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Create Passive Income by Leveraging Debt to Cover Tax Liability

Ariana N. Warren
Marcum LLP

Marcum LLP's Ariana N. Warren explains how leveraging debt can earn passive income, using an example of a nonprofit that purchases a building while earning rental income from it, and how to accurately calculate debt-financed income to report and pay tax on unrelated business income.

Not all debt is bad. Debt can be good—it can even be great. When strategically leveraged with an asset, debt instruments not only can cover their obligations, but also can provide surplus income and generate revenue.

Income earned in this manner, without active participation, yields passive revenue—a unique source of unrelated business income for nonprofits. This is better known as debt-financed income, or DFI.

Any asset acquired with debt that generates income can create DFI. The clearest example of DFI is a nonprofit purchasing a building while earning rental income from it.

Buying the building from a bank often requires a mortgage, which is a debt instrument. While there is outstanding debt on the building, the nonprofit may choose to rent portions of its space to a separate legal entity. The nonprofit will earn income from the space, but its ownership in the asset generating the income

is held in the mortgage, a debt obligation. This creates DFI and, potentially, the requirement to report this income on federal Form 990-T.

Common Exceptions

Not all rental agreements automatically create DFI. Every rule usually has an exception, the most common being the use of 15% or less of total space by the lessee, renting to a related exempt organization, and the neighborhood land rule. Other less common exclusions include property used to create research income; property leased to a medical clinic to further the lessor's exempt purpose; meeting the volunteer, donated goods, or convenience exception; and real property acquired by a qualified organization.

There are a couple of ways to determine how much space is used and whether the lease income is taxable. This measurement typically is determined by number of floors or square footage leased. When considering number of floors, total floors available in the building are compared with the number of floors being used for other than an exempt purpose. Square footage follows a similar comparison, using actual footage for the numerator and denominator. For example:

Total number of floors in building: 14
Floors used for debt finance income: 3
DFI Percentage: 21.43%

If less than 15% of the total space is used for unrelated activities, no part of the property will be considered debt financed.

When relatedness exists, as defined in the instructions for Form 990, both entities generally are working toward a similar exempt purpose. In that case, the second entity is performing charitable work rather than commercial work, and rental income from this entity would be excluded from consideration of debt financing. In this circumstance, the lessee must be carrying out the exempt purpose of the lessor.

Property that can be excluded from DFI under the neighborhood land rule can temporarily produce income without being subject to the debt financed property rules, under certain conditions. The acquired property must be within the same neighborhood as other property owned by the exempt organization. The exempt organization can't change or modify its intent to use the property for its exempt purpose within the first 10 years of ownership. And the property may not be subject to any lease term that exceeds five years.

Calculating Taxable DFI

Calculating taxable DFI is usually completed in multiple steps and includes different data points for the debt, income, and expenses related to the property. Specifically, you must evaluate: the average acquisition indebtedness, the average adjusted basis, gross income, and direct expenses. In addition, a method for calculating DFI percentage must be selected to properly report the activity on federal Form 990-T, used by nonprofit organizations to report and pay tax on unrelated business income.

Average acquisition indebtedness considers the average debt held at the beginning of each month, excluding interest, and treating partial months as full months. The outstanding debt for each month is first aggregated and then divided by the total months the property was held. The average adjusted basis considers the original cost of the property, adjusted for additions, disposals, and depreciation, on the first and last days of the tax year.

These two different benchmarks are used to arrive at average basis. This calculation is completed by adding the adjusted basis at the beginning of the year to the basis at the end of the year, and then dividing this sum by two.

These two data points—average acquisition indebtedness and average adjusted basis—are then used to derive a ratio. With average acquisition indebtedness as the numerator and average adjusted basis as the denominator, this quotient is multiplied against gross income to arrive at unrelated debt financed income, known as UDFI. For example:

Gross income: $27,488
Acquisition indebtedness /adjusted basis: $661,916 / $940,823 = 70.36%
UDFI: 70.36% x $27,488 = $19,339

Next, a method must be chosen that will consistently be applied in future years, applying either the square footage or number of floors method. This example demonstrates the total square footage method:

Total square feet: 10,624
Square feet generating DFI: 2,400
DFI percentage: 22.59%

Of the total building and maintenance expenses incurred during the year, 22.59% would be attributed to DFI, reducing the taxable income. Common building

expenses usually include costs such as janitorial services, insurance, utilities, grounds maintenance, depreciation, taxes, and repairs.

Let's use an example of $21,377 of direct expenses available to apply to DFI. Before taxable income can be reduced, the indebtedness ratio of 70.36% that was applied earlier against revenue would have to be applied, leaving $15,039 in expenses.

Finally, with all data considered, unrelated debt financed income less expenses allocable to DFI would provide the federal taxable income amount:

UDFI: $19,339
Expenses: $15,039
Taxable income: $4,300

In business, few things are greater than income earned effortlessly. For nonprofits, passive income is one of the most valuable ways to have assets work while they support your exempt purpose.

This income stream requires little to no time and is measurable, reliable, and typically timely with minimal ongoing effort for evaluation. The surplus created is income apart from contributions that typically require solicitation, apart from program service revenue that requires active service in the field. And unlike grant income, it doesn't require writers or maintenance of debt covenants.

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Author Information

Ariana N. Warren, CPA, is a senior manager in the tax and business services division of Marcum LLP and a member of the firm's nonprofit and social sector group.