *Tax Notes*, Jan. 25 2010, p. 513, *Doc 2010-150*, or *2010 TNT 17-12*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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The unrelated trade or unrelated business income tax imposes tax on the unrelated business income of tax-exempt organizations, including charities and pension plans. The general principle is that tax is imposed on business income no matter what its use or destination. UBIT defends the tax base by preventing the shift of business assets from taxable corporations to exempt entities. Employee stock ownership plans (ESOP), however, are exempt from UBIT on S corporation stock of their employers. Pension funds supporting state and local government employees assert exemption from the UBIT, as do other governmental affiliates. Some UBIT-exempt entities have participated in abusive shelters as accommodation parties in transactions designed to allow high-bracket taxpayers to avoid tax on their economic income. Those abuses show the need for UBIT to protect the tax base. The proposal would end the UBIT exemp-

tion for ESOPs and governmental affiliates, including governmental pension plans.

A. Current Law

Sections 511-513 impose a tax on the unrelated business taxable income of an otherwise tax-exempt organization, including a charity or qualified pension fund. The tax rate is the section 11 rate for corporations or the section 1(e) brackets for trusts, depending on whether the entity is a corporation or a trust. Currently, the maximum tax rate is 35 percent for both types of entities. Before the adoption of the UBIT in 1950, business income was tax exempt for a charity or pension fund if the recipient devoted the receipts to its tax-exempt purpose.¹ Thus, for example, when New York University took over all the stock of Mueller Macaroni Factory, Mueller became a tax-exempt feeder corporation.² Congress decided in 1950 that business income should be subject to tax even if it is destined for an exempt purpose.

The Senate Finance Committee explained UBIT as necessary to overcome unfair competition. It stated that the tax on unrelated business income "primarily addressed the problem of unfair competition. The tax-free status of section 501(c)(3) organizations enabled them to use their profits tax free to expand operations, which their competitors could expand only with profits remaining after taxes."³

The favored rationale for UBIT relies less on the unfair competition argument and more on the argument that UBIT prevents charities from taking direct ownership of businesses, which deprives Treasury of revenue from those businesses.⁴ According to data from the Flow of Funds Accounts, pension funds alone own 23 percent of domestic corporations,⁵ which are subject to 35 percent tax. The shareholders' tax exemption cannot immunize their corporations from tax, and the tax-exempt organizations bear the burden of corporate tax on the corporations they own. Tax-exempt organizations would not allow Treasury to collect tax from the corporations they

¹See, e.g., *Lichter Foundation, Inc. v. Welch*, 247 F.2d 431 (6th Cir. 1957).

²*C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951).

³Sen. Finance Comm., S. Rep. No. 2375, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 483, 504.

⁴See Daniel Halperin, "The Unrelated Business Income Tax and Payments From Controlled Entities," *Tax Notes*, Dec. 12, 2005, p. 1443, *Doc 2005-24023*, or *2005 TNT 238-27*; Henry B. Hansmann, "Unfair Competition and the Unrelated Business Income Tax," 75 *Va. L. Rev.* 605 (1989).

⁵Flows of Funds Account of the United States for the Fourth Quarter of 2009, Table L. 213 (Corporate Equities) (sum of private pension funds and state and local pension funds).

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own if they could avoid the tax by taking direct ownership. For example, take 9 percent as the pretax return appropriate to the risks of some business. The corporate tax of roughly one-third of income reduces the after-tax return to 6 percent. No tax-exempt organization would rationally invest in corporate stock returning only 6 percent after tax if it could instead buy the business and business assets directly and receive 9 percent after tax.⁶ If the after-tax income of a business could be improved by 150 percent simply by direct ownership rather than stock ownership, inevitably the exempt organizations would replace stock they owned with direct ownership of assets.

