STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **MCKINSEY MASTER RETIREMENT PLAN TRUST** For Redetermination of a Deficiency or for Refund of Unrelated Business Income Tax under Article 13 of the Tax Law for the Years 1994, 1995 and 1996.	: : : : : :	DETERMINATION DTA NO. 817551

Petitioner, McKinsey Master Retirement Plan Trust, 55 East 52nd Street, New York, New York 10022, filed a petition for redetermination of a deficiency or for refund of unrelated business income tax under Article 13 of the Tax Law for the years 1994, 1995 and 1996.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on September 26, 2000 at 10:30 A.M., with all briefs to be submitted by May 31, 2001, which date commenced the six-month period for issuance of this determination (Tax Law § 2010[3]). Petitioner appeared by Phillips, Lytle, Hitchcock, Blaine and Huber, LLP (Edward M. Griffith, Jr., Esq, of counsel). The Division of Taxation appeared by Barbara G. Billet, Esq. (Nicholas A. Behuniak, Esq., of counsel).

ISSUE

Whether the imposition of New York State unrelated business income tax under Tax Law Article 13 against petitioner, a trust which holds and administers the assets of certain retirement plans governed by the Employment Retirement Income Security Act of 1974 ("ERISA"), is barred under the preemption clause of ERISA § 514(a).

FINDINGS OF FACT [1]

1. McKinsey & Company, Inc., is an international management consultant company. It has approximately 80 offices that operate in 42 countries. Its consultants number about 6,000, and they are citizens of over 90 countries.

2. Petitioner, McKinsey Master Retirement Plan Trust, has since its establishment on December 14, 1994, held the assets of the McKinsey & Company, Inc. Profit-Sharing Retirement Plan and the McKinsey & Company, Inc. Money Purchase Pension Plan ("the Plans").

3. Both of the Plans are subject to the provisions of the Employment Retirement Income Security Act of 1974 ("ERISA"). They are exempt from Federal income taxes, except for Federal unrelated business income tax, and New York franchise taxes. [2]

4. McKinsey & Company employees receive an annual firm contribution under each plan based upon a percentage of qualifying compensation paid during the calendar year.[3] At year end, participants are offered the opportunity to elect how their contributions shall be allocated, or reallocated, among the investment options offered under each plan.

---

1 The parties stipulated to certain facts and such stipulated facts are included herein. In addition, petitioner submitted proposed facts numbered "1" through "9" and "11" through "14", and the Division of Taxation submitted proposed facts numbered "2" through "23" (the omission of the number "10" in petitioner's sequence of numbers as well as the omission of number "1" in the Division's sequence of numbers appears to be the result of inadvertant numbering error). These proposed facts are supported by the record and have been incorporated in the Findings of Fact herein.

2 It is the petitioner Trust which is specifically exempt from taxation pursuant to Internal Revenue Code ("IRC") § 401(a).

3 McKinsey's employees who are foreign nationals receive a 12 percent contribution to the Profit Sharing Retirement Plan, while McKinsey's United States employees receive a 7 percent contribution to the Profit Sharing Retirement Plan plus a 5 percent contribution to the Money Purchase Pension Plan (together equaling a 12 percent total contribution).

5. Petitioner has an investment office which creates and puts together funds through which participants in the Plans may invest. The investment office consists of approximately four or five highly trained individuals who can, and do, seek additional help from outside third-party investment advisors, attorneys and accountants in running the funds and making investment decisions. During the years in question, various investments were offered to Plan participants in the form of separate funds, each of which encompassed a specific asset type or strategy. Participants selected from among the funds and, in effect, constructed their own investment portfolios. The funds were specifically designed by petitioner to allow participants to diversify their investments into various asset classes and risk levels.

6. The funds are created to offer very attractive benefits and unique investment opportunities for participants, and the investment managers' primary focus in selecting investments for the funds is on the final return to investors. To this end, investment managers go through an elaborate process of finding investment opportunities and screening them by various criteria to estimate what their return will be and whether to invest.

