

# **What to Consider Before Allowing a Third Party to Use Real Property**

## **Introduction**

Most church organizations will at one time or another be approached by an individual or organization wanting to use or lease a portion of their facilities for some activity or purpose. Whether the request is for a one-time short term use, (e.g. a wedding reception or retirement dinner), or a multi-year lease, (e.g. a day care center or AA group), there are a number of ecclesiastical, practical, financial, tax, and legal considerations. Church organizations entering into such relationships without thinking through these implications unnecessarily risk the resources of the church. As Christians, we are all called by God to be good stewards of the resources with which we have been entrusted. In the context of allowing third parties to use church property, this means analyzing the risks and rewards of the proposed use and how the proposed use will impact the broader ministry of the church now and in the future.

There are a number of issues a church organization should review and consider in making its decision. These issues include, but are not limited to, 1) the compatibility of the proposed use with its mission and ministry and the Social Principles of our Church. ¶ 2532.3 of *The Book of Discipline* states the local church trustees are permitted to lease to third parties “only when such use is consistent with the Social Principles (¶¶ 160-166) and ecumenical objectives,” 2) the compatibility of the proposed use with the existing and future uses, 3) the financial impact on the church organization of the proposed use, 4) the legal, liability and insurance implications of the proposed use, 5) real property tax implications of the proposed use, 6) federal income tax implications of the proposed use, 7) sales and other tax implications of the proposed use, and 8) zoning, access, and licensing requirements caused by the proposed use.

The following discussion, Checklist and sample lease forms are designed to help a church organization identify and consider the relevant issues. However, these are merely a starting point and are not a substitute for professional legal, tax, and insurance advice. As the following discussion will make clear, these issues can be complicated. Accordingly, you should seek competent professional advice before allowing any outside organization to use church facilities. Minimally, before you allow an outside organization to use church facilities you should do the following:

- 1) Consider whether the proposed use is compatible with the mission, ministry and current uses of the church organization;
- 2) Consult with an attorney about the proposed use and its potential legal, tax and financial ramifications;

- 3) Before allowing a third party to use your property, with the aid of legal counsel, prepare and execute a written agreement memorializing the terms under which the third party will be allowed to use the property. The agreement should minimally address the following:
  - a. Who are the parties to the agreement?
  - b. Who is allowed to use the property?
  - c. What portion of the property is the third party allowed to use?
  - d. When and for how long can the third party use the property?
  - e. For what purposes can the third party use the property?
  - f. What uses are limited or prohibited?
  - g. The amount of compensation (if any) the church will receive for the use of the property.
  - h. How will the costs associated with maintaining and operating the premises be allocated between the parties?
  - i. What are the respective clean-up and maintenance responsibilities of the church and the third party?
  - j. Who is responsible for providing and paying for any security necessitated by the proposed use?
  - k. Is the third party required to defend and indemnify the church against any claims related to its use of the property?
  - l. What type of insurance coverage and limits is the third party required to maintain, if any?
  - m. Which organization will be responsible for the tax implications caused by the proposed use?
  - n. Which organization is responsible for addressing zoning, access, or licensure issues caused by the proposed use?
  - o. How and under what circumstances can the third party's use of the property be terminated?
  
- 4) Finally, you should consult with your insurance agent or broker regarding the proposed use to ensure adequate insurance coverage.

This process should be followed anytime a church organization considers allowing a third party to use its property. In some instances, you may be able to develop a list of acceptable one-time, short-term uses and a form agreement for those uses, with the aid of your attorney. However, for longer-term relationships there is no substitute for following this process to create a unique lease each time the church organization receives a request. In addition, this process should be utilized even when the church organization is not receiving any compensation from a third party for the use of the property. The amount of money a church organization receives (if any) is but one of the issues that needs to be considered. The following discussion and Checklist are designed to further expand these issues.

### **Compatibility of the Proposed Use with the Mission and Ministry of the Church**

In deciding whether to allow a third party to use all or a portion of a church organization's real property, the first consideration must be whether the proposed use is compatible with the mission and ministry of the Church. *The Book of Discipline* provides specific guidance to local church trustees on appropriate uses for a church's real property. *The Book of Discipline* in ¶ 2532.3 states:

When a pastor and/or a board of trustees are asked to grant permission to an outside organization to use church facilities, permission can be granted only when such use is consistent with the Social Principles (¶¶ 160–166) and ecumenical objectives.

