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REDEFINING A BLURRY LINE: A PROPOSAL TO REFORM THE TAXATION OF PENSION FUND BUSINESS AND INVESTMENT INCOME

by

Jesse Boretsky[*]

ABSTRACT

Pension funds are established to provide workers in the private and public sectors with tax-advantaged retirement benefits. Corporate and public pension funds today collectively hold portfolios worth trillions of dollars and pursue similar investment strategies designed to balance the requirement of diversification with the need to achieve sufficient investment returns to meet the demands of plan participants and their beneficiaries. While all pension funds are generally exempt from taxation under the Code, tax-qualified corporate pension funds are still subject to tax liability on the receipt of active business income under the Unrelated Business Income Tax (UBIT). This rule creates harsh consequences for corporate pension funds when combined with the Code's particular definition of "business income" in the context of pension fund investment activity. These rules therefore exacerbate the underlying horizontal inequity issues for participants in private and public pension plans. A recent proposal in Congress attempts to resolve this issue by subjecting public pension funds to tax on UBIT income. This Article explores the rationales for taxing pension funds on UBIT income more generally and the extent of the horizontal inequity that exists due to the differing tax treatment of public and private pension funds. This Article concludes that rather than tax public pension funds on UBIT income, Congress should instead reform the UBIT rules to allow corporate pension funds to invest more freely without fearing tax consequences under the UBIT.

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INTRODUCTION

Although both private and public pension funds exist to provide workers with essential tax-advantaged retirement benefits, their income-generating activities are treated very differently under federal tax law. Pension plans operated by private employers are generally exempt from taxation if they meet the stringent conditions imposed by section 401(a) of the Internal Revenue Code (Code). However, corporate pension funds can still face tax liability under the unrelated business income tax (UBIT) provisions of the Code. By contrast, pension funds administered by state and local government employers have long been viewed as not only exempt from federal taxation but also outside of the federal tax system altogether. Meanwhile, despite its

role in defining the boundaries of the tax exemption system, the UBIT enjoys a dubious reputation and has long been subject to significant criticism from scholars and other commentators. The UBIT has been described as "clumsy,"[1] "poorly designed,"[2] "ill-defined and inadequately enforced,"[3] and the source of "more unfairness than it can possibly prevent."[4] Unsurprisingly, numerous scholars and commentators have called for the repeal or reform of the UBIT over the years,[5] and these calls for reform present an opportunity to address the very different tax burdens imposed on private and public pension funds by the UBIT rules.

Scholars generally do not distinguish pension funds from other categories of tax-exempt organizations when discussing reforms to the UBIT rules. This is, however, an oversimplification as both the rationale for exempting pension funds from taxation and the treatment of pension funds under the UBIT rules are substantially different from other categories of exempt organizations, such as university endowments and public charities.[6] One crucial difference is that contributions to pension funds are not truly exempt from taxation but rather enjoy the benefit of tax deferral until the funds

1. Kevin M. Yamamoto, *Taxing Income from Mailing List and Affinity Card Arrangements: A Proposal*, 38 SAN DIEGO L. REV. 221, 256 (2001).

2. Michael S. Knoll, *The UBIT: Leveling an Unfair Playing Field or Tilting a Level One?*, 76 FORDHAM L. REV. 857, 872 (2007).

3. Kalle Condliffe, Note, *Balancing the Equities: Considering the "Flip-Side" of the UBIT and Forming a Workable Solution*, 6 BROOK. J. CORP. FIN. & COM. L. 211, 222 (2011).

4. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1038 (1982).

5. *See* Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 NW. U. L. REV. 225, 225 (2012) (calling for repeal of the debt-financed income rule); Emily Cauble, *Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities*, 29 VA. TAX REV. 695, 723–24 (2010) (advocating for repeal of the debt-financed income rule to allow tax-exempt entities to invest passively in any investment partnership without incurring UBIT liability); Summer A. Lepree, *Taxation of United States Tax-Exempt Entities' Offshore Hedge Fund Investments: Application of the Section 514 Debt-Financed Rules to Leveraged Hedge Funds and Derivatives and the Case for Equalization*, 61 TAX LAW. 807, 852–53 (2008) (advocating for the partial repeal of the debt-financed income rule for investments in hedge funds but also calling for ultimate repeal of all tax on passive debt-financed income); William H. Weigel, *Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)*, 50 TAX LAW. 625, 657 (1997) (arguing for the repeal of the rule because its anti-abuse function has become too narrow to justify the administrative and tax burden on tax-exempt entities).

6. Cauble, *supra* note 5, at 742 & n.149.

are disbursed to the individual participant upon retirement. Another fundamental distinction is that investing accumulated assets of the fund is a central function of a pension fund rather than merely a by-product of the receipt of excess funds not immediately expended on other exempt purposes.[7] Finally, the existing UBIT rules as applied to private pension funds raise substantial horizontal equity concerns by treating public and private pension funds differently.[8] These distinctions suggest that reform to the UBIT rules for pension funds is both urgent and may look very different from reforms that affect other categories of exempt organizations.

Furthermore, Congress, despite the great deal of attention directed at critiquing and exposing the flaws of the UBIT regime, has shown little interest in comprehensively reviewing the structure and operation of the UBIT rules. Instead, Congress has been more inclined to tinker with portions of the UBIT, often in response to lobbying pressure rather than because of principled objections to the operation of the rules.[9] In March 2014, Congressman David Camp, then Republican chairman of the House Ways and Means Committee, submitted a series of proposed reforms to the UBIT as part of the Tax Reform Act of 2014, one of the most important of which was an amendment to Code section 511(a) clarifying that state and local governmental pension funds were subject to the UBIT.[10] As the Advisory Committee notes make clear, although governmental pension funds are widely considered to be exempt from taxation under the current UBIT rules, it is unclear whether this exemption resulted from careful deliberation or rather developed through oversight and inattention.[11] The Camp bill was intended to resolve this ambiguity by subjecting public pension funds that are qualified under section 401(a) to taxation under the UBIT. However, the bill was ultimately withdrawn and the future applicability of the UBIT to the income of state and local governmental pension funds remains unclear.

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7. *Id.* at 742 n.149 (citing Suzanne Ross McDowell, *Taxing Leveraged Investments of Charitable Organizations: What Is the Rationale?*, 39 CASE W. RES. L. REV. 705, 715 (1988–1989)).

8. *See infra* notes 121–30 and accompanying text.

9. For example, in response to lobbying by pension trusts, Congress granted an exemption from the debt-financed income rules under Code section 514(c)(9) for income earned by qualified pension trusts from leveraged investments in real estate. Congress subsequently extended the debt-financed real estate exception to include investments by universities and other post-secondary institutions. *See* Lepree, *supra* note 5, at 830–31.

10. H.R. 1, 113th Cong., 2d Sess. (2014).

11. ADVISORY COMM. ON TAX EXEMPT AND GOV'T ENTITIES, INTERNAL REV. SERV., 2014 REPORT OF RECOMMENDATIONS 1, 198 (2014).

The current UBIT rules create horizontal inequity between participants in public and private pension plans. The recent proposal to integrate qualified public pension trusts into the UBIT regime represents an attempt to remedy the unequal treatment of public and private pension funds under the UBIT. While Congress may well wish to equalize the treatment of public and private pension funds, there are ways to do so without subjecting public pension funds to a tax regime that is both inefficient and outdated. This Article proposes that Congress can reach a more equitable, efficient, and administrable result by crafting a limited exemption from the UBIT for business income earned from assets held by private pension funds primarily for investment purposes. Part I provides a brief introduction to the UBIT rules. Part II discusses modern pension fund investing strategies and the ways in which the UBIT rules affect basic investment practices. Part III reviews the various justifications for the unrelated business income and debt-financed income rules in order to determine which rationales are applicable to the taxation of pension fund assets. Part IV then considers the issue of horizontal inequity in the differing treatment of corporate and public pensions under the UBIT and determines that reform to the UBIT rules would be reasonable and beneficial. This Part also addresses the lingering question of whether governmental pension plans can be constitutionally subject to taxation under the UBIT and proposes a number of policy reasons why Congress should choose not to pursue the taxation of public pension funds under the UBIT. Finally, Part V introduces a new reform to the rules governing the taxation of corporate pension funds that would modernize the rules regarding the investment income exemption and thereby substantially resolve the present horizontal equity concerns in this area of tax law.

I. A BRIEF OVERVIEW OF THE UBIT

Although generally exempt from taxation, tax-exempt organizations can still incur federal tax liability under the UBIT rules, a series of provisions enacted more than half a century ago to address concerns stemming from the operation of commercial businesses by tax-exempt organizations. Under the UBIT rules, a tax-exempt organization is subject to tax at regular corporate rates on income from an "unrelated trade or business,"[12] which the Code

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12. I.R.C. §§ 511–513. Prior to the enactment of the UBIT rules in 1950, a tax-exempt entity could escape taxation altogether even if it owned other businesses, so long as the income received by the exempt entity was used only in support of its exempt functions. *See* Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 608 (1989). Exempt entities are still permitted to own and operate businesses that produce goods and services unrelated to their exempt purposes, albeit while bearing the tax, but an entity will lose its

defines as "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption . . . ."[13] The Treasury Regulations make clear that the meaning of the term "trade or business" in this context closely tracks the widely used definition and criteria found in section 162.[14] The Regulations further provide that business activities are "related" to an organization's exempt purposes "only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income)";[15] and such activities are "substantially related" only where "the causal relationship is a substantial one."[16] For example, the sale of tickets to a student recital by a nonprofit performing arts center is held to be substantially related to the organization's exempt purposes.[17] Similarly, the sale of art supplies and books at a gift shop run by an art museum would be considered substantially related to the organization's exempt purposes, but the sale of science books would not.[18]

For private, employer-sponsored pension funds, a special deeming provision in section 513(b) provides that the conduct of "any trade or business" automatically constitutes the conduct of an unrelated trade or business.[19] The logic behind this special rule is readily apparent. A pension fund has no specific "exempt purpose" other than the accumulation of income to support the employee and his or her beneficiaries after the termination of employment, and therefore it is impossible to cabin the concept of "related business activity" in the same manner as for a charitable organization that exists to further a particular charitable purpose. The existence of a realm of "related business activity" is therefore treated as a necessary corollary to the concept of

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exemption if the business activity constitutes too substantial a portion of the exempt entity's total activities. *Id*. This is actually not contained in the UBIT at all. *See* John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 491 (2002) ("The UBIT itself, however, provides no guidance on whether commercial activity, even if taxed, should threaten exempt status.").

13. I.R.C. § 513(a).

14. *See* Reg. § 1.513–1(b) ("Accordingly, for purposes of section 513 the term *trade or business* has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services." (emphasis added)).

15. Reg. § 1.513–1(d)(2).

16. *Id.*

17. Reg. § 1.513–1(d)(4)(i), Ex. 1.

18. *See* John D. Colombo, *The NCAA, Tax Exemption, and College Athletics*, 2010 U. ILL. L. REV. 109, 138 (citing Rev. Rul. 73–104, 1973–1 C.B. 263, 264).

19. I.R.C. § 513(b)(2).

unrelated business income. Thus, in general, for all categories of tax-exempt organizations except pension funds, the receipt of active business income from a business controlled by a tax-exempt organization remains completely exempt from taxation under the UBIT rules so long as the conduct of the business is substantially related to the exempt purposes of the organization.[20] In order to understand the logic of this result, it is useful to consider the structure of tax exemption as it existed prior to the enactment of the UBIT.

