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Client Alert

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New York Court Holds that ERISA Preempts State Tax Law on Unrelated Business Income Tax

The New York State Tax Appeals Tribunal recently held that the Employee Retirement Income Security Act ("ERISA") preempts New York State's tax on unrelated business taxable income. The decision in *In re McKinsey Master Retirement Plan Trust* (N.Y. Tax App. Trib., No. 817551, 5/8/03) reverses prior authority and may enable trusts maintained in connection with ERISA-covered employee benefit plans to file claims for refunds of previously paid unrelated business income tax ("UBIT").

Unrelated Business Income Tax Generally

The earnings on investments made by pension plan trusts are generally tax-deferred until withdrawn or distributed. However, if an investment is not substantially related to the exempt purpose of the trust (*i.e.*, based on the facts involved, it does not contribute importantly to accomplishing the exempt purpose, other than through the production of funds) or the trust utilizes leverage or invests in a pass-through investment vehicle utilizing leverage in acquiring assets, the trust will be subject to Federal tax on its unrelated business taxable income even before such amounts are withdrawn or distributed. "Unrelated business taxable income" is generally defined as the gross income derived from any unrelated trade or business regularly carried on by an exempt organization, such as a pension trust, less the deductions directly connected with carrying on the trade or business. Similarly, Section 290 of Article 13 of the New York State tax law (the "Tax Law") provides that a trust of a pension plan carrying on an unrelated trade or business in New York is required to pay a tax at the rate of 9% on its allocated unrelated business taxable income for such year, or $250, whichever is greater, and is required to file a New York State tax return.

Facts of Case

McKinsey & Company maintained two ERISA-covered pension plans, the assets of which were held in the McKinsey Master Retirement Plan Trust (the "Trust"). The Trust was exempt from taxation under Section 501(a) of the Internal Revenue Code, except for the Federal UBIT. Participants in the pension plans were able to direct the investment of their account balance among the investment options available under each plan. These investment options included, but were not limited to, separate funds created by the Trust, each of which encompassed a specific asset type or strategy. Some of these funds had investments that incurred UBIT (*i.e.,* investments in limited partnerships which utilized debt financing). The investment return for those participants who invested in funds that generated unrelated business taxable income was reduced, dollar for dollar, by the amount of the UBIT paid by the Trust.

In addition to filing a Federal UBIT return, the Trust also filed UBIT returns with several states, including New York State. The Trust was required to determine a New York apportionment factor that related, in part, to the underlying investments of the separate funds in the Trust. The Trust subsequently filed with the New York State Division of Taxation (the "Division") for refunds of the UBIT for the tax years it had theretofore filed returns. The Division denied the claims on the basis that the UBIT imposed under the Tax Law was not preempted by ERISA. On appeal, the Administrative Law Judge reversed the Division's determination and granted the Trust's claims for refunds of UBIT (and associated penalties and interest previously paid by the Trust on account of an underpayment of estimated UBIT). The New York State Tax Appeals Tribunal affirmed the Administrative Law Judge's determination.

ERISA Preemption

ERISA generally preempts all state laws that "relate to" any employee benefit plan. A state law has been held to "relate to" an employee benefit plan if it "refers to" or "has a connection with" an ERISA-covered employee benefit plan such that its impact thereon is more than tenuous, remote or peripheral. The Tax Appeals Tribunal found that the UBIT is a tax imposed on the income from investments of ERISA-covered employee benefit plans and subjects such plans to reporting and compliance requirements on a state-by-state basis. The Tax Law gives rise to filing and payment duties that involve estimation and timing issues, all of which militate against the congressional aim of achieving a uniform body of pension law with minimal financial and administrative burdens and conflicts between the various state and Federal jurisdictions. In fact, the statute specifically refers to ERISA-covered employee benefit plans and results in the imposition of tax directly and immediately upon the income of ERISA-covered employee benefit plans. Furthermore, the Tax Appeals Tribunal found that the tax imposes significant reporting and payment requirements, involving accounting, record keeping and other administrative burdens impacting the structure, investment strategies and administration of ERISA-covered employee benefit plans. The tax also results in the reduction of investment returns of participants who invested in funds that generate unrelated business taxable income.

Based on these conclusions, the Tax Appeals Tribunal found that the Tax Law is connected with ERISA-covered employee benefit plans in more than a , tenuous, remote or peripheral manner and, therefore, must be preempted.

Conclusion

The decision in *In re McKinsey Master Retirement Plan Trust,* which cannot be appealed by the State, presents a potential opportunity for pension funds. State tax refunds may be available for amounts already paid. Because claims for refunds generally must be filed within three years from the return filing date or two years from payment of tax, whichever period expires later, ERISA-covered employee benefit plans should promptly review all New York State UBIT filings and payments to determine whether the decision may provide the potential for refunds.

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