7. During the years in question there were approximately 15 different funds available to participants in the Plans. Some of the funds had investments which incurred unrelated business income tax ("UBIT"). Those funds were the Hedging Strategies Fund, the Real Estate and Related Securities Fund, the Special Situations Fund, and the International Equities Fund. These funds, from time to time, invested in limited partnerships. The limited partnerships, in turn, incurred debt at various times in an effort to increase earnings. Income earned from such debt (debt-financed income) constituted unrelated business taxable income subject to UBIT at the Federal level and (unless preempted) under Article 13 of the Tax Law.

8. It is not necessary or required that the funds make or offer investments which will generate unrelated business income and incur the UBIT. The incurrence of UBIT is one of several factors the investment managers consider in choosing investments, but it is not necessarily the most important consideration. Investment managers invest in limited partnerships which incur the UBIT because the investment managers believe such investments may, even though they incur the tax, offer a greater total gross return than alternatives which do not incur any UBIT. The investment return of those plan participants who invested in funds that generated unrelated business taxable income was reduced, dollar for dollar, by the amount of UBIT paid by petitioner.

9. Every year each participant is provided a detailed description of what each fund invests in. The detailed description of each of the funds' investments expressly warns if a particular fund has potential exposure to UBIT liability. Participants do not have to select funds which have exposure to UBIT, but rather can invest as much or as little as they choose in the various funds, and may invest nothing in those funds which have exposure to UBIT. Each participant also receives a detailed personalized account statement which, among other things, discloses those funds invested in which have UBIT liability and the amount thereof. In selecting investments for the separate funds, petitioner's investment office was largely guided by final returns to fund participants. Because UBIT decreases these returns, petitioner's investment office may elect to not invest in or may reduce investments in limited partnerships that have, or are expected to have, debt-financed income.

10. For the years 1994, 1995 and 1996, petitioner filed tax returns under Article 13 of the Tax Law, reporting unrelated business taxable income. In each case, petitioner was required to determine a New York State apportionment factor which related, in part, to the underlying

investments of the separate funds. Petitioner paid UBIT under Article 13 of the Tax Law for the years in issue in the respective amounts of $147,412.00, $4,102.00 and $225,860.00. Payment of the tax is accounted for as an expense of the Trust, and is thereafter allocated to the specific investment funds which generated the UBIT and to such funds' participants on a dollar for dollar basis, as described hereinafter (***see***, Finding of Fact "15").

11. As required under Article 13, petitioner made estimated payments of UBIT for each of the years in issue. Since petitioner had no control over the debt financing of the limited partnerships in which certain of its funds were invested, the determination of estimated taxes was problematic. For calendar year 1996, petitioner paid interest and penalties of approximately $14,000.00 relating to the underpayment of estimated UBIT.

12. Petitioner determined the net asset value (NAV) of the separate funds on a monthly basis. In making this determination, petitioner was required to take into account any potential UBIT liability. However, information related to debt-financed income was not available from the limited partnership on a monthly basis. Such information was not supplied by the limited partnerships until several months after the end of the calendar year (via Forms K-1 detailing for the partners of each partnership the results, including tax results, of partnership operations). Accordingly, petitioner estimated the amount of UBIT liability based on past debt-leveraged ratios of the limited partnerships in arriving at its monthly calculation of NAV.

13. Petitioner's determination of NAV of the separate funds on a monthly basis is required under the plans and is used for purposes of calculating the amount of the participant's benefits upon their termination of employment, death or retirement. In such case, if the participant was invested in funds that generated unrelated business taxable income, the participant would be paid

out using the NAV at the end of the month in which his services terminated, which would include an estimate of UBIT liability.

14. At the end of each calendar year, participants are given the opportunity to reallocate their retirement funds among the various investment alternatives. For this purpose, month-end NAV's are used, which in the case of certain funds contain estimates of UBIT. After information relating to the debt-financed income is received from the limited partnerships several months later, the NAV's of the affected funds are readjusted. Thus, the participants in an affected fund at that time will either benefit from an overestimate of UBIT or be charged in the case of an underestimate. Those participants who eliminated their investment in one of the affected funds at the end of the year would likely have been credited with a higher or lower NAV at the time of "cash-out" than the later-determined actual NAV of the fund.

