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Finding success while heeding requirements with tax-exempt partners

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Many large tax-exempt investors, such as state pension funds and colleges and universities, are teaming up with real estate developers across the region to acquire, develop, update, or reposition real properties for rental or resale. With the uptick in real estate values, we are seeing more cash coming into the market through investments like these. Typically, these are structured as joint venture partnerships.

These partnerships are usually beneficial for both parties. However, the real estate developer needs to understand that there are unique issues when investing with a tax-exempt partner. Some of these issues include increased property restrictions due to Unrelated Business Taxable Income (UBTI) concerns, less flexibility on structuring, decreased depreciation deductions, and increased tax reporting and complexity.

Talking to a tax professional in advance can help minimize some of the additional burdens that can occur when working with a tax-exempt partner.

Common Issues

Depreciation Differences

A portion of the property that is deemed tax exempt must be depreciated using the Alternative Depreciation System (ADS) instead of the typical Modified Accelerated Cost Recovery System (MACRS). ADS depreciation is calculated using a straight line method over a longer recovery period than MACRS. As a result, depreciation is recovered at a slower pace. This translates to fewer deductions and more taxable income.

Defining Tax Exempt Use Property

If you work with tax exempt organizations, the property may be defined as tax exempt use property if it meets one of several requirements. Tax exempt use property is:

- * Certain property leased to a tax exempt entity
- * Property owned by a partnership which has tax-exempt partners and non-tax exempt partners that does not have certain qualified income allocations

Be Mindful of UBTI

Tax-exempt entities generally do not pay tax on their earnings, unless the earnings are considered UBTI. Determining which portion of the earnings is UBTI requires special calculations and reporting on the tax return.

UBTI is defined as any trade or business that is substantially unrelated to the usual business of the exempt organization. Dividends, interest, annuities, royalties, and rents from real property are generally excluded from UBTI calculations. However, rental income is included in UBTI to the extent it is debt-financed.

This means that if a tax-exempt entity owns rental real property purchased with cash, it is generally

exempt from a UBTI calculation. However, if the entity obtains acquisition indebtedness (i.e. mortgage) then a percentage of the income becomes UBTI. To calculate the amount that is debt financed, the partnership must determine the percentage of average acquisition indebtedness for the tax year over the average adjusted basis of the property.

Some tax-exempt investors are very sensitive to UBTI and set restrictions on the property to avoid UBTI. The real estate developer needs to be cognizant of these restrictions. Examples of these restrictions are not allowing debt on the property, restricting refinancing and leases, and restricting the services that can be provided to the tenants of the property.

Joint venturing with tax-exempt entities can be lucrative. However, it is imperative to understand the unique issues you'll face when working with them. You should always consult your tax advisors in these situations.

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