Accordingly, it is important to understand the outside organization's business or mission and how that third party intends to use the property. Given this information, the church organization can determine whether the requested use is consistent with the mission, ministry, Social Principles and ecumenical objectives of the Church. For example, it goes without saying that liquor stores or betting parlors would not be appropriate uses for church property. Many church organizations find that they can avoid conflicts with the Social Principles by limiting the use of church property by outside organizations to other not-for-profit groups. However, even with other not-for-profit groups, the church organization needs to assess the organization's mission and anticipated uses of the property.

A church organization can help ensure this assessment by developing a "Real Property Use Policy or Procedure" that, among other things, assigns the task of investigating the third party's business, mission and intended uses to a person or committee familiar with the Church's mission and ministry, Social Principles, and existing real property uses. The policy should also identify who or what body has the responsibility and authority for approving all uses of the property by third parties.

### **Compatibility of the Proposed Use With Existing and Future Uses**

When a church organization agrees to allow a third party to use its property, it should consider whether the proposed use is compatible with the church's existing uses, programs and activities. For example, if the sanctuary is to be shared with a mission congregation, timing for Sunday morning worship would undoubtedly be a major concern. Likewise, leasing the underused second floor gymnasium for basketball practice would impact groups like the church council that meet directly below the gymnasium.

Before a church organization allows a third party to use its property, it must consider the nature of the proposed use and how it might affect or limit the organization's current and

future programs and activities. The church organization must also make sure the proposed use will not prevent the organization from living up to any existing commitments it may have with other organizations for the use of the property. Avoiding scheduling conflicts is of course a very important consideration in this regard. However, as the above examples illustrate, it is not the only consideration when assessing whether a proposed use is compatible with the church organization's existing and future uses.

### **The Financial Impact of the Proposed Use**

Allowing a third party to use a church organization's property can have a substantial financial impact. The proposed use may cause additional operating, maintenance, and utility costs. For example, a space that was otherwise unused may need additional cooling or heating when leased. A janitor may be required for set up and clean up. A building supervisor may need to be on the premises to open the building, address concerns and lock up after the third party is done using the premises. Additional insurance may need to be purchased to cover risks associated with the proposed use. At the same time, a third party's use may result in additional revenue for the church organization in the form of rental payments. In assessing the financial impact of the proposed use, the church organization needs to consider the additional operating, maintenance and utility costs caused by the proposed use (if any), who will bear those costs (third party or church organization), and the amount of income (if any) the church organization will realize from allowing the third party to use the property.

### **Legal, Liability and Insurance Issues**

It is essential to always remember "We are the Church" and our purpose is to actively and courageously carry out mission and outreach. In today's society, sometimes it is possible to feel paralyzed when viewing all the things that can go wrong with any new venture, even allowing third parties to use church property. However, we know that part of our mission is to be of the world and set an example in reaching out and sharing with others. In carrying out that part of the church's mission, we must also remember that we have an obligation to be good stewards of the resources with which we have been entrusted by God. Before allowing a third party to use church property, church organizations must assess the potential risks and liabilities associated with the proposed use; decide whether allowing a third party to use the property in light of those risks is in the best interests of the church's mission; and if it is, take steps to manage and insure against those risks.

Some of the actions a church may take to manage its risks include:

1. Making sure that the property is well kept, in good condition, and any unsafe conditions are promptly repaired or changed.<sup>1</sup> This

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<sup>1</sup> Among the provisions specifically directing such review is ¶ 2532.4 of *The Book of Discipline*.

needs to be one even if no third party use is ever considered. But it may be additionally important to third parties who are unfamiliar with the church organization's property or who may be in less than fully supervised settings. For example, a janitor closet with chemicals should always be locked. A rickety bell tower stairway that has only a small "Do Not Enter" sign on a rope may need to be closed off with a secure door.

2. Executing an agreement specifying the rights and responsibilities of the church and the third party with regard to the third party's use of the property.
3. Executing an agreement obligating the third party to defend and indemnify the church organization against all claims related to the third party's use of the premises.
4. Executing an agreement obligating the third party to produce an insurance certificate that confirms the third party has specific minimum types of insurance coverages and limits, names the church organization as an additional insured, and specifies that in claims related to the third party's use of the premises, the third party's insurance is primary.
5. Reviewing the church organization's insurance needs given the proposed use with the church's insurance agent or broker.<sup>2</sup>
6. Obtaining competent legal advice regarding the proposed use and the preparation of a written agreement memorializing the terms and conditions of the third party's use of the property.

