

UBTI and Debt Financed Real Estate

Real estate investment opportunities come before tax exempt organizations and trusts in a variety of ways. With respect to tax-exempt investment accounts such as individual retirement accounts, the most common situation perhaps is where the account acquires an equity interest in a pass-through fund that is formed to place capital in commercial or rental real estate. In such cases, if the underlying fund decides to proceed with the acquisition, it may be necessary to borrow part of or the entire purchase price. However, the fund should be mindful of the fact that its ownership of debt-financed property may cause the recognition of unrelated business taxable income for certain investors that have acquired an interest in the fund through a tax-exempt retirement account or qualified retirement plan.

Defining the Issue. A tax-exempt organization or trust is subject to the unrelated business income tax (or “UBTI”), a tax on certain business income that is imposed notwithstanding the organization or trust’s exempt status. Examples of tax-exempt trusts would include individual retirement plans (or “IRAs”), 401k plans, and charitable trusts that are created for estate tax purposes.

Under Sect. 512(b) of the Internal Revenue Code, investment income from stocks, bonds, and real estate is not generally subject to UBTI. Thus, to the extent that a tax exempt organization or trust acquires real estate in a straight cash transaction, the income derived from the property is not subject to UBTI. However, such income can be taxable if derived from debt-financed property. Debt-financed property is property that is acquired with borrowed funds. Thus, if an exempt organization purchases corporate securities or commercial or rental real estate with borrowed funds, all or part of the dividends or rental income from the property may be subject to the unrelated business income tax.

The tax rules that apply to debt-financed property are located at Sect. 514 of the Internal Revenue Code. **Please note that debt financing of property with recourse debt is not permitted under the federal tax code and is considered a prohibited transaction under Sect. 4975(c)(1)(C).** Thus, if a tax exempt trust is acquiring a property with debt, such debt must be non-recourse to the underlying trust account holder.

There is a \$1,000 deduction that is applicable to a taxpayer’s income derived from UBTI sources. Thus, the first \$1,000 of UBTI is not subject to federal income taxes. What this means in the case of a \$50,000 investment in a private real estate fund is that the first 2% of the investor’s income from the fund will not be subject to UBTI, but with the trust tax rates being applicable to any income over and above \$1,000 in a given year. The trusts tax rates for 2012 start at 15% for the first \$2,400 of taxable income and gradually increase to 35% for income over \$11,650.

What is Debt-Financed Property? Debt-financed property is property that is held to produce income and with respect to which there is acquisition indebtedness. Acquisition indebtedness is

debt incurred in connection with the purchase or improvement of real estate, whether the indebtedness is incurred before, after, or at the time of the acquisition or improvement.

Note that the rules that apply to debt-financed property are subject to some exceptions. The most important exception relates to property used by an organization or trust in its exempt function. Debt-financed property does not include any property, 85% or more of which is used in relation to an exempt function. If the entire property is not relieved from classification as debt-financed property under the 85% test, property may still escape debt-financed classification if its use is substantially related to the organization's exempt function.

Under certain circumstances, land acquired for prospective use in an exempt function is not treated as debt-financed property during the period prior to its conversion to the exempt use; however, there are several limitations on the application of this exception. For example, the conversion to an exempt use must occur within 10 years from the acquisition of the property, and the property must be in the neighborhood of other land owned by the organization. Although, if the organization actually converts the property to an exempt use within the 10-year period, the property is not debt-financed property irrespective of whether it is in the neighborhood of other property owned by the organization, and the organization is entitled to a refund of any taxes paid before the conversion. Also, if there is a structure on the land when it is acquired by the organization, the intended exempt use must entail the demolition or removal of the structure.

Calculating UBTI on Debt-Financed Property. The debt/basis ratio is used to determine the amount of income and deductions with respect to debt-financed property that must be taken into account in computing UBTI. That ratio is a fraction, the numerator of which is the average acquisition indebtedness and the denominator of which is the average adjusted basis. The average acquisition indebtedness is the average amount of the debt during the period the organization or trust owns the property during the taxable year. The average adjusted basis is the average of the adjusted bases on the first and last days of the taxable year.

By way of example, assume that an exempt organization or trust owns an office building, all of which constitutes debt-financed property. If the rental income from the building is \$20,000 and the debt/basis percentage is 75%, the organization must include \$14,000 in UBTI (which factors the \$1,000 UBTI deduction). The types of income that are subject to the UBTI calculation include both rental income and capital gains realized from sales.

Offsetting UBTI. If debt-financed property is acquired by a pass-through private real estate fund, the business deductions of the underlying property will pass through to the investors of the fund and can be used to offset the UBTI income derived from the property. It has also been suggested by certain sponsors of private drilling programs that the strategic acquisition of a drilling program investment in an IRA can potentially generate significant intangible drilling cost ("IDC") deductions that can help to offset the income taxes generated from the sale of debt-financed property. This observation is supported by certain special tax rules that apply to IDC deductions if the program wells are drilled by March 31 of the tax year following the year of investment (See, Sect. 461(i) of the Internal Revenue Code). Under such special rules that apply to private drilling programs, the IDC-related income tax deductions for the year of the investment can potentially range from 80% to 90% of the subscription amount, which arguably

provides for some strategic tax planning opportunities if the IDC deduction can be linked up with a significant taxable event occurring inside the tax exempt trust (e.g., such as the sale of debt-financed real estate at a significant capital gain to the extent of the UBTI tax incurred).