Tax-exempt organizations have adapted to UBIT by investing in businesses primarily by buying stock that blocks the exempt organization from having to compute UBIT itself.⁷ The direct revenue yield from UBIT is a relatively modest \$556 million,⁸ but the UBIT saves more revenue indirectly by stopping tax-driven shifts that would take advantage of direct ownership if that form of ownership were UBIT exempt. The general system of UBIT ensures that at least one level of tax is paid on business income regardless of the charitable use of the funds. By taxing unrelated activities, the UBIT also functions as a "nondiversion constraint," by focusing managers of exempt entities on their primary task of implementing the organization's exempt purposes.⁹

Despite the broad reach of the UBIT, there are entities that are exempt or claim to be exempt from its reach and have in recent years abused their UBIT exemption. In 1997 Congress exempted ESOPs from the UBIT rules on stock of an ESOP's employer that had elected S corporation status.¹⁰ An ESOP is an employee stock bonus retirement plan that holds primarily stock of the beneficiary's employer. The ESOP is exempted from the diver-

sification of portfolio requirements, which are otherwise generally required to maximize investment security of the plan beneficiaries. An S corporation pays no tax on its business earnings, but pays the taxable income out to its shareholders pro rata to their shares.¹¹

In 1996 Congress allowed qualified pension funds to be shareholders of an S corporation for the first time, but required that the pension funds treat the income from the S corporation as unrelated trade or business income subject to UBIT.¹² Legislation in 1997 made ESOPs the exception to that rule by exempting them from UBIT. Thus, exemption on both the S corporation level and the shareholder level is unique to ESOPs.

Pension funds for state and local employees have also claimed immunity from UBIT, relying at least in part on section 115, although it is not clear that they were all entitled to immunity on that basis. Section 115 has as its title "Income of States, Municipalities, etc.," but, as it has developed, it applies only to entities organized separately from a state or political subdivision, and excludes from gross income any income derived "from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof."¹³ The IRS interprets the accrual requirement as requiring that on dissolution, assets go to the state or a political subdivision.¹⁴ It further requires that section 115 organizations not "benefit private interests."¹⁵ The benefits of defined-benefit pension funds, however, accrue to individuals and not the state or political subdivision, making the applicability of section 115 questionable at best.¹⁶ In addition, those governmental plans that choose to qualify under section 401(a), as many do, would seem to have chosen to subject themselves to UBIT.

Governmental pension plans also have looked to a 30-plus-year-old news release to claim a UBIT exemption.

⁶The sale or liquidation of appreciated business assets is a taxable event to an existing business conducted in corporate form, which would block some shift from corporate to noncorporate form. But even if a tax on sales of existing appreciated business property impedes the transfer, the superiority of a 9 percent return over a 6 percent return would mean that all expansion of any business held by an exempt organization would be of the direct ownership. Business assets that have lost value or have modest appreciation would also move over to noncorporate form.

The IRS has also ruled that no gain was recognized in a reorganization under which a business became entirely tax exempt as an S corporation owned by its ESOP. See Robert Willens, "ESOPs and S Corporations," *Tax Notes*, Mar. 15, 2010, p. 1407, *Doc 2010-4341*, or *2010 TNT 52-11*.

⁷Andrew W. Needham and Anita Beth Adams, "Private Equity Funds," *735 Tax Mgmt Portfolio*, A-34 to A-39 (2004) (saying that exempt entities set up blocker corporations to avoid UBIT).

⁸IRS, Statistics of Income: Exempt Organizations' Unrelated Business Income Tax Year 2006, Table 1, available at <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97210,00.html>.

⁹See Frances R. Hill, "Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint," 56 *SMU L. Rev.* 675 (2003).

¹⁰Taxpayer Relief Act of 1997, P.L. 105-34, section 1523(a), amending section 512(e) by adding new paragraph (3).

¹¹Sections 1361-1378.

¹²See section 512(e). This UBIT rule applies to section 501(c)(3) organizations as well as pension plans.

¹³The language of section 115 entered the code as part of the first income tax bill after adoption of the 16th Amendment. The legislative history, although far from clear, suggests that it sought, somewhat gratuitously, to codify the notion of intergovernmental constitutional immunity. Today, however, we interpret the Constitution to permit Congress to tax income-producing activities of state and local governments. As discussed in the text, section 115 has been applied not to states and their political subdivisions but to entities organized separately from them. See Ellen P. Aprill, "Excluding the Income of State and Local Governments: The Need for Congressional Action," 26 *Ga. L. Rev.* 421 (1992).

