Publication 598

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Tax on Unrelated Business Income of Exempt Organizations

Volume 3 of 3

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Income From Property Financed With Qualified 501(c)(3) Bonds

If any part of a 501(c)(3) organization's property financed with qualified 501(c)(3) bonds is used in a trade or business of any person other than a section 501(c)(3) organization or a governmental unit, and such use isn’t consistent with the requirements for qualified 501(c)(3) bonds under section 145, the section 501(c)(3) organization is considered to have received unrelated business income in the amount of the greater of the actual rental income or the fair rental value of the property for the period it is used. No deduction is allowed for interest on the private activity bond. See sections 150(b)(3) and (c) for more information.

Disposition of Property Received From Taxable Subsidiary and Used in Unrelated Business

A taxable 80%-owned subsidiary corporation of one or more tax-exempt entities is generally subject to tax on a distribution in liquidation of its assets to its exempt parent (or parents). The assets are treated as if sold at fair market value.

Tax-exempt entities include organizations described in sections 501(a), 529, and 115, charitable remainder trusts, U.S. and foreign governments, Indian tribal governments, international organizations, and similar non-taxable organizations.

A taxable corporation that transfers substantially all of its assets to a tax-exempt entity in a transaction that otherwise qualifies for nonrecognition treatment must recognize gain on the transaction as if it sold the assets at fair market value. However, such a transfer isn’t taxable if it qualifies as a like-kind exchange under section 1031 or an involuntary conversion under section 1033. In such a case, the built-in appreciation is preserved in the replacement property received in the transaction.

A corporation that changes status from taxable to tax-exempt is treated generally as if it transferred all of its assets to a tax-exempt entity immediately before the change in status (thus subjecting it to the tax on a deemed sale for fair market value). This rule doesn’t apply where the taxable corporation becomes exempt within 3 years of formation, or had previously been exempt and within several years (generally a period of 3 years) regains exemption, unless the principal purpose of the transactions is to avoid the tax on the change in status.

In the transactions described above, the taxable event is deferred for property that the tax-exempt entity immediately uses in an unrelated business. If the parent later disposes of the property, then any gain (not in excess of the amount not recognized) is included in the parent's UBTI. If there is partial use of the assets in unrelated business, then there is partial recognition of gain or loss. Property is treated as disposed if the tax-exempt entity no longer uses it in an unrelated business.

Losses on the transfer of assets to a tax-exempt entity are disallowed if part of a plan with a principal purpose of recognizing losses.

Income From Debt-Financed Property

Investment income that would otherwise be excluded from an exempt organization's UBTI (see *Exclusions* under *Income*, earlier) must be included to the extent it is derived from debt-financed property. The amount of income included is proportionate to the debt on the property.

Debt-Financed Property

In general, the term “debt-financed property” means any property held to produce income (including gain from its disposition) for which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year). However, the tax on unrelated debt-financed income under section 514 does not apply to property used for an exempt purpose. See *Exceptions to Debt-Financed Property*, later. Sources of unrelated debt-financed income include rental real estate, tangible personal property, and corporate stock.

Acquisition Indebtedness

For any debt-financed property, acquisition indebtedness is the unpaid amount of debt incurred by an organization:

1. When acquiring or improving the property,
2. Before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement, and
3. After acquiring or improving the property if:
    a. The debt would not have been incur-red except for the acquisition or improvement, and
    b. Incurring the debt was reasonably foreseeable when the property was acquired or improved.

The facts and circumstances of each situation determine whether incurring a debt was reasonably foreseeable. That an organization may not have foreseen the need to incur a debt before acquiring or improving the property doesn’t necessarily mean that incurring the debt later wasn’t reasonably foreseeable.

Example 1. Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building that Y rents to an insurance company for nonexempt purposes. The debt is acquisition indebtedness since the debt, though incurred after the improvement of the office building, would not have been incurred without the improvement, and the debt was reasonably foreseeable when, to make the improvement, Y reduced its working capital below the amount necessary to continue current operations.

Example 2. X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners will share equally in the profits of the partnership, each will invest $3 million, and X will be a limited partner. X invests $1 million of its own funds in the partnership and $2 million of borrowed funds.

The partnership buys as its sole asset an office building that it leases to the public for nonexempt purposes. The office building costs the partnership $24 million, of which $15 million is borrowed from Y bank. The loan is secured by a mortgage on the entire office building. By agreement with Y bank, X isn’t personally liable for payment of the mortgage.

X has acquisition indebtedness of $7 million. This amount is the $2 million debt X incurred in acquiring the partnership interest, plus the $5 million that is X's allocable part of the partnership's debt incurred to buy the office building (one-third of $15 million).

