NONPROFIT REAL ESTATE DEVELOPMENT PROJECTS—UBIT AND REAL PROPERTY TAX

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If a nonprofit organization does not properly formulate the legal structure of a real estate development project, it can face unintended and serious tax consequences.

Many nonprofit organizations that own real property in New York City and other urban areas are facing a similar problem—increasing capital costs to maintain their property and decreasing resources to sustain their mission. These nonprofit organizations are often cash poor but asset rich, which in urban areas, translates to valuable properties in desirable locations but little to no cash to operate. One attractive option for these organizations to maintain their presence in the communities that they have served for decades is to monetize their most valuable asset by entering into a real estate development transaction. However, if a nonprofit organization does not creatively and strategically formulate the legal structure of a real estate development project, it can face unintended and serious tax consequences.

This article commences with a brief discussion of federal income tax imposed on nonprofit organizations. The second part of this article focuses on three legal structures for real estate development projects involving a nonprofit organization, along with their associated income tax and real property tax implications: (1) a joint venture partnership; (2) a ground lease; and (3) a sale of a fee interest with title to a condominium transferred back to the nonprofit organization. These three legal structures allow the organization to continue to own all or a portion of its real property asset while generating income to sustain its mission and growth. The third part of this article considers the effects these development structures have on a nonprofit organization's New York State real property tax exemption.

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Federal income tax imposed on nonprofit organizations

Nonprofit organizations are generally exempt from paying federal income tax if they meet the requirements of a tax-exempt organization under Section 501(c).[1] However, Section 501 also sets forth fundamental exceptions on recognized tax-exempt entities that earn revenue from a regularly carried on business which is outside of the entities' tax-exempt purpose.[2] Such tax is referred to as unrelated business income tax (UBIT) and is calculated at the corporate income tax rate. UBIT is imposed on a nonprofit organization when the nonprofit organization's "*trade or business*," which is "*regularly carried on*," is not "*substantially related*" to the performance by such organization of its charitable, educational, or other purposes or functions constituting the basis for its exemption.[3]

However, the Code contains several special rules and modifications to UBIT which are relevant to nonprofit organizations entering into a real estate development transaction, including that income from real estate is generally not considered income derived from an unrelated business or trade for the proposes of UBIT, provided that the real property in question is not debt-financed.[4] Debt-financed property is defined in Section 514 as property which is held to provide income and which has acquisition indebtedness (property purchased or improved with borrowed funds) at any time during the tax year.[5]

ganizations entering into ground leases or real property leases.

Joint venture partnership

One potential real estate development structure that a nonprofit organization may enter into is a joint venture partnership with a for-profit developer.[8] Often, the nonprofit organization's contribution to the partnership is its real property interest in the land; such land is transferred to the joint venture partnership. The for-profit developer contributes capital, strong financial statements necessary to obtain a loan, and expertise in real estate (specifically development). In return for the nonprofit organization and the for-profit developer's contributions, the two partners hold an interest in the joint venture project.[9]

An attractive option for nonprofit organizations to maintain their presence in the communities that they have served for decades is to monetize their most valuable asset by entering into a real estate development transaction.

Section 514's intent is to treat an otherwise tax-exempt entity the same as an ordinary non-tax-exempt entity when property is purchased or improved through the use of borrowed capital in order to avoid an unequal playing field for nonprofit and for-profit organizations within the real estate business realm.[6] This distinction is particularly significant when considering self-development or joint venture partnerships (discussed below).

In addition, rent from real property received by a nonprofit organization is not considered UBIT provided that the rent is a fixed amount and not partially or entirely based on income or profits derived from use of the real property (except for an amount grounded on a fixed percentage of the gross receipts or sales).[7] This modification to UBIT is vital for nonprofit or-

The joint venture project often consists of the construction of either commercial or residential units on the property, which are expected to generate income to maximize the property value. The income generated from the project is split between the joint venture parties in accordance with each organization's percentage of ownership interest in the project, which income is dispersed as partnership distributions in accordance with the terms of the joint venture agreement. Partnership distributions are considered income generated from real property pursuant to UBIT. However, if the property is not debt-financed the distributions may fall under an exception to UBIT.

In either scenario (whether the property is debt-financed or not) the for-profit organization is taxed on the income distributions re-

[1] Section 501(c). This article focuses on organizations exempt from federal income taxes pursuant to Section 501(c)(3). When this article uses the term "nonprofit organization" it is referring to a charitable organization pursuant to Section 501(c)(3).

