

Neighborhood Land Use Rules, UBI, and Nonprofits

Many churches rent some or all of their property from time to time. A church might purchase one or more homes adjacent to its property to house ministers or facilitate future expansion. Often, when not needed for staff or with no immediate plans to expand the church rents the homes. If the purchase of the home(s) was debt-financed, one of the issues that arises in such cases is the application of the federal unrelated business income tax, which is a tax on the net income generated by a church or other public charity from an unrelated trade or business.

In general, rental income received by a church is exempt from the unrelated business income tax, but an exception applies in the case of rental income derived from debt-financed property. Internal Revenue Code (IRC) Section 514 states that income from dividends, interest, annuities, royalties, rents, and capital gains and losses must be included in the definition of unrelated business taxable income to the extent it is derived from debt-financed property. Debt-financed property is defined as; "...any property held to produce income and that is subject to an acquisition indebtedness, such as a mortgage, at any time during the tax year".

However, the tax code further specifies that if a church acquires real property in order to use it for its own exempt purposes within 15 years, the income from the property will not be treated as debt-financed income if the intent to use the property for exempt purposes within 15 years is not abandoned.

This exception to the definition of debt-financed property is referred to as the "*neighborhood land rule*."

The neighborhood land rule only applies to the first 15 years after the property has been acquired. In cases where the IRS has been asked to make a definitive ruling, they have stressed the fact that the regulations stipulate that in order to satisfy the regulation, future use of the acquired land by the organization for its exempt purpose before the expiration of the relevant period (e.g. 15 years) must be "reasonably certain." The organization does not necessarily have to show binding contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative action toward the fulfillment of such a plan.

It is important to note that the ability of a church to actually apply the neighborhood land rule after the first 5 years of the 15-year eligibility period exists only if the church forwards this information to the Commissioner of the Internal Revenue for a ruling, at least 90 days before the end of the fifth year after acquisition of the land.

Churches and ministries need to be careful when it comes the issue of land and facility use because the receipt of as little as \$1,000 in gross income from unrelated use is enough to trigger the unrelated business income tax and reporting requirements. We strongly recommend that you consult with your CPA or a tax specialist before you engage in any activity you think might be outside your exempt purposes.

Internal Revenue Code Sections Related to the Neighborhood Land Rule

7.27.9.4 (02-23-1999)

Neighborhood Land Rule

If an organization acquires real property and intends to use it for exempt purposes (within 10 years), it will not be treated as debt-financed property if it is in the neighborhood of other property used by the organization for exempt purposes and the intent to use the property for exempt purposes (within 10 years) is not abandoned. This provision is referred to as the "neighborhood land rule." IRC 514(b)(3)(A).

Property is considered in the "neighborhood" of property owned and used by an organization for its exempt purposes if the acquired property is contiguous with the exempt purpose property. If the acquired property is not contiguous with the exempt purpose property, it may still be in the "neighborhood" of such property if it is within one (1) mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. Regs. 1.514(b)-1(d)(1)(ii).

Some criteria to consider in determining whether noncontiguous property is still in the "neighborhood" of exempt purpose property include the availability of land and the intended future use of the land. For example, a university attempts to purchase land contiguous to its present campus but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university purchases such land. Under these circumstances, the contiguity requirement is unreasonable and the land purchased would be considered "neighborhood land."

7.27.9.4.1 (02-23-1999)

Exceptions

The neighborhood land rule does not apply to property 10 years after it is purchased. Further, the rule applies after the first five years only if the organization satisfies the Service that future use of the land for exempt purposes, before the expiration of the 10-year period, is reasonably certain. The organization need not show binding contracts in satisfying this requirement but must have a definite plan detailing a specific improvement and a completion date, and show some affirmative action toward the fulfillment of such plan. At least 90 days prior to the end of the fifth year the organization must forward the necessary information to the Service. Regs. 1.514(b)-1(d)(1)(iii).

If the neighborhood land rule is inapplicable because the acquired land is not in the neighborhood of other land used for exempt purposes or because the organization fails to establish after the first five years that the property will be used for exempt purposes, but the land is eventually used for exempt purposes within the 10-year period, such property is not treated as debt-financed property for any period prior to such conversion. Regs. 1.514(b)-1(d)(2).

7.27.9.4.2 (02-23-1999)

Limitations

The neighborhood land rule applies with respect to any structure on the land when acquired, or to the land occupied by the structure, only so long as the intended future use of the land requires

that the structure be demolished or removed in order to use the land for exempt purposes. Thus, during the first five years after acquisition (and for subsequent years if there is a favorable ruling in accordance with IRC 514(b)(3)) improved property is not debt-financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. Regs. 1.514(b)–1(d)(3)(i) provide that if there is an actual demolition of such structures, the use made of the land need not be the one originally intended as long as it is any use which furthers the exempt purposes of the organization.

In addition to the above limitation, the neighborhood land rule and exceptions thereto do not apply to structures erected on the land after its acquisition nor to property subject to a business lease (as defined in IRC 514(f) immediately before the enactment of the Tax Reform Act of 1976) whether the organization acquired the property subject to the lease or whether it executed the lease subsequent to acquisition.

Where the neighborhood land rule is initially inapplicable but the land is eventually used for exempt purposes, a refund of taxes shall be allowed in accordance with IRC 514(b)(3)(D) and Regs. 1.514(b)–1(d)(4).

7.27.9.4.3 (02-23-1999) Churches

The neighborhood land rule also applies to churches or a convention or association of churches but with two differences. First, instead of the 10-year period during which an organization must demonstrate the intent to use acquired property for exempt purposes, a 15-year period applies. Second, there is no requirement that the acquired land be in the neighborhood of other property used by the organization for exempt purposes. Regs. 1.514(b)–1(e).

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This material is presented with the understanding that the author is providing basic information only, and assumes no liability whatsoever in connection with its use. Tax laws are constantly changing, are subject to differing interpretations, and the facts and circumstances in any particular situation may not be the same as those presented here. Therefore, we urge you to do additional research and make sure that you are fully informed and knowledgeable before using the information contained herein.