TAX ISSUES FOR REAL ESTATE LEASING BY TAX-EXEMPT ORGANIZATIONS

Part One: Residential and Commercial Leases

Written by:

Michael J. Huft
mhuft@schiffhardin.com
312.258.5627

Nina M. Knierim
nknierim@schiffhardin.com
312.258.5594

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One Atlantic Center, Suite 2300
1201 West Peachtree Street
Atlanta, Georgia 30309
t 404.437.7000 f 404.437.7100

225 Franklin Street, Suite 2600
Boston, MA 02110
t 617.848.5750 f 617.848.5784

6600 Sears Tower
233 South Wacker Drive
Chicago, IL 60606-6473
t 312.258.5500 f 312.258.5600

One Westminster Place
Lake Forest, IL 60045-1885
t 847.295.9200 f 847.295.7810

900 Third Avenue
New York, NY 10022
t 212.753.5000 f 212.753.5044

One Market
Spear Street Tower
Thirty-Second Floor
San Francisco, CA 94105
t 415.901.8700 f 415.901.8701

1666 K Street NW, Suite 300
Washington, DC 20006
t 202.778.6400 f 202.778.6460

It is not uncommon for tax-exempt organizations to want to lease real estate they own to residential or commercial tenants, whether the real estate consists of empty land or existing buildings. Such rentals often provide a good source of revenue for the organization, as well as a means of maintaining in use property that the organization may wish to hold for long-term development for its own uses, but is temporarily not needed. In other cases, it involves property that may never be used by the organization, but the organization believes that leasing the property will produce greater income, or at least a steady stream of income over a longer period of time, than would be available by selling the property outright.

In these regards, tax-exempt organizations are no different from for-profit businesses that need to find a use for property that may be temporarily or permanently not needed for the business's operations. There are major differences, however, in the consequences. Although tax-exempt entities do not ordinarily pay tax on their income, the federal tax code does tax the income of tax-exempt organizations that is derived from commercial activities. Although an organization is permitted to engage in some degree of commercial activity (and pay the tax on the income derived from such activity), if the taxable income from the activity constitutes too large a portion of the organization's overall income, it will jeopardize the organization's exemption.

This article examines the issues that must be dealt with by tax-exempt organizations in leasing real estate to third-party lessees. A second article in this series will examine the special problems of tax-exempt organizations that wish to develop vacant land in order to increase their revenue, whether through leasing the improvements to third parties or by eventually selling the improved property. A third article will examine the special cautions that must be observed if the real estate is debt-financed.

THE 'UBIT'

The federal tax code imposes a tax (referred to as the unrelated business income tax, or "UBIT"), computed at the corporate income tax rate, on the unrelated business taxable income ("UBTI") of most exempt organizations, including universities, churches, public hospitals, charities and foundations, social welfare organizations, certain cooperatives, business leagues, and pension and other qualified plans. With certain exceptions not relevant here, the unrelated business taxable income of an organization subject to UBIT is the gross income derived by such organization from any unrelated trade or business regularly carried on by it, less any allowed deductions that are directly connected with such trade or business, both computed with certain modifications. An unrelated business is any trade or business, the conduct of which is not substantially related to the performance by such organization of the functions that constitute the basis of its exemption from tax.

The tax code provides for the categorical exclusion from UBTI of income from certain enumerated sources or arising from certain activities. Of particular relevance to this article, all rents from real property are excluded from UBTI, provided that the determination of the amount of such rent does not depend in whole or in part on the net income or profits derived by any person from the property leased (this point will be developed in the second article in this series). In addition, if personal property is leased with the real property and if the portion of the overall rent attributed to it exceeds 10%, the excess will be considered UBTI. If more than 50% of the rental income is attributed to personal property, then the entire amount of the rent will be included in UBTI. In the latter case, the portion of the rent income attributed to real property can be retained as tax free by the execution of a separate lease for the personal property.

TAX-FREE CIRCUMSTANCES

There is, in general, no provision that excludes from UBTI income from the performance of services that constitute an unrelated business. However, in certain circumstances, income attributable to services provided in connection with the rental of real property will be considered to be included in the tax-free rental from real property. The general rule is that payments received for services rendered in connection with the rental of real property will be excluded from UBTI, unless both of the following are true:

1. The service is primarily for the convenience of the occupant; and
2. The service is not usually or customarily rendered in connection with the rental of real property for occupancy.

However, if a certain service does not pass this test for exclusion, then, unless the income from that service is separately accounted for, the entire rental income will be subject to tax. Neither the tax code nor the applicable regulations provides much specific guidance as to what services or activities in connection with the rental of real property an organization may perform without subjecting the income to tax. Rather, it is necessary to turn to IRS rulings provided to specific organizations for further guidance.

The IRS has issued numerous private letter rulings indicating that certain specific services rendered to occupants fall within the exception provided by the regulations and, therefore, do not affect the exclusion from UBTI of rentals received from real property. Although private letter rulings may not be used or cited as precedent, they do indicate the thinking of the IRS with respect to a particular tax question. If numerous letter rulings are consistent with respect to a particular question, then, despite their lack of precedential value, that will be a strong indication of how the IRS would rule in other similar situations.

SEVERAL CATEGORIES

Based on these rulings, we can distinguish several different categories of services offered in connection with the rental of real property that will not prevent the rental income from being excluded from UBTI.

Development Activities Performed by the Organization With Respect to the Property

These are designed to improve the long-range earning capacity of the property and to protect the value of the property. Thus, these activities are not performed primarily for the convenience of the tenant and, therefore, will not cause the rent received from the property to be taxable. These include such things as:

- Construction and development;
- Renovations (including making physical alterations to the premises to rent space or to comply with building codes or for other safety purposes);
- Employing architects, contractors, and other service providers for designing and constructing improvements to the properties; and
- Negotiating and contracting for feasibility studies and supervising compliance with local, state or federal laws and regulations.

