

What's News in Tax

Analysis That Matters from Washington National Tax

Monday, November 1, 2010



by Rick Speizman and V. Moore,
Washington National Tax

Rick Speizman is the Partner-in-Charge of the Exempt Organizations Group of Washington National Tax and V. Moore is a director in that group.

Can I Park Here? The Tax Court Weighs in on the UBTI Controversy

For a long time, it has not been entirely clear under what circumstances a tax-exempt organization's revenue from parking would be included in unrelated business taxable income ("UBTI"). This article discusses the history of the controversy and analyzes a recent Tax Court case that appears to indicate that the Tax Court agrees with the IRS—all income from parking (at least as ordinarily done) is UBTI.

What Is UBTI?

Although generally exempt from federal income tax, organizations described in section 501(c), private pension trusts described in section 401(a), and state colleges and universities are subject to tax on their UBTI.¹ UBTI is defined, generally, as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of the trade or business, both computed with the modifications provided in section 512(b).² The term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the organization's need for income or the use it makes of the profits) to the exercise or performance by an exempt organization of the purpose or function constituting the basis for its exemption.³ A trade or business is "substantially related" to an organization's exempt purposes only if it contributes importantly to the accomplishment of such purposes, based on all the facts and circumstances

¹ Section 511.

² Section 512(a).

³ Section 513(a). Note that section 513 provides exceptions for certain types of business activities, such as, for example, a business in which substantially all of the work is performed by volunteers, a business carried on primarily for the convenience of the organization's members, students, patients, etc., and a business selling merchandise received by the organization as contributions.

Unless otherwise indicated, references to “section” or “sections” in this article are to the Internal Revenue Code of 1986 (the “Code”), as most recently amended, or to the U.S. Treasury Department regulations, as most recently adopted or amended.

involved.⁴ For a pension trust described in section 401(a), “unrelated trade or business” is defined as any trade or business regularly carried on by such trust or by a partnership of which it is a member.⁵ A “trade or business” for these purposes is any activity carried on for the production of income from the sale of goods or the performance of services.⁶

Exclusion of Rents from Real Property

Section 512(b)(3) generally excludes from UBTI rents from real property (and rents from personal property leased with the real property, if the rents attributable to the personal property are an incidental amount of the total rents received under the lease).⁷

The provision of services could cause rental activity income to be taxable. The regulations provide that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant do not constitute rent from real property if:

- The services are rendered primarily for the convenience of the occupant (e.g., the supplying of maid service), and
- The services are not of the type customarily rendered in connection with the rental of rooms or other space for occupancy only.

For example, the regulations state that the section 512(b)(3) exclusion does not apply to income received for the use or occupancy of rooms or other quarters in hotels, boarding houses, tourist camps or tourist homes, motor courts, motels, parking lots, warehouses, or storage garages. On the other hand, the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash are not considered as services rendered to the occupant.⁸ In addition, the IRS has stated that security services, parking, an unstaffed exercise room, swimming pools, tennis courts, and other recreational facilities are services

⁴ Section 1.513-1(d)(2) of the Treasury regulations.

⁵ Section 513(b).

⁶ Section 513(c).

⁷ Section 512(b)(3). The term “incidental” is defined in section 1.512(b)-1(c)(2)(b) of the Treasury regulations as meaning 10 percent or less. If more than 10 percent of the total rent received under the lease is attributable to personal property, the portion attributable to personal property is not excluded. The exclusion does not apply to any portion of the rent if more than 50 percent of the total rent is attributable to personal property or if the determination of the amount of rents depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). Section 512(b)(3)(B).

⁸ *Id.*

customarily rendered in connection with the rental of rooms or space for occupancy only.⁹

An example of the section 512(b)(3) exclusion from UBTI appeared in Revenue Ruling 69-178. The revenue ruling concerned an exempt organization that permitted its members and outside individuals and groups to use its meeting hall for a fee.¹⁰ The IRS ruled that the receipts constituted rents from real property within the meaning of section 512(b)(3) (excluded from UBTI) because the charges were made for the use and occupancy of space in real property and only utilities and janitorial services were provided. The IRS noted that the fact that the use was only for short periods of time did not destroy the character of the receipts as rent from real property.