[2] Section 512.

[3] Section 512; Hansmann, "Unfair Competition and the Unrelated Business Income Tax," 75 Virginia Law Review, 605–607 (1989).

[4] Section 512(b)(3); IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations* (2017), www.irs.gov/pub/irs-pdf/p598.pdf.

[5] Sections 512 and 514(c). The term "acquisition indebtedness" does not include indebtedness inherent in the purpose of the organization's tax exemption. There are additional modifications to rent received from debt-financed property not noted in this article. See Section 512(b)(3).

[6] Rev. Rul. 77-72, 1977-1 CB 157. The computation of UBIT is set forth in Section 514(a).

[7] IRS Pub. 598, Note 4, *supra*.

[8] The structure and tax implications discussed in this article would be different if the joint venture was between two nonprofit organizations or the joint venture was building affordable housing.

[9] The nonprofit organization may obtain additional consideration (cash or in-kind consideration) depending on the terms of the transaction.

[10] Section 501.

[11] Section 512(b)(3).

[12] Sections 512 and 514(c). The term "acquisition indebtedness" does not include indebtedness inherent in the purpose of the organization's tax exemption. There are exceptions to debt-financed property.

[13] Section 512(b)(4); IRS Pub. 598, Note 4, *supra*.

[14] Section 512(a)(1).

ceived since the organization does not qualify as a tax-exempt entity pursuant to Section 501(c).[10] In the unlikely event that there is no debt-financing on the property (such as a construction or acquisition loan), the partnership distributions paid to the nonprofit organization would generally not be considered unrelated business income since income received from real property without debt-financing is an exclusion to UBIT, provided that the profits are based on a fixed sum (other than an amount based on a fixed percentage of sales).[11] However, in the more common scenario where the property is encumbered by debt-financing, the income generated from the encumbered property would not be excluded from UBIT. Therefore, the nonprofit organization would be required to pay income tax, calculated at the corporate income tax rate, on the partnership distributions.[12]

Note that with affordable housing projects where the legal owner of the property is a nonprofit organization and the property is being used for the nonprofit organization's exempt purpose of constructing and operating affordable housing, there are ways to structure the partnership to avoid the tax consequences that often burden joint venture partnerships, but this is beyond the scope of this article.

Ground lease

A second potential real estate structure that a nonprofit organization may enter into is a ground lease, where the title to the property would continue to be held in the name of the nonprofit organization, but the property would be leased to a third party tenant (often for 49 or 99 years). The ground lease structure insulates the nonprofit organization from paying federal income tax on the ground lease payments received over the term. As mentioned above, income received from rental property is exempt from UBIT as long as there is no debt-financing on the property and the rent is based on a "fixed sum" (subject to further exceptions in the Code).[13]

If the tenant desires to improve the property and obtains financing, the loan will be secured against the leasehold estate and the debt will be in the tenant's name. A loan on the leasehold estate would not impart debt-financing on the fee ownership of property or in the name of the nonprofit organization. Therefore, the property would not be considered debt-financed property under Section 512(b)(4) and the nonprofit organization would be exempt from paying UBIT on the rent received pursuant to the ground lease.[14]

Due to this favorable tax treatment, the nonprofit organization often nets more revenue

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under a ground lease scenario as opposed to post-tax income received through a joint venture partnership of debt-financed property even when the gross income generated from the joint venture partnership is higher than the ground lease payments.

Sale with a transfer of a condominium unit to the nonprofit organization

A third real estate development structure is a sale with a condominium unit transferred back to the nonprofit organization, which allows the nonprofit organization to maintain a presence on the property and in the community.[15] It is imperative that the nonprofit organization's unit be transferred to the nonprofit organization after construction through a leasehold condominium regime.[16] The title to the nonprofit organization's unit should be held in the name of the nonprofit organization and the leasehold interest in the real property is assigned to the newly developed condominium association, which shields the nonprofit organization from the obligation of paying New York State real property tax (as further discussed below).

Three legal structures for real estate development projects involving a nonprofit organization are: (1) a joint venture partnership; (2) a ground lease; and (3) a sale of a fee interest with title to a condominium transferred back to the nonprofit organization.