¹⁴Rev. Rul. 90-74, 1990-2 C.B. 34.

¹⁵*Id.*

¹⁶*Cf.* See GCM 34,704 (Dec. 2, 1971) (recognizing section 115 status for a public employee pension fund when the fund did not maintain individual accounts for beneficiaries, beneficiaries received benefits from trust income but were not entitled to access to trust corpus, and beneficiaries were large classes instead of specified and definitely ascertainable individuals). Section 415(m)(1) (specifying that a qualified governmental excess benefit arrangement constitutes income derived from the exercise of an essential governmental function exempt from tax under section 115).

In 1977 the IRS published a news release saying it was studying the question whether state and local government retirement plans had to comply with prohibitions in qualified plans against discrimination in favor of highly compensated employees. The IRS said it would resolve those issues in favor of the taxpayer or governmental unit pending its review.¹⁷ No end of the study was ever announced, and there is no evidence of a continuing IRS study. A 33-year-old news release is not an opinion of law on which taxpayers can reasonably rely. Moreover, it is an extraordinarily broad reading of a news release on discrimination to deem it an opinion about UBIT.

While section 115 specifically exempts income earned from the exercise of a state function provided by entities separately organized from a state or political subdivision, a state or political subdivision itself is likely exempt by implication without need for statutory exemption.¹⁸ There is, however, no constitutional protection for entities by reason of their connection with a state.¹⁹ The 16th Amendment explicitly states that Congress may impose a tax on incomes, "from whatever source derived."²⁰ Congress can tax states and their political subdivisions if it so chooses. Section 511(a)(2)(B) represents such a choice. It subjects state colleges and universities to UBIT, whether they are an agency or instrumentality of any government or political subdivision, or owned and operated by a government or political subdivision.

B. Reasons for Change

The income tax is a tax on the business harvest of the country. The UBIT extends the tax to businesses held by tax-exempt organizations, including charities and pension funds, so that business income is taxed no matter how worthy the use of the proceeds. That general rule of tax on business income would in principle cover UBIT imposed on entities affiliated with a state or local government, as well as ESOPs. UBIT already applies to business income received by colleges and universities affiliated with a state or local government. UBIT should apply without ambiguity to pension funds affiliated with state and local government employees as well. The primary function of UBIT is to prevent business assets

from moving into exempt vehicles, a move that would reduce needed revenue. UBIT is also needed to defend the tax base from entities currently exempt from UBIT seeking to profit on this UBIT exemption by serving as tax-indifferent counterparties or accommodation parties to various tax shelter schemes.

The recent abusive SC2 scheme, for example, shows the need to extend UBIT to tax-exempt entities that are not now subject to UBIT. For a fee, municipal pension funds acted as accommodation parties to park income to allow high-rate taxpayers to defer or avoid tax on their income.²¹ Then-IRS Commissioner Mark Everson testified to Congress that he could not "overstate the seriousness of the involvement of tax-exempt and government entities as accommodation parties to abusive transactions," including transactions like the SC2.²² Participation by UBIT-exempt organizations in tax avoidance schemes is not a matter of morality, but a matter of economic incentives that arise from UBIT exemption. Taxpayers who want to avoid tax are willing and able to pay entities

²¹The core of the scheme was allocating business income to a UBIT-exempt entity which was the temporary owner of an S corporation. While the tax-exempt entity was allocated the income for the years it held the S stock, the original owners in fact kept the income by preventing distribution of the income on the stock and then buying the stock back under an option or optionlike arrangement. In form, the KPMG SC2 transactions had no restrictions preventing distribution of the earnings attributed to the governmental pension plan to that pension plan while it owned the shares. The tax-exempt organization's stock was nonvoting, however, and the original owners controlled the corporation and would prevent all distributions until the tax-exempt entity was redeemed out. The SC2 was the subject of an extensive investigation and report by the Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations, which examined internal e-mails and 58 replications of the scheme. "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2," Minority Staff Report of the U.S. Senate Permanent Subcommittee on Investigations (Nov. 18, 2003), S. Prt. 108-34.