Example 3. A labor union advanced funds, from existing resources and without any borrowing, to its tax-exempt subsidiary title-holding company. The subsidiary used the funds to pay a debt owed to a third party that was previously incurred in acquiring two income-producing office buildings. Neither the union nor the subsidiary has incurred any further debt in acquiring or improving the property. The union has no outstanding debt on the property. The subsidiary's debt to the union is represented by a demand note on which the subsidiary makes payments whenever it has the available cash. The books of the union and the subsidiary list the outstanding debt as inter-organizational indebtedness.

Although the subsidiary's books show a debt to the union, it isn’t the type subject to the debt-financed property rules. In this situation, the very nature of the title-holding company and the parent-subsidiary relationship shows this debt to be merely a matter of accounting between the two organizations. Accordingly, the debt isn’t acquisition indebtedness.

Change in use of property. If an organization converts property that isn't debt-financed property to a use that results in its treatment as debt-financed property, the outstanding principal debt on the property is thereafter treated as acquisition indebtedness.

Example. Four years ago a university borrowed funds to acquire an apartment building as housing for married students. Last year, the university rented the apartment building to the public for nonexempt purposes. The outstanding principal debt becomes acquisition indebtedness as of the time the building was first rented to the public.

Continued debt. If an organization sells property and, without paying off debt that would be acquisition indebtedness if the property were debt-financed property, buys property that is otherwise debt-financed property, the unpaid debt is acquisition indebtedness for the new property. This is true even if the original property wasn’t debt-financed property.

Example. To house its administration offices, an exempt organization bought a building using $600,000 of its own funds and $400,000 of borrowed funds secured by a pledge of its securities. The office building wasn’t debt-financed property. The organization later sold the building for $1 million without repaying the $400,000 loan. It used the sale proceeds to buy an apartment building it rents to the general public. The unpaid debt of $400,000 is acquisition indebtedness with respect to the apartment building.

Property acquired subject to mortgage or lien. If property (other than certain gifts, bequests, and devises) is acquired subject to a mortgage, the outstanding principal debt secured by that mortgage is treated as acquisition indebtedness even if the organization didn’t assume or agree to pay the debt.

Example. An exempt organization paid $50,000 for real property valued at $150,000 and subject to a $100,000 mortgage. The $100,000 of outstanding principal debt is acquisition indebtedness, as though the organization had borrowed $100,000 to buy the property.

Liens similar to a mortgage. In determining acquisition indebtedness, a lien similar to a mortgage is treated as a mortgage. A lien is similar to a mortgage if title to property is encumbered by the lien for a creditor's benefit. However, when state law provides that a lien for taxes or assessments attaches to property before the taxes or assessments become due and payable, the lien isn’t treated as a mortgage until after the taxes or assessments have become due and payable and the organization has had an opportunity to eliminate the lien by paying the amount it secured in accordance with state law. Liens similar to mortgages include (but aren’t limited to):

1. Deeds of trust,
2. Conditional sales contracts,
3. Chattel mortgages,
4. Security interests under the Uniform Commercial Code,
5. Pledges,
6. Agreements to hold title in escrow, and
7. Liens for taxes or assessments (other than those discussed earlier in this paragraph).

Exception for property acquired by gift, bequest, or devise. If property subject to a mortgage is acquired by gift, bequest, or devise, the outstanding principal debt secured by the mortgage isn’t treated as acquisition indebtedness during the 10-year period following the date the organization receives the property. However, this applies to a gift of property only if:

1. The mortgage was placed on the property more than 5 years before the date the organization received it, and
2. The donor held the property for more than 5 years before the date the organization received it.

This exception doesn't apply if an organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent (other than a payment under an annuity obligation excluded from the definition of acquisition indebtedness, discussed under *Debt That Isn’t Acquisition Indebtedness*, later).

Whether an organization has assumed and agreed to pay all or part of a debt in order to acquire the property is determined by the facts and circumstances of each situation.

Modifying existing debt. Extending, renewing, or refinancing an existing debt is considered a continuation of that debt to the extent its outstanding principal doesn’t increase. When the principal of the modified debt is more than the outstanding principal of the old debt, the excess is treated as a separate debt.

Extension or renewal. In general, any modification or substitution of the terms of a debt by an organization is considered an extension or renewal of the original debt, rather than the start of a new one, to the extent that the outstanding principal of the debt doesn’t increase.

The following are examples of acts resulting in the extension or renewal of a debt:

1. Substituting liens to secure the debt,
2. Substituting obligees whether or not with the organization's consent,
3. Renewing, extending, or accelerating the payment terms of the debt, and
4. Adding, deleting, or substituting sureties or other primary or secondary obligors.

Debt increase. If the outstanding principal of a modified debt is more than that of the unmodified debt, and only part of the refinanced debt is acquisition indebtedness, the payments on the refinanced debt must be allocated between the old debt and the excess.

