Taxation on a Congregation's Rental Property

Will our congregation's tax status change if we rent or lease our property?

Some other unrelated organization wants to rent space in our congregation's building to hold their meetings, to operate an after school program, or for some other purpose. If we lease space to them, what are the legal problems?
The following is a very brief discussion identifying important issues that a congregation should consider. The congregation should consult with a lawyer or other advisor, since the following discussion is not intended as legal advice in particular situations.

Federal Income Tax - The leasing of property owned by a church will NOT result in the loss of the church's exempt status for federal income tax purposes. However, the congregation may be subject to federal income tax on some or all of the net rental income if the church has outstanding indebtedness. If the congregation is debt free, none of the net rental income will be subject to tax. Even where the congregation has some indebtedness, there are several exceptions that avoid the imposition of tax. This question of federal income taxation is discussed in more detail in another explanation, Taxation of a Congregation's Rental Income.

State Income Tax - Many states mirror the federal tax treatment. If the congregation is located in a state that does not follow the federal definitions for exempt entities and taxable income, it will be doubly important to check with a tax professional who is knowledgeable about income taxation by the particular state.

Local Real Estate Tax - Exemption from real estate taxes is governed by state law and varies from state to state. What is exempt in one state may be taxable in another state. Furthermore, exemption from real estate tax may vary from county to county within the same state. In some states, what the local tax accessor / collector says or thinks the state law is, controls. Therefore, check with the local taxing authorities or a local tax professional to find out whether the congregation will lose its real estate tax exemption if it leases property.

Taxation of a Congregation's Rental Income
Since 1969, churches have been subject to the Unrelated Business Income Tax (UBIT) for federal income tax purposes, to the same extent as other 501(c)(3) tax-exempt organizations. A church that is liable for UBIT must file an IRS Form 990-T by the 15th day of the 5th month following the end of its fiscal year.

Section 511 of the Internal Revenue Code of 1986 (Code), as amended, imposes the corporate tax rate on Unrelated Business Taxable Income (UBTI). UBTI is defined in

Code Section 512. Rental income is excluded from taxation under Code Section 512(b), unless the rental income is derived from Debt-Financed Property (DFP) (as defined in Code Section 514) that is subject to outstanding Acquisition Indebtedness (AI) incurred in acquiring or improving the property. If a congregation is debt free, none of its rental income could be derived from DFP subject to AI, since there obviously is no outstanding debt. Therefore, a congregation that is debt free will not incur any liability for UBIT with respect to its rental income.
There are exceptions that may remove rental income from taxation, even when the church has outstanding AI. These exceptions are complicated and may be difficult to apply in specific situations. Only two are mentioned here. One is where more than 85 percent of the use of the DFP is devoted to the church's exempt purposes (see Income Tax Regulation §1.514(b)-1(b)(1)). A second exception is where the rent is received from a related organization for an exempt purpose use (see ITR §1.514(b)-1(c)(2)). An example of a related organization is a separately incorporated school whose board of directors is elected by the congregation.

Where the church does have outstanding AI, and none of the exceptions apply, some or all of the "net" rental income will be subject to taxation. "Net" rental income is the gross rents less allowable deductions, including depreciation, attributable to the rented space. The percentage (never more than 100 percent) of "net" rental income that will be subject to taxation is determined by the following fraction: Average outstanding AI Average adjusted basis

Average adjusted basis is the cost of the property including improvements reduced by accumulated depreciation allowable.

It is strongly recommended that a congregation secure the services of a competent tax professional if it has or believes it may have exposure for UBIT.

This explanation on federal income tax consequences of a congregation leasing its property was prepared in February 1998, by Mr. David J. Hardy, senior attorney, in the Office of the Secretary of the Evangelical Lutheran Church in America, 8765 West Higgins Road, Chicago, IL 60631. It is informational only and may not be considered legal advice.