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Getting Schooled on Unrelated Debt Financed Income ("UDFI"): An Opportunity for Private Schools

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Many tax exempt private schools have seen increasing growth in recent years, leading them to expand through the purchase of new facilities. Often these purchases are achieved through debt financing.

As with any transaction made by a tax exempt organization which involves debt financing, one of the main concerns is the tax exposure to the organization; specifically, if this transaction will generate unrelated debt financed income ("UDFI").

In many cases, buildings generate rental income, if tenant occupied, for the school, either 1) during an interim period while the current tenants maintain residence until their leases expire or 2) throughout the life of the building as a way to generate additional revenue with excess space.

Not-for-profit organizations are generally exempt from tax on passive investment income. This includes items such as interest, dividends, rents, and royalties. However, such income can be taxable if derived from debt-financed property. Debt-financed property is property that is acquired with borrowed funds, also known as "acquisition indebtedness." Thus, if an exempt organization purchases commercial or rental real estate with borrowed funds, all or part of the rental income from the property could be classified as UDFI, which would be subject to the unrelated business income tax ("UBIT").

However, the term "debt-financed property" is subject to several exceptions. Internal Revenue Code§ 514(c)(9) provides that certain categories of exempt organizations are excused from the debt-financed property rules with respect to the acquisition and improvement of real property. Specifically, it excludes from the definition of "acquisition indebtedness," indebtedness incurred by a "qualified organization" in acquiring or improving real property – this includes educational organizations as described in § 170(b)(1)(A)(ii).

An educational organization qualifies as such if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

It is important to note, however, that even for these types of educational organizations this exception from acquisition indebtedness does not apply in the following situations:

1. The acquisition price is not a fixed amount determined as of the date of the acquisition or the completion of the improvement. However, the terms of a sales contract may provide for price adjustments due to customary closing adjustments, such as prorating property taxes, and may also provide for a price adjustment if it is for a fixed amount dependent upon subsequent resolution of certain items such as zoning approvals, title clearances, and the removal of easements. These conditions in the contract will not cause the price to be treated as an undetermined amount.

2. Any debt or other amount payable for the debt, or the time for making any payment, depends, in whole or in part, upon any revenue, income, or profits derived from the real property.

3. The real property is leased back to the seller of the property or to a person related to the seller.

4. The seller, a person related to the seller (as defined in item 3), or a person related to a qualified retirement plan provides financing for the transaction on other than commercially reasonable terms.

Ultimately, the use of debt financing to acquire or improve real property can be a valuable tool for expansion and revenue generation for qualified exempt schools. Extra care should be taken to make sure that the transaction is structured to be compliant with the requirements above to avoid any resultant UBIT.

Please contact our experts if you have any questions on this effective tax strategy as well as the related accounting treatment for such transactions.

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