Prior to the enactment of the UBIT rules, all income earned by a tax-exempt organization was exempt from taxation so long as the income was used to further the organization's exempt purposes.[21] Under the "destination of income" doctrine, first articulated by the Supreme Court in the 1924 case of *Trinidad v. Sagrada Orden de Predicadores*,[22] the source of income was irrelevant to a determination of whether the income was taxable in the hands of an exempt organization.[23] This rule allowed tax-exempt organizations considerable freedom to operate commercial enterprises and engage in other profit-making activities. The high-water mark of the destination of income test came in the *C.F. Mueller Company* case, where the Third Circuit held that NYU's acquisition of the Mueller macaroni company exempted the company's revenues from taxation.[24] Although the destination of income test was questioned by some courts and commentators in the decades after *Sagrada Orden*,[25] it remained the dominant framework for assessing the taxability of income earned by a tax-exempt organization during this period.[26] The destination of income test was only overruled by Congress in 1950, when it enacted the UBIT.[27]

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20. Cauble, *supra* note 5, at 714.

21. Revenue Act of 1916, Pub. L. No. 64-271, § 11(a)(6), 39 Stat. 756, 766 (exempting from taxation any income received by any "[c]orporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual").

22. Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 581 (1924).

23. *Id.* at 581–82 (holding that income derived by a religious order from rents, dividends, interest, and even from the sale of wine, chocolate, and other goods was exempt from taxation if used to support the organization's charitable purposes).

24. C.F. Mueller Co. v. Comm'r, 190 F.2d 120, 122–23 (3d Cir. 1951).

25. *See, e.g.*, C.F. Mueller Co. v. Comm'r, 14 T.C. 922 (1950), *rev'd*, 190 F.2d 120; Debs Mem'l Fund, Inc. v. Comm'r, 3 T.C. 949 (1944), *rev'd*, 148 F.2d 948 (2d Cir. 1945).

26. *See, e.g.*, *C.F. Mueller*, 190 F.2d at 122 (noting that the destination of income test has "predominated through the more than thirty years that the substance of section 101(6) has been in effect. And the repeated re-enactment of the exemption virtually unchanged, until lately, enhances the quality of the petitioner's position.").

27. *See* McDowell, *supra* note 7, at 707–08.

The UBIT should therefore be evaluated against the backdrop of congressional displeasure at the increasing involvement of tax-exempt organizations in commercial activities, exemplified by the *Mueller* case, and the destination of income doctrine. However, the UBIT framework was in fact only a partial revocation of the destination of income doctrine because the rules continue to allow tax-exempt organizations to earn "related" business income. Therefore, the UBIT rules accept that tax-exempt organizations should be free to engage in potentially unlimited amounts of commercial activity, at least in certain areas of commercial activity.[28] In fact, the UBIT rules go much further than implicitly sanctioning extensive commercial activities by tax-exempt organizations. By designing the UBIT to remove the subsidy altogether for certain types of business income while failing to place any limits on the amount of income that can be received tax-free from other forms of business and investment activity, the UBIT rules permit tax-exempt organizations to earn in effect unlimited amounts of income on a tax-free basis, even in situations where the receipt of additional income may be completely disproportionate to the funding needs of the organization.

In addition to the problems with the UBIT's treatment of active business income, the rules for passive investment income have also reached a stage of confusion and uncertainty. Despite a clear consensus at the time that passive income such as dividends, interest, and royalties would not be subject to the UBIT,[29] the rules on passive income have failed to keep pace with the evolution in forms of investment by tax-exempt organizations.[30] Today, if a tax-exempt entity borrows to finance the acquisition of an investment asset, a portion of the resulting investment income is subject to the UBIT under the debt-financed income rules added to the Code in 1969.[31] Debt-financed

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28. Professor John Colombo refers to this element of the design of the UBIT rules as Congress's "implicit blessing" to tax-exempt organizations to engage in substantial commercial activity despite the seeming bluntness of the UBIT provisions. John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667, 670 (2007).

29. Suzanne McDowell notes that it is inaccurate to refer to these exceptions collectively as the "passive income exception" because "all of these items are excludable without regard to the active or passive nature of the activity that generated the income." McDowell, *supra* note 7, at 708 n.18.

30. *See* Cauble, *supra* note 5, at 724.

31. I.R.C. § 514. Under § 514(a)(1), the amount of unrelated, debt-financed income taxable under UBIT is determined using the ratio of average acquisition indebtedness over the taxable year to the average adjusted basis over the taxable year. Under § 514(c)(1), acquisition indebtedness is the unpaid amount of indebtedness (1) used to acquire or improve property or (2) incurred before or after the acquisition or improvement if the debt would not have been incurred but for the acquisition or

property is defined in this context as any property held to produce income and with respect to which there is "acquisition indebtedness" during the taxable year, unless the use of the property is substantially related to the performance of the entity's exempt function.[32] Borrowing for the purpose of making investments is not considered substantially related to an organization's exempt purpose.[33]

In certain cases, an exception to the debt-financed income rules applies to income from real estate. In 1980, Congress first exempted certain real estate investments made by qualified pension trusts from the debt-financed property rules.[34] Today, qualified pension funds, educational institutions, and charitable endowments are able to avoid incurring UBIT on debt-financed income from leveraged real estate investments.[35] However, the exception is subject to a number of restrictions that are intended to minimize the possibility of reintroducing the earlier abuses of the sale-leaseback era.[36] Specifically, the exception is withdrawn if any of the following conditions are present: the purchase price is unfixed at the time of the sale;[37] the amount of indebtedness or the timing of repayment is made contingent on income generated by the property;[38] or the exempt organization receives financing from, or leases the property back to, the seller or any other disqualified individual.[39] In addition, although a qualified pension trust is permitted to invest in real property through a partnership,[40] the restrictions are equally onerous. Where a qualified pension trust invests in a partnership alongside taxable partners,[41] partnership allocations must meet either the "qualified

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improvement and, if incurred after, was reasonably foreseeable at the time of acquisition or improvement.

32. I.R.C. § 514(b)(1).

33. I.R.C. § 514(b).

34. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 110, 94 Stat. 3521, 3525–26 (codified as amended at I.R.C. § 514(c)(9)). The exception was broadened four years later to include leveraged investments in real property by educational institutions and their affiliated support organizations. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1034, 98 Stat. 494, 1040 (codified at I.R.C. § 514(c)(9)(C)(i)).

35. I.R.C. § 514(c)(9).

36. Lepree, *supra* note 5, at 830.

37. I.R.C. § 514(c)(9)(B)(i).

38. I.R.C. § 514(c)(9)(B)(ii).

39. I.R.C. § 514(c)(9)(B)(iii)–(v).

40. I.R.C. § 514(c)(9)(B)(vi).

41. A separate exemption, with no restrictions on partnership allocations, applies if all the partners in the partnership are tax-exempt organizations. *See* I.R.C. § 514(c)(9)(B)(vi)(I).

allocation rule" set forth in section 514(c)(9)(B)(vi)(II)[42] or the "disproportionate allocation rule" under section 514(c)(9)(E).[43]

II. Pension Funds and the UBIT Rules

A. *Pension Funds as Institutional Investors*

In keeping with the importance of their mission,[44] pension funds historically pursued conservative investment strategies that focused on equity and fixed income investments.[45] However, in recent decades both public and private pension funds have significantly expanded their investments in alternative asset classes, such as real estate funds, infrastructure funds, private equity funds, and hedge funds (private funds).[46] Though the overall share of pension fund ownership of private fund assets remains significantly smaller than their share of public equities, pension funds now hold more than a quarter of the $6.7 trillion managed by private funds as of 2014.[47] Public pension funds are the largest category of institutional investor in the private fund space with 12.8% of the total holdings, while corporate pension funds are close behind at 12.5%.[48] And, while private pension funds continue to hold

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42. I.R.C. § 514(c)(9)(B)(vi)(II).

43. I.R.C. § 514(c)(9)(E).

44. A pension fund can generally be defined as a pool of assets that are "bought with contributions to a pension plan for the exclusive purpose of financing pension plan benefits." OECD, PENSIONS AT A GLANCE 2013: OECD AND G20 INDICATORS 194 (2013), http://www.oecd.org/pensions/public-pensions/OECD PensionsAtAGlance2013.pdf.

45. Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 247 (2009).

46. James P. Hawley et al., *Introduction* to CORPORATE GOVERNANCE FAILURES: THE ROLE OF INSTITUTIONAL INVESTORS IN THE GLOBAL FINANCIAL CRISIS 1 (James P. Hawley et al. eds., 2011) ("Institutional investors . . . have long since become the majority holders of not only public equity but other asset classes as well (e.g., bonds, hedge fund and private equity investments, real estate)."); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 17–18 (2008) ("[E]ven the most stolid institutional investors include alternative assets like venture capital funds, private equity funds, and hedge funds in their portfolios. Many of the most powerful investors, such as major public pension funds and university endowments, invest large shares of their portfolios in alternative assets." (footnote omitted)).

47. DIV. OF INV. MGMT., SEC. & EXCH. COMM'N, PRIVATE FUNDS STATISTICS: FOURTH CALENDAR QUARTER 2014, at 12 tbl.11 (2015), https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2014-q4.pdf.

48. *Id.* And, although private pension funds are still the largest category of exempt institutional investor, they will likely soon be surpassed by public pension

portfolios containing billions of dollars in assets, their holdings are rapidly being outpaced by the growth in the size of public pension funds in recent decades. Public pension funds now collectively have assets totalling nearly $660 billion under active investment management in hedge funds and private equity alone.[49] Furthermore, the largest individual governmental pension funds now vastly exceed their largest private counterparts.[50] For example, the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the United States, had more than $293 billion in assets as of 2015.[51]

However, pension fund investments in alternative funds remain controversial. Criticism of pension fund managers has tended to focus on their exposure to greater risk from investing in alternative funds. For example, some members of Congress have expressed concern over the size and riskiness of pension fund investments and questioned their appropriateness.[52] And while public criticism of alternative investments by other types of institutional investors, especially university endowments, has focused on the tendency of these institutions to hoard cash rather than spend the returns on their exempt

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funds, which will become the most significant bloc of tax-exempt institutional investors. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 996–98 (2010) (citing data from BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1945–1954 (2009), https://www.federalreserve.gov/Releases////z1/20100311/annuals/a1945-1954.pdf). "Pre-1990, the most important type of institutional owner was the private pension fund. Ownership by private pension funds had increased from one percent in 1950 to 17% in 1990." *Id.* at 997. "Since 1990, the picture has changed drastically. Holdings by private pension funds have declined from 17% in 1990 to 11% in 2008 . . . ." *Id.* at 998. Public pension funds, by contrast, experienced modest growth during this period, rising from eight percent to nine percent by 2008. *Id.* at 996 tbl.1. Mutual funds, which are not exempt from taxation under the UBIT rules, experienced the most significant growth during this period, more than tripling their share of total holdings, from 7% to 22%. *Id.* at 998.

49. Siona Listokin et al., *U.S. Public Pension Funds and Alternative Investments* 1 (Inst. for New Econ. Thinking, Preliminary Paper, 2014), https://www.ineteconomics.org/uploads/papers/PublicPensionFundsandAlternativeInvestments.pdf.

50. Lepree, *supra* note 5, at 811.

51. Timothy Pollard, *CalPERS' Asset Allocation as of Jan. 31*, PENSIONS & INV. (Mar. 10, 2015), http://www.pionline.com/article/20150310/INTERACTIVE/150319987/calpers-asset-allocation-as-of-jan-31.

52. WILLIAM KLUNK, CONG. RESEARCH SERV., RS22679, PENSION FUND INVESTING IN HEDGE FUNDS 4 (2007).

purposes,[53] dissatisfaction over pension fund investments in alternative assets has tended to focus on high fees charged to the funds and questionable performance by alternative asset managers.[54] However, despite some movement of pension funds away from certain categories of alternative investments,[55] pension funds can be expected to remain heavily invested across the sphere of alternative investments.[56]

B. The Impact of the UBIT Rules on Pension Fund Investment Decisions

There are a number of ways in which pension funds can inadvertently generate taxable income from their ordinary investment activities. At the most basic level, because pension funds frequently invest in private funds predominantly organized as limited partnerships,[57] the pension fund is exposed to tax liability whenever the partnership receives income that is treated as active business income.[58] Similarly, if a pension fund invests in an investment partnership that borrows money to finance the acquisition of an asset that generates only passive income for UBIT purposes (for example a hedge fund buying a stake in a publicly traded corporation), the debt-financed

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53. Victor Fleischer, *Stop Universities from Hoarding Money*, N.Y. TIMES, (Aug. 19, 2015), https://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html?_r=0.