15. Regardless of the existence of any New York State UBIT, petitioner will incur Federal UBIT if the limited partner debt-financed investments are made. Petitioner is required to file a Federal tax return with the Internal Revenue Service ("IRS") disclosing its unrelated business income and paying appropriate Federal UBIT thereon. Petitioner, the Trust, is the party who files the UBIT returns with the IRS and with the Division of Taxation ("Division"), and is the party liable for the payment of any UBIT due or assessed. The tax is accounted for by petitioner as an administrative expense. The Trust's exposures to Federal and New York State (and other states') UBIT is accounted for by reducing the assets available in a particular fund. The income left in the fund after payment of all fund expenses, including any UBIT, is then apportioned to the participants who allocated their pension interests to that fund.

16. In addition to filing a UBIT return with the IRS and with New York State, petitioner also files UBIT returns and pays UBIT with Illinois, Connecticut, Maryland and California.

17. New York State's UBIT is calculated based on the Federal unrelated business income numbers reported to the IRS by petitioner. New York applies an apportionment adjustment to the Federal amount to arrive at a taxpayer's New York State unrelated business income subject to State UBIT. The Division has applied Tax Law § 290 against many other types of tax-exempt entities in addition to tax exempt trusts such as petitioner.

18. On October 14, 1998, the Division received from petitioner three Forms CT-8 ("Claim for Credit or Refund of Corporation Tax Paid"), seeking refunds of the unrelated business income tax and any attendant penalties and interest paid by petitioner for the years 1994, 1995 and 1996. The Division responded to these claims by letters dated October 30, 1998 (pertaining to petitioner's claim for 1994) and November 5, 1998 (pertaining to petitioner's claims for 1995 and 1996). These letters denied petitioner's claims for refund on the basis that the UBIT imposed under Article 13 of the Tax Law was not preempted by the provisions of ERISA. Petitioner challenged these denials, ultimately commencing the subject proceeding via the filing of a timely petition with the Division of Tax Appeals.[4]

CONCLUSIONS OF LAW

A. Section 290 of Tax Law Article 13 imposes a tax on the unrelated business income of every organization described in IRC § 511(a)(2) and every trust described in IRC § 511(b)(2) that carries on an unrelated trade or business in New York State. Tax Law § 292 provides that the unrelated business income of a taxpayer subject to the UBIT is the taxpayer's Federal unrelated business taxable income, as defined in the IRC §512, with certain modifications specified in Tax

4 The November 5, 1998 refund denial letter references the year 1997 (as well as the years 1995 and 1996). However, the balance of documents in the record makes clear that the years at issue in this proceeding are 1994, 1995 and 1996.

Law § 292. The tax is at the rate of nine percent on the portion of the taxpayer's unrelated business income allocated to New York.

B. The New York UBIT mimics the Federal UBIT imposed under IRC § 511. In so doing, it defines those entities subject to the New York tax as those same entities subject to the Federal tax. Specifically, IRC § 511(a)(2) and (b)(2) provide that the UBIT is imposed on every IRC § 501(a) tax exempt organization described in IRC § 501(c) and IRC § 401(a).[5] In turn, IRC § 501(c)(1) through (27) specifies numerous organizations which, while generally exempt from taxation, are subject to both the Federal and New York State UBIT. In addition, and directly relevant to this matter, is IRC § 401(a) which specifies tax exemption for trusts "created or organized in the United States and forming part of a stock bonus, pension or profit sharing plan of an employer . . . ." It is undisputed that petitioner, the trust holding the assets of the McKinsey plans, complies with the statutory requirements set forth in IRC § 401(a). Thus, while petitioner enjoys both Federal and New York State tax exempt status in general, it nonetheless is specifically subject to the Federal UBIT and, unless its imposition is otherwise preempted, to the New York State UBIT under Tax Law Article 13.[6]

C. Federal preemption of state law may occur pursuant to the United States Constitution, or as the result of Federal legislation. There is no claim here that the New York State UBIT is prohibited on constitutional grounds. Accordingly, the sole question is whether New York State UBIT under Tax Law Article 13, § 290, is preempted under Federal statute either because it is

---

5 The only section 501(a) tax exempt organizations not subject to the UBIT are those described in IRC § 501(d), to wit, religious and apostolic organizations.

6 New York State affords the same general tax exempt status as does the Federal government to those entities listed in IRC § 501(c)(1) through (27) and IRC § 401(a) (***see***, 20 NYCRR 1-3.4; Tax Law § 601[h]).

imposed on stock bonus, pension or profit sharing plans per direct definitional reference to IRC § 401(a), or because of its actual impact on the subject plans.