Parking Revenues as UBTI

Prior to 1990, there was considerable controversy, inside and outside the IRS, as to the meaning of the reference to parking lots in the regulations. Some felt that the regulations mean that parking is itself a service; others interpreted the regulations as meaning that parking is an example of a rental activity when services (e.g., valet parking) could cause the income to be taxable. The IRS issued private letter rulings taking both positions.

In 1990, the IRS adopted the position that income from the direct operation of a parking lot is never “rent from real property” subject to the exclusion from UBTI under section 512(b)(3), regardless of whether additional services are provided to parking lot occupants.¹¹ On the other hand, the IRS acknowledged that income from the lease of a parking lot to a third-party operator constitutes “rent from real property” that may be excluded from UBTI when the only services provided to the third-party lessee in connection with the lease are those usually and customarily rendered in connection with the rental of space for occupancy only. The IRS’s conclusion was based in large part on its interpretation of the legislative history of the unrelated business income tax provisions.

⁹ Internal Revenue Manual, Part 7, Chapter 27, Exempt Organizations Tax Manual, 7.27.6.7.4.5 (02-23-1999).

¹⁰ Rev. Rul. 69-178, 1969-1 C.B. 158.

¹¹ G.C.M. 39825 (Aug. 17, 1990). General counsel memoranda are opinions of the IRS Office of Chief Counsel. They are not precedential authority, but they do provide insight into how the IRS interprets the law.

Revenue Ruling 2004-24¹²

Revenue Ruling 2004-24 provides an analysis, for purposes of section 856(d), relating to the taxation of real estate investment trusts ("REITs"), in three factual situations involving the provision of parking facilities at rental properties.

To qualify as a REIT, generally, at least 95 percent of an entity's gross income must be from sources listed in section 856(c)(2) and at least 75 percent must be from sources listed in section 856(c)(3), both of which include rents from real property. The term "rents from real property" for this purpose includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated.¹³ Services furnished to tenants are considered customary if, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with the service, and the service is furnished to the tenant, or to the guests, customers, or subtenants of the tenant, primarily for the convenience or benefit of the tenant.¹⁴ The regulations mention the furnishing of parking facilities as an example of a service that is customarily furnished to the tenants of a particular class of buildings in many geographic markets.¹⁵ Also, services rendered through an independent contractor from whom the REIT does not derive any income, and any amount that would be excluded from UBTI under section 512(b)(3) if received by a tax-exempt organization, are permitted services.¹⁶

The significant differences between the REIT rules and the UBTI rules are illustrated in the revenue ruling through three factual situations. In all three situations, the IRS concluded that parking is a permissible service for a REIT, but would result in UBTI to a tax-exempt organization:

- (1) The REIT owns commercial real estate such as office buildings, shopping centers, and residential apartment complexes. Each property also includes parking for the use of the tenants and their guests or customers that is in or adjacent to the buildings. The parking facilities do not have parking attendants. The REIT maintains, repairs, and lights the parking facilities, and pays taxes and insurance. These services are customarily provided in all geographic markets.

¹² 2004-1 C.B. 550.

¹³ Sections 856(c)(2), 856(d)(1)(B).

¹⁴ Section 1.856-4(b)(1) of the Treasury regulations.

¹⁵ *Id.*

¹⁶ Section 856(d)(7)(C). If impermissible tenant service income exceeds one percent of all amounts received or accrued during the year with respect to the property, none of the amounts received from the property is considered rents from real property. Section 856(d)(7)(B).

- (2) Same facts as Situation 1, except that some of the parking is assigned and marked as reserved for use by particular tenants. Enforcement of the space assignments is by an independent contractor. The services in connection with the reserved parking are performed by an independent contractor.
- (3) Same facts as Situations 1 and 2, except that some of the parking is available for use by the general public, there are parking attendants, and the parking is managed by an independent contractor, who employs the parking attendants. The parking attendants collect parking fees and may occasionally park cars to achieve maximum capacity or safety, although it is not “valet parking” (no separate fee is charged for an attendant to park cars). Occasionally, an attendant may provide minor, incidental emergency services, such as charging a battery or changing a flat tire. The independent contractor remits the parking fees to the REIT, and is paid arms'-length compensation. These services are provided to tenants and guests at attended parking facilities in all geographic markets, and the facilities available to the general public can reasonably be expected to be used predominantly by the REIT's tenants and their guests, customers, and subtenants, or are provided by an independent contractor.

