



TAX ISSUES FOR REAL ESTATE LEASING BY TAX-EXEMPT ORGANIZATIONS

Part Two: Developing and Leasing Vacant Land

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The first article in this series (March 2009) examined the issues involved when a tax-exempt organization leases improved property to one or more parties, for example a research building owned by a university leased to one or more private businesses. The primary issue examined in that article was whether or not the lease payments to the university constituted, in whole or in part, payments for services provided to the tenants, rather than purely payments for the rental of real property.

This article will examine the issues involved when a tax-exempt organization owns a tract of vacant land that it wishes to develop and lease, so as to realize a stream of income from the land greater than would be realized by a simple sale or lease of the unimproved property. The third and final article in this series will examine the special cautions that must be observed if the real estate is debt-financed.

Review of UBIT

As described more fully in the earlier article, 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. 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, including all rents from real property, 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.

Avoiding Participation in Development

The basic problem to be resolved when a tax-exempt organization desires to develop and lease vacant land for purposes other than its exempt purposes is that this involves two separate activities – (i) developing the property and (ii) leasing the property.

Whereas income from leasing the property (in the form of rent) is generally excluded from UBTI, the activity of developing the property is considered to be an unrelated business, and the income attributable to that activity is therefore taxable to the organization. Although an exempt organization rarely acts as a developer itself, it frequently enters into a relationship with a professional developer to improve the property. Therefore, it is important to structure the relationship between the exempt organization and the developer appropriately. A joint venture or partnership (including a limited liability company taxed as a partnership) between the developer and the tax-exempt

landowner, which is often used by non-exempt landowners to develop and lease property, will not work in the case of a tax-exempt landowner. Since the net income, or profits, of a partnership are attributed pro rata to the partners, and since the IRS deems the right to receive a share of the profits to be equivalent to participation in the activity giving rise to the profits, regardless of any actual physical involvement, the portion of the profits allocable to the exempt entity will be treated as taxable income from the unrelated business of developing real estate.

Use of Ground Lease with Appropriate Rental Formulas

The most frequent alternative that is used by tax-exempt organizations to avoid UBTI in the development and leasing of land is a ground lease, whereby the organization leases the property to a developer, which will then develop the property (often involving subdivision) and sublease the parcels to the ultimate tenants. Because the whole purpose for developing the property is frequently so that the exempt organization can realize a greater return from rentals than it would from simply leasing or selling the vacant land, the rental terms in the ground lease are frequently complex so that the rental income will approximate what the organization would have received as its share of the profits under a joint venture with the developer. For example, in addition to a flat base rental amount each year, the lease may include additional rental amounts based on a calculation of completed square footage of improvements and/or a percentage of gross revenues received by the developer from the ultimate tenants ("percentage rent"), often reduced by certain expenditures of such tenants, including maintenance charges for common areas, taxes and other assessments, or similar amounts. Furthermore, the lease may designate certain dates on which the base rent will increase, either by an amount fixed or calculable under the lease, or to be renegotiated by the parties by agreement or appraisal.

It is important to take care in drafting such a lease, however, since the subtractions from percentage rent for costs realized by the ultimate tenants could make what started out as rent based on gross proceeds to look very much like rent based on net income or profits, even if not so expressed in the lease. Even if an agreement is called a lease, and the payments are all termed "rent," the IRS will recharacterize the arrangement as a joint venture, or partnership (and tax the profits received by all "partners"), if it concludes that the reality is that the two parties are sharing profits, regardless of the terminology of the agreement. A provision permitting the parties to renegotiate the base rent at some point in the future, based either on agreement or on a reappraisal of the property, can also be a hidden time bomb. Unless the lease carefully sets appropriate parameters to the process, there

is nothing to prevent the parties from basing their new agreement on net income, or the appraiser from using net income of any person as one of the bases of the appraisal.