D. The potential for preemption in this case arises under the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). Specifically, section 514(a) of ERISA (29 USC § 1144[a]) provides in relevant part that "the provisions of [ERISA] shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan. . . ." Section 514(c) of ERISA (29 USC 1144[c]) defines "State law" and "State" as follows:

> (1) The term 'State law' includes all laws, decision, rules, regulations, or other State action having the effect of law, of any State . . . .
>
> (2) The term 'State' includes a State, any political subdivisions thereof, or any agency or instrumentality of either, which *purports to regulate, directly or indirectly, the terms and conditions of employee benefit plans covered by [ERISA]*. (Emphasis added.)

E. Courts that have addressed the issue of ERISA preemption have ultimately concluded that the statutory text of the preemption provision, and specifically the phrase "relate to," is essentially "unhelpful." The courts have therefore directed an analysis that looks "to the objectives of the ERISA statute as a guide to the scope of the state law that Congress understood would survive [preemption]." (***DeBuono v NYSA-ILA Medical & Clinical Services Fund***, 520 US 806, 138 L Ed 2d 21; ***New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.***, 514 US 341, 131 L Ed 2d 695). The Supreme Court has described the Congressional intent underlying ERISA's preemption provision as follows:

> To ensure that plans and plan sponsors would be subject to a uniform body of benefits law; the goal was to minimize the administrative and financial burden of complying with conflicting directions among States and between States and the Federal Government . . . , [and to prevent] the potential for conflict in substantive law . . . requiring the tailoring of plans and employer conduct to the peculiarities of the law of each jurisdiction." ***(New York***

State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co., supra.)

F. The critical question is whether the State action impermissably relates to the subject ERISA plans in violation of ERISA § 514(a). The U.S. Supreme Court has held that a state law "relates to" a covered ERISA plan for purposes of preemption under ERISA § 514(a) if the state law either: (1) impermissably "refers to" an ERISA plan or (2) has a "connection with" such a plan (***Shaw v. Delta Air Lines, Inc.***, 463 US 85, 96-100 [1983]; ***Cal. Division of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc.***, 519 US 316, 324 [1997)]). Though very broadly worded ERISA's preemption provision is not unlimited, and preemption will not occur unless the state law in issue affects an ERISA plan "in more than a tenuous, remote or peripheral way" (***Morgan Guaranty Trust Company of New York v. Tax Appeals Tribunal***, 80 NY2d 44, 587 NYS2d 252; ***Shaw v. Delta Air Lines, Inc., supra.***). Petitioner takes the position that the State UBIT runs afoul of the ERISA preemption provision on both counts. Petitioner first maintains that Tax Law § 290 must be preempted because, through its definitional references to the IRC, it directly "refers to" ERISA plans. Petitioner also argues that the State UBIT's connection with and resulting impact on petitioner's plans is far more than tenuous, remote or peripheral. Petitioner asserts the tax imposes undue administrative, economic and structural burdens upon the plans in a manner inconsistent with the aforementioned Congressional purpose of national uniformity and minimization of the burden of myriad local regulation in the realm of pension and benefit plans. The Division disputes each of these arguments, claiming that the UBIT is a neutral tax of general application whose impact on petitioner is not unduly burdensome either administratively, structurally or economically.

G. In 1992, the New York Court of Appeals addressed the question of ERISA preemption in ***Morgan Guaranty Trust Co. v. Tax Appeals Tribunal*** (***supra***). The Court held that the gains tax formerly imposed under Tax Law Article 31-B was preempted by ERISA where the tax was imposed on the gain derived from the sale of certain real property owned by an ERISA-regulated entity. While noting that the former gains tax was a law of general application without specific reference or application to ERISA-covered plans, the Court applied settled ERISA preemption principles and found that the former gains tax had "more than a tenuous, remote or peripheral connection" to employee benefit plans. Specifically, the Court found that because the former gains tax imposed certain record keeping and reporting requirements, it impacted on the structure and administration of the ERISA-regulated plan. Even more significant in the Court's opinion was the economic impact of the former gains tax on the plan. The Court found that the former gains tax directly depleted plan assets and thus necessarily influenced the plan's investment strategy. Accordingly, the Court found that the former gains tax "related to" employee benefit plans within the meaning of section 514(a) of ERISA and its imposition was therefor preempted (***id***., 587 NYS2d at 254-258).

