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Second Circuit Rules That ERISA Does Not Preempt California's Unrelated Business Income Tax On Pension Plans

The Second Circuit Court of Appeals recently affirmed a district court's conclusion that ERISA does not preempt California's tax on unrelated business taxable income ("UBTI") on pension plans. The court also found that the claim of preemption is not barred under the Tax Injunction Act. The decision in *Hattem v. Schwarzenegger*, 2d Cir., No. 05-3926-cv, 5/23/06 (http://caselaw.lp.findlaw.com/data2/circs/2nd/053926p.pdf), could pose significant problems for ERISA-covered employee benefit plans that have made investments that generate UBTI in California and other jurisdictions whose UBTI statutes are similar to California's statute. The decision is also important because it is more evidence that over the last decade there has been a significant change in preemption analysis that has resulted in a narrowing of the scope of its application.

Unrelated Business Income Tax Generally

The earnings on investments made by pension trusts are generally tax-deferred until withdrawn or distributed. However, if the trust engages in an active trade or business or the trust utilizes leverage or invests in a pass-thru investment vehicle utilizing leverage in acquiring assets, the trust will be subject to Federal tax on its UBTI (*i.e.*, generally the gross income derived from that business, less the deductions directly connected with carrying on the trade or business) even before such amounts are withdrawn or distributed. Many state tax laws also provide for a UBTI tax similar to the Federal tax. For example, Sections 17651 and 23731 of the California Revenue and Taxation Code impose a tax on the UBTI of every trust. The primary, non-revenue-based rationale behind both the federal and state UBTI schemes is to even the playing field among tax-exempt and taxable organizations by ensuring that tax-exempt entities pay taxes on revenue unrelated to their tax-exempt purpose.

Facts of Case

AT&T Corporation maintains the AT&T Master Pension Trust (the "Trust") for the sole purpose of holding and managing the assets of the various ERISA-covered employee benefit plans established and maintained by AT&T. The Trust, with approximately $20 billion of investments, is a tax-exempt trust under Section 501(a) of the Internal Revenue Code (the "Code"), although it does pay Federal tax on its UBTI. Between 1994 and 2002, the Trust paid more than $6 million in UBTI taxes to California, incurred substantial administrative and fiduciary costs in analyzing the California UBTI impact of certain potential investments, and lost income as a result of avoiding UBTI-generating investments. As a result, a plan participant, the plan trustee and plan fiduciary brought suit against the State of California to challenge California's UBTI scheme, arguing that ERISA preempts the scheme.

ERISA Preemption

ERISA generally preempts all state laws which "relate to" any employee benefit plan. While the plain reading of the statute suggests that the preemption provision has broad application, the Supreme Court has gradually narrowed the scope of the ERISA preemption provision by declining to interpret the phrase "relate to" literally. Instead, the Supreme Court has concluded that a state law "relates to" an employee benefit plan if it "has a connection with" or "refers to" such a plan. In determining whether a "connection with" an ERISA-covered employee benefit plan exists, the Supreme Court has instructed that a state law is not preempted if its impact on an ERISA-covered employee benefit plan is only tenuous, remote

or peripheral, as is the case with many laws of general applicability. Nor is a state law preempted because it has an indirect economic effect on choices; rather, the law must actually bind plan administrators by dictating which choices must be made in order for it to function as a regulation of an ERISA-covered plan. Similarly, the Supreme Court has made clear that a state law that does not expressly or implicitly refer to ERISA-covered employee benefit plans has no "reference to" such plans merely because such plans are included within the group of entities affected by such law.

Applying these standards, the Second Circuit concluded that California's UBTI scheme does not have an impermissible "connection with" or "refer to" an ERISA-covered plan, and the facts of the case did not satisfy the high standard for preemption. In particular, the Second Circuit found that California's UBTI scheme is one of general applicability that does not single out ERISA trusts or govern one of the areas that has been found to be of the kind that ERISA was intended to control exclusively. The court reached this conclusion even though California's UBTI scheme under Section 17651 of the California Revenue and Taxation Code provides that the UBTI tax applies in the case of any trust which generally is exempt from taxation under Section 17631 of the California Revenue and Taxation Code, which section specifically references organizations described in Section 401(a) of the Code. In addition, in the court's view, while California's UBTI scheme may have an indirect effect on a trust's investment choices, the scheme itself does not force trust fiduciaries to act in a certain manner. Rather, the state tax is simply another factor for plan fiduciaries to consider when deciding whether to make a particular investment. The Second Circuit also noted that the administrative costs of the statute were slight and not the sort that would render a statute preempted.

In a similar case regarding New York State's tax on UBTI, the New York State Tax Appeals Tribunal, after conducting a preemption analysis similar to the analysis by the Second Circuit in *Hattem v. Schwarzenegger*, held that ERISA does preempt New York State's tax on UBTI, which provides that a qualified pension trust is required to pay a tax on its allocated UBTI and is required to file a New York State tax return. In *In re McKinsey Master Retirement Plan Trust* (N.Y. Tax App. Trib., No. 817551, 5/8/03) (http://www.nysdta.org/Decisions/817551.dec.htm), the Tax Appeals Tribunal gave significantly more weight to the administrative and economic burdens the New York statute imposed on ERISA-covered employee benefit plans than the Second Circuit did in *Hattem v. Schwarzenegger* in connection with the California statute. Specifically, the Tax Appeals Tribunal found that New York State's tax on UBTI was not a tax of general application and specifically "refers to" ERISA-covered pension plans and is "connected with" ERISA-covered employee benefit plans in more than a tenuous, remote or peripheral manner. For a complete discussion of *In re McKinsey Master Retirement Plan Trust*, please see our previous Client Alert from June, 2003, entitled "New York Court Holds that ERISA Preempts State Tax Law on Unrelated Business Income Tax."

Conclusion

Pension funds should be mindful of the decisions in *Hattem v. Schwarzenegger* and in *In re McKinsey Master Retirement Plan Trust* when analyzing state UBTI tax laws for preemption. Statutes that are statutes of general applicability, whose effect on ERISA plans is only incidental, may not be preempted. Statutes that clearly subject a pension trust to state taxation on its UBTI by "referring to" pension trusts are more ripe for preemption.

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