The applicable Treasury Regulations under the federal Tax Code contain additional details to help determine whether rent receipts depend in whole or in part on the income or profits derived from any person from the property leased. These include the following (the regulations use the term “rents from real property” to mean rental income that is excluded from UBTI):

- Since no amount received with respect to any real property qualifies as “rents from real property” where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property, even if a small portion of the rental formula is based in any person’s profit from the property, then entire rental income will be taxable. However, no amount received shall be excluded from the term “rents from real property” solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or federal, state, or local sales taxes).
- Thus, “rents from real property” would include rents where the lease provides for differing percentages or receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease and is not renegotiated during the term of the lease in a manner having the effect of basing the rent on income or profits.
- An amount received as rent that is based on a fixed percentage or percentages of the lessee’s receipts or sales reduced by escalation receipts (including those determined under a formula clause) will qualify as “rents from real property.” Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent shall be increased to reflect all or a portion of an increase in real estate taxes, property insurance, operating costs of the prime tenant, or similar items customarily included in lease escalation clauses.
- An amount received as rent that consists, in whole or in part, of one or more percentages of the lessee’s receipts or sales in excess of determinable dollar amounts may qualify as “rents from real property,” but only if (i) the

determinable amounts do not depend in whole or in part on the income or profits of the lessee, and (ii) the percentages and the determinable amounts are fixed at the time the lease is entered into and are not renegotiated during the term of the lease in a manner having the effect of basing rent on income or profits.

- If a tax-exempt organization leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant’s gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the tax-exempt organization from the prime tenant with respect to such property is disqualified as “rents from real property.” The IRS has issued a number of favorable rulings, however, in which the rent is tied to cash flow rather than to profits.

In private rulings, the IRS has sanctioned several ways in which a prime lease to a tenant that subleases to others can structure a gross receipts formula for rent that will not result in the rental payments being characterized as based in whole or in part on profits. For example, the IRS has permitted a rental formula based on shifting percentages applied to gross sales of the preceding year. A rental formula may include a fixed base rent, a percentage rent above some fixed base, additional rent such as from sharing of sale or refinancing proceeds, and reimbursement for all or part of increases in CAM (common area maintenance), real estate taxes, and property insurance. Inflation increases may be built into a rental formula.

In addition to structuring rental payments pursuant to a cash flow formula, a rental formula may also incorporate certain exclusions from rent without causing the rent to be characterized as based on net income or profits. For example, the regulations described above permit a rental formula to be based on a percentage of sales or receipts, even if such sales or receipts are adjusted for returned merchandise and federal, state or local sales taxes. The IRS has ruled privately that in determining percentage rentals, the following items may be excluded from gross income: “any amount received by the Prime Tenant from Space Tenants on account of real estate taxes, assessments, operating costs and common area charges under so-called escalation clauses or otherwise.” In addition, the IRS has permitted the exclusion of amounts received by a ground lessee from occupancy tenants as reimbursement for common area expenses.

The IRS has permitted the following exclusions from gross receipts in determining percentage rent: (i) escalation payments, (ii) additional service adjustments, (iii) amounts received by the lessee from sales of its interest in improvements located on the premises, (iv) receipts from the lessee's other businesses where the only connection with the project is that the entity through which such business is conducted occupies space in the project, (v) proceeds from casualty insurance on the project, (vi) subtenant security deposits, and (vii) reimbursements of the lessee's costs of preparing, altering or restoring improvements on the project. The additional service adjustments are amounts which reimburse the lessee for costs in providing services and electric utilities outside of normal operating hours or over and above standard services.

In addition, the IRS has permitted a percentage formula based on the tenant's gross sales reduced by (i) returns and refunds in fact made by the tenant, (ii) exchange of merchandise between stores of the tenant where such exchanges are made solely for the convenient operation of the tenant's business and not for the purpose of consummating a sale which has theretofore been made, (iii) sales of fixtures after substantial use thereof in the conduct of the tenant's business on the premises, and (iv) the amount of any city, county, state or federal sales or excise taxes on such sales which is both added to the selling price (or absorbed therein) and paid to the taxing authority by the tenant.

Additional Issues if the Property is Developed and Sold

Although space does not permit a full discussion of the issues involved where the exempt organization wishes to develop, then sell, its vacant land, the underlying problem is similar. Although gain from the sale of real property is excluded from UBTI (with the important proviso that the property is not subdivided into, or otherwise sold as, a sufficiently large number of lots so that the organization is treated as being in the business of selling lots), engaging in the business of developing the property will give rise to taxable income. The most common solution is also to lease to the developer, making sure the rental provisions follow the guidelines discussed above, who will then sell the individual lots. The goal is to devise a workable rental formula that will afford a return to the exempt organization of an amount that would mimic its share of the profits without actually being so characterized. Alternatively, the parties can use a deferred sales contract, whereby the developer would make payments to the organization only as the units begin to be sold, again using a sales formula to afford an adequate return to the organization without causing it to be treated as participating in the profits from the development activities.

About the Author

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, 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.

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