Nonprofit Navigator

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Rental income - UBTI or not?

By Colette Kamps, CPA

Some nonprofit organizations supplement their revenue by renting out space that they own. In some cases, this rental income may be subject to tax which requires filing of Form 990-T. The main determining factor is whether or not the property being rented is debt financed. If not, the rental income is generally treated like investment income, which is exempted from tax. But if the organization does have debt on the property, it must classify the rental income (or a portion of the income) as unrelated business income (UBI). Debt-financed property is any property with indebtedness at any time during the year.

Here is an interesting consideration that some are not aware of. If substantially all of a property's use is directly related to the performance of an organization's exempt purpose, rental income is not UBTI. Substantially all is defined as 85% or more of the use of the property. To determine to what extent an organization uses its property for a particular purpose (or to determine if this 85% test is met), you could compare the total time the property is used for rentals with the time used for the exempt purpose. Obviously, this would be a beneficial exercise for an organization that may wish to plan in advance to avoid UBI.

Example

United Charities (UC), a Section 501(c)(3) organization, owns a seven-story office building acquired with borrowed funds (with each floor having equal footage). The bottom floor is leased as retail space, and its use is unrelated to UC's tax-exempt purpose. The remaining floors are used by UC in its exempt function. Although the building was acquired with debt, it is not debt-financed property because substantially all of its use is related to UC's exempt function (6 floors ÷ 7 floors ≥ 85%). Thus, the income from leasing the first floor is not unrelated debt-financed income.

But if it is determined that the organization does have UBI relating to rental income from the debt-financed property, the UBI is calculated as follows:

(**Average indebtedness** *(average for the year)* **divided** by **average adjusted basis** (see below)) **multiplied** by the **gross rental income**.

The **average adjusted basis** is the original cost, plus any additions/improvements, less depreciation (so in other words, the book basis of the property).

Example

The loan balance is $750,000 at the beginning of the year and $720,000 at the end of the year, so the average loan balance is $735,000. The book basis of the property is $1,200,000 and the gross rental income for the year was $50,000. The UBI would be $30,625 (735/1200 x 50).

UBTI is not disallowed for a tax-exempt entity, but tax-exempt status can be jeopardized if unrelated business activities become substantial in relation to total activities of the organization.

Fast Facts

- 150+ team members
- 50% are CPAs
- Arizona's largest locally owned accounting firm
- Your money stays in the state
- Well-known leader in CPA services for AZ nonprofits
- Nonprofit CPAs volunteer on boards and committees for local charities
- Your team provides complimentary CPE and customized presentations for nonprofit boards and staff

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Fraud prevention check up
By Colette Kamps, CPA

If you are a member of a finance committee or a Board of Directors, or a member of management in the accounting department of a nonprofit organization, you may wish to perform a fraud "check up" of your organization. There is a very effective check up tool available at the Association of Certified Fraud Examiner's (ACFE) website.

Why should my organization do this?

Putting your organization through this process is a great way to gauge the effectiveness of your fraud prevention systems and controls. In addition, it's a valuable process to keep up the conversation about the possibility of fraud in order to ensure fiduciary responsibility.

The process

The process involves completion of a checklist which may be best completed through an open discussion and analysis involving both finance committee members as well as accounting personnel. This exercise, hopefully, will result in identification of areas needing improvement so that the organization can address these areas for tightening up. The organization may consider adopting a policy for going through this checklist on an annual basis and reporting the results to the board of directors.

Calculating your fraud risk

The checklist is based on a point system, where you can grade your organization in various areas, to end up with a total score. This will help in assessing where, and to what extent, improvements need to be made.

Be proactive

It's important for all organizations to realize that fraud is not uncommon and it typically takes a significant amount of time for it to be detected. Constant attention to internal controls that either prevent, or detect and correct potential fraud on a timely basis, can help to reduce the risk of fraud occurring, and reduce the time to detection. You can access the ACFE's fraud check up at **http://www.acfe.com/fraud-prevention-checkup.aspx**.

If you have any questions, Colette can be reached at (480) 839-4900 or ColetteK@hhcpa.com.

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Henry+Horne has performed several audits of our annual financial statements, and each year they have submitted the reports on or before deadline. All members of the engagement team are very knowledgeable, extremely responsive and professional.