Notice 2004-30, issued in April 2004, gave notice that the IRS would challenge the tax benefits claimed, but expressly exempted transactions in which the S corporation's ESOP had been the accommodation party, "pending further review." Notice 2004-30, 2004-1 C.B. 828, *Doc 2004-7174*, 2004 TNT 64-9. Because the ESOP is the only vehicle in which the accommodation party has an explicit exemption from UBIT, the notice for all its forceful language seems to have exempted from its scope the vehicle in the best position to effect the income parking plan, because of its clear statutory exemption from UBIT.

Congress in 2006 adopted section 4965 to address the participation of tax-exempt entities in prohibited tax shelter transactions. The entities that are subject to this tax, however, are limited and do not include pension plans. For pension plans, only the tax on managers applies. SC2, however, used governmental pension plans as accommodation parties; thus, the section 4965 tax would not have reached the pension fund itself. Moreover, section 4965 does not apply to section 115 or other governmental entities generally.

²²Mark W. Everson, Commissioner of Internal Revenue, Testimony before U.S. Senate Finance Committee Hearing on Charitable Giving Problems and Best Practices (June 22, 2004), *Doc 2004-12950*, 2004 TNT 121-39.

¹⁷Internal Revenue News Release, IR-1869, Aug. 10, 1977.

¹⁸In addition to section 115, governmental affiliates claim exemption from income tax on the basis that (a) they are themselves political subdivisions because they possess all or some of the sovereign powers of taxation, eminent domain, or police power, or (b) they are integral parts of a state or political subdivision. They may also seek status as tax-exempt section 501(c)(3) organizations. For other purposes of the tax law, they may also seek to qualify as state instrumentalities. See Aprill, "The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates," 23 *J. Corp. L.* 803 (1998).

¹⁹As one ruling explains, "Income earned by a state, a political subdivision or a state, or an integral part of a state or political subdivision of a state is generally not taxable in the absence of specific statutory authorization for taxing such income." Rev. Rul. 87-2, 1987-1 C.B. 18. See also Rev. Rul. 71-131, 1971-1 C.B. 28; Rev. Rul. 71-132, 1971-1 C.B. 29; GCM 14,407, C.B. XIV-1, 103 (Jan. 28, 1935).

²⁰U.S. Const., Amend. XIII.

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that are exempt from UBIT to participate in schemes that erode federal revenue. If the rules of UBIT exemption give organizations a hand to play, they will inevitably play it.

Another Shelf Project proposal has recommended that ESOPs be repealed,²³ but if that recommendation is not adopted, there is a serious need to apply the UBIT to ESOPs. ESOPs are undiversified funds that jeopardize the security of the retirement funds of the employee beneficiaries. Not only are the ESOP investments overinvested in one stock, but the stock is stock of the employer. So if the business fails, the employee can lose his job and retirement nest egg all at once. As noted above, in 1996 Congress allowed tax-exempt entities to become shareholders of S corporations for the first time,²⁴ but it simultaneously provided that the income from S corporation stock and gain from the sale of the stock was subject to UBIT.²⁵ The 1996 provision attempted to ensure that the business income of the nation was taxed although held by an otherwise tax-exempt entity. S corporation provisions were enacted to end double taxation of

corporate income but not all income. Then in 1997, Congress exempted ESOPs from UBIT on their S stock, with the Finance Committee saying that the UBIT was inappropriate because it would impose tax "at the ESOP level and also again when the benefits are distributed to the ESOP participants."²⁶ The ESOP harms beneficiaries by giving incentives for underdiversification, in violation of the first premise of wise investment policy. The special exemption for ESOPs from UBIT is against public policy.

