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Entity-Level Taxes: Wait, I Thought I Was Tax Exempt?

By Sean Hamner and Douglas Schwartz

U.S. public pension plans often operate under the assumption that they are immune from taxation. After all, most are considered "super tax-exempt" under U.S. federal income tax law,[1] meaning they are not subject to income tax, including on unrelated business taxable income.[2] However, despite their tax-exempt status, public plans can, and often do, bear the economic burden of taxes imposed at the *entity level* of investments made by such pension plans. These taxes may not be upfront and apparent, but they quietly erode returns all the same.

This article explores some of the most common situations where entity-level taxes can impact public plans along with some best practices on how to mitigate the issue. While these taxes may not be directly assessed against the pension plan, they are real, and they matter.

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The Partnership Tax Audit Rules

Let us begin at the federal level with partnership tax audit rules.[3] Under the Bipartisan Budget Act of 2015 (BBA), Congress introduced a new centralized partnership audit regime that fundamentally changed how partnerships are audited and how tax liabilities are assessed by the IRS. The key shift is that now the partnership itself, not the partners, is responsible for paying any tax adjustments resulting from an IRS audit. This is a significant departure from the prior regime, where tax adjustments flowed through to the partners, who would then pay any additional tax owed. Under the BBA rules, subject to the discussion below, the default rule is that the partnership pays the tax at the entity level at the highest applicable individual or corporate rate.

What does this mean for public plans? Most of the commingled investment funds for alternative assets are treated as partnerships for federal income tax purposes.[4] Thus, even though a public plan may be exempt from federal income tax, it can still indirectly bear the economic burden of a tax assessment paid by the partnership from an IRS audit. Fund sponsors generally treat these tax audit assessments paid at the fund level as a distribution to the partners. The public plan is not personally writing a check to the IRS, but it is still footing the bill.

As mentioned above, there are steps that can be taken to mitigate this risk. First, the BBA rules allow partnerships to make "push-out elections" with respect to IRS tax assessments.[5] A push-out election shifts the tax liability from the partnership itself to the individual partners who were in the partnership during the reviewed year. In essence, the tax is pushed from the entity level out to the partner level. This causes investors from the audited year to receive amended K-1s and to be responsible for their allocable portion of the tax assessment rather than the fund. A public plan would be exempt from the portion of taxes allocable to it. Second, the BBA rules allow partnerships to modify the tax assessment amount to account for the tax-exempt status of their partners,[6] which has the effect of lowering the tax assessment paid at the partnership level. However, it is still up to the partnership to pursue current and former investors for their share of the tax liability. No matter how strong the distribution offset, or collection remedies may be in the document, they are only as good as an investor's ability or willingness to pay.

State Taxes on Pass-Through Entities

Federal taxation is only part of the story. State governments have their own tax regimes, and they don't always follow the federal rules. States have ways to tax income earned within their borders, even when that income flows through a pass-through entity to a tax-exempt entity. This section will discuss three state tax regimes that affect public plans: franchise taxes, gross receipt taxes, and the state taxation of REITs. A Real Estate Investment Trust (REIT) is a special type of vehicle created by the tax code to invest in real property assets.

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Franchise Taxes

A franchise tax is a state-imposed levy on businesses for the privilege of operating within that state, regardless of whether the business has a net income. It is typically based on factors like a company's net worth, capital stock, or gross receipts, depending on the state's tax structure. This tax can also be called a business privilege tax.

A fund that operates a business within a state with a franchise tax will owe a franchise tax to the state. Though some businesses are exempted from franchise taxes,[7] most investment funds with an institutional investor base will still owe the franchise tax. The tax amount is borne by the fund and is treated as a fund expense borne by the partners, including tax-exempt partners.

Gross Receipts Taxes

Some states impose gross receipts taxes on entities doing business in the state, which is a revenue tax on the gross receipts of an entity. Because a gross receipts tax is based on all income from sales and services without deductions for costs or expenses, it applies regardless of whether the business is profitable, making it a tax on business activity rather than earnings.[8]

Just like with franchise taxes, funds that operate a business within a state with gross receipts tax will pay a tax at the fund level. Again, a tax-exempt investor is not directly taxed, but the tax reduces the distributable income of the fund entity, effectively lowering the return on investment.

State Taxation of REITs

For federal income tax purposes, a REIT is treated as a corporation, but it receives a deduction for its distributions to shareholders, meaning a REIT that makes shareholder distributions equal to 100% of its taxable income will pay no tax at the REIT level. Therefore, a REIT is an efficient investment vehicle that can avoid double taxation like a pass-through entity.[9]

While REITs can generally avoid federal income tax, some states do not conform to federal REIT rules, leading to unexpected tax liabilities.[10] Once again, this entity-level tax is indirectly borne by public plan investors that invest through a REIT in the fund structure. Public plan advisors should be aware that though a REIT qualifies for favorable treatment at the federal level, it may still be subject to state-level taxes that reduce its tax efficiency.