By taking this approach, a church organization can fulfill both its outreach and stewardship missions.

### **Zoning, Access, Permit and Other Regulatory Issues**

A third party's use of a church's property may create zoning, permit, access and other regulatory issues. Before allowing a third party to use its property, a church organization should be aware of these issues and make sure that responsibility for addressing them is clearly established in writing between the parties. In most cases, that responsibility should be assigned to the third party.

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<sup>2</sup> ¶ 2532.2 refers to the local church trustee responsibility for insurance.

In regard to zoning, the parties need to consider whether the proposed use is a permitted use given the property's zoning. For example, a factory cannot generally be built in a residential area, and sometimes even churches are banned from residential areas without special zoning permits or exceptions. Accordingly, if a day care center wants to use the church building five days a week, it is possible that the applicable zoning ordinance will prohibit such a use. A third party should only be allowed to use the property if it can do so under the existing zoning or it can obtain a zoning change or variance permitting the proposed use.

In regard to access, the parties need to consider whether the proposed use will require modifications to the property in order to comply with local, state or federal handicap access statutes. These statutes can dictate such things as the number, size or set up of facilities, such as washrooms, as well as the entrance requirements for a building. Complying with such requirements can be very expensive for an older building with stairs, narrow doorways, or old washrooms. The parties must establish in writing who has the responsibility and the financial burden of complying with such mandates.

In some cases, a third party may want to make certain physical changes to the property. This may require a permit from the local government authority and a public hearing. Again, the parties must clearly establish who has the responsibility and the financial burden of complying with such local permit processes.

Finally, the proposed use may also be subject to other regulatory requirements. For example, day care centers are usually required to be licensed by the state. A third party's ability to use the property should always be conditioned on its compliance with all applicable local, state, and federal ordinances, regulations, and statutes, including all licensing requirements.

### **Real Property Tax Issues**

In most states, property owned and used by a church organization for religious or charitable purposes is exempt from real property taxation provided certain requirements are met. When a church allows a third party to use its property, the real property tax exemption may be partially or totally lost. Each state differs as to its treatment of otherwise exempt property that is used by a third party. Therefore, a careful analysis of a particular state's property tax statutes should be performed prior to a church organization allowing a third party to use its property.

### **Federal Income Tax Issues**

When a church organization leases property that it owns to another party (tax-exempt or for-profit), it is important to follow certain federal tax guidelines when structuring the lease relationship to provide the greatest protection to the church's tax-exempt status and to minimize the likelihood that income from the lease will be construed as unrelated business income tax (UBIT) and subject to tax under Section 511(a) of the Internal Revenue Code (the

“Code”).<sup>3</sup> This analysis can be very complicated and generally requires the assistance of competent legal and/or tax counsel.

### **Other Tax Considerations**

A third party’s use of church property may generate sales, use, excise or other taxes. The church organization needs to be aware of these other tax considerations. In most instances, since these taxes are directly related to the third party’s use of the premises, the organization should require the third party to be responsible for collecting and paying such taxes.

### **Property Use Checklist**

*The following is intended to help religious organizations in their review and analysis of the implications of a third party’s use of the Church’s real property.*

A religious organization considering renting or sharing its facility or properties with another organization should consider the following questions as part of the initial analysis. If the parties decide to go forward and enter into an agreement or lease, the services of an experienced attorney should be used to draft the lease or sharing agreement.

### **Compatibility of the Proposed Use with the Mission and Ministry of the Church**

1. ----- What is the third party’s business, purpose, and mission?
2. ----- What is the third party’s intended use of the property?
3. ----- Are the third party’s business, purpose, and mission and intended use of the property, compatible with the mission, ministry, Social Principles and ecumenical objectives of the Church?
4. ----- Has the third party filled out an application or submitted a letter of request outlining the general purpose, times and fees for the proposed use? Do you understand the nature of the third party organization? Are references part of the application?

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<sup>3</sup> Although rentals of church property do give rise to unrelated business income tax (UBIT), Internal Revenue Code Section 513 specifically exempts rental income from being taxable UBIT in most circumstances. Consult with your own tax or legal advisor for UBIT questions. See also [IRS Publication 1828](#) and specific items in the attached Property Use Checklist.

