

## Insights

### Three Minute Update - Positioning for the Future: Non-Profits and Real Estate

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Nonprofit businesses across Indiana pursue their purpose often tied to the hope of finding new paths for the expression of their dreams. Each new cycle could bring new opportunities to serve the non-profit's core mission or offer new challenges or new collaborations with other allied organizations. Maybe this is the year your nonprofit buys that facility to provide clients a brick-and-mortar location, or maybe you simply want to move the operations from your home office to a space of its own. If expanding your nonprofit into real estate is the goal, a number of key issues must be considered.

Numerous issues arise in any real estate transaction, including the need for proper due diligence, securing financing, and making a business plan for the added risks real property ownership can entail. For an Indiana nonprofit corporation, additional requirements and obligations must be considered when venturing into real estate, such as: can a nonprofit organization hold title to real estate? Must a real estate subsidiary be a certain type of entity? And does a nonprofit landlord jeopardize its tax-exempt status by receiving rent? Ultimately, these questions are best answered through consultation with your attorneys and accountants, and we provide this alert with the hope of providing a brief birds-eye view of the road ahead.

#### **Structuring a Real Estate Purchase for a Nonprofit**

Commercial real estate transactions involving for-profit companies often follow a prescribed structure to help protect the acquiring company from the uncertain risks and liabilities that can accompany real property ownership.

Often, an operating company will form and control a subsidiary, a separate business entity known as a real estate holding company, to take title to the land and lease the land to the operating company. The form of the new entity will depend on the circumstances of ownership. An Indiana limited liability company (LLC) is most often used because of the ease in formation and operations. Under this arrangement, the holding company charges rent to the operating company and helps protect the operating company from liabilities and debts incidental to the ownership of real estate. At the same time, the holding company's focus becomes singular: to own and lease real property for a profit. That "for-profit" objective can create concerns for the non-profit organization.

Indiana nonprofit corporations are legally entitled to not only purchase, own, and hold an interest in real property, but they may also receive, hold, and deal in and with the interests of any entity. This means that under Indiana law, an Indiana nonprofit corporation can form and control a subsidiary real estate holding

company and that subsidiary, whether a nonprofit corporation or another business entity, can legally hold title to the real estate.

### **Selecting a Real Estate Holding Company Structure for a Non-Profit Entity**

Selecting the right type of entity to be formed by the nonprofit corporation as a wholly owned subsidiary requires an in-depth legal analysis of both Indiana and federal law relating to general corporate matters as well as to issues involving tax-exemptions. A nonprofit corporation that is also tax-exempt will almost always select an entity that will assure protection of its tax-exempt status under Section 501(c)(3) of the Internal Revenue Code ("IRC"). The key question to face is whether the formation of "any entity" will suffice or will a certain type of subsidiary be required under federal tax law?

The IRC limits the types of entities that qualify for tax-exempt treatment under Section 501(c)(3) to corporations and other community chests, funds, or foundations; however, the Internal Revenue Service has offered guidance that permits an LLC to be considered exempt for federal income tax purposes if the LLC is formed as a wholly owned subsidiary of an exempt organization. This means that so long as the exempt organization is the sole member of the LLC, the LLC will come under the parent's tax-exempt umbrella.

### **Ensuring Compliance with IRC 501(C)(3)**

In order to protect the tax-exempt status of both entities, the nonprofit organization must fully consider whether holding an interest in real estate falls within the organization's exempt purpose under Section 501(c)(3), so as not to engage in impermissible activities that jeopardize its tax-exempt status.

Generally, to maintain its tax-exempt status, a nonprofit organization must be organized and operated exclusively for religious, charitable, or scientific purposes and must pass the Internal Revenue Service's "operational test," whereby an organization will not be regarded as operated exclusively for an exempt purpose if more than an insubstantial part of its activities do not further an exempt purpose. An analysis under the "operational test" is a highly fact-sensitive endeavor focusing on the confluence of federal tax law and nonprofit activities. This effort will be best undertaken under the guidance of legal counsel experienced in tax-exempt matters.

A potential issue faced by nonprofits holding real estate could involve the generation of unrelated business income (UBI) associated with the rent charged for use of the property. Generally, UBI describes the income from a trade or business regularly conducted by an exempt organization that is not substantially related to the performance by the organization of its exempt purpose or function. UBI most often will be taxable to the exempt organization even though other revenues generated by the exempt activities will not be taxable.

Rental income for most tax-exempt organizations will likely be characterized as UBI without an exclusion within the application of the operational test. Importantly, receipt of UBI does not automatically jeopardize tax-exempt status under Section 501(c)(3). However, holding property for rent can put the exempt status at risk in several ways. This could be seen as a way for a private individual or other party to improperly benefit from use of the tax-exempt assets of the exempt organization. Another arises when the proportion of the revenue generated from this non-exempt activity exceeds permissible levels.

### **Property Tax Considerations**

Indiana nonprofits that own real estate can qualify for exemptions from Indiana property taxes. The property

must be used in furtherance of the owner's exempt purposes. Maintaining the exemption requires timely annual or biannual submission of the Application for Property Tax Exemption (see State Form 9284), unless the submission requirement is waived per Indiana Code 6-1.1-11-4. The Application for Tax Exemption must be filed in duplicate on or before April 1 of the assessment year with the county assessor of the county in which the property that is subject of the exemption is located.

Holding real estate for rental to third parties increases the risk that a property tax exemption will be unavailable. Similarly, even if the property continues to be used by the exempt organization, use of the property by the organization or letting it be used by others for activities that generate UBI could risk loss of the property tax exemption. The analysis will focus on whether the use of the property by whoever occupies the premises constitutes an acceptable exempt activity.

## **Conclusion**

We at Krieg DeVault are often asked to advise nonprofits on how best to balance their conduct with their charitable purpose to determine if pursuing an interest in real estate is an appropriate endeavor. If your nonprofit organization is considering an investment of this nature, you are wise to engage legal counsel experienced with tax exemption issues to navigate the complexities of creating an exempt subsidiary real estate holding company. Legal counsel can also assist with evaluating an organization's purpose and activities to avoid running afoul of local, state, and federal tax consequences. If you have questions regarding information found in this alert, please contact **George C. Lepeniotis**, **Alex C. Bowman**, or any member of our **Business Practice** or **Real Estate and Environmental Practice**.

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