International Information Regimes

To reduce tax evasion and hiding of assets, the U.S. Treasury and its non-U.S. counterparts regularly exchange information on bank and financial accounts in their home countries and information on owners in the counterpart country. Public plan investors are most familiar with the Automatic Exchange of Information regime under the U.S. Foreign Account Tax Compliance Act (FATCA) and the counterpart Common Reporting Standard (CRS) of the Organisation for Economic Co-Operation and Development, which applies to non-U.S. jurisdictions. A fund may be subject to heavy withholding and other penalties if it does not obtain correct information on investors and furnish that to the proper U.S. or international tax authorities, and those penalties normally apply to the fund and therefore reduce returns of all investors (including public fund investors who otherwise are exempt from these reporting requirements). Almost all partnership agreements and subscription documents will solicit the necessary information from investors under FATCA or the CRS, and if there are penalties, empower management to make all possible efforts to seek reimbursement from recalcitrant investors who supplied faulty information or refused to supply any information. However, as with the case of partnership audits above, there can never be a guarantee that the fund will collect every dollar from the investors who caused the problem.

Where a fund focuses on infrastructure, in general, and renewable energy and other green infrastructure, in particular, the risk is greater that a public plan investor will be forced into a parallel or alternative vehicle with adverse tax consequences...

Foreign Taxes and Withholding

A non-U.S. jurisdiction does not necessarily care that a U.S. public plan is super tax exempt under U.S. law: The U.S. investor is still responsible for demonstrating that it is exempt under that country's internal tax laws, or to a lower rate of or outright exemption from withholding under any tax treaty between the U.S. and that country. Some countries impose taxes with respect to outside investors in addition to income tax withholding (example *e.g.*, the French apply 3% tax on real estate). Such taxes are not covered by tax treaties, but a country may allow reduced taxes or an outright exemption under its internal tax laws.

Clean Energy Blockers

Where a fund focuses on infrastructure, in general, and renewable energy and other green infrastructure, in particular, the risk is greater that a public plan investor will be forced into a parallel or alternative vehicle with adverse tax consequences (*e.g.,* entity-level taxes that are indirectly borne by the vehicle investors) than is the case with other funds with different investment focuses (*e.g.,* non-infrastructure real estate, private equity, or credit). The availability to taxable investors and joint venturers of tax credits and other benefits for renewable energy and other green technology projects often require that management create blocking and other intermediary structures such that tax-exempt investors like a public pension investor do not have indirect economic interests in the underlying projects. The recent One Big Beautiful Bill Act has cut back credits for solar and wind projects but has not eliminated those credits and has not cut back the benefits for alternative fuel or other renewables.

Conclusion: Know What You're Paying For, and Protect Yourself

Public plans may be exempt from federal income tax, but that doesn't mean they're immune from the economic impact of all taxes. Entity level taxes, whether imposed under federal law or by state and local governments, can quietly chip away at investment returns.

Understanding where these taxes arise and how they operate is essential for successfully advising public plans. We need to ask whether the entities in which the plan invests are subject to tax, and if so, who ultimately bears the cost.

Public plan investors can also take the following steps to protect themselves:

- Be sure that the limited partnership agreement not only authorizes the general partner but also requires, on at least a "commercially reasonable efforts" basis, to reduce an imputed underpayment to account for the tax-exempt and other special circumstances of fund investors, and to allocate the reduction to such investors. These provisions should be in addition to the more standard ones whereby fund management may offset distributions to account for, or otherwise pursue current or former investors, that investor's share of an imputed underpayment. (Ideally a fund would always make a push-out election so that no financial burden from an audit falls on the fund itself, but funds generally do not like push-out elections because of the costs and complications involved.) If the agreement does not include these provisions, then provide them in a side letter.
- Pay attention to, and complete carefully, certifications in subscription agreements to claim exemptions from foreign taxes or withholdings. They are there for a reason.
- If a fund invests outside the U.S., be sure that the partnership agreement provides that the general partner will, on at least a "commercially reasonable efforts" basis and at a limited partner's request and expense, make any filings, provide such information, or take other actions as are necessary for such investor to obtain a reduction of, exemption from, or refund of, taxes withheld or paid with respect to such investor as a result of investments made by the fund. If the agreement does not include these provisions, then provide them in a side letter.
- If the plan regularly invests in funds that in turn invest outside the U.S., obtain and keep current exemption rulings or letters from tax authorities in jurisdictions where those funds are most likely to invest. Public plans as a matter of practice should obtain and maintain at least an exemption letter from the Canadia Revenue Agency, and an exemption ruling from the Australian Tax Office.

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Endnotes

[1] For this position, super tax-exempt investors rely on IRC Section 115.
[2] *See* IRC Section 511.
[3] Note that this section discusses the federal partnership tax audit rules. Though some states have adopted similar rules for state tax audits, these rules are not universal at the state level.
[4] Note that this is true regardless of whether the fund is a limited liability company or a limited partnership since both types of entities are treated as partnerships for tax purposes unless the fund files IRS Form

8832 and elects to be taxed as a corporation.
[5] *See* IRC Section 6226.
[6] *See* IRS Section 6225(c).
[7] Though it varies from state to state, some exempted entities include religious organizations, credit unions, homeowners' associations, and other nonprofits.
[8] For example, Ohio levies a Commercial Activity Tax (CAT) on gross receipts from business activities in the state.
[9] Note that while REITs can be useful tax planning tools, they have strict qualification and compliance rules.
[10] For example, New Hampshire imposes an entity-level tax on REITs, without allowing a deduction for dividends paid.