

# Renting Property - IRS & WA State Tax Issues for Nonprofits

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# IRS Taxes – Unrelated Business Income

- 3 conditions for classification:
  1. Income from the activity must be a trade or business
  2. The trade or business must be regularly carried on
  3. The trade or business must not be substantially related to the exempt purpose of the organization (aside from the need for the funds)
- Unrelated Business Taxable Income (UBTI)
  - Exempt organizations pay tax at corporate rates

## IRS Taxes – What is a “Trade or Business”?

A trade or business = an activity carried on for the production of income from sale of goods or services. Examples include:

1. selling goods at a church bazaar
2. selling commercial advertising in organization's program
3. operation of a café
4. parking lot rental

## IRS Taxes – What does “Regularly Carried On” mean?

### Factors to consider:

1. The frequency and continuity with which the activities are conducted and the manner in which they are pursued.
2. Determined in light of the purpose of the unrelated business income in order to place the business activities of exempt organizations on the same tax basis as the taxable business endeavors with which they compete.

Example: the IRS maintains that an activity carried on one day a week on a year-round basis, such as the use of a church parking lot for commercial parking one day per week, is “regularly carried on”.

# IRS Taxes - Substantially Related Business Income

A church operates a bookstore. Is the sale of bookstore items substantially related to the church's exempt purposes?

1. Is the income from the activity considered a trade or business?
2. Is the trade or business regularly carried on?
3. Is the trade or business substantially related to the exempt purpose of the organization (aside from the need for the funds)?
  - Sale of Bibles and Christian related books?
  - Sale of clothing and jewelry with no Christian related message?
  - Sales of newspapers, candy, and similar sundries?

## IRS Taxes - Substantially Related Business Income

A charity that rents a portion of its premises to another charity with similar purposes is not subject to UBIT on that rental income (even if there is acquisition debt).

Substantially related when the rental activity:

1. has a causal relationship to the achievement of exempt purposes (other than through the production of income)
  - Example: Church renting to another church or para-church organization
2. contributes importantly to the accomplishment of the charity's exempt purposes

## IRS Taxes – Exceptions to Unrelated Business Income Tax

1. Volunteers: Activities in which substantially all work is performed by unpaid volunteers.
2. Convenience of its members: Activities carried on by a church or other charitable organization primarily for the convenience of its members, students, or employees.
3. Selling donated merchandise, substantially all of which has been received by the exempt organization as gifts or contributions.
4. Qualified sponsorship payments (versus advertising).
5. In general: interest, dividends, gain on sale of property, rents on real property (exceptions discussed later in webinar).

# IRS Taxes on Real Property Rentals

- Real property rental income:
  - generally NOT taxed as UBTI
  - TAXED if the property has “acquisition debt”





# IRS Taxes - What is "Acquisition Debt"?

- The unpaid balance of debt incurred:
  1. ... in acquiring or improving property
  2. ... before or after acquiring property
    - If the debt would not have been reasonably incurred but for such acquisition or improvement
  3. A refinance obligation continues as "acquisition debt"

## Example “Acquisition Debt”

First Church currently owes \$500,000 on a liability treated as acquisition indebtedness. To fund a shortfall in cash reserves, due to a drop in donations, the church refinances the debt and borrows an additional \$100,000 from the same lender. The church executes a \$600,000 note for the total obligation. What part of the new debt will be considered acquisition debt?

Answer: \$500,000

## Example “Acquisition Debt” – Property Sale (not used for exempt purposes)

First Church buys unimproved land with the intent of using the property for church purposes. The purchase price was \$2 million, \$1 million paid in cash plus a 5 year interest only \$1 million seller financed contract (which is considered acquisition debt). The church never uses the property for church purposes, but sells the property in year 4 for \$8 million (at which time the \$1 million debt is paid in full). How much of the \$6 million gain is taxable?

- a) \$6,000,000
- b) \$3,000,000
- c) \$0

## “Substantially All” IRS Exception to Acquisition Debt



- Substantially all (85% or more) of the property is used for the organization’s exempt purposes
  - Excluded from definition of debt financed property
  - Renting to another exempt (but not related) entity may be substantially related to lessor’s exempt purposes

# “Substantially All” IRS Exception

- Example:
  1. A church rents a room to a local government agency. The room comprises 8% of the church building. The remainder of the church's property is used for religious purposes.
  2. The church property is debt-financed.
- Question:
  - Is the rental income from debt-financed property subject to unrelated business income tax?



# “Neighborhood Land” Exception from Debt-financed Property Rules

- Temporarily rented without being subject to “debt-financed” property rules
- Property purchased to be used within 10 years (15 years for churches)
  - Must notify the IRS within five years if not converted
- Structures would be demolished in order to use the land for exempt purposes
- Neighborhood = contiguous, or if not possible, within 1 mile
  - Contiguous rules N/A for churches

# “Neighborhood Land” Exception for IRS



- Example:
  - Church purchases a home next to the church and intends to demolish to expand its church facilities within 15 years

## IRS UBIT Rules: Parking Lot Rentals

- Subject to UBIT: Rental of parking spaces during the week for non-church purposes – such as to a local business or a government entity (not considered rental of real estate, only use of space). See IRS Pub 1828
- Not subject to UBIT: The church rents its entire parking lot to a third party who operates the church parking lot and pays a flat rental price, or rental price based on a percentage of gross rentals (assumes no acquisition debt on the property).



## IRS UBIT Rules: Cell Tower Rental Income

- Subject to UBIT: Rents received by charity for the use of communication towers or antenna owned by the charity (not considered rental of real estate, broadcasting towers are considered personal property). See IRS PLR 200104031
- Not subject to UBIT: The church rents a specific area of church property on which the cell company constructs and maintains a cell tower (assumes no acquisition debt on the property).

# Reporting IRS Unrelated Business Income

- If gross receipts > \$1,000
- Use IRS Form 990-T
  - Lower capital gains rates? (no - use Corporate rate)

# Washington State Business & Occupation Taxes

- Long-term rentals exemption from B&O tax
  - 30 continuous days or longer
  - 24/7 rental of facility (RCW 84.04.390)
- Other rentals:
  - Church is considered as granting a license to use real estate, but does not confer exclusive control or dominion
  - Generally B&O taxed as “service and other activities”

## Washington State Sales and B&O Taxes – Parking Spaces



Example: XYZ Company wants to use 50 parking spaces between 6am and 8pm Monday through Friday at a rate of \$20 per parking space per month, or \$1,000 per month. Which excise taxes apply?

- a) Service and other B&O tax?
- b) Retail B&O as well as sales taxes?
- c) No tax?

## Washington State Sales and B&O Taxes – Parking Spaces



- Rental of parking spaces:
  - Considered a retail sale (when less than exclusive use 24/7 for >30 days)
  - Required to collect sales tax on charges for parking