Although Revenue Ruling 2004-24 is at least nominally about the REIT provisions and the analysis does not hinge on whether the income in question would be excluded under section 512(b)(3), the IRS appears to have gone to some lengths to include the section 512(b)(3) analysis. Perhaps this was intended to put the IRS's UBTI position with respect to parking into more authoritative, precedential guidance (albeit in “dicta”).

IRS Rules that Parking Revenues Not UBTI

Subsequent to the issuance of Revenue Ruling 2004-24, the IRS issued a private letter ruling holding that a tax-exempt title-holding company's revenues from the rental of parking spaces to apartment tenants was not UBTI under the circumstances.¹⁷ The ruling concerns a section 501(c)(2) title-holding company that owns a residential apartment building. For an additional rental charge, tenants of the apartment building may rent off-street parking spaces that are adjacent to the apartment units.

¹⁷ P.L.R. 200621031 (Mar. 1, 2006). Private letter rulings are taxpayer-specific rulings furnished by the IRS National Office in response to requests made by taxpayers and can only be relied upon by the taxpayer to whom issued. It is important to note that, pursuant to section 6110(k)(3), these items cannot be used or cited as precedent. Nonetheless, such rulings can provide useful information about how the IRS may view certain issues.

In the ruling, the IRS stated that, generally, revenue from the operation of a parking lot is not considered rent from real property that is excluded from UBTI. However, in this case, the IRS applied a facts and circumstances approach and concluded that the parking fees will be received only from tenants of the apartments, and that the title-holding company will not be operating a parking lot for the use of the general public. Based on these facts, the IRS concluded that the parking fees should be considered part of the rent. Although a portion of the rent (including the parking fees) will be UBTI because the property will be debt-financed, the IRS ruled that the title-holding company's receipt of the parking fees will not jeopardize its tax-exempt status.

The ruling does not mention Revenue Ruling 2004-24. It is unclear whether this is due to an oversight on the part of the drafter or because a distinction was drawn between the facts in the ruling and those in the three situations in Revenue Ruling 2004-24. It's hard to see a distinction, though, as Revenue Ruling 2004-24 provides that income from parking provided for the tenants of residential apartment complexes would not be excluded from a tax-exempt organization's UBTI as rent from real property.

Tax Court Holds Parking Lot Rental Income Is UBTI

In August 2010, the Tax Court held that an exempt organization's revenue from rental of a parking lot to its members is not excluded from UBTI as rents from real property.¹⁸ The organization owns property on which there are two parking lots and a recreational facility most of which is restricted to the organization's members. Daytime use of the parking lots during summer months is restricted to members who have paid a fee. Parking is on a first-come, first-served basis; there are no assigned parking spaces. The organization employs a guard during the daytime in the summer months, who checks cars for parking permit decals but does not collect fees or offer valet services. The organization leases the parking lots to unrelated businesses during non-summer months and during the evening and night during summer months.

The Tax Court held that the organization's operation of the parking lots was not substantially related to the organization's exempt purposes. In addition, the court held that the organization's parking revenue from members was not excluded from UBTI as rents from real property, citing language in the legislative history and the regulations under section 512(b)(3). The court interpreted the regulations to say that the services provided by an operator of a parking lot (at least a typical parking

¹⁸ [Ocean Pines Association, Inc. v. Commissioner, 135 T.C. No. 13 \(Aug. 30, 2010\)](#).

lot) are primarily for the convenience of the customer and are other than those usually or customarily rendered in connection with the rental of rooms or space for occupancy only. The court also held that the lease payments from unrelated businesses are rent from real property because the organization did not directly operate the parking lot on behalf of the businesses.

Conclusion

It would appear that the Tax Court has weighed in on the side of the IRS. It remains to be seen whether the Tax Court's holding will be appealed or followed by other courts. It also remains to be seen whether there might be a factual scenario in which the courts would hold that an exempt organization's revenues from parking would be excluded from UBTI as rents from real property. At this point in time, however, it appears that the Tax Court agrees with the IRS that revenues from operation of a typical parking lot are not excluded from UBTI as rents from real property.



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