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George E. Reed

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EXEMPTIONS FROM UNRELATED BUSINESS TAX—RENTAL INCOME

GEORGE E. REED, ESQUIRE
ASSOCIATE GENERAL COUNSEL
U.S. CATHOLIC CONFERENCE
WASHINGTON, D.C.

INTRODUCTION

From the very inception of the unrelated business tax in 1950, one of the critical areas involved the tax status of rental income. Rental income derives from various types of arrangements, many of which do not and did not fall into any consistent pattern. Some of the arrangements were obviously designed to exploit loopholes in the law, and it was necessary to prevent this by enacting legislation to combat this practice. On the contrary, there were other situations where the general provisions of unrelated business taxation might result in the imposition of a tax which was unwarranted. Accordingly, it was found necessary to legislate certain modifications to the basic unrelated business tax. Prominent among these is rental income.

EXEMPTION OF RENTAL INCOME

Section 512(b) of the Internal Revenue Code contains several categorical exemptions from the unrelated business tax including rental income in some cases. I am confident that if the various dioceses represented here conduct an inventory of all of their property, it would be found that there is a variety of rental income. For example, parochial schools, parish halls, former convent residences, all of these, in many instances, have been rented. Additionally, an inventory will probably note some leasehold interests in farmland, parking lots, and buses or other educational equipment. How do we apply the exemption in section 512(b) to these and related areas of rental income?

RENTAL INCOME FROM AN APARTMENT HOUSE

- A. Let us assume for purposes of a basic example that the Diocese owns an apartment house free and clear of all debt and that it rents the apartment complex and receives rental income therefrom. The apartment is unfurnished and consequently the income is primarily from

real property. Under these and similar circumstances, all of the rental income would be exempt from unrelated business income under the terms of section 512(b).

- B. Let us take the same example with the one modification, namely that a minimum amount of furniture is included in the rental arrangement. This raises the question of whether the inclusion of *personal* property defeats the exemption. The basic rule is that where personal property is listed with real property and the rent attributable to personal property is *incidental*, then the basic exemption is not affected. INT. REV. CODE of 1954, § 512(b)(3)(A)(ii).

The criterion for the term "incidental" is 10 percent. Accordingly, if the furniture in the rental apartment complex is less than 10 percent of the value of the rented premises, then all of the rental income would be exempt.

On the other hand, let us assume that the rent from the apartment complex was \$100,000 per year and that substantial furniture was included worth approximately \$30,000. The rent attributable to the personal property would equal \$30,000 per year. The \$30,000 could not be excluded from the computation since the amount is not an incidental portion of the total rents. The exclusion from unrelated business income would amount to \$70,000 rather than \$100,000.

- C. Finally, let us assume that we have a very fancy apartment complex and that it is furnished with antique furniture throughout. The value of the furniture is in excess of 50 percent of the value of the real property. In that event, since the personal property has a value in excess of 50 percent of the real property, there would be no exemption. INT. REV. CODE of 1954, § 512(b)(3)(B)(i).

NET LEASES OR JOINT VENTURE

(IRC § 512(b)(3)(B)(ii))

- A. Continuing with our basic example, let us assume that the Church enters into a management contract with a real estate agency, according to which the agency would manage the apartment house and the rent paid to the Church would depend on the *profit* derived. This would, in effect, be a *net lease* and consequently there would be no basis for an exemption from the unrelated business tax. On the other hand, if the agreement was based on a percentage of the rent, that is, a percentage of gross, then it would be excluded from the unrelated business tax. In short, the basic rule is that when the rental income depends on net, it is taxable; when it depends on gross income, it is not taxable.

- B. Departing from our basic example for a moment, some consideration should be given to the lease of farmland with a sharecropping arrangement. Undoubtedly, many here have had occasion to examine the case of *State National Bank of El Paso v. United States* (1972), which dealt with a sharecropping arrangement by a nonprofit organization. The court stated:

The fact that the income was based on net profits did not alter the lease arrangement. Many agreements are reached on such a basis. Moreover, the tenant had control over the operation of the farm. He hired and fired the employees, determined the crops to be planted, and paid Social Security for the employees. These facts pointed to a landlord-tenant relationship.

