Tax Advisory

By George Martin

Deals With Tax-Exempt Partners Require Deft Maneuvering

Real estate owners and developers are looking to tax-exempt investors as a potential source of capital. Pension funds and REITs continue to be the major player in terms of commercial real estate equity. For those contemplating a joint venture with a tax-exempt organization, tax-exempt should not be misconstrued to mean no tax implications. In fact, the tax implications can be quite complex.

There are basically two tax questions to consider and both are related to the issue that tax-exempt organizations are most concerned about—Unrelated Business Taxable Income. The first question is: "What is the impact of financing on UBTI?" The second question is: "What are rents from real property?"

UBTI is gross income, less allowable deductions, generated from a trade or business that is regularly carried on and is not substantially related to the organization's tax-exempt purpose. Tax-exempt organizations are subject to tax on any UBTI.

In the case of a partnership with a tax-exempt organization, if the partnership conducts a trade or business that would result in UBTI if the tax-exempt partner conducted it directly, the tax-exempt partner must treat its share of the income generated by the partnership's activities as UBTI. Certain passive income is excluded from UBTI including interest, dividends and rents from real property. Rental income should not pose a problem but unfortunately, it's not quite that simple.

Excluding rents from real property from the definition of UBTI is an over-simplification. If rents are derived from debt-financed property, the exclusion doesn't apply. Debt-financed property is property with debt incurred to finance either the purchase of, or an improvement to, the property generating income. If acquisition indebtedness exists, a portion of the income will be UBTI for the tax-exempt entity.

Fortunately, there is an exception to the exception found in Section 514(c)(9) of the tax code. Under this rule, acquisition indebtedness does not include debt incurred by a qualified organization in acquiring or improving real property. For example, a pension trust invests in a partnership holding real estate subject to acquisition indebtedness, any income or gain from the partnership will not be UBTI.

However, this seemingly helpful exception still has complexities, including the fractions rule. The fractions rule provides that qualified organizations shouldn't be deterred from investments by imposing taxes on them. At the same time, they should not be permitted to manipulate the flexibility in the partnership rules to create disproportionate allocations that would effectively share their tax-exempt status with taxable entities.

The fractions rule imposes a limitation on partnerships that have both qualified organizations and taxable entities as partners. In order to satisfy the rule, a qualified organization can never have an allocation of income greater than its smallest share of loss. As a practical matter, any partnership agreement that provides for something other than fixed sharing allocations throughout the term of the partnership should be carefully reviewed. There are many typical business arrangements among taxable partners that would fail to satisfy the Section 514(c)(9) exception if a tax-exempt organization were one of the partners. Examples include a leaseback of property by the qualified organization to the seller; seller financing; and an acquisition from a party related to the qualified organization or a lease to a related party.

> "For those contemplating a joint venture with a tax-exempt organization, tax-exempt should not be misconstrued to mean no tax implications."

With greater frequency, owners are pursuing opportunities to create new revenue sources from non-real estate activities. In order to generate additional revenue, owners leveraged access to a portfolio of buildings to take advantage of the tech boom. Deals with service providers have become common in the industry.

But remember—the exclusion from UBTI is expressly for rents from real property. The definition converges with the rules governing rents from real property for REITs. Under UBTI and REIT rules, revenue generated by a tax-exempt entity for providing services to its tenants, which are not considered usual and customary for that market, will not be considered rents from real property. The determination of a service as usual or customary depends on the facts and circumstances of each case.

These alternative revenue sources can be a sore subject to the extent tax-exempt entities are partners in a deal. Careful consideration must be given to make-whole provisions and other strictly written provisions of a partnership agreement that potentially even exclude an owner from pursuing such ventures. ■

George Martin is a Boston-based senior manager of real estate tax for PricewaterhouseCoopers.