Property Leased to a Tax-Exempt Entity

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The purpose of this brief is to review how the provisions set forth under Internal Revenue Code Section 47(c)(2)(B)(v), dealing with property leased to a tax-exempt entity, may impact the use of the rehabilitation tax credit. These rules apply for both the 10% non-historic tax credit and the 20% historic tax credit.

Disqualified Lease Rules

When a property owner leases their building or a portion of their building to a tax-exempt entity, i.e. governmental unit, a tax-exempt organization, or a foreign person/entity, it is important that they are familiar with the "disqualified lease" rules that may prevent them from claiming an otherwise eligible rehabilitation tax credit.

Internal Revenue Code Section 168(h) contains a comprehensive set of rules dealing with leases of property to "tax-exempt entities". Under these rules, real property, which is leased to a tax-exempt entity in a "disqualified lease", is treated as "tax-exempt use property". Qualified rehabilitation expenditures associated with tax-exempt use property are not eligible for the rehabilitation tax credit.

A "disqualified lease" is defined in Internal Revenue Code Section 168(h)(1)(B)(ii) as a lease to a tax-exempt entity where:

(1) Part or all of the property was financed directly or indirectly by an obligation in which the interest is tax-exempt under Internal Revenue Code Section 103(a) and such entity (or related entity) participated in the financing, or
(2) Under the lease there is a fixed or determinable purchase price or an option to buy, or
(3) The lease term is in excess of 20 years, or
(4) The lease occurs after a sale or lease of the property and the lessee used the property before the sale or lease. See Internal Revenue Code Section 168(h)(1)(B)(ii).

Lease Term

When determining whether a lease has a term in excess of 20 years, the term of the lease is deemed to begin when the property is first made available to the lessee under the lease. Treasury Regulation 1.168(j)-1T Q17 states that the lease term includes not only the stated duration, but also any additional period of time which is within the realistic contemplation of the parties at the time the property is first put into service. The Treasury Regulations cite Hokanson v. Commissioner 730 F.2nd 1245, 1248 (9th Circuit 1984).

The Treasury Regulations also provide that the term of the lease includes all periods for which the tax-exempt lessee or a related party has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value determined at the time of renewal.

In other words, a lessor is allowed to renew a tax-exempt entity's original "under 20 year lease" as long as the new lease is at fair market value.

The 35% Threshold Test

An exception under Internal Revenue Code Section 168(h)(1)(B)(iii) provides that property is treated as tax-exempt use property only if the portion of such property leased to tax-exempt entities under disqualified leases is more than 35% of the property.

The phrase "more than 35%" means more than 35% of the net rentable floor space of the building. The net rentable floor space would not include the common areas of the building, regardless of the terms of the lease. See Treasury Regulation 1.168(j)-1T Q-6.

If more than 35% of a building is leased to a tax-exempt entity, a taxpayer would be able to claim the rehabilitation tax credit on the expenditures incurred for the portion of the building not rented to a tax-exempt entity. This is illustrated in the following example:

A taxpayer purchases a building for $50,000 and spends $100,000 to rehabilitate the property. Three fourths of the building is leased to a tax-exempt entity for 25 years making 75% of its net rentable space tax-exempt use property. No rehabilitation tax credit would be allowed on the $75,000 of rehabilitation expenditures attributable to the tax-exempt use portion of the building. However, the taxpayer would be allowed a rehabilitation tax credit on the $25,000 expended on the portion of the building not leased to a tax-exempt entity.

In situations where an expenditure is not considered to be a qualified rehabilitation expenditure because it is applicable to a portion of the building which is tax-exempt use property, the expenditure can still be included in the computation to determine whether a building has been "substantially rehabilitated". See Internal Revenue Code Section 47(c)(2)(B)(v).

Property Owned by Partnerships with Taxable and Tax-Exempt Partners

Many tax-exempt organizations are affiliated with "for-profit" entities. In these situations, tax-exempt use property would not include property which is predominantly used by a tax-exempt entity in an unrelated trade or business (directly or through a partnership in which such entity is a partner) on which it pays taxes. See Internal Revenue Code Section 168(h)(1)(D).

When property is owned by a partnership that consists of both taxable and tax-exempt partners, Internal Revenue Code Section 168(h)(6) sets forth a number of specific rules intended to prevent the use of tiered arrangements or partnerships and other pass-through entities to allocate in a disproportionate manner the tax benefits and burdens of property owned by tax-exempt entities. In general, if any property that is not otherwise treated as tax-exempt use property is owned by a partnership that has both tax-exempt and taxable partners, the proportionate share of the property allocated to the tax-exempt partners will be treated as tax-exempt use property.

Any allocation to the tax-exempt entity of partnership items must be a "qualified allocation" (meaning equal distribution of income, gain, loss, credit and basis) and must have "substantial economic effect" (the Treasury Regulations provide that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences)

Disqualified Lease Rule Examples:

Example 1: A taxpayer rehabilitates an historic structure and leases the building to the City of Pleasantville. The taxpayer financed the rehabilitation with tax-exempt bonds issued by the City of Pleasantville. Even if the lease term is less than 20 years, the fact that the rehabilitation was financed (directly or indirectly) with bonds exempt from tax under Internal Revenue Code Section 103(a), the agreement between the city and the taxpayer will result in a disqualified lease.

Example 2: A taxpayer rehabilitates an historic structure and leases the building to the Willow Theater, a non-profit community theater group. If the taxpayer includes in the lease agreement an option for the Willow Theater to purchase the building after 15 years, the agreement will result in a disqualified lease.

Example 3: A taxpayer rehabilitates an historic structure and leases the building to a foreign owned corporation. The lease agreement contains a provision where the lease term is equal to 15 years with a legally enforceable option to renew the lease for an additional 10 years at a fixed, non-negotiable price. Since the lease term is in excess of 20 years, the agreement creates a disqualified lease.

If, in this example, the lease agreement contained a 15 year option to renew at the fair market value that will be determined at the time of renewal, the agreement would **not** result in a disqualified lease.

Example 4: The historic St. Johns School was in dire need of a substantial rehabilitation. The school sold the building to a XYZ Limited Partnership for $500,000. The Partnership spent $1,000,000 rehabilitating the property. The Partnership leased the property back to St. Johns School. The resulting agreement would be a disqualified lease because Internal Revenue Code Section 168(h)(1)(B)(iv) specifically states a disqualified lease occurs after a sale (or other transfer) of property by, or lease of the property from, the tax-exempt entity and the property has been used by the entity before the sale (or other transfer) or lease.

Acknowledgements

William F. Machen, Esq., Holland & Knight LLP, "The Historic Rehabilitation Tax Credit: Selected Tax Structuring Issues"