Subsequent to ***Morgan***, the United States Supreme Court decided ***DeBuono v. NYSA-ILA Medical & Clinical Services Fund*** (***supra.***). In ***DeBuono***, the U.S. Supreme Court did not preempt New York State's imposition, under Public Health Law § 2807(d), of a tax on gross receipts from patient services at hospitals, residential health care facilities and diagnostic and treatment centers, including hospitals owned and operated by an ERISA qualified plan. The Court held that the tax, implemented to reduce the State's Medicaid deficit, was a tax of general application which did not impact the calculation of ERISA benefits or impact the determination of an employee's eligibility for such benefits. The Court also held that the existence of an ERISA plan was not a critical element of a state cause of action, and that no provision in the tax expressly referred to an ERISA plan. ***DeBuono***, upon which the Division's position in this case rests most heavily, confirmed the Supreme Court's reasoning in ***New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.*** (***supra***.), including its rejection of a strictly literal reading and application of the phrase "relates to" in favor of the conclusion that in using that phrase, Congress did not intend to alter the starting presumption against supplanting state laws, especially state action in areas of traditional state regulation. Rather, the preemption review must focus on the objectives of ERISA and on the nature of the effect of the State law on ERISA plans (***California Division of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc., supra.***).[7]

H. Treated first is the issue of whether the UBIT must be preempted because it impermissably refers to covered ERISA plans. It is clear that mere reference to a covered plan in the words of a state law will not necessarily result in preemption. Rather there must be some legal impact on the plan resulting from such reference. A state law is said to impermissably relate to ERISA "by reference" if it imposes requirements by reference to ERISA plans, or if it acts immediately and exclusively on ERISA plans, or if an ERISA plan is essential to the state law's operation (***Mackey v. Lanier Collection Agency & Serv.***, 486 US 825, 100 L Ed 2d 836; ***District of Columbia v. Greater Washington Board of Trade***, 506 US 125, 121 L Ed 2d 513). In this case, the State law's reference to ERISA plans is clear and results in the imposition of tax directly and immediately upon ERISA covered plans. That is, Tax Law § 290 defines the

---

7 The Division's reliance upon ***DeBuono*** and ***Travelers*** is made clear by its December 2, 1998 issuance of Technical Services Bureau Modified Advisory Opinion TSB-A-97(10.1)C concluding, based on ***DeBuono*** and ***Travelers***, that the UBIT imposed under Article 13 was not preempted by ERISA. This advisory opinion reverses TSB-A-97(10)C, dated May 9, 1997, which, based specifically on ***Morgan***, reached the opposite conclusion and held Article 13 preempted under ERISA.

organizations subject to New York's UBIT by reference to such organizations as defined under the IRC. Turning to the relevant referenced sections of the IRC results in specific state tax imposition on plans such as petitioner's plans, to wit, stock bonus, pension or profit sharing plans as described in IRC § 401(a). While New York's UBIT imposition is perhaps most accurately described as occurring pursuant to a "reference within a reference," the result is nonetheless that a specifically defined type of income (unrelated business taxable income) earned by qualified ERISA plans is, pursuant to state law, directly subject to state taxation. Given that the imposition of tax results from direct reference to qualified plans, it is difficult to conclude that Tax Law Article 13 does not therefore relate to ERISA plans within the meaning and intent of ERISA's preemption language.

I. The Division asserts, and petitioner does not dispute, that taxation is an area of traditional state government authority. When a state act is within an area of traditional state authority, the proponent of preempting such action bears a "considerable burden" to overcome the starting assumption that the state act is not to be superceded. Thus, for preemption to occur, a review of the operation of the state law must show that it is the type of enactment Congress intended ERISA to supercede (***DeBuono v. NYSA-ILA Medical & Clinical Services Fund, supra., California Division of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc., supra.***). At the same time, while not disputing the starting assumption against preemption, petitioner does maintain that there is no presumption against preemption or that any such presumption is overcome, *per se,* in the context of an impermissable "reference to" an ERISA plan, since such a reference and its resulting impact provides the necessary link to trigger preemption (***see, Prudential Insurance Co. v. National Park Medical Center, Inc.***, 154 F3d 812).