This position is consistent with the case of *United States v. Myra Foundation*, 382 F.2d 107 (8th Cir. 1967).

Both of these decisions were based upon the law prior to 1969 which did not impose tax status on net leases. On appeal, in the *El Paso* case, the circuit court reviewed the decision and has sent it back to the district court for determination of the issues by a jury. Whether the court is implying that there may possibly be an exception to the net lease rule or not is difficult to say. However, it is doubtful whether IRS could acquiesce in an unfavorable decision. It is highly probable that the Service would assess an unrelated business tax on any sharecropping arrangement where the income is dependent on net profits.

- C. Certainly, if the Church shared in the management of the farm, or to get back to our basic example, if it shared in the management of the apartment house, there would be a basis for denying the tax on the ground of *joint venture*. One of the consistent grounds for denying exemption has been that of the joint venture between an exempt organization and a nonexempt entity.

RENDERING OF PERSONAL SERVICES IN CONNECTION WITH RENTAL
ARRANGEMENTS
(IRC § 512(b)(1)-(5))

Returning to our example of the apartment, let us assume that rent was predicated not only on occupancy but also on the provision of personal services, such as personal maid service. Under these circumstances, none of the rental income would be exempt. On the other hand, if general services, such as janitorial services were provided, this would not have any effect on the exemption.

Departing from our basic example, I should call to your attention that many of our parish halls have been rented for wedding receptions and similar functions. If the rental income derives mainly from the lease of the hall, there is no difficulty; but frequently catering services are involved. If

these catering services are not voluntary services, then the rental income would be subject to taxation because of the personal services.

BUSINESS LEASE

Legislation was enacted early in the development of the unrelated business legislation designed to impose a tax on what is termed a "business lease." Taking the example of the apartment again, let us assume that a private individual sold the apartment house to the Church for a sum of \$1 million. The Church, in the sale transaction, agreed to lease back the apartment house to the private individual for a rental of \$50,000 a year. The lease would be for 20 years. Such an arrangement under the "business lease" provisions of the law would subject the rental income to taxation, for the lease is in excess of five years and there would be a lessor indebtedness at the end of the period sustained by the lessor in acquiring the leased property. The Church would not be able to obviate this situation by a clause providing that the lease could be renewed every four or five years at the option of the lessee. In short, options of renewal may not be used to avoid the five-year limitation. The basic exception to such an arrangement is rental for a related purpose. For example, the lease by a *hospital* to doctors who are on the staff of the hospital and who agree to provide services for the emergency room, has been considered to be a related purpose and exempt from the business lease provision. Rev. Rul. 464, 1969-2 CUM. BULL. 132.

OCCUPANCY OF BUILDING

If the building, which has been rented as an apartment, is partially occupied by the Church organization for its exempt purposes, then there is a basis for claiming an exemption of all of the rental income. Normally, the building must be at least 50 percent occupied by the exempt organization.

IMPACT OF DEBT FINANCING (IRC §§ 514 and 512(b)(4))

In all of the foregoing examples we have, with the exception of the business lease, been considering the rental property which is owned by the Church free and clear of all debt encumbrances.

- A. If, on the other hand, the Church has incurred an indebtedness on the property, for example, either in acquiring the apartment or in making improvements, then there is a debt financing which subjects the rental income to taxation. If the apartment is valued at \$1 million, and if the indebtedness is \$250,000, then an unrelated business tax would be imposed on the rental income on the basis of the percentage of the indebtedness to the value of the property. Appropriate business deductions could be taken under these circumstances.

- B. Treasury has not ruled concerning the implication of borrowing by a parish church from a diocesan fund. However, we have discussed this matter with the Exempt Organizations Branch of IRS, and they have informally ruled that this would be considered an *interagency transaction* and consequently would not be considered to be a debt financing operation.

IMPLICATIONS OF SALE OF PROPERTY

Assume that the Church is tired of all of the confusing variations with respect to the rental of property, such as the apartment house, and it wishes to sell the facility. What are the implications?

If there is no debt financing, then no capital gains tax will be imposed. On the other hand, if there is debt financing, then a capital gains tax will be imposed in proportion to the average indebtedness at the end of the taxable year.