Furthermore, this legal structure often also includes the payment of cash consideration to the nonprofit organization. Generally, a nonprofit organization is not subjected to UBIT for income received from the sale of property. Section 512(b)(5) excludes from the computation of UBIT all gains or losses from the sale, exchange, or other disposition of property other than "(a) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (b) property held primarily for sale to customers in the ordinary course of the trade or business."[17] A sale of a nonprofit organization's real property does not fall into subsection (a) or (b) of Section 512(b)(5).[18] Therefore, under a sale with a condominium unit transferred back to the nonprofit, neither the cash nor the condominium would result in unintended tax consequences imposed on the nonprofit organization.

Real property tax consequences imposed on nonprofit organizations

Nonprofit organizations are generally exempt from paying New York State real property tax on property they own if all of the following requirements of New York State Real Property Tax Law (NYS RPTL), section 420-a are met: (1) the nonprofit owner is exclusively organized for "religious, charitable, hospital, educational, or moral or mental improvement of men, women or children purposes, or for two or more such purposes;" (2) the property is exclusively operated and used for one or more of the above-mentioned tax-exempt purpose or purposes; and (3) the earnings and profits do not inure to the benefit of any member or employee (except reasonable compensation for services performed to carry out one or more of the charitable purposes).[19] The exemption from New York State real property tax requires an analysis of the ownership of the property, the physical use of the property, and the profits received from operation of the property.[20]

A nonprofit organization entering into a joint venture transaction or a ground lease would not be exempt from paying New York State real property tax. In a joint venture partnership, where the property is owned by a for-profit joint venture entity, the property would not be tax exempt because it fails the first requirement of NYS RPTL, section 420-a.[21] Moreover, although the nonprofit organization still owns the property pursuant to a ground lease and thus part one of NYS RPTL, section 420-a requirements would be satisfied, the property is not being used for the nonprofit organization's exempt purpose and thus the nonprofit organization would not be relieved from paying New York State real property tax pursuant to the second requirement set forth in NYS RPTL, section 420-a.[22]

However, a sale-condo back structure allows the nonprofit organization to apply for a tax exemption on its condominium unit, since title to the condominium unit is held by the nonprofit organization and the unit is used to carry out its charitable purposes pursuant to NYS RPTL, section 420-a provided that any profit generated does not inure to the benefit of a private shareholder or individual. Note that the same tax treatment would be applicable if the real property was ground leased, but the nonprofit organization retained a leasehold condominium unit within the building to continue its mission.

Conclusion

In New York City or other cities where many nonprofit organizations' most valuable asset is the property they are sitting on, entering into a real estate transaction can not only save such organizations from closing their doors but can also generate revenue to sustain the organizations' mission for future generations. However, it is imperative that the legal structure for a real estate transaction involving a nonprofit organization is adequately formulated to avoid federal income tax and real property tax pitfalls. If a nonprofit organization is obligated to pay real property tax or federal income tax as a result of a real estate transaction, the benefits to entering into the transaction may be outweighed by the financial burden placed on an otherwise tax-exempt entity. ■

[15] Part or all of the consideration of the transaction can be in the form of the construction of a unit for the nonprofit organization. For more information about the New York Attorney General's requirements for the sale and disposition of assets of nonprofit and religious organizations, see New York Attorney General, "A Guide to Sales and Other Disposition of Assets Pursuant to Not-for-Profit Corporation Law § § 510, 511 and 511-a and Religious Corporations Law § 12," www.charitiesnys.com/pdfs/sales_and_other_dispositions_of_assets.pdf.

[16] The title to the property must be owned by the nonprofit organization to obtain an exemption of New York State real property tax. If the unit is leased back to the nonprofit organization, the nonprofit would not be entitled to a tax exemption. See section 420-a(a) of the New York State Real Property Tax Law. Note that a condominium structure creates two separate tax lots.

[17] Section 512(b)(5).

[18] Richardson and Barrett, "UBIT: Sale of Land" (1994), www.irs.gov/pub/irs-tege/eotopich94.pdf.

[19] Section 501; New York State Real Property Tax Law, sections 420-a, 420-b, 446, and 462.

[20] *Matter of Greater Jamaica Dev. Corp. v New York City Tax Comm.*, 25 N.Y.3d 614, 36 N.E.3d 645 (NY, 2015).

[21] The analysis would be different if the joint venture was comprised of two nonprofit organizations and the property was being used for the joint venture's tax-exempt purpose, such as for affordable housing.

[22] The transactional documents executed pursuant to the ground lease structure generally shifts the burden of paying the taxes to the tenant.