J. It is true that the UBIT at issue here, as well as Public Health Law § 2807(d) at issue in ***DeBuono***, are both revenue raising measures, i.e., taxes. However, as pointed out earlier, the Supreme Court noted that Public Health Law § 2807(d) clearly operated in a field traditionally regulated by the states (health and safety), and was not a tax on ERISA plans, *per se*, but a tax on health care facilities. Moreover, the Court concluded that the actual impact of the tax in ***DeBuono*** was essentially neutral. In this regard, the Court explained that if the ERISA fund which operated the subject hospitals had chosen to purchase the medical services from independent hospitals rather than provide such services by running hospitals itself, the tax impact of that choice would have been felt through the increased expense in rates for services charged by the independent service providers to recoup their own tax costs per Public Health Law § 2807(d). Thus, the ERISA funds would have been left with the simple choice of charging more to cover the indirect tax cost (in economic impact the same as the direct tax payment in question) or offering more limited services to plan members.

In contrast to Public Health Law § 2807(d), and the result in ***DeBuono***, the Article 13 UBIT does not operate directly in a sphere of traditional state regulation such as health and safety. Rather, the Article 13 UBIT is a revenue raising measure, piggybacked onto a virtually identical Federal UBIT. While the State UBIT was enacted with the same intent as its Federal counterpart, to wit, to level the playing field between tax exempt organizations and for profit organizations, it clearly does not operate in the areas of safety, health or any other area of traditional state regulation such as family law (***see, e.g., Hisquierdo v. Hisquierdo*,** 439 US 572, 59 L Ed 2d 1). In fact, rather than operating in a field traditionally regulated by the states, the UBIT, by its reference to IRC § 401(a), thrusts itself into a field (pension and benefit plans) specifically taken over by and subject to Federal regulation. Moreover, unlike ***DeBuono*** where the majority of the hospitals subject to the tax were not ERISA run, the tax statute at issue in this case includes by direct reference pension and benefit plans under IRC § 401(a) as among those specifically subject to the tax. Rather than catching some ERISA entities within its general application, the UBIT specifically defines such entities as subject to its imposition.

K. The Division points out that although Congress specified ERISA plans as among those organizations generally exempt from taxation per IRC § 501(a), it nonetheless imposed the Federal UBIT on ERISA plans. The parties do not dispute the intent behind enactment of the Federal or State UBIT. In general, as well as specifically with regard to the debt-financed income in this case, Congress recognized that tax exempt entities enjoy an advantage over their taxable counterparts with regard to comparable income producing activities, including specifically those activities which do not directly relate to the exempt entities' core purposes (other than raising money). By enacting the UBIT, Congress sought to minimize this difference (narrow the spread) between exempt and for profit entities with respect to comparable activities unrelated to the exempt entities' core purposes. The Division reasons that since the State UBIT operates in a manner consistent with the Federal UBIT, in that it serves to further the Federal aim of "leveling the playing field," then the state law should stand as in furtherance of Congress's purpose and intent. This argument lends little support to the Division's position. While Congress enacted the Federal UBIT some 20 years prior to ERISA, and left the UBIT essentially unchanged upon enactment of ERISA, it does not follow that Congress in any manner expected or intended the states to enact similar measures. Congress aimed to maximize the financial well-being of ERISA plans (***see, e.g.,*** 29 USC § 1001[a]), and to foster uniformity in plan regulation, minimizing administrative and economic burdens on ERISA plans. The imposition of a state tax aimed at, *inter alia*, ERISA pension plans, is clearly at cross purposes with such aims.