54. Chris Flood, *Hedge Funds Remain a Popular Choice for Institutional Investors*, FIN. TIMES (June 7, 2015), http://www.ft.com/intl/cms/s/0/3d990070-0946-11e5-b643-00144feabdc0.html#axzz42rNXwKVY.

55. Dan Fitzpatrick, *CalPERS Pulls Back from Hedge Funds*, WALL ST. J. (Jul. 23, 2014), https://www.wsj.com/articles/calpers-pulls-back-from-hedge-funds-1406156915.

56. Flood, *supra* note 54.

57. The reason for this universal mode of organization is that, under the partnership tax rules, pass-through entities such as limited partnerships are not subject to entity-level taxation. I.R.C. § 701.

58. When a partnership earns income, the income is allocated to the partners in accordance with the partnership agreement, and the partners pay tax on their share of the partnership income on a current basis. I.R.C. §§ 702, 704. As compared to use of the corporate form, this pass-through system benefits not only the taxable members but also the tax-exempt members of the partnership because even a tax-exempt shareholder would bear the burden of entity-level taxation in the form of reduced after-tax distributions. Under § 513(b)(2), whenever a partnership earns income that would be treated as income from the conduct of an unrelated trade or business in the hands of a partner, the share of such income is included in the gross income of the partner. I.R.C. § 512(c). This rule is consistent with a general principle of partnership taxation: the activities of a partnership are attributed to its partners. *See, e.g.*, Rev. Rul. 98–15, 1998–1 C.B. 718.

income rules still risk transforming such income into UBIT income.[59] Therefore, pension funds need to be very careful in negotiating assurances that the investment partnership will not undertake investments that generate UBIT income and will structure their investments so as to minimize the possibility of UBIT liability for the pension fund investors.

The necessity of avoiding the receipt of active business income and debt-financed income imposes a substantial limitation on private pension funds looking to invest in alternative assets. For example, a private equity fund that invests in a portfolio company organized as a partnership or an LLC will pass on unrelated business income to a pension fund investor.[60] It should be noted that although the private equity fund is not directly engaged in an active business, a pension fund investor will not be insulated from the constructive receipt of active business income earned farther down the chain of ownership. Similarly, a pension fund that invests in a real estate fund that earns income from the sale of "dealer property"[61] will receive unrelated business income on its share of the gain from the sale of the property.[62] Finally, investments in infrastructure—such as toll roads, ports, and energy pipelines—can generate taxable business income collaterally from operating revenues, even if the eventual sale of the underlying infrastructure asset is considered a tax-free passive investment under the UBIT.[63]

In addition, pension funds can also face UBIT risk when the investment partnership uses borrowing as part of its investment strategy. When a tax-exempt entity, such as a pension fund, invests in a partnership that uses borrowed funds to finance its investments, a portion of the tax-exempt entity's income from the fund will be taxable as debt-financed income.[64] For example,

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59. Reg. § 1.514(c)–1(a)(2), Ex. 4.

60. Although private equity funds are not generally considered to be engaged in a trade or business, some courts and commentators have recently begun to challenge this result.

61. Dealer property is defined as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. § 1221(a)(1). *See also* Stephen L. Owen, *Using Business Entities to Achieve Real Estate Capital Gains*, 52 ANN. TAX CONF. 33, 33 & 36 n.13 (2006).

62. I.R.C. § 512(b)(5)(B) (providing that gain from the sale of property "held primarily for sale to customers in the ordinary course of the trade or business" is treated as unrelated business income in the hands of an exempt organization). *See also* Cauble, *supra* note 5, at 706.

63. Oscar Teunissen & Joni Geuther, *Infrastructure Investing: Global Trends and Tax Considerations*, 20 J. INT'L TAX'N 38, 47 (2009).

64. Reg. § 1.514(c)–1(a)(2), Ex. 4. *See also* T.A.M. 1996-51-001 (June 27, 1996) (explaining that debt-financed taxable income passes through the partnership to the tax-exempt partners).

a tax-exempt investor that invests in a hedge fund would be subject to the UBIT on the portion of the income it earns from the hedge fund's assets that are treated as having been purchased using borrowing. This creates a conflict between tax-exempt investors and the fund's managers. Investment funds have historically relied on borrowing as part of their investment strategies in order to, *inter alia*, increase return on investment.[65] Indeed, the burden of the debt-financed income rules falls most heavily on tax-exempt investors in hedge funds since hedge funds primarily invest in assets that generate passive investment income otherwise exempt from the UBIT, yet also frequently fund such investments using borrowing.[66] Therefore, the hedge fund's income is in part treated as debt-financed income and a "tax-exempt investor's share of that income [is treated as] debt-financed and subject to the [UBIT]."[67]

Because of the importance of minimizing UBIT liability, pension trustees and fund managers invest significant resources in structuring transactions so as to minimize or avoid the application of the UBIT rules. Their methods vary both in their complexity and effectiveness. Overall, however, these tax structuring devices generate a great deal of inefficiency and complexity because, even as the exempt investor seeks to avoid investing in a pass-through entity, the private fund must remain organized as a pass-through entity in order to avoid entity-level tax for the managers and the fund's other taxable investors. One strategy to avoid UBIT is for exempt investors to simply avoid investing directly in pass-through entities. Instead, the fund will set up a domestic corporation that will receive capital contributions from the exempt investors and then invest alongside the regular fund on behalf of the exempt investors. This tactic is often associated with venture capital funds,[68] but it is commonly used in private equity, real estate, and hedge funds as well.[69]

Pension funds can also bypass potential UBIT liability on certain types of alternative investments by investing through an overseas blocker corporation. Hedge funds in particular are able to use this form of tax structuring to negate virtually all potential UBIT consequences for pension fund investors. This tactic involves funneling a tax-exempt entity's investments into the fund through an offshore corporation, usually incorporated in a tax haven jurisdiction. This way the offshore blocker avoids

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65. Brunson, *supra* note 5, at 236.

66. Cauble, *supra* note 5, at 705; Henry Ordower, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58 AM. J. COMP. L. 295, 304 (2010).

67. Ordower*, supra* note 66.

68. Calvin H. Johnson, *Why Do Venture Capital Funds Burn Research and Development Deductions?*, 29 VA. TAX REV. 29, 51–52 (2009).

69. KPMG, INVESTMENT STRUCTURES FOR REAL ESTATE INVESTMENT FUNDS 7 (2012).

owing taxes in the United States and in the country of incorporation.[70] The formation of offshore blocker corporations is a relatively simple way to avoid the burden of any tax based on the debt-financed income rules.[71] In addition, although commentators generally deride the use of blocker corporations as a triumph of form over substance,[72] the structure has been blessed by the Internal Revenue Service (Service).[73]

Occasionally, tax structuring may succeed in avoiding the application of the UBIT but will trigger other negative tax consequences to the exempt investor, other investors in the partnership, or other stakeholders. For example, due to the need to avoid debt financing, private equity funds sometimes avoid directly taking on debt that is used to fuel acquisitions by the fund. Instead, where debt is used in private equity transactions, it is often taken on by the portfolio companies, rather than by the fund.[74] As a consequence, the portfolio companies are responsible for the debt obligation and, if a portfolio company defaults on its debt, lenders can look only to the assets of the portfolio company for recourse.[75] Therefore, while it is possible for pension funds to navigate around the restrictions of the unrelated business income and debt-

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70. Brunson, *supra* note 5, at 237.

71. Lepree, *supra* note 5, at 809 (noting that the attribution rule contained in Code section 514(a) is "peculiar to pass-through taxation" and so is "easily avoided" using a foreign C corporation).

72. *Id.* at 810 ("This inconsistent result is technically correct under current law. Yet, it elevates form over substance in a way that is undesirable from a policy standpoint, particularly on horizontal equity grounds."). However, under the doctrine of *Moline Properties*, the separate corporate existence must be respected under tax law. Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943).

73. P.L.R. 2002-51-018 (Sept. 23, 2002); P.L.R. 2002-51-017 (Sept. 23, 2002); P.L.R. 2002-51-016 (Sept. 23, 2002).

74. Letter from Douglas Lowenstein, President, Private Equity Growth Capital Council, to Jennifer J. Johnson, Sec'y, Bd. of Governors of the Fed. Reserve Sys. 7 (Mar.30, 2011), https://www.federalreserve.gov/SECRS/2011/April/20110404/R-1405/R-1405_033011_69272_589530718989_1.pdf ("With the exception of certain real estate funds, private equity funds almost never borrow, and frequently they are prohibited by their partnership agreements or other governing documents from borrowing. To our knowledge none are reliant on short-term credit markets or regularly roll-over debt as part of their operations. Private equity funds rarely borrow because of the particular tax concerns of tax-exempt LPs concerning unrelated business taxable income."). This is true even in leveraged buyouts, where debt investors contribute approximately 70% of the capital and private equity funds acquire approximately 30% of the equity in a shell company that invests in the target company. *See* Valentina Elzon, *What's Private Equity Got to Do With It?*, 30 REV. BANKING & FIN. L. 691, 716 (2011).

75. Letter from Douglas Lowenstein to Jennifer J. Johnson, *supra* note 74, at 7.

financed income rules in some instances, there are significant compliance costs and costs from foregone investment opportunities.

III. ONGOING DEBATE OVER THE JUSTIFICATION FOR THE UBIT

Although commentators are generally critical of the structure of the UBIT regime, there are several widely accepted rationales for regulating the scope of commercial activities by tax-exempt organizations. In addition to the rationales discussed in the legislative history, contemporary scholars and policymakers have developed other justifications for the UBIT. This section reviews the principal historical justifications for the UBIT rules and assesses how well they appear to further the rationales endorsed by contemporary scholars and policymakers. The most important rationales are eliminating unfair competition; protecting the corporate tax base; preventing abusive tax shelter activity; enforcing accountability among nonprofit managers; and preventing the over-subsidization of exempt organizations. Many of these rationales, however, apply only weakly to the activities of private, employer-sponsored pension funds.

A. Eliminating Unfair Competition by Tax-Exempt Entities

Any discussion of the historical rationales for the UBIT must necessarily begin with the concept of "unfair competition." The legislative history makes clear that the UBIT was enacted primarily as a response to the perceived danger of "unfair competition" arising from competition between businesses controlled by tax-exempt organizations (non-taxable businesses) and taxable businesses.[76] However, what precisely Congress meant by the term "unfair competition" has never been conclusively established. The final Senate report released before passage of the UBIT cited concerns about non-taxable businesses being able to expand more rapidly than their taxable

76. S. REP. NO. 81-2375, at 28 (1950) ("The problem at which the tax on unrelated business income is directed is primarily that of unfair competition."). For more discussion, see, for example, Knoll, *supra* note 2, at 863 ("The rationale for the UBIT was and is that without such a provision charities would enjoy an unfair tax-derived competitive advantage over their taxable competitors."); Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax,* 54 EMORY L.J. 1475, 1488–89 (2005) ("The main stated purpose of the UBIT was undoubtedly to prevent unfair competition between taxable and tax-exempt persons."). This conclusion is further supported by the manner in which the exclusion of passive investment income from the scope of the UBIT was justified in Congress. The Senate report explains that passive investment income was excluded because it was "not likely to result in serious competition for taxable businesses having similar income." S. REP. NO. 81-2375, at 30–31.

counterparts by reinvesting untaxed profits.[77] In addition, scholars such as Michael Knoll and Ethan Stone have suggested that Congress may also have meant the term to include the ability of such businesses to indirectly exploit their exemption by undercutting taxable competitors with lower prices and outbidding them for labor and capital.[78]

Despite the fact that the unfair competition rationale has continued to play an important role in explaining both the enactment of the UBIT and its persistence,[79] the argument that tax-exempt organizations are capable of abusing their exemption to obtain an unfair competitive advantage has largely been rejected by scholars. Indeed, commentators routinely go so far as to assert that the unfair competition rationale has been wholly discredited.[80] Knoll argues that, from an economic standpoint, tax-exempt organizations would be unable to exploit their tax exemption to grow more quickly than their taxable counterparts because for-profit businesses would offset this advantage by borrowing more or issuing additional equity any time worthwhile investment opportunities arose.[81]

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77. S. REP. NO. 81-2375, at 28 (stating that the tax-exempt status of tax-exempt entities "enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes").