5. ----- What is the social agenda of the third party? (Consider the Social Principles.)
6. ----- What potential social/political conflicts may arise between the church organization and the third party as a result of its social agenda?
7. ----- Can potential problems be avoided or reduced by careful communication and agreements?
8. ----- Will the sharing of space with this third party organization adversely affect either party's public image or reputation? (For example, rental to a tobacco shop or a store that sells lotto tickets or weekly meetings of an extreme political group.)
9. ----- Will allowing the third party to use the property cause tension within the church organization?
10. ----- Has the church organization reviewed the political, practical and social implications of the proposed use in relation to its neighbors and the community? (For example, a 7 nights a week homeless shelter operation in a residential area, 4 miles from public transportation.)
11. ----- Is the space-sharing agreement intended to enhance the church's religious, educational and charitable outreach, or simply to provide income? <sup>4</sup>
12. ----- What precedent will be set by allowing this organization to use church property?
13. ----- Is there a common basis for conflict resolution between the organizations?

#### **Compatibility of the Proposed Use with Existing and Future Uses**

14. ----- Does the church organization understand exactly how the third party intends to use the property?
15. ----- Will the parties execute an agreement that clearly identifies what uses are prohibited or limited by the third party?

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<sup>4</sup> If a sharing arrangement is being discussed with an unaffiliated start-up church or ministry, consider the appropriateness of United Methodist affiliation.

16. ----- During what days and times will the third party use the property?
17. ----- Has the church organization analyzed how the proposed use would impact or limit the church's present and/or future ministry, goals, programs, and activities?
18. ----- How much of the property does the third party want to use?
19. ----- Will the proposed uses interfere with or impact existing meetings or functions? (Consider security concerns, sound problems, washroom facilities, cooking facilities, parking space, etc.)
20. ----- What space should be used in common, and what space will be used exclusively by one party or the other?
21. ----- For common space sharing, has a schedule (including set-up/take-down time) been developed that will work for joint usage?
22. ----- Will the use of space be long term or short term?
23. ----- If the use will be long term, has the church organization considered how this may limit its ability to sell, renovate or expand the property?
24. ----- How will access to, and locking up of, the building be handled? (Keys, electronic key cards, password codes, etc.)

**Financial Impact of the Proposed Use**

25. ----- How much does it cost now to operate the facility annually? Per square foot?
26. ----- How will the proposed use impact the operating, maintenance, and utility costs for the property (e.g. heating, cooling, other utilities, janitorial, supervisory personnel, etc)?
27. ----- Will the third party bear any additional costs generated by the proposed use? If not, how will the costs be apportioned between the parties in the agreement?
28. ----- Who will be responsible for cleaning and maintaining the property used by the third party and the common areas? Who will pay for this?

29. ----- What standards will be used in maintaining the property?
30. ----- Will the church receive any rental income from the proposed use of the property? If so, how much?
31. ----- Will the income be used to defray the increased costs of operating the building, or does the church expect to get more income than the increased operating costs?

**Insurance, Liability and Legal Issues**

32. ----- Has the church organization assessed the risks associated with the proposed use?
33. ----- Has the church organization considered the appropriateness of the proposed use for the property?
34. ----- Have the parties agreed on their respective rights and responsibilities regarding the use of the property?
35. ----- Who will pay to defend against or pay for any claims arising out of the third party's use of the property?
36. ----- What security issues does the proposed use create? (For example, fencing around playground equipment). Who is responsible for addressing such security issues?
37. ----- Does the third party have a risk management plan sufficient to address any risks caused by its use of the property? If so, has the church organization reviewed it?
38. ----- Will the third party be required to defend and indemnify the church organization against claims related to its use of the property?
39. ----- Will the third party be required to have insurance with certain minimum coverages and limits to back up its obligations under any use agreement?
40. ----- Will the third party be required to list the church as an additional insured on its insurance policy and present a certificate of insurance?
41. ----- Does the lease or agreement reflect such insurance requirements?