L. Pursuant to ERISA's "savings" clause, certain state laws, to wit, banking, securities, insurance and general criminal statutes, are exempted or saved from preemption (***see*** ERISA § 514[b][2][A]; ***Morgan Guaranty Trust Company of New York v. Tax Appeals Tribunal, supra.***). However, Congress has made it clear that state tax laws are not exempt from preemption (***see*** ERISA § 514[b][5][B]; 29 USC 1144[b][5][B][i]). The courts have also concluded that there is no greater or stricter standard applied in preemption analysis simply because a state tax law, as opposed to some other state law, is involved (***DeBuono v. NYSA-ILA Medical & Clinical Services Fund, supra.***). Rather, the preemption standard remains that the challenged state action must either impermissibly "refer to" ERISA in a manner resulting in a legal consequence to the ERISA entity, or must be "connected with" an ERISA plan such that its impact thereon is more than tenuous, remote or peripheral. In this case, both of these standards are met. The Division maintains that the UBIT is "not inconsistent" with ERISA's objectives. It appears that the State UBIT is consistent with (or acts in furtherance of) Congress's objective of leveling the playing field between tax exempt and for profit entities, as described (essentially a commerce concern). Nonetheless, the State UBIT is also clearly at odds with Congress's ERISA intent of providing a uniform body of benefits law which fosters maximum stability and security with minimum conflict of law and regulatory burdens between various jurisdictions (***New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co., supra.***). In sum, by its reference to ERISA plans as described, Article 13 impermissably relates to such plans and must be preempted.

M. Treated next is the second, or alternative, basis upon which a state law may be found to impermissably relate to ERISA so as to result in preemption. This basis examines whether the state law in issue is "connected with" an ERISA plan in more than a tenuous, remote or peripheral manner. The Division maintains that the State UBIT is just one of many factors for petitioner's investment managers to consider in determining each fund's investment choices, and that it is not a consideration so onerous or burdensome as to limit petitioner to only one course of action or eliminate most other alternative courses of action (i.e., other attractive investments). The Division also asserts that the State UBIT burden is less significant than other impositions on ERISA plans in that the UBIT applies to only a part of petitioner's total income, and that it is only part of petitioner's overall potential UBIT liability (a "layer" of UBIT in addition to petitioner's Federal UBIT), which is imposed at the relatively low rate of nine percent. Finally, the Division asserts that since the State UBIT follows the Federal UBIT, and since petitioner is subject to the latter tax in any event, any timing, estimation or other compliance difficulties (***see*** Findings of Fact "12" through "14") will exist in any event, thus leaving any comparable State difficulties as minimal additional burdens.

N. As a starting point, the fact that the UBIT applies to only a portion of petitioner's income (and with respect to the State UBIT, only the portion of that portion allocable to New York) is not significant since the tax nonetheless directly applies to ERISA plans. Moreover, in this case the tax, to a far greater extent than the tax upheld in ***DeBuono***, clearly imposes administrative, structural and economic burdens and requirements on the plans. The Division's argument that the existence of the Federal UBIT requires the plan to carry out administrative chores including record keeping and estimation steps, with attendant timing difficulties, fails to acknowledge the additional requirements at the state level, including specifically issues of nexus and apportionment. These latter concerns are not present at the Federal level, and require plan administrators to become familiar and cope not only with New York's rules but with the myriad rules and regulations of other states which impose a UBIT. This result clearly works against Congress's goal of uniformity in regulation and administration of ERISA plans (***New York State Conference of Blue Cross & Blue Shield Plans v. Travelers, supra.; Ingersoll-Rand, Co. v. McClendon***, 498 US 133, 112 L Ed 2d 474).