Lease Management Activities Undertaken by the Organization

These are activities that are normal and incidental to the management of real estate investments and are not undertaken primarily for the convenience of the tenants. They include:

- Negotiating lease terms;
- Billing for rent and other payables;
- Collection and deposit of rents; and
- Accounting.

Maintenance Services Provided By the Organization in Connection with the Overall Operation of the Property

The areas maintained are primarily common areas, not individual lease spaces, and, therefore, such services are of the type provided primarily for the convenience of the landlord, not the tenant. These include:

- Pest control;
- Landscaping;
- Fire protection;
- Guard services; and
- Janitorial and cleaning services to the common areas of the property.

Causing Lines and Conduits To be Connected to the Leased Premises

These services, which allow for the provision of utility services such as electricity, gas, and water to the tenants, are essential to the operation of the property and thus are not primarily rendered for the convenience of the tenants.

Services That Are Primarily of Convenience to the Tenant

These are services that are primarily for the tenant, rather than the landlord, but are customarily offered or provided to tenants of similar properties located in the same geographic market. It is useful to examine these items separately in the residential and commercial contexts.

RESIDENTIAL RENTAL PROPERTY

There is a wide range of services in connection with residential leasings that the IRS has concluded will not result in the taxation of rental income. Most of these services are offered as part of the rental agreement. Examples include:

- Utilities, including water, sewer, and gas;
- Internet access;
- Swimming pools;
- Telecommunication services;
- Cable television;
- Self-service coin operated laundry;
- Monitored security system;
- Vending machines;

- Trash removal; and
- Parking (but only if the parking lot is for the exclusive use of tenants and their guests and is not available to the general public).

The IRS generally allows these services or "amenities" based on the representation by the organization that the services provided to tenants are customarily offered in connection with similar rentals of residential units in the geographical market of the property. In a specific case, it is, therefore, important to make sure that the services in question are ordinarily provided by other landlords of similar properties in the area.

Although the available letter rulings enumerate very few specific services that are deemed to be primarily for the convenience of the tenant, that is likely because there are so many ways that a landlord could provide services to a tenant that would very obviously be primarily for the tenant's convenience that they are rarely asked about by those submitting a letter ruling request. Among the services that the IRS has ruled will result in the taxation of rental income are dining hall services and housekeeping or maid services.

COMMERCIAL RENTAL PROPERTY

Private letter rulings pertaining to the lease of commercial space show many similarities in the types of services that organizations provide to tenants of residential rental properties. As before, whether a service was considered permissible or impermissible typically hinges on the representation by the organization that the services are customary and are expected of a lessor in a similar class of buildings in the local geographic market. Some of these services include:

- Cleaning, repairing and repainting tenants' premises as they move in or out or renew their leases (some remodeling may be performed to suit the particular needs of a tenant at the commencement of a lease term, or upon renewal; however such services should not be performed inside a tenant's premises during the term of its lease);
- Providing usual and customary utilities including heat, gas, electricity, water, sewer, and air conditioning;
- Providing parking services and private roads accessing them; and
- Telecommunication services.

These services may be provided to the tenants as a package of services for a fee, or the tenants may be charged a fee for each individual service received, which may be based upon the actual amount of usage of a particular service. With respect to telecommunications services, rulings suggest that their acceptability may depend on the requirement that no provider enter into an agreement with the organization to offer any services that the provider does not also offer to other customers who are not tenants, and that the telecommunications services provided to tenants not be customized to fit the specific needs of a particular tenant (rather, tenants would be offered a menu of services that are generally available to customers of the provider, whereby the tenants can pick from that menu the services they wish to receive). The IRS notes that, as with common utilities, the provision of the telecommunication services has become an essential means of communicating business information and data.

The conclusions discussed in this article do not depend on whether the organization owns the property outright. For example, where a building is owned by a developer who ground leases the land from the organization, the ground rent paid to the organization will not be included in UBTI even though it ultimately derives in part from the payment for services performed in connection with the rental of real estate if such services are consistent with the rules described here.

Thus, a tax-exempt organization may provide a very broad range of services in connection with rental real estate without subjecting either the rentals received from such properties or the specific payment it may receive separately for the performance of such services to taxation as UBTI. However, caution must be exercised to insure that such services are of the type that will not subject the entire rental income derived from the real estate to tax. If it is necessary to provide a service to tenants that would subject the rent payments to tax, it is advisable to execute a separate contract for that service, thereby making only the income from that service taxable, while the remaining rental income continues to be excluded from UBTI.

About the Authors

Michael J. Huft concentrates his practice in the field of tax-exempt organizations and charitable giving. His practice encompasses all phases of exempt organization law, ranging from the establishment and achievement of tax-exempt status of new organizations to governance and operations, fundraising, real-estate transactions of tax-exempt organizations, the unrelated business income tax, management of private foundations, endowments, and foreign transactions.

Mr. Huft has experience representing a wide range of tax-exempt organizations, including private foundations, schools and universities, professional organizations, churches and other religious organizations, and organizations active in the areas of the arts, health care, scientific and medical research, housing, neighborhood redevelopment, cultural and civic affairs, as well as social welfare organizations, trade associations, business leagues, business and housing cooperatives, and professional fundraisers.

Nina M. Knierim focuses her practice on various litigation and transactional issues in intellectual property law, franchise law and non-profit law. Prior to joining Schiff Hardin, Ms. Knierim gained experience at Duke University's Community Enterprise clinic where she counseled non-profit organizations in real estate, tax exemption, and intellectual property matters. In addition, Ms. Knierim worked as a legal clerk reviewing patent applications and performing research on various issues relating to patent and technical transfers at Duke University.

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