42. ----- Has the church organization consulted with an attorney and its insurance professional regarding the best way to address risks related to the proposed use?
43. ----- Does the church organization have adequate insurance coverages and limits given the proposed use?
44. ----- What steps should be taken to protect and secure valuable property and equipment belonging to the parties from damage, theft or misuse?
45. ----- What is the duration of the proposed use?
46. ----- What is the legal status of each organization, e.g. not-for-profit corporation, religious corporation or unincorporated association?
47. ----- Do you have a standard rental agreement or does a new agreement need to be drafted? Has your legal advisor reviewed the final agreement before signing?
48. ----- What legal authority does each participant need in order to enter into a legally binding agreement? (Some groups require corporate resolutions to authorize negotiation and execution of a lease.)
49. ----- Have adequate provisions been made for termination of the agreement?
50. ----- Does another United Methodist church in this district or conference have a sample agreement for the uses you are planning that you can supply to your legal counsel for review?
51. ----- Has the church organization consulted with an attorney regarding the proposed use and the drafting of an agreement to memorialize the terms and conditions of the proposed use?

**Real Property Tax Issues**

52. ----- Will the proposed use affect the church organization's real estate tax exemption?
53. ----- Can any adverse real estate tax consequences be minimized?

54. ----- Who will pay any additional real estate taxes incurred?
55. ----- Does the lease provide that the third party is responsible for paying any and all real estate taxes that become due as a result of the proposed use?
56. ----- Will any rental payments include reimbursement of property taxes that may be imposed on the church as a result of the proposed use?
57. ----- Is the third party a nonprofit entity that is recognized as exempt from federal income taxes under the Internal Revenue Code? If so, do the activities of the third party complement or further the church's mission?
58. ----- Does an annual real property tax exemption certificate need to be filed with the state or county to maintain the church's exemption?
59. ----- Is the church organization required to notify the state or county when it leases or allows its property to be used by a third party?
60. ----- Are careful records required to be kept as to the square footage leased to the lessee and the rental income collected by the church organization?
61. ----- The church organization should prepare and retain minutes of any meeting in which the topic of leasing the church's property was discussed. The minutes should reflect discussion as to whether or not entering into a lease with a particular lessee would be in furtherance of the church's mission.

### **Federal Income Tax and Other Tax Issues**

62. ----- In many instances, rental of church property is exempt from unrelated business income tax (UBIT). However, consider whether in your case, the rental income received by the church will cause any local, state or federal tax liabilities.<sup>5</sup>
63. ----- How can any adverse income tax consequences be minimized? Who will pay any additional income taxes incurred?
64. ----- Will there be a written lease which sets forth the terms and conditions of the lease relationship?
65. ----- The relationship between the church organization and the lessee should not be one of a partnership or a joint venture.

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<sup>5</sup> Your tax or legal advisor should consult with you on specific UBIT issues. See [IRS Publication 1828](#) regarding UBIT issues and analysis.

66. ----- The amount of rent charged should not be tied to the income or profits of the lessee but may include either a fixed percentage or percentages of sales.
67. ----- If personal property is leased in connection with real property, the portion of the rental payment allocated to the personal property must be “incidental” (not more than 10%) in comparison with the total rental payment.
68. ----- If the property leased is subject to a mortgage or is otherwise “debt financed,” then the rental income will be subject to UBIT unless one of the following exceptions apply:
- At least 85% of the lessee’s use of the property is substantially related to the exercise or performance of the church’s mission;
  - The property is used by the lessee for research activities; or
  - Substantially, all of the lessee’s work is performed without compensation, the lessee’s business is carried on primarily for the convenience of members, students, patients, officers, or employees, or the lessee’s business is the selling of merchandise, substantially all of which was received as gifts or contributions.
69. ----- Who will ensure proper payment of any state sales tax on retail sales out of the facility that may be subject to state sales taxes?

**Zoning, Access, Permit and Other Regulatory Issues**

70. ----- What are the permitted uses under the property’s present zoning?
71. ----- Is the proposed use a permitted use? If not, is the third party’s use contingent on the third party obtaining a zoning change or variance allowing for the proposed use?
72. ----- Is the third party required to be in compliance with all local, state, and federal rules, regulations, and statutes applicable to the proposed use, including any license requirements?
73. ----- Will allowing the third party to use the property require the church organization to comply with local or state handicap access statutes or the

Americans with Disabilities Act? If yes, will modifications be required?  
If so, who will pay for them?

74. ----- Is the building structure appropriate for the intended use, or will renovations be required to bring the building into compliance with the local building, safety and fire codes?
75. ----- If improvements need to be made before the proposed use begins, who pays for them, who makes sure they are up to code, and who benefits from them when the agreement ends?

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