



## **The Church Network Unrelated Business Income – Rental Income Activities November 15, 2023**

Disclaimer – For information only – intended to provide a general understanding of issues to consider.  
Contact a professional for specific advice.

### **Sources**

1. Church Law & Tax – Church & Clergy Tax Guide
2. IRS Publication 598 – Tax on Unrelated Business Income of Exempt Organizations
3. <https://www.irs.gov/charities-non-profits/exclusion-of-rent-from-real-property-from-unrelated-business-taxable-income>

### **Purpose of the UBIT regulations - Directed primarily at unfair competition with commercial business.**

- Partially consider – what is the underlying purpose for carrying on the activity –
  - o Are we intending to make a significant profit from the activity?
  - o Or are we providing it as a community service, IAW with our exempt purpose/mission?

### **1. What constitutes unrelated business income – To be UBI the activity:**

#### **a. Must constitute a trade or business and be regularly carried on.**

- i. Activities are *regularly carried on* if they show a **frequency and continuity** and are **pursued in a manner similar to comparable commercial activities** of nonexempt organizations.
  1. Dependent upon how the activity would normally be carried on by a commercial organization (one-time, seasonal, year-round).
  2. Commercial business conducts activities year-round, but we conduct once a year – not UBI (state fair).

#### **b. Must not be substantially related to the church's exempt purpose.**

- i. To be substantially related - the activity must **contribute importantly** to the **accomplishment of the church's exempt purpose**. Alignment.
- ii. In determining whether an activity contributes importantly, **the size and extent of the activity** involved must be **considered in relation to** the nature and extent of our exempt function.
  1. **Renting space to T/E org's** vs. private parties unrelated to our purpose.
  2. **Are we primarily a church** that does a little bit of unrelated activities?  
Or perform a lot of unrelated activities in relation to being a church?

#### **iii. We must be clear in defining what our exempt purpose is.**

**2. Excluded trade or business activities (not treated as UBI):**

- a. Substantially all the work is performed by unpaid volunteers (holiday craft sales).
- b. Activities carried on by a church for the convenience of its members or employees (coffee shop sales in the church).
- c. Selling merchandise which has been received as gifts or contributions (auctions).
- d. Qualified sponsorship payments, certain bingo games, and the distribution of low-cost articles incidental to soliciting charitable contributions (about \$11.70 indexed).

**3. Exclusions to unrelated business taxable income:**

- a. Dividends, interest, annuities, other investment income and royalties.
- b. Certain gains or losses from sale or exchange of certain property included as inventory.
- c. **Rents from real property** – see the exclusions below.

**4. Exclusions to rental income being excluded:**

- a. **Rents from personal property** (kitchen equipment).
  - i. If a combination of real and personal property (mixed leases):
    - 1. Under 10% personal property is ok.
    - 2. Over 50% is all UBI.
    - 3. 10% - 50% exclude only the portion that is rental of real property.
- b. **Rents for income from personal services - or a combination of rental activities and other services** that are **not customary to the rental** (customary = you'd expect with a building, like security, parking, tech, simple beverages, etc.)
  - i. e.g. providing **substantial "personal services"** to lessees that are not **customary** to the room rental, e.g. room rental and inside catering, or running the event for them - may be UBI.
  - ii. **Have the rental contract be specific** in what services are provided or what property is rented and how much is being charged, etc.
  - iii. **And/or structure the contract** so that someone else provides the personal services (outside caterer provides the food and charges customer directly).
- c. **Debt-financed property (see below).**
- d. **Rents based on net profits** (other than based on a fixed % of gross receipts or sales)
- e. **Leased to a controlled entity** (depending on the circumstances).

**5. Debt-financed property (under IRC Section 514):**

- a. The IRS states that **property purchased with borrowed money** and a mtg/lien exists (acquisition indebtedness existing at any time of the year) and **held to produce investment income** is referred to as debt-financed property.
  - i. Primary purpose of this rule - **Every single IRS example for acquisition indebtedness related to a specific separate property that was purchased with debt for the purpose of producing income.**

- b. IRC Section 514(c) **defines acquisition indebtedness** as the outstanding amount of an indebtedness **incurred before, during or after that acquisition or improvement**.
  - i. In the case of indebtedness incurred before or after, **acquisition indebtedness exists only if the indebtedness would not have been incurred but for such acquisition or improvement**.
  - ii. If you incurred debt to build or renovate the sanctuary, but are renting out classrooms that were not part of the renovation, then you do not have acquisition debt on the classrooms – no UBI.
  - iii. If there is acquisition indebtedness, then a portion of the income activity is treated as taxable – the percentage that the “average unpaid acquisition indebtedness” is of the “average basis.”
    - 1. Generally, the average acquisition indebtedness is computed by averaging the monthly indebtedness during the year. The average basis is computed by averaging the beginning-of-the-year and end-of-the-year basis amounts.
  - iv. **Modifications of the original acquisition indebtedness** may impact the calculation if there is new debt – the new debt may be excluded.
- c. **There are exceptions to the debt-financed property rules, including:**
  - i. **The 85% rule** – if substantially all of the use of the church’s property is **substantially related to exempt purposes**, then not UBI.
    - 1. Generally, if **85 percent or more of the time utilized in hours/days (particularly if space is shared), or physical space used (Sq. Ft.),** is related to the church’s exempt purpose.
  - ii. **The Neighborhood Land Rule** – if a church acquires real property mainly to use it for exempt purposes **within 15 years** and the decision to use the property is not abandoned, then it is not treated as debt-financed property.
    - 1. **To apply the rule after 5 years**, must show that it is **reasonably certain** to use the land for the exempt purpose. Have definite plans detailing specific improvements and completion dates, and some affirmative action toward fulfillment of such plans. Also demolish any existing structures (the demolition rule). **Plans must be forwarded to the IRS 90 days** before the end of the fifth year for their approval.
    - 2. **Actual use** – If the church can’t establish after the first 5 years that it is reasonably certain to be used within 15 years, but the land is in fact converted to an exempt use with the 15-year period, the land isn’t treated as debt financed property for any period before the conversion.
  - iii. **Property acquired by gift with an underlying mortgage** – in certain circumstances for a certain amount of time.
  - iv. **Property used in the first three excludable activities in 2. a-c above** (volunteers, convenience of members and selling donated merchandise)

**6. Church parking lots:**

- a. Leases entered into with a **third party who operates the church's parking lot** and **pays fixed rent to the church**, such payments **would not be subject to tax**, as they would constitute rent from real property
- b. vs. if the Church operated the parking lot and charged fees to the general public – that would be UBI since it would not be rent from real property.
- c. Any fees paid by employees for parking lot use are ok.

**7. Cell phone towers** – per Church & Clergy Tax Guide – renting a *specified area of church property* on which a communications tower is erected *may* be partially or wholly exempt from UBI.

**8. Allocation of costs to the UBI calculation**

- a. Be very clear in determining which costs are directly connected and can be allocated to the debt-financed property / rental space –
  - i. Including specific direct costs,
  - ii. and indirect costs – such as salary and benefits for employees overseeing the activity, custodial, utilities, parking lot resurfacing, building renovations, etc. Depreciation is computed on straight line basis.
- b. Go through your general ledger and consider – would we have incurred this cost except for the rental activities?

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