C. Explanation of the Proposal

The proposal would extend the UBIT of sections 511 through 513 to ESOPs, section 115(1) entities, governmental pension plans, and any other entity claiming exemption by reason of its relation to a state or political subdivision. The tax rate would be the tax brackets of section 11 if the entity is organized as a corporation, or section 1(e) if the entity is organized as a trust. The proposal would also allow the IRS to issue rulings that the entity is subject to UBIT in order to defend the tax base of the federal income tax.

The purpose of this proposal is not to tax states on their traditional sources of revenue at a time when they are under financial stress, but rather to block a move of a business from taxable to tax-exempt form. It would also block abuses in which the tax-exempt status of the entity is used to avoid tax on private individuals. According to census data, the states derive significant revenue from a variety of activities.²⁷ Under this proposal, the revenue from these activities would be considered to be related to the state's function, and not from unrelated trades or businesses subject to UBIT, even though taxable private businesses, for instance, run hospitals and colleges, and have produced electricity. Road tolls, lottery tickets, and parking fees would be considered state or local taxes under this proposal, even though private enterprises could make money from parking lots and even roads. If a city takes over a business, such as a macaroni factory — which is not a business related to state function as it is now understood — any income from the activity would be treated as producing UBIT under this proposal. A city participating in a tax scheme such as SC2 to reduce the taxable income of individuals would not be treated as related to the city's function. If a city owns S corporation stock, the distributable income would be UBIT to the city.

²³See Andrew Stumpff and Norman Stein, "Repeal Tax Incentives for ESOPs," *Tax Notes*, Oct. 19, 2009, p. 337, *Doc 2009-21480*, or *2009 TNT 202-9*. An ESOP is a retirement plan that invests primarily in the stock of the employer, which is destructive to employee interests. Modern portfolio theory has proven that investors, including employees, should diversify their investment. Any one stock is a very volatile investment. Any one stock might collapse in value. A diversified portfolio with many unlike investments reduces the volatility because some investments will rise as others fall, and not all the investments will collapse. Investing in stock of the employer makes things worse because if the employer stock collapses, the employee loses his job, the career relevance of his skills and his entire nest egg, as well. An employee with his job, his skills, and retirement funds in one company can wake up one morning and find that the stock is worthless. Another Shelf Project proposal, by Andrew Stumpff and Norman Stein, has recommended repeal of ESOPs in full. As Stumpff and Stein put it:

If something bad happens, the employees stand to simultaneously lose both their jobs and their retirement funds. Unfortunately, this concern is no longer theoretical. Companies that maintained ESOPs when their stock became worthless include Enron, WorldCom, Bear Stearns, Lehman Brothers, the Tribune Company, and many others.

When the Tribune Co., which publishes the *Chicago Sun*, the *Los Angeles Times*, and *The Baltimore Sun* went bankrupt, its shares were owned exclusively by the reporters and other employees of the papers. Many bankruptcies are shocks to employees. Enron was once awarded prizes for being the best-managed company in America, and it had a AAA rating for its bonds until it became bankrupt.

The proposal here to end the UBIT exemption for ESOPs would come into effect if and only if the greater proposal is not adopted, which would repeal the ESOP provisions in full, because of the harm that ESOPs do to the public interest.

²⁴Small Business Job Protection Act of 1996, P.L. 104-188, section 1316(a) enacting section 1361(c)(6).

²⁵Small Business Job Protection Act of 1996, P.L. 104-188, section 1316(c) enacting section 512(e)(1) and (2).

²⁶Sen. Finance Comm., Report on Tax Relief Act of 1997, Rep. No. 105-33, on P.L. 105-34, section 1523(a) enacting section 512(e)(3).

²⁷These activities include college tuition, ownership of hospitals, parking facilities, port facilities, airports, sale of natural resources, sale of lottery tickets, liquor, and school lunches, fees for parks and recreation, rents from housing and industrial development, rates charged for sewage and solid waste management, and public utilities services including delivery of water, electricity, gas, and bus and railway transit. See <http://www.census.gov/govs/estimate/>.