78. Knoll, *supra* note 2, at 866; Stone, *supra* note 76, at 1489.

79. *See, e.g.*, Knoll, *supra* note 2, at 863; Stone, *supra* note 76, at 1479 (explaining that the UBIT was "justified then and has been justified since as a measure to protect taxable businesses from unfair tax-exempt competition and to protect against erosion of the tax base by rapacious charities buying or crushing taxable businesses").

80. *See, e.g.*, Jennifer Anne Spiegel, Note, *Sierra Club: Rationalizing the Royalty Exception to the Unrelated Business Income Tax*, 63 FORDHAM L. REV. 1697, 1724 ("The academic criticisms of the rationale for UBIT suggest that concerns over unfair competition probably are unfounded. Thus, if no alternative rationale for UBIT existed, it would be appropriate to repeal UBIT.").

81. Knoll, *supra* note 2, at 866. However, some scholars have continued to offer explanations for why the unfair competition rationale may be at least partially sound. Professor Henry Hansmann has proposed a modest defense of the unfair competition account on the theory that, in the absence of the UBIT, tax-exempt businesses may be able to use their higher rates of return from unrelated commercial businesses gradually "to displace for-profit firms, not by driving them out of business through price competition but rather by purchasing them." Hansmann, *supra* note 12, at 611–12. Professor Ethan Stone has also argued that, although for-profit businesses should theoretically be insulated from the effects of unfair competition by borrowing, businesses operated by tax-exempt organizations may still benefit from an unfair competitive advantage in the real world due to "imperfectly competitive product and capital markets . . . and different taxation of the return on different forms of capital." Stone, *supra* note 76, at 1489.

Another source of frustration with the unfair competition account is that there is no obvious explanation for why unfair competition should be deemed to exist solely in the realm of unrelated commercial activities. Professor Susan Rose-Ackerman has attacked the unfair competition rationale on the grounds that the UBIT actually promotes unfair competition in the sphere of related commercial activities by effectively compelling tax-exempt organizations to concentrate their commercial activities in specific areas related to their exempt purposes, which in turn produces greater harm for taxable businesses already operating in those sectors.[82] Professors Boris Bittker and George Rahdert have also pointed out that the unfair competition rationale ignores the potential for unfair competition in the realm of passive investment activity.[83] They suggest that proponents of the unfair competition rationale should be equally concerned by the ability of managers of tax-exempt organizations to undercut competitors with lower interest rates on loans or below-market rent on real estate.[84]

Finally, Stone has argued that Congress was simply being disingenuous in constructing a narrative centered on unfair competition to justify the UBIT. He argues that the UBIT can be explained as a form of "political symbolism" intended to put tax-exempt organizations on notice that the exemption system requires them not only to engage in "good works" but also to actively refrain from commercial activities that undermine the spirit of the exemption.[85] It is ironic that, although no empirical evidence of unfair competition has ever been presented,[86] Stone's model of political symbolism has been partially vindicated by research showing that charitable donations are affected by the level of commercial activity undertaken by nonprofit organizations.[87]

In sum, although these various criticisms are addressed at different aspects of the unfair competition rationale, they collectively undermine confidence in the accuracy and reliability of concerns about unfair competition. These scholarly criticisms of the unfair competition rationale suggest that unfair competition probably would not exist in the absence of the UBIT to any degree sufficient to justify its onerous restrictions on nonprofit commercial activity.

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82. Rose-Ackerman, *supra* note 4, at 1022.

83. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 319 (1976).

84. *Id*.

85. Stone, *supra* note 76, at 1543.

86. Bittker & Rahdert, *supra* note 83, at 319.

87. Colombo, *supra* note 12, at 556 n.270.

B. Protecting the Corporate Tax Base

Closely related to the unfair competition rationale is the explanation that taxing profits from unrelated commercial activities is essential to preventing the erosion of the corporate tax base. It has been argued that, in the absence of the UBIT, tax-exempt organizations would redirect funds currently invested in corporate stock and other passive investments to acquire and operate commercial businesses.[88] Ultimately, such a result would pull more businesses out of the reach of the corporate tax regime and thus significantly diminish the government's tax revenues. Indeed, the legislative history reveals that this too was among Congress's concerns in enacting the UBIT. The Senate report refers to the well-known *Mueller* case and notes with alarm that tax-exempt entities would build on the subsidy provided by the tax-exemption system to acquire other taxable businesses until entire industries were owned by vast nonprofit monopolies.[89]

Contrary to the widespread rejection of the unfair competition rationale, the protection of the corporate tax base continues to be viewed as an important and legitimate policy concern by academics and commentators.[90] Given these considerations, it is strange that the UBIT has always incorporated a substantial exception for commercial activity undertaken by nonprofit organizations in so-called "related" spheres. The existence of the exception for related business activities demonstrates that the protection of the corporate tax base is more akin to a guiding principle rather than an all-consuming objective. Congress must be taken to have determined that concerns about the existence of untaxed corporate profits in the area of "related businesses" were outweighed by the needs of nonprofit organizations to raise revenue apart from charitable contributions. This undermines the argument that the UBIT is necessary as a bulwark against the erosion of the corporate tax base.

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88. Cauble, *supra* note 5, at 712 ("[A]s a result of the existence of the corporate income tax, the UBIT is necessary in order to prevent a tax-exempt entity from shifting resources away from widely-held corporations and towards business ventures controlled by the tax-exempt entity . . . .").

89. *Revenue Revision of 1950: Hearings Before the H. Comm. on Ways & Means*, 81st Cong., 2d Sess. 579–80 (1950) (statement of John D. Dingell, Member, H. Comm. on Ways & Means: "[T]he advantage of a tax-exempt corporation . . . is so great that, if something is not done to level it off, the macaroni monopoly will be in the hands of the universities or their subsidiary companies . . . . [E]ventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry.").

90. *See, e.g.*, Colombo, *supra* note 12, at 532, 557.

C. Preventing Exempt Organizations from Engaging in Tax Sheltering

The UBIT rules may also indirectly help to protect the corporate tax base by limiting the ability of tax-exempt entities to engage in tax shelter activities with taxable counterparties.[91] The UBIT helps to reduce the total amount of tax shelter activity in the system by identifying certain abusive shelter transactions involving tax-exempt organizations and imposing tax upon the otherwise exempt organization acting as the accommodation party.[92] Setting aside the objection that it is inefficient to target the tax-exempt accommodation parties to abusive transactions instead of the taxable entity,[93] it has been argued that preventing exempt entities from entering into abusive transactions using their exemption has long been viewed as an objective that lies at the heart of the UBIT. Indeed, Stone directly connects growing support in Congress for the UBIT throughout the 1940s with the growth of the income tax in the postwar era. He argues that the UBIT was seen as a way to attack the rise in the use of tax-exempt entities as accommodation partners in tax shelter transactions.[94]

The original UBIT provisions implemented this anti-tax shelter agenda by excluding certain rental income derived from lease agreements considered to be abusive from the definition of passive investment income found in section 512(b).[95] These so-called "supplement U" leases were defined as leases of real property with a term of more than five years where the purchase of the property by the tax-exempt entity was funded through borrowing.[96] This measure was intended to undermine a wave of sale-leaseback transactions that arose in the 1940s and permitted tax-exempt organizations to earn fees by purchasing property from taxable businesses with

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91. Indeed, whenever tax-exempt entities enter into abusive transactions to shelter otherwise taxable income earned by unrelated corporations there is a corresponding reduction in the corporate tax base. *See Corporate Tax Shelters: Hearing Before the H. Comm. on Ways & Means*, 106th Cong. 29 (1999) (statement of Jonathan Talisman, Acting Assistant Sec'y for Tax Policy, U.S. Dep't of the Treasury: "[C]orporate tax shelters are designed to, and do, substantially reduce the corporate tax base.").

92. *Brunson*, *supra* note 5.

93. Stone, *supra* note 76, at 1479 (critiquing the focus of the UBIT on punishing tax-exempt accommodation parties instead of targeting the efforts of taxable parties to avoid taxes in the first place).

94. *Id.* at 1493–94.

95. Revenue Act of 1950, Pub. L. No. 81-814, ch. 994, §§ 422(a)(4), 423, 64 Stat. 906, 949–52.

96. *Id.* at § 301(a), 64 Stat. at 950–52 (amending I.R.C. § 423(a)).

borrowed funds and then leasing it back to the original owners.[97] Similar concerns regarding the erosion of the corporate tax base through tax shelter activity were again used by Congress to justify the adoption of the debt-financed income rules in 1969.

Although pension funds did not historically play a prominent role as accommodation partners in tax shelter transactions,[98] there is little doubt that they have that capacity today due to their sizable real estate holdings. Indeed, Congress already enacted section 514(c)(7) in 1954 as a means of preventing pension funds from entering into abusive real estate transactions with the employer funding the plan.[99] Section 514(c)(7) provided that income earned by a pension trust from the acquisition of property and its subsequent rental would be subject to taxation under the UBIT rules where the pension trust leased the property to the corporation that created and funded the pension trust.[100] There is little doubt that pension funds would be willing to again enter into tax avoidance transactions with taxable entities in the event of a repeal of the UBIT.

D. Enforcing Accountability Among Nonprofit Managers

A related argument in support of the UBIT is that both the unrelated business income and the debt-financed income rules promote accountability within tax-exempt organizations by limiting their ability to independently fund their operations. It is argued that, in the absence of the UBIT rules, tax-exempt organizations would be able to grow using tax-exempt revenue from sources such as unrelated commercial activities and leveraged investments, which have no bearing on their degree of public support. Thus, the UBIT helps keep nonprofit managers reliant on donations, which in turn promotes accountability in their activities. This argument was embraced by the Treasury

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97. Stone, *supra* note 76, at 1514–16 (describing in detail the structure of a sale-leaseback transaction).

98. *Id.* at 1516 (noting that historically charities and insurance companies were the most common tax-exempt parties to real-estate driven tax-avoidance transactions).

99. I.R.C. § 514(c)(7) (1954).

100. *Id. See also* Kenneth L. Black, *A Review of Certain Substantive Changes to the Internal Revenue Code*, 7 U. FLA. L. REV. 235, 256 (1954); J. Miles Thomas, Jr., *Leasebacks in Commercial and Family Transactions*, 28 MONT. L. REV. 25, 37 (1967).

Department to support the enactment of the debt-financed income rules in 1969,[101] although it was never formally endorsed by Congress.[102]

The accountability rationale relies on the assumption that because the exemption subsidy is conferred on certain organizations so that they may further a public purpose, there is a duty on the government "to ensure that such organizations are in fact serving the public."[103] Forcing tax-exempt organizations to rely more on charitable contributions arguably furthers that objective.[104] However, this rationale obviously has less applicability to the activities of a pension fund. While pension funds benefit from tax exemption because they serve an important public purpose,[105] they receive no support in the form of charitable contributions. Instead, pension funds rely on employer and employee contributions, as well as returns from fund investments.[106] In addition, pension fund managers owe fiduciary duties to the participants in the

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101. *Unrelated Debt-Financed Income of Tax-Exempt Organizations: Hearing on H.R. 15942 and H.R. 15943 Before the H. Comm. on Ways & Means*, 89th Cong., 2d Sess. 21–22 (1966) (statement of Stanley S. Surrey, Assistant Sec'y of the Treasury: "By borrowing, the organization can extend the function of its exemption beyond the protection of income stemming from charitable contributions or membership fees . . . . [T]he organization which makes such use of its exemption can sever itself from reliance upon contributors or members and eliminate the healthful scrutiny of its purposes and activities which that reliance implies.").