O. The Division asserts the UBIT does not act exclusively on ERISA plans, but also impacts many other types of exempt organizations, and notes that the tax does not require the existence of an ERISA plan to operate, but only requires that an exempt organization earn unrelated business income. In ***Morgan Guaranty Trust Company of New York v. Tax Appeals Tribunal*** (***supra.***), the Court of Appeals rejected the argument that preemption might be determined by comparison, i.e., no preemption will occur if the state law applies to an ERISA plan in the same manner and for the same reasons as it applies to other citizens, notwithstanding that such application may burden the plan. The Court concluded that such an approach is flawed because it sidesteps and ignores the actual impact a state law has on a covered ERISA plan (***id.***, 587 NYS2d at 258). In this case, the UBIT does impose significant requirements on plans, including reporting and payment requirements, involving accounting, record keeping, and other administrative burdens. It is true that the UBIT targets exempt organizations, but in so doing specifically defines, by reference to the IRC, those particular exempt organizations subject to the tax and those that are not subject. Religious and apostolic organizations per IRC § 501[d]) are specifically excluded from coverage, while stock bonus, pension and profit sharing plans, i.e., ERISA entities, are specifically defined as subject to the tax per IRC § 401(a). [8] In sum, the UBIT is a state tax directed at ERISA entities per IRC § 401(a). The UBIT could have been imposed so as to have included all exempt organizations. Instead, it was imposed in a more specific fashion so as to identify those particular entities and organizations subject to the tax. The tax also directly impacts on the plan's investment strategy, in that it is imposed directly on the investment profits from certain of the plan's investments. In sum, every ERISA plan with investments which generate unrelated business income is subject to the tax, with the result being a reduction of funds available for plan beneficiaries, coupled with increased administrative burdens on the plans. This differs from cases which have, over ERISA preemption claims, upheld various state taxes or impositions, such as: a two-percent municipal income tax notwithstanding that some post-tax income was directed for contribution into ERISA plans (***Firestone Tire and Rubber Co. v. Neusser***, 810 F2d 550), a business tax imposed on employers regardless of whether such employers maintained an ERISA plan (***Thiokol Corp. v. Roberts***, 76 F3d 751), a surcharge imposed on commercial insurers and HMO's regardless of whether the patients were covered under an ERISA plan (***New York State Conference of Blue Cross & Blue Shield Plans v. Travelers, supra.***), and a tax imposed on hospitals regardless of whether the hospitals were operated by an ERISA plan (***DeBuono v. NYSA0ILA Medical & Clinical Services Fund, supra.***). In contrast, the State UBIT applies by definition directly to every ERISA plan and results in liability every time such a plan earns unrelated business income in excess of the statutory minimum amount (***see*** IRC § 512[b][12]).

---

8 This definitional exclusion of certain exempt organizations undermines the argument that the UBIT is a tax of general application against all exempt organization which simply catches some ERISA entities within its wide sweep. Rather, it directly applies to ERISA entities.

P. The Division claims that any UBIT impact could be eliminated by the choice not to make investments with the potential to generate unrelated business taxable income including, specifically, debt-financed income. This approach of eliminating possible investment choices not only would have a clear impact on a fund's investment strategy, but is inconsistent with ERISA regulations which direct funds to offer to participants diversified investment opportunities with different asset classes and risk levels (***see*** ERISA § 404[c]; 29 USC 1104[c]; 29 CFR 2550.404[c][1]).

Q. Petitioner asserts that the State UBIT is connected with its plans in a number of impermissable ways. Petitioner first asserts that the tax serves to negate ERISA (and the plans) anti-alienation provisions (***see,*** ERISA § 206[d][1]; 29 USC 1056[d][1]; IRC § 401[a][13]; Treas Reg § 1.401[a]-13). However, as the Division points out, the cited provisions serve to protect against assignments or alienation of benefits due a plan participant, but not to protect an ERISA entity from its own expenses or general liabilities in the first instance. The UBIT, a liability of petitioner in the first instance, which is thereafter equitably allocated against the particular plan or plans and ultimately their participants, does not violate the anti-alienation provisions. On the other hand, petitioner's claims that the tax impacts plan structure, administration and economics in more than a remote, tenuous or peripheral manner are borne out. Most significant is the impact not only of whether a given state imposes a UBIT, but whether the plan is subject to any given state's UBIT. In this context, the issue of nexus or connection between the state, the plan and the investment vehicle must be examined and determined. Furthermore, and assuming the plan is subject to UBIT, the question of how much unrelated business income must be apportioned to each state, including New York, becomes relevant, involving therein examination of each state's apportionment formula, as well as potentially varying definitions of unrelated business income and apportionable income on a state-by-state basis. Subjecting ERISA plans to state UBIT, if nothing else, immediately gives rise to reporting and compliance requirements on a state-by-state basis, as well as filing and payment duties which involve estimation and timing issues. All of these requirements run counter to the Congressional aim of achieving a uniform body of pension law with minimal financial and administrative burdens and conflicts among and between the different states and between the states and the Federal government. In sum, Article 13 is connected with petitioner's plans so as to impact them in more than a remote, tenuous or peripheral manner. Thus, Article 13 impermissably relates to the plans and must be held preempted.

R. The petition of McKinsey Master Retirement Plan Trust is hereby granted, as are its claims for refund of unrelated business income tax plus penalties and interest paid for the years 1994, 1995 and 1996.

DATED: Troy, New York
November 29, 2001

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE