

Tax- Exempt Entities: Structuring Real Property Investments

As a general rule, passive receipts such as dividends, interest, rents, and royalties are excluded from the scope of the unrelated business income tax because such receipts do not represent involvement in business by tax exempt organizations that would provide an unfair competitive advantage against their taxable counterparts. In contrast, when exempt organizations make leveraged investments, the potential for unfair competition increases. Thus, Congress included income derived from debt-financed investments as part of unrelated business taxable income.

As a simple example, assume that a school purchased an apartment complex by paying the full purchase price at the time of acquisition. Any rental income derived from the property, and any related deductions, are not subject to taxation because the property is not debt-financed and rents are generally excluded from the computation of the unrelated business income tax. In contrast, if the school paid one-half of the purchase price at the closing and gave a note and mortgage for the balance, the property would be debt-financed property to the extent of the indebtedness. In this case, part of the rental income, and related deductions, would be subject to the unrelated business income tax.

Real Property Exception. Debt-financed property is property held to produce income with respect to which there is “acquisition indebtedness.” Acquisition indebtedness is the unpaid amount of indebtedness incurred to acquire or improve real property. In the case of five categories of qualified exempt organizations, however, acquisition indebtedness does not include indebtedness incurred to acquire or improve real property. However, there are some limitations on the types of transactions that qualify for this special treatment. The real property exception does not apply if:

- The price for the acquisition or improvement is not a fixed amount determined as of the acquisition or the completion of the improvement;
- The amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, is dependent, in whole or in part, upon any revenue, income, or profits derived from the property;
- Any time after the acquisition, the real property is at leased by the qualified organization to the seller or a person related to the seller;

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- The real property is acquired by a qualified trust from, or is at any time after the acquisition leased by such trust to, certain disqualified persons; and
- Any person related to the seller or to a qualified trust provides the financing.

Thus, in our example, the school can purchase real property using borrowed funds and, assuming the transaction is structured to comply with the limitations described above, rental income derived from the property will not be treated as debt-financed income.

Application of Real Property Exception to Partnerships. Many exempt organizations choose to make real property investments through partnerships, limited liability companies, or similar entities (collectively, the “Partnership”). Although the Partnership is treated as a pass-through entity for federal income tax purposes, the Partnership is recognized under state law as a separate entity apart from its partners. Thus, potential liabilities associated with ownership of real property can be isolated in the Partnership, thereby protecting the exempt organization’s other assets from creditors associated with the real property. In addition, an exempt organization that joins together with other taxable or nontaxable entities may be able to assemble larger development projects, or achieve a degree of diversification, that would be impractical for a single organization acting alone.

The real property exception is also available when qualified organizations use Partnerships to invest in realty if the Partnership satisfies all the conditions (described above) that apply to a qualified organization making a direct real property acquisition. In addition, the Partnership must meet two important requirements having to do with allocations to partners under the partnership agreement. First, the allocation of items to an exempt organization cannot result in the exempt organization having a share of the overall Partnership income for any taxable year greater than such exempt organization’s share of overall Partnership loss for the taxable year. The second requirement is that each allocation with respect to the Partnership must have substantial economic effect. The allocation requirements are designed to prevent abuse of the real property exception by Partnerships that allocate taxable income to exempt partners and losses to taxable partners.

Planning Considerations. When an exempt organization invests in real property using a Partnership, the requirements for taking advantage of the real property exception are complex. Provisions that routinely appear in traditional partnership agreements can disqualify an

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investment from the unrelated business income tax exception. Thus, an exempt organization must thoroughly negotiate all real property transactions and carefully draft the Partnership agreement to ensure compliance with the rules of the real property exception.

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