102. McDowell, *supra* note 27, at 726–27.

103. *Id.* at 727.

104. The force of this argument is diminished, however, when one considers the available data on the sources of funding for publicly supported 501(c)(3) organizations, which depend most on contributions from the general public. According to data from the Service, public charities earned approximately $801.2 billion from program service revenue and only around $248.6 billion from public contributions, gifts, and grants in 2004. *See* Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Perspective*, 27 SOI BULL., no. 3, Winter 2008, at 128 tbl.2.

105. Gregory A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969, 989 (1995) (book review) ("Financing both the leisure time and the care needed by the infirm has been the object of both public and private retirement vehicles, pension funds among them. . . . [N]ot only is the money deposited in pension funds 'held in trust' for the beneficiaries, triggering traditional fiduciary obligations, but the public has a powerful interest in the security of such funds because they prevent the beneficiaries from having to depend on public resources.").

106. *See* Adam Riff, Note, *The Eminent Domain Path Out of a Public Pension Crisis*, 37 CARDOZO L. REV. 307, 311 (2015).

pension plan, rather than to the public at large or, in the case of a public pension fund, to the government-employer.[107]

E. Preventing the Over-Subsidization of Tax-Exempt Organizations

A final justification for the UBIT is that it is designed to impose reasonable limits on the scope of the tax exemption system itself. In the absence of the UBIT, the system would revert to one[108] where all income earned by a nonprofit organization would be essentially exempt from taxation.[109] Thus, the UBIT rules impose a substantial, although often arbitrary, limitation on the ability of tax-exempt organizations to earn revenue from certain sources.

The underlying question remains how best to determine the proper scope of the tax exemption subsidy in order to provide support to tax-exempt entities only when it is needed in order to allow them to fulfill their exempt purposes. As John Colombo notes, this question asks whether the subsidy is being used by the recipient organization "to increase desirable charitable outputs" rather than being used either to "increase[e] the supply of a [public] good already . . . supplied in sufficient quantity," or used for a nonexempt purpose altogether.[110] Unfortunately, it is very difficult in practice to design a tax exemption subsidy that provides a perfectly tailored subsidy. However, scholars have argued that the tax law is correct in withdrawing the exemption for unrelated business income, even in the absence of a formula for a perfectly tailored subsidy. Henry Hansmann has argued that since a nonprofit that invests in an unrelated business venture is allocating funds away from its exempt functions, it would undermine the spirit of the subsidy to exempt such commercial activity from tax.[111]

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107. McDowell, *supra* note 27, at 737 n.158 ("Pension plans owe a fiduciary duty to plan participants and accountability to those participants is regulated under the Employee Retirement Income Security Act. The notion of dependence on the public for support through donations and membership fees has no relevance to pension plans.").

108. *See supra* notes 21–27 and accompanying text.

109. Even in the absence of the UBIT framework, the exemption would not be universal as the Code sometimes imposes taxation for certain types of income and for certain types of tax-exempt organizations. For example, under Code section 4940, a two percent excise tax is imposed on the net investment income earned by domestic private foundations in order to support the costs of auditing and ensuring compliance with the specific rules that govern private foundations.

110. Colombo, *supra* note 12, at 542.

111. *Id.*

It is difficult, however, to apply this argument to a pension fund, which is granted exemption in order to allow the fund to accumulate income to support individual retirement benefits.

IV. PUBLIC PENSION FUNDS AND THE UBIT RULES

Unlike their private-sector counterparts, public pension funds are generally assumed to be outside the intended scope of the UBIT,[112] despite the absence of any authority expressly exempting them from the legislation.[113] This creates a clear horizontal equity problem given the disparate tax burdens imposed on public and private pension funds. Nonetheless, whether the UBIT rules should apply to public pension funds remains a controversial subject.[114] A recent congressional proposal would have partially integrated public pension funds into the UBIT framework.[115] However, this section concludes that subjecting public pension funds to the UBIT would needlessly burden public finances, whereas reform to the UBIT rules for private pension funds would be a more effective and equitable solution.

A. *Horizontal Equity Concerns and Pension Fund Taxation*

Tax legislation is traditionally evaluated on the basis of the criteria of equity, efficiency, and administrability.[116] Equity, which refers to the general

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112. Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421, 480–87 (1992).

113. *Id.* at 484–86; *see also* David W. Powell, *Church and Governmental Plans*, 372-4th TAX MGMT. PORT. (BNA) § III.D n.185 ("Pension practitioners have suggested that providing pensions is an essential governmental function and that the income of a pension trust accrues to the benefit of a state or local government because it reduces the amount of future contributions needed to fund the benefits under the plan. In light of this interpretation and a broad reading of IRS News Release IR-1869, many practitioners have taken the position that fund income, including unrelated business taxable income, which is part of a governmental pension plan, could be considered tax exempt [under section 115] regardless of whether the plan is tax qualified" under § 401(a).).

114. Aprill, *supra* note 112, at 480.

115. See *infra* note 132 and accompanying text.

116. PHILIP D. OLIVER, TAX POLICY 1–2 (3d ed. 2011); Manoj Viswanathan, Note, *Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future*, 82 N.Y.U. L. REV. 656, 668 (2007). These criteria are a distillation of the larger set of criteria formulated by Professor Joseph Sneed, who proposed that federal tax legislation should be evaluated under the criteria of (1) "adequacy," (2) "practicality," (3) "equity," (4) "stability," (5) "reduced economic inequality," (6) "free market compatibility," and (7) "political order." Joseph T. Sneed, *The Criteria*

principle that the tax burden imposed on taxpayers should be fair both in terms of their ability to pay the tax and their position as compared to similarly situated taxpayers,[117] is often viewed as the primary objective in the design of tax policy.[118] Efficiency refers to the principle that taxes should distort economic decision-making as little as possible.[119] Finally, administrability requires that the law be as simple and administrable as possible to aid the Service in monitoring and detecting abuses and to facilitate taxpayer compliance.[120] The question of how best to design the UBIT to equalize the treatment of public and private pension funds is primarily a matter of equity. However, this section contains some discussion of efficiency considerations as they pertain to the economic consequences of taxing public pension funds under the existing UBIT framework.

The equity criterion can be further subdivided into two categories: horizontal and vertical equity.[121] Horizontal equity refers to the notion that similarly situated entities should be assessed equal taxes.[122] Vertical equity refers to the notion that entities with more taxable income should incur a greater tax burden.[123] Vertical equity concerns are usually of greater salience in the design of tax provisions that affect individuals rather than organizations,[124] whereas horizontal equity considerations have historically received more scrutiny from corporate tax experts.[125] Horizontal equity is also extremely relevant in the context of provisions imposing tax on otherwise exempt organizations. The UBIT itself was a response to horizontal equity concerns stemming from the ability of tax-exempt organizations to compete

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of Federal Income Tax Policy, 17 STAN. L. REV. 567, 568 (1965); *see also* Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 62–63 n.262 (1988) (discussing the Sneed criteria).

117. Susan Pace Hamill, *An Argument for Tax Reform Based on Judeo-Christian Ethics*, 54 ALA. L. REV. 1, 7 (2002) (defining vertical and horizontal equity in the context of tax policy).

118. OLIVER, *supra* note 116, at 1.

119. *Id.*

120. *Id.* at 2.

121. Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 732 (2003).

122. *Id.*

123. *Id.*

124. *See* Michael A. Livingston, *Radical Scholars, Conservative Field: Putting "Critical Tax Scholarship" in Perspective*, 76 N.C. L. Rev. 1791, 1796–97 (1998).

125. *Id.*

with taxable entities without paying tax on their profits.[126] For example, horizontal equity is satisfied by requiring a university-run television station to pay tax on its advertising revenue at the same rate as a commercial television station.[127] However, the UBIT rules have also historically contained significant departures from the principle of horizontal equity. In addition to the exclusion for related business activities,[128] many different types of exempt organizations were historically excluded from the scope of the UBIT.[129]

The differing treatment of public and private pension funds under the UBIT is fundamentally an issue of horizontal equity. Under the current framework, private pension funds are taxed on all income generated by unrelated business activities, even if the income derives from passive investments in alternative assets, while public pension funds are exempt from taxation for identical investment activities. However, the taxation of public pensions under the UBIT also raises the thorny issue of taxing profit-making activities engaged in by states and their affiliated entities.[130] State and local governments engage in an enormous variety of commercial activities, which remain untaxed under present federal law and yet which compete with taxable businesses at the same time.[131] A recent congressional proposal, however, included a provision that would resolve these horizontal equity considerations by taxing public pension funds on UBIT income.

B. Taxing Public Pension Funds Under the UBIT Is Within Congress's Authority

In February 2014, Congressman David Camp submitted the proposed Tax Reform Act of 2014, which included an amendment to section 511(a) of

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126. Aprill, *supra* note 112, at 466–67; Amy L. Henrich, Note, *Preferential Treatment of Charities Under the Unemployment Insurance Laws*, 94 YALE L.J. 1472, 1489 (1985).

127. *See, e.g.*, Iowa State Univ. of Sci. & Tech. v. United States, 500 F.2d 508, 516 (Ct. Cl. 1974) (concluding that advertising revenues from the operation of a radio station were taxable as unrelated business income to a university).

128. I.R.C. § 513(a) (excluding business activities "substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . .").

129. For example, the UBIT was amended in 1969 to apply to commercial activities undertaken by churches and other religious organizations. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

130. Mark J. Cowan, *Leaving Money on the Table(s): An Examination of Federal Income Tax Policy Towards Indian Tribes*, 6 FLA. TAX REV. 345, 351 (2004) (arguing that horizontal equity problems "plague[]" the treatment of state commercial ventures, tribal commercial ventures, and nonprofit commercial ventures).

131. Aprill, *supra* note 112, at 421.

the Code providing that state and local pension funds that are qualified under section 401(a) would be subject to the UBIT.[132] Although public pension funds are not required to qualify under section 401(a) to benefit from the exemption from federal taxation,[133] many public pension funds choose to do so in order for plan participants to claim individual tax benefits on their pension income.[134] This proposal therefore represented a significant departure from the widely held belief that governments and their instrumentalities are exempt from federal taxation. To appreciate why Congress could indeed tax public pension funds on their UBIT income, it is necessary to examine the scope of

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132. Tax Reform Act of 2014, H.R. 1, 113th Cong. § 5001 (2014). This would not, however, have instantly rendered all public pension funds subject to the UBIT. Unlike a private pension fund, which must be organized as a qualified trust under Code section 401(a), a public pension fund is not faced with the same obligation in order to claim exemption from federal taxation. Rather, public pension funds have long been treated as exempt under a general principle of tax law that says state and local governments and their instrumentalities are exempt from federal taxation. Indeed, many public pension plans are organized directly as so-called "integral parts of government" rather than as separate trusts or are organized as trusts that are nonqualified under Code section 401(a). The Camp amendment proposed to tax only public pension funds that were qualified for exemption under Code section 501, which requires a pension trust to be qualified under Code section 401(a) first.

133. *See* Kathleen Paisley, *Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions*, 4 YALE L. & POL'Y REV. 188, 190–91 (1985). Therefore, the Camp proposal would create different tax consequences for otherwise identical public pension funds depending on whether the fund was already qualified under Code section 401(a).

134. Christopher R. Hoyt, *Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities*, 13 VA. TAX REV. 641, 655 (1994). Take, for example, the organization of the California Public Employees' Retirement System (CalPERS). The authority under California law for the existence of CalPERS and the rules specifying its structure and operations are found in section 17 of article XVI of the California Constitution. CAL. CONST. art. XVI, § 17; CAL. GOV'T CODE §§ 20000–22980 (Westlaw 2017); CAL. CODE REGS. tit. 2, §§ 550–589.10 (Westlaw 2017). Management and control of the system is vested in the CalPERS Board of Administration, which is composed of thirteen members, seven of which are politicians or governmental appointees and six of whom are elected by the members of the pension system. CAL. GOV'T CODE § 20090 (Westlaw 2017). The CalPERS fund is a trust administered under the Board of Administration's authority. *Id.* § 20170. Similarly, the Michigan Public School Employees Retirement System is organized as a trust under which the management and control of the system is vested in the Public School Employees' Retirement Board. MICH. COMP. LAWS § 38.1322 (Westlaw 2017). All members of the board are appointed by the Governor. *Id.* The fund's governing statute also explicitly states that the fund is intended to qualify as a qualified pension plan under § 401(a) of the Code. *Id.* § 38.1408.

Congress's authority to tax state and local governments and their instrumentalities.

The question of whether Congress can tax the assets of public pensions depends in part on the categorization for tax law purposes of the relationship between a particular pension fund and the governmental unit sponsoring it. There are several distinct categories of entities that are related to state and local governments and that can share the governmental unit's exemption.[135] The categorization of an entity depends largely on its relationship to the governmental unit.[136] First, if an entity is deemed to be an "integral part of a state or political subdivision," then it is exempt under the same broad implied immunity that applies to the states and their political subdivisions.[137] In addition, section 115—the only provision in the Code that directly addresses the exemption for state and local governments—exempts separately organized governmental entities so long as the entity exists to raise revenue for the government.[138] In addition, due to the absence of case law or regulations interpreting these principles, Service rulings play a central role in this area of the law.[139] Public pension funds do not clearly fit into a single category and could theoretically be classified as either an integral part of a state or local government or as a section 115 entity, depending on their degree of independence from the government.

First, as already noted, if an organization can qualify as an integral part of a state or political subdivision, it is exempt on the basis of the government's implied statutory immunity.[140] Service guidance requires that an integral part of a state or political subdivision be controlled by government

135. The immunity of state and local governments is the original source of the exemption for all entities affiliated with states and their political subdivisions. Although there is no provision of the Code that explicitly exempts states and their political subdivisions from federal income taxation, the Service has long treated states and their political subdivision as exempt from federal income taxation under an implied statutory immunity. Ellen Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803, 803–04 (1998). Political subdivisions are defined by the Service "as entities with the sovereign powers of taxation, eminent domain, and police power." *Id.* at 803.

136. *Id.* at 804.

137. *Id.* ("IRS rulings recognize the close relationship between integral parts and section 115 entities by testing particular entities first under one doctrine and then under the other.").

138. I.R.C. § 115.

139. Aprill, *supra* note 135, at 806 (noting that the role of Service rulings can be explained by the nearly complete absence of regulations and that the Service has issued interpretive regulations promulgated under § 103 (interest on state and local bonds) but not for integral parts, § 115 entities, or instrumentalities).

140. *Id.* at 804.

officers and operated without an independent organizational form.[141] Recent rulings make clear that "control" in this context means not only direct oversight over the entity's daily operations but also financial commitments by the state or political subdivision to fund its operations.[142] Conversely, if the entity is operated separately from the government, then exemption may be available under section 115 if it is derived from the exercise of an essential governmental function and accrues to the government.[143] According to Service guidance, three factors are relevant in determining whether the entity qualifies for exemption under section 115:[144] (1) whether the entity makes or saves money for political subdivisions;[145] (2) whether its assets revert to the state upon dissolution;[146] and (3) whether private parties benefit. The grant of section 115 status to any entity that makes or saves money for the government is often characterized as an exceedingly generous interpretation of the statutory language by the Service.[147]

The earliest Service authority addressing the taxation of public pension funds comes from General Counsel Memorandum 34,704, in which the Service ruled that a state retirement fund could only be exempt under section 115 and not as an integral part of the state government.[148] The Service reasoned that because the fund was expressly organized as a trust and was therefore "legally separate" from the state, it could not be considered as an integral part of the state.[149] Subsequently, in Private Letter Ruling 82-16-088, the Service granted an exemption to a state retirement fund set up for the

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141. *See, e.g.*, Rev. Rul. 74–15, 1974–1 C.B. 126; Rev. Rul. 60–384, 1960–2 C.B. 172; Rev. Rul. 55–319, 1955–1 C.B. 119.

142. *See, e.g.*, P.L.R. 97-33-003 (May 9, 1997); P.L.R. 97-06-006 (Nov. 8, 1996); P.L.R. 96-27-016 (Apr. 5, 1996); P.L.R. 96-22-019 (Feb. 28, 1996).

143. I.R.C. § 115(1).

144. Aprill, *supra* note 135, at 816.

145. For example, a pooled liability fund has been held to satisfy the essential government function test. *See* P.L.R. 87-53-008 (Oct. 1, 1987). The Service held that the pooled liability fund protects the "financial security" of the political subdivisions by providing coverage "at a lower cost than could be obtained commercially." *Id.*

146. *See, e.g.*, Rev. Rul. 90-74, 1990–2 C.B. 34 (explaining that the accrual test is satisfied if, upon dissolution, the assets go to political subdivisions). The Service does not interpret *accrual* as requiring that the political subdivisions have any current right to the income or assets.

147. Aprill, *supra* note 135, at 816.

148. G.C.M. 34,704 (Dec. 2, 1971). Some commentators feel that this result is inconsistent with past Service rulings in this area. *See* Boyd J. Black, *Tax Exemption Issues for Public Employee Retirement Systems*, 4 EXEMPT ORG. TAX REV. 801, 802 (1991).

149. G.C.M. 34,704 (Dec. 2, 1971).

state's public school employees as an integral part of the state government.[150] Curiously, despite the fact that the fund was structured as a separate trust, the Service concluded that the integral part doctrine applied and exempted the fund from taxation under the state's implied statutory immunity.[151] In ruling that status as an integral part of the state government attached to the fund, the Service specifically noted that the financial obligations of the administrative board managing the fund were designated as obligations of the state and that the enabling statute "also provided for appropriations for [the board's] operating expenses . . . from the state treasury."[152]

In the final piece of Service guidance addressing the tax exemption of state and local retirement funds, the Service once again reverted to section 115 as the basis for the exemption of a municipal pension fund created to benefit a municipality's police officers, firefighters, teachers, and judges.[153] The letter ruling, Private Letter Ruling 88-25-087, makes no reference to any of the previous rulings and, unlike Private Letter Ruling 82-16-088, the analysis pays scant attention to the organization of the fund or the relationship of the governing board to the municipal government.[154] Instead, the letter ruling concentrates on the question of whether the provision of retirement benefits satisfies the "essential government function" element found in section 115.[155] Thus, the existing Service authority is inconsistent overall in its reasoning but seems to generally support the classification of public pension funds as exempt under section 115.

In proposing to tax public pension funds under the UBIT, the Camp legislation referenced another category of governmental entity, public post-secondary institutions, which are theoretically exempt under section 115 but are specifically included within the UBIT framework. Under section 511(a)(2)(B), public post-secondary institutions are subject to tax on their UBIT income,[156] partially negating the exemption under section 115. This

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150. P.L.R. 82-16-088 (Jan. 22, 1982).

151. *Id.*

152. *Id.*

153. P.L.R. 88-25-087 (Mar. 28, 1988).

154. *Id.*

155. *Id.* (finding that the investment and management of retirement funds on behalf of government employees is a "recognized governmental function that directly benefits the City").

156. Code section 511(a)(2)(B) taxes "any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions." The legislative history reveals that this provision was intended to

provision was enacted as part of the original UBIT provisions, and Congress may have chosen to focus on public universities due to the public outcry over their commercial activities at that time[157] and anxiety over NYU's involvement in the "macaroni monopoly."[158] The broad scope of section 511(a)(2)(B) has been consistently upheld by both the Service and the courts.[159] In General Counsel Memorandum 37,567,[160] the Service concluded that section 511(a)(2)(B) constituted a valid congressional override not only of section 115 but also of the implied statutory immunity of state and local governments, at least insofar as it was applied to the unrelated business income of public colleges and universities.[161] Similarly, in *Iowa State University of Science & Technology v. United States*,[162] the Court of Claims held that the Service could assess tax on the unrelated business income generated by a university's wholly owned television station. The court expressly rejected the university's argument of immunity under the intergovernmental tax immunity.[163] Section 511(a)(2)(B) thus demonstrates that there is in practice

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equalize the taxation of state colleges and universities with that of private colleges and universities. S. REP. NO. 82-781, pt. 2, at 57–58 (1951).

157. *See generally* Stone, *supra* note 76, at 1498 n.71. While the article does not discuss the enactment of Code section 511(a)(2)(B), the author makes several references throughout the piece to Congress's particular focus on the unrelated business activities of universities while debating the enactment of the UBIT rules. By contrast, pension funds, and particularly public pension funds, are a more recent category of exempt entity and were less likely to invest in the operation or acquisition of taxable businesses due to the constraints imposed on pension fund trustees by their fiduciary duties. *See* Norman S. Milks, *Unrelated Taxable Income: Federal Tax Liability for Exempt Pension Funds*, 8 W. St. U. L. Rev. 37, 37–38 (1980) (noting that pension fund assets historically had little exposure to the UBIT "due to the nature of their investments, which were placed primarily in stocks, bonds and savings").

158. *See supra* note 89.

159. *See, e.g.*, G.C.M. 37,567 (Aug. 31, 1978) (addressing the taxability of income earned by a public university from the provision of hotel services to the general public. The Service determined that, in the absence of § 511(a)(2)(B), any income earned by the university would be exempt under the intergovernmental tax immunity. The Service then concluded that even if a university was operated as a separate entity and claimed exemption under § 115, the university would still be subject to tax on its unrelated business income under § 511(a)(2)(B).). *See also* Iowa State Univ. of Sci. & Tech. v. United States, 500 F.2d 508 (Ct. Cl. 1974).

160. G.C.M. 37,567 (Aug. 31, 1978).

161. *Id.* at 5 ("The Internal Revenue Code now expressly provides [under section 511(a)(2)(B)] that the income tax should be applied to colleges and universities that are political subdivisions, to the extent that such colleges or universities drive income from unrelated business activities.").

162. 500 F.2d 508 (Ct. Cl. 1974).

163. *Id.* at 522–23.

very little constraint on Congress's power to adjust either the limits of the intergovernmental tax immunity or section 115. This suggests that there is therefore no constitutional prohibition on the taxation of governmental pension funds under the UBIT.

C. Obstacles to Recent Proposals to Tax Public Pension Funds Under UBIT

While the introduction of the Camp proposal suggests that Congress may ultimately choose to revisit the issue of taxing public pension funds under the UBIT, there are a number of reasons why such proposals should be rejected, at least under current conditions. First, any proposal to extend the UBIT to public pension funds would raise additional complicated questions regarding the use of tax havens by state and local government entities to evade UBIT. In addition, any effort to tax public pension funds would be politically difficult given the ongoing crisis in the funding of public pension plans across the country. This section considers both arguments in turn and concludes that the taxation of public pension funds is an undesirable response given other options available to Congress.

While taxing public pension funds on UBIT income would address horizontal equity concerns, it would also introduce additional economic inefficiency into the UBIT system and lead to increased overseas tax avoidance measures by public pension funds. The efficiency criterion dictates that tax laws should not encourage taxpayers to undertake economically unproductive actions.[164] Taxing public pension funds on UBIT income would result in new, inefficient distortions as public pension fund administrators would rationally choose to engage in costly tax structuring manoeuvres to minimize their UBIT liability.[165] One particularly effective tax planning strategy is the use of foreign blocker corporations located in tax haven jurisdictions to structure investments that would otherwise give rise to UBIT. As discussed earlier in the Article, a foreign blocker is incorporated to serve as a conduit for an exempt organization to invest in a domestic investment partnership without generating UBIT income.[166] Because UBIT income does not pass through to an exempt organization that invests in a corporation, the offshore blocker will allow for avoiding tax under the UBIT.[167] And, although the use of foreign blockers is mostly associated with investments in hedge

164. OLIVER, *supra* note 116, at 1.

165. *See* Ted Dougherty & Jay Laurila, *UBIT Reform Could Help Close the Pension Gap*, 150 TAX NOTES 1175, 1175–76 (Mar. 7, 2016) (reviewing tax planning strategies currently pursued by corporate pension plans).

166. *See supra* notes 70–73 and accompanying text.

167. Brunson, *supra* note 5, at 237.

funds,[168] they are widely used for investments in other types of private funds as well to achieve similar results for exempt investors.[169] While the use of offshore blockers by exempt organizations has been blessed by the Service,[170] many commentators continue to argue that they lead organizations to locate assets overseas where they are harder to identify and track[171] and indirectly encourage the abusive use of offshore blockers by other taxpayers.[172] In light of these considerations, Congress should not tax public pension funds on UBIT income without first implementing reforms that reduce the incentives for public pension fund administrators to react in ways that reduce tax liability but are inefficient and wasteful.

In addition, any proposal to tax governmental pension funds would inevitably require careful scrutiny regarding its political feasibility. The ongoing crisis in the funding of public pension systems across the country has received widespread attention in the press and in academic studies.[173] Recent estimates of the extent of public pension underfunding have ranged from $900

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168. *See id.* at 235–37; Lepree, *supra* note 5, at 813–18; Andrew M. Dougherty, Comment, *Unfair and Unintended: The Tax-Exempt Organization Blocker Loophole*, 2013 B.Y.U. L. REV. 1341, 1342–47.

169. *See, e.g.*, Benedict Kwon, *Exempt Entity Investments in Private Equity Funds: Blockers vs. U.S. Partnerships*, 109 J. TAX'N 49, 51–54 (2008). Much of the attention in the literature on the use of offshore blockers by domestic hedge funds likely stems from the focus by most scholars on reform of the debt-financed income rules, which implicate hedge funds more than other forms of alternative funds, such as private equity or infrastructure funds.

170. Brunson, *supra* note 5, at 242 (arguing that the reduction of tax liability through the use of a blocker corporation "does not rise to the level of inappropriate tax evasion").

171. Dougherty, *supra* note 168, at 1351.

172. Brunson, *supra* note 5, at 246–48.

173. *See, e.g.*, Jack M. Beermann, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3 (2013); Paul M. Secunda, *Litigating for the Future of Public Pensions*, 2014 MICH. ST. L. REV. 1353 (2014); Gavin Reinke, Note, *When a Promise Isn't a Promise: Public Employers' Ability to Alter Pension Plans of Retired Employees*, 64 VAND. L. REV. 1673 (2011); Dean Baker, *The Origins and Severity of the Public Pension Crisis*, CTR. FOR ECON. & POL'Y RES. (Feb. 2011), http://cepr.net/documents/publications/pensions-2011-02.pdf; Joshua D. Rauh, *The Public Pension Crisis*, HOOVER INST. (Apr. 12, 2016), http://www.hoover.org/research/public-pension-crisis.

billion[174] to as much as $3.8 trillion.[175] Although the amount of projected revenue that would have been raised by the Camp proposal was relatively insignificant at only $100 million over the next decade,[176] UBIT liability would also be expected to impose substantial costs on governmental pension funds from compliance costs and foregone investments.[177] Taken together, this suggests that any proposal to tax public pension funds on UBIT income would almost certainly be seen as politically impossible. It seems, therefore, that equalizing the treatment of public and private pension funds under the UBIT by extending UBIT coverage to public pension funds is unlikely to prove a feasible solution to the horizontal equity concerns identified in this Article. The following section therefore recommends a new framework for addressing these horizontal equity concerns by proposing a reform to the tax treatment of pension fund investment income.

V. PROPOSAL

After reviewing the principal rationales for the UBIT rules and their applicability to the new avenues of pension fund investment, it is clear that reform is needed to ensure that the taxation of pension funds under the UBIT is both rational and equitable. Currently, the UBIT rules materially burden a critical function of private employer-sponsored pension funds, while public pension funds benefit from a complete exemption from tax liability. This section proposes that the UBIT rules should be reformed to exempt all business and investment income that is derived from an asset that is primarily investment in nature. A narrowly tailored modification to the provision defining unrelated business activity for qualified pension trusts would permit private pension funds to invest alongside their public-sector counterparts in alternative assets without incurring either increased UBIT liability or countervailing tax structuring expenses.

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174. *The State Pensions Funding Gap: Challenges Persist*, PEW CHARITABLE TRUSTS (July 2015), http://www.pewtrusts.org/~/media/assets/2015/07/pewstates_statepensiondebtbrief_final.pdf.

175. Alicia H. Munnell et al., *The Funding of State and Local Pensions: 2012-2016*, ISSUE BRIEF (Ctr. For Retirement Res., B.C., Mass.), July 2013, http://crr.bc.edu/wp-content/uploads/2013/07/slp_32-508.pdf.

176. ADVISORY COMM. ON TAX EXEMPT & GOV'T ENTITIES, INTERNAL REV. SERV., 2014 REPORT OF RECOMMENDATIONS 1, 198 (June 11, 2014).

177. *See generally* Dougherty & Laurila, *supra* note 165, at 1175 (reviewing compliance costs for private pensions).

A. Creating a New Category of Related Business Income for Pension Funds

This Article proposes that the rules barring qualified pension trusts from receiving business income should be modified to permit private pension funds to invest in a range of alternative assets that generate business income. Current law provides that whenever a pension fund earns income that is attributable to the conduct of a trade or business, the income is automatically treated as earned from an unrelated trade or business.[178] This rule effectively prohibits a pension fund from participating in a range of modern investments or forces the fund to engage in costly tax structuring to avoid incurring UBIT liability. To remedy this problem, Congress should amend the UBIT to permit pension funds to earn business income that is derived from an asset that is held by a pension fund primarily for investment purposes.

While private pension funds have long been unable to benefit from the exception for related business activities, Congress's purpose in imposing such a strict bar on the receipt of business income by private pension funds has never been comprehensively explained. On the one hand, this issue may have historically merited little scrutiny given that pension funds invested primarily in equity and fixed income investments, which were not categories of investment activity that historically raised significant UBIT concerns.[179] On the other hand, Congress may have been satisfied that the exception for related business activity was inherently inapplicable to pension funds.[180] While courts have succeeded in delineating a sphere of related commercial activity for all manner of nonprofit institutions—such as hospitals,[181] universities,[182] and

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178. I.R.C. § 513(b)(2).

179. Palmiter, *supra* note 45, at 247.

180. I.R.C. § 513(a) ("The term 'unrelated business' means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . .").

181. *See, e.g.*, Hi-Plains Hosp. v. United States, 670 F.2d. 528 (5th Cir. 1982) (holding that the sale of drugs by a rural hospital to private patients of hospital staff constituted a related business activity).

182. *See, e.g.*, Rensselaer Polytechnic Inst. v. Comm'r, 732 F.2d 1058 (2d Cir. 1998) (permitting a university to deduct expenses attributable to depreciation of a sports facility rented on a part-time basis for commercial use on the basis of hours devoted to an unrelated business); Nat'l Collegiate Athletic Ass'n v. Comm'r, 914 F.2d 1417 (10th Cir. 1990) (holding that the sale of advertising by the NCAA did not qualify as a regularly carried on business activity so as to come within the ambit of the UBIT rules), *action on dec.*, 1991–15 (July 15, 1991).

charities[183]—pension funds would seem to resist such an analysis. According to this view, because a pension fund is created solely to manage and invest the assets contributed by and for plan participants, it is difficult to intuitively identify an area of related commercial activity.

However, there is in fact no logical barrier to identifying a sphere of related business activity in the context of pension fund investment activity. The Treasury Regulations implicitly recognize as much by defining business activities as "related" to an organization's exempt purposes "only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income)."[184] Similarly, pension funds seek to invest in alternative assets such as private equity and hedge funds, which often involves the receipt of business income, in order to further their exempt purpose of increasing the retirement assets of plan participants. This suggests that the UBIT's blanket prohibition on the receipt of business income by pension funds should be refocused in favour of a narrowly tailored but flexible approach that permits pension funds to invest in alternative assets to further their exempt purpose.

Under the proposal advanced in this Article, the UBIT would be amended so that the receipt of income attributable to the conduct of a trade or business by a pension fund would not automatically be deemed to give rise to unrelated business income. Specifically, section 513(b)(2) would be modified to replace the Code's automatic designation of business income as income from an unrelated trade or business with a rule treating business income as related to a fund's exempt purpose so long as the income was derived from an asset that was acquired at least primarily as an investment. Thus, a pension fund would only incur UBIT liability if it earned business income from an asset that was not held primarily for investment purposes. This analysis would be implemented via a multifactor standard that would require the pension fund to individually classify the assets in its portfolio as either held for investment or active business purposes. Under this standard, a trade or business would be considered "related" if the fund's primary purpose for engaging in the activity constituting the trade or business or generating collateral business income was primarily for investment purposes.

This analysis would be guided by a set of qualitative factors that would examine the role of the asset in the fund's portfolio and the nature of the fund's

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183. *See, e.g.*, Ark. State Police Ass'n, Inc. v. Comm'r, 282 F.3d 556 (8th Cir. 2002) (holding that the publication of an industry magazine, "The Arkansas Trooper," constituted income from the conduct of an unrelated trade or business).

184. Reg. § 1.513–1(d)(1).

involvement in the activity giving rise to business income.[185] First, the test should consider the size of the fund's investment in the assets giving rise to the business income. If the business income is derived from assets that constitute a small portion of the fund's overall portfolio then that would bolster the argument that the fund is investing in the assets primarily with the objective of pursuing a diversified investment strategy. An unusually large investment in a particular asset category or a particular industry may indicate that the fund is trying to exploit its tax-free status in order to accumulate a disproportionately large interest in that sector of the economy. This factor could also serve as the basis for a safe harbor provision, permitting pension funds to safely invest in assets generating business income so long as the size of the investment fell below a minimum threshold when compared with the fund's total portfolio. Second, the test would depend on the length of time the fund has held the particular asset and the turnover in other assets of the same class held by the fund. Frequent turnover would indicate that the fund is holding the assets for investment purpose rather than to exploit the commercial profits. Nevertheless, the timeline for assessing this factor would need to be relatively long to account for the fact that pension funds are by nature long-term, stable investors. For example, an investment in private equity may entail a timeline of nearly a decade or more, and an investment in real estate or infrastructure may only come to fruition after decades have elapsed. Finally, the test would consider the degree of active management by the pension fund in its investment in the asset. Greater involvement in management suggests that the pension fund is acting as a business owner rather than as a passive investor.[186]

This reform would alleviate the need for pension funds to forgo investment opportunities or incur significant tax planning and compliance costs when pursuing investments in alternative assets. While pension funds can already employ tax planning techniques to mitigate UBIT consequences from certain types of alternative investments, these methods result in inefficient expenditures that would not arise in the absence of the restrictions

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185. The concept of a four-factor qualitative standard was proposed by James Blundell, Jr., in different circumstances to determine whether a taxpayer should qualify for trade or business status based on personal stock-trading activities. *See* James H. Blundell, Jr., Comment, *Trade or Business Status for the Full-Time, Active Investor: A Call for a Qualitative Standard*, 29 SANTA CLARA L. REV. 209 (1989).

186. It should be noted, however, that active management of business operations is not necessarily inconsistent with status as an investor. Private equity managers, for example, are heavily involved in the operation and governance of the fund's portfolio companies, yet have successfully presented themselves as passive investors. *See* Steven M. Rosenthal, *Private Equity Is a Business: Sun Capital and Beyond*, 140 TAX NOTES 1459, 1459–60 (Sept. 23, 2013).

imposed by the current UBIT rules.[187] By contrast, this proposal is not intended to extend a carte blanche to pension funds to acquire and operate existing businesses without incurring tax liability. For instance, the qualitative standard would treat a pension fund's acquisition of a stake in a commercial enterprise as subject to tax under the UBIT where the application of the qualitative factors revealed that the fund intended to rely on the profits of the business and actively manage the business itself rather than passively holding the assets of the business as an investment.

B. Addressing Potential Objections

As previous sections of this Article have established, there are several rationales for restricting the ability of nonprofits to engage in commercial activities that apply to pension fund investments. For example, in the absence of the UBIT, pension funds would be able to acquire existing businesses and thereby remove their profits from the scope of the corporate tax system.[188] However, these rationales are also so broadly formulated that virtually any reform proposal will ultimately come into conflict with these objectives to at least some degree.[189] Thus, these rationales should be made to yield in appropriate circumstances to countervailing concerns of equity and rational administration of the tax system. Just as with the horizontal equity concerns discussed earlier in the Article, the tax law must ultimately construct specific rules that appropriately balance these broad and conflicting objectives. The reform proposed by this Article would both mitigate the horizontal equity problem in the taxation of private and public pension funds and would allow private pension fund managers to make ordinary investment decisions in accordance with their fiduciary duty of prudent investment without needing to account for the risk of UBIT liability. While this reform would equally raise

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187. Dougherty & Laurila, *supra* note 165, at 1177.

188. Although the system of corporate taxation has been referred to as a "lobster pot" that deters companies from abandoning the corporate form, see Note, *Losing Control: Toward a New Understanding of the Taxation of Post-Incorporation Stock Sales*, 108 HARV. L. REV. 1661, 1667–68 (1995), this general principle may not apply in the case of a pension fund or other exempt organization, freed from the restrictions of the UBIT regime, and seeking to restructure an entity taxable as a corporation into a pass-through entity. The exempt owner would trigger a substantial immediate tax liability but thereafter would avoid any future taxes on the business profits of the enterprise.

189. *See* Cauble, *supra* note 5, at 725 n.99 (observing that any time the categories of investment income exempt from UBIT are expanded, the total size of the subsidy granted to exempt organizations will increase and therefore raise concerns about the scope of the subsidy).

concerns regarding reduction in the corporate tax base and the over-subsidization of pension funds, all of these risks can be managed effectively by limitations built into the proposal and external factors that affect how corporate pension funds allocate assets.

1. Permitting Collateral Business Income Does Not Threaten the Corporate Tax Base

While allowing pension funds to earn business income generated from alternative assets without UBIT consequences would result in some income that is currently taxed under the corporate tax regime escaping tax, there are several reasons to believe the impact on the corporate tax base would be relatively limited overall. In the first place, the proposal advocated by this Article would continue to bar pension funds from acquiring complete control over the assets of an otherwise taxable business. This feature of the proposal addresses Congress's specific concern, evident from the legislative history of the UBIT, that permitting exempt organizations to acquire and expand otherwise taxable businesses (so-called "feeder corporations") would eventually result in the monopolization of entire sectors of the economy by exempt organizations.[190] The reform proposed in this Article also goes further by restricting the exemption from UBIT liability to circumstances in which the business income is a collateral result of the fund's investment strategy.

Furthermore, the impact of this proposal on the total size of the corporate tax base would likely be limited by the fiduciary restrictions on pension fund managers when investing in alternative investments.[191] The fiduciary standards governing the investment of pension fund assets would act as a significant counterweight against any risk that the corporate tax base would be substantially eroded by the mass reallocation of pension fund investments from traditional investments toward alternative assets, including private equity and hedge funds. All trustees of private employer-sponsored pension funds are subject to the fiduciary duties imposed by the Employee

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190. *Revenue Revision of 1950: Hearings*, *supra* note 89, at 579–80; *see also supra* Part III.A–B.

191. Alternative investments are distinguished from traditional investments in the fiduciary investment sphere. Traditional investments include assets such as stock and bonds while alternative investments include private equity funds, hedge funds, real estate and infrastructure funds, commodities, and derivatives. *See* Suzanne L. Shier, *Does Diversification Require Sophisticated Assets?*, A.L.I.-A.B.A. EST. PLAN. COURSE MATERIALS J., Apr. 2010, at 47. For additional background on the historical evolution of trustee investment regulation, see Philip J. Ruce, *The Trustee and the Prudent Investor: The Emerging Acceptance of Alternative Investments as the New Fiduciary Standard*, 53 S. TEX. L. REV. 653 (2012).

Retirement Income Security Act of 1974 (ERISA), which imposes duties of prudence and loyalty on trustees, as well as a duty to diversify investments.[192] The "prudent investor" standard is central to understanding the fiduciary's duty of prudence under ERISA in selecting investments and allocating the total mix of plan assets between different categories of investments.[193] Since 1979, the regulations have made clear that a fiduciary satisfies the duty of prudent investment with respect to a particular investment if the fiduciary has thoroughly considered the role of the investment in the context of the plan's entire portfolio, the risk of loss and opportunity for return, and the plan's specific requirements for diversification, liquidity, cash flow, and overall return.[194]

While pension funds have invested in pass-through entities such as private equity funds for decades,[195] the proportion of assets allocated to alternative investments as a percentage of total pension fund assets remains relatively low.[196] It is impossible to estimate how pension fiduciaries would react to the limited repeal of UBIT on their investments in pass-through entities, but the effect would be dampened to some extent by diversification[197] and liquidity[198] considerations. Thus, were pension funds to be permitted to

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192. 29 U.S.C. § 1104(a)(1)(A)–(C) (2016); *see also* Emily Adams, *Protecting America's Financial Future: Why Courts Should Enforce ERISA's Duties of Prudence and Disclosure*, 26 A.B.A. J. LAB. & EMP. L. 345, 349–50 (2011).

193. 29 U.S.C. § 1104(a)(1)(B) (requiring a fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"); *see also* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 663 (2016).

194. 29 C.F.R. § 2550.404a–1(b) (2016).

195. Ruce, *supra* note 191, at 686.

196. *See* Andrew W. Needham, *Private Equity Funds,* 735-3d TAX MGMT. PORT. (BNA) § II.C.3 ("Although most tax-exempt investors commit only a small percentage of their available capital to investments in private equity and other alternative asset classes, these investments account for a large percentage of the total capital of most funds.").

197. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 872–73 (1992) ("[D]iversification across asset classes, and across firms within an asset class, is the means of choice by which institutions limit risk.")

198. A number of scholars have pointed out that the liquidity crises faced by many university endowments and other tax-exempt institutional investors during the 2008 financial crisis were caused in part by the volatility of alternative investment values and their illiquidity. *See* Cauble, *supra* note 5, at 731; Ruce, *supra* note 191, at 687.

earn "related" business income through investments in alternative assets, the total amount of pension fund assets allocated away from investment in corporate equity and placed into additional alternative investments likely would not increase substantially above a certain range dictated by fiduciary considerations.

2. Collateral Business Income and the Over-Subsidization of Corporate Pension Funds

Allowing corporate pension funds to earn business income related to investments in alternative assets is also unlikely to result in excessive subsidization of those funds. First of all, permitting corporate pension funds to earn business income from these investments does not systematically enlarge the scope of the subsidy granted to those pension funds. Rather, it allows private pension funds to reallocate existing assets into new areas of investment, with potentially higher returns. While there is no way to estimate the actual impact of this reform on the amount of tax-free investment returns earned by such pension funds collectively, it is unlikely to be outweighed by the greater efficiency gains from allowing pension funds to allocate their assets into investments that they judge will yield a greater return. As Hansmann has remarked, there is also no way to establish that Congress, in designing the contours of the exemption, achieved the correct amount of subsidy for exempt organizations.[199]

Secondly, justifying the current categorical restriction on the ability of pension funds to earn business income as a means of controlling the subsidy extended to pension funds reflects a deeply flawed approach to the design of the exemption subsidy for pension funds. As Cauble has pointed out, any attempt to restrict the amount of the subsidy by taxing only certain types of income is ultimately arbitrary and almost certainly ineffective.[200] Placing overall limits on the extent of the subsidy granted to an organization should rarely, if ever, depend on restricting the organization's access to certain types of income. Instead, limits on the subsidy should be crafted to respond to identifiable circumstances in which over-subsidization occurs. For example, policymakers and commentators are at present debating whether or not to tax large university endowments that are allegedly the result of hoarding assets and abusing the intent of the subsidy conferred upon them.[201] In this context,

199. Hansmann, *supra* note 12, at 621.

200. Cauble, *supra* note 5, at 725 n.99.

201. *See, e.g.*, Fleischer, *supra* note 53; Janet Lorin, *Cash-Strapped Connecticut Wants to Tax Yale Endowments*, BLOOMBERG (Mar. 23, 2016), http://www.bloomberg.com/news/articles/2016-03-23/yale-endowment-tax-proposal-eyed-by-cash-strapped-connecticut; Roger Schillerstrom, *Targeting Endowments*,

some commentators have suggested a tax on investment income would be a more effective means of minimizing over-subsidization concerns rather than an excise tax on the assets currently held by the endowments.[202] However, such reasoning should not be gratuitously applied to limit pension fund investments in alternative assets without substantial evidence of a specific, direct link between such investments and over-subsidization concerns.[203]

CONCLUSION

Although both private and public pension funds serve essential roles as tax-advantaged vehicles designed to meet the societal objective of helping workers attain adequate retirement savings, they are treated very differently under federal tax law. Private employer-sponsored pension funds are only exempt from taxation on investment returns if they meet the conditions imposed by section 401(a) and avoid the onerous and often arbitrary

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PENSIONS & INV. (Feb. 22, 2016), http://www.pionline.com/article/20160222/PRINT/302229997/targeting-endowments.

202. David S. Miller, *Reforming the Tax Treatment of Exempt Organizations and Their Patrons*, 67 TAX LAW. 451, 501 (2014) (proposing that a tax on exempt investment income be applied to university endowments that do not pay out a sufficient percentage of assets on their exempt purposes to stimulate spending).

203. That is not to say that problems of over-subsidization cannot arise in the context of pension funds. Defined-benefit plans provided by private employers can be abused through overfunding where the employer obtains the reversion of the tax-advantaged funds in the terminated fund (*see* Michael J. Collins, *Reviving Defined Benefit Plans: Analysis and Suggestions for Reform*, 20 VA. TAX REV. 599, 637–38 (2001)), although the steady decline in the number of defined benefit plans offered in the private sector may mitigate such concerns already. If such circumstances were to arise again, Congress might choose to respond by imposing a tax on the passive investment income of a fully funded pension fund that exceeded a specified percentage of the fund's combined gross income from investment earnings and contributions. A tax on excessive investment income would mitigate the risk that pension funds would receive an unintended subsidy if there were no limitation on the exemption for investment income. *See* Colombo, *supra* note 12, at 542 (explaining that, without limitations on the tax exemption subsidy, tax-exempt organizations can accumulate excessive amounts of funding that ultimately bear little relation to the amount of public goods supplied by the organization). *But cf.* Cauble, *supra* note 5, at 742 (noting that any restriction on the tax exemption for pension fund investment income would be contrary to the purpose of the subsidy granted to pension funds). The ceiling above which investment income would be subject to tax under the UBIT would be set at a relatively low number, certainly lower than the average ratio of investment income to contributions in public and private pensions. The exact percentage, however, could be set by the Service and Treasury after careful study of the sources of pension funding and could be included in the regulations pursuant to Code section 513(b)(2).

restrictions of the UBIT rules. By contrast, public pension funds currently escape the federal tax system altogether by virtue of the political and constitutional dynamics that continue to influence the design of the federal tax system. In this context, the drag on pension fund investing activities caused by the UBIT raises obvious horizontal equity concerns. This Article has examined the application of the historical rationales for the UBIT to the case of modern pension fund investing and concludes that the rules are overbroad in their restrictions on today's institutional investing practices. This Article has also examined the rationales for taxing public pension funds on UBIT income and concluded that such a modification of the UBIT rules would be at present both inefficient and politically infeasible. Instead, this Article concludes that an effective solution to the problem of horizontal inequity in the taxation of private and public pension funds lies in a reform to the definition of related business income in the pension fund context that would allow private pension funds to invest alongside their public counterparts and thereby further the objectives of the modern system of retirement savings.