Example. An organization has an outstanding principal debt of $500,000 that is treated as acquisition indebtedness. The organization borrows another $100,000, which isn't acquisition indebtedness, from the same lender, resulting in a $600,000 note for the total obligation. A payment of $60,000 on the total obligation would reduce the acquisition indebtedness by $50,000 ($60,000 x $500,000/$600,000) and the excess debt by $10,000.

Debt That Isn't Acquisition Indebtedness

Certain debt and obligations aren't acquisition indebtedness. These include the following.

- Debts incurred in performing an exempt purpose.
- Annuity obligations.
- Securities loans.
- Real property debts of qualified organizations.
- Certain Federal financing.

Debt incurred in performing exempt purpose. A debt incurred in performing an exempt purpose isn’t acquisition indebtedness. For example, acquisition indebtedness doesn’t include the debt an exempt credit union incurs in accepting deposits from its members or the debt an exempt organization incurs in accepting payments from its members to provide them with insurance, retirement, or other benefits.

Annuity obligation. The organization's obligation to pay an annuity isn’t acquisition indebtedness if the annuity meets all the following requirements.

1. It must be the sole consideration (other than a mortgage on property acquired by gift, bequest, or devise that meets the exception discussed under *Property acquired subject to mortgage or lien*, earlier in this chapter) issued in exchange for the property received.

2. Its present value, at the time of exchange, must be less than 90% of the value of the prior owner's equity in the property received.

3. It must be payable over the lives of either one or two individuals living when issued.

4. It must be payable under a contract that:

    a. Doesn’t guarantee a minimum nor specify a maximum number of payments, and

    b. Doesn’t provide for any adjustment of the amount of the annuity payments based on the income received from the transferred property or any other property.

Example. X, an exempt organization, receives property valued at $100,000 from donor A, a male age 60. In return X promises to pay A $6,000 a year for the rest of A's life, with neither a minimum nor maximum number of payments specified. The amounts paid under the annuity aren’t dependent on the income derived from the property transferred to X. The present value of this annuity is $81,156, determined from IRS valuation tables. Since the value of the annuity is less than 90 percent of A's $100,000 equity in the property transferred and the annuity meets all the other requirements just discussed, the obligation to make annuity payments isn’t acquisition indebtedness.

Securities loans. Acquisition indebtedness doesn’t include an obligation of the exempt organization to return collateral security provided by the borrower of the exempt organization's securities under a securities loan agreement (discussed under *Exclusions*, earlier in this chapter). This transaction isn’t treated as the borrowing by the exempt organization of the collateral furnished by the borrower (usually a broker) of the securities.

However, if the exempt organization incurred debt to buy the loaned securities, any income from the securities (including income from lending the securities) would be debt-financed income. For this purpose, any payments because of the securities are considered to be from the securities loaned and not from collateral security or the investment of collateral security from the loans. Any deductions that are directly connected with collateral security for the loan, or with the investment of collateral security, are considered deductions that are directly connected with the securities loaned.

Short sales. Acquisition indebtedness doesn’t include the “borrowing” of stock from a broker to sell the stock short. Although a short sale creates an obligation, it doesn’t create debt.

Real property debts of qualified organizations. In general, acquisition indebtedness doesn't include debt incurred by a qualified organization in acquiring or improving any real property. A qualified organization is:

1. A qualified retirement plan under section 401(a),
2. An educational organization described in section 170(b)(1)(A)(ii) and certain of its affiliated support organizations,
3. A title-holding company described in section 501(c)(25), or
4. A retirement income account described in section 403(b)(9) in acquiring or improving real property in tax years beginning on or after August 17, 2006.

This exception from acquisition indebtedness doesn’t apply in the following six situations.

1. The acquisition price isn’t 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. The contract also may provide for a price adjustment if it is for a fixed amount dependent upon subsequent resolution of limited, external contingencies 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. However, see *Note 1* at the end of this list.

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. However, see _Note 1_ at the end of this list.

3. The real property is leased back to the seller of the property or to a person related to the seller as described in section 267(b) or section 707(b). However, see _Note 2_ at the end of this list.

4. The real property is acquired by a qualified retirement plan from, or after its acquisition is leased by a qualified retirement plan to, a related person. However, see _Note 2_ at the end of this list. For this purpose, a related person is:

    a. An employer who has employees covered by the plan,

b. An owner with at least a 50% interest in an employer described in (a),

c. A member of the family of any individual described in (a) or (b),

d. A corporation, partnership, trust, or estate in which a person described in (a), (b), or (c) has at least a 50% interest, or

e. An officer, director, 10% or more shareholder, or highly compensated employee of a person described in (a), (b), or (d).

5. The seller, a person related to the seller (under section 267(b) or section 707(b)), or a person related to a qualified retirement plan (as described in (4)) provides financing for the transaction on other than commercially reasonable terms.

6. The real property is held by a partnership in which an exempt organization is a partner (along with taxable entities), and the principal purpose of any allocation to an exempt organization is to avoid tax. This generally applies to property placed in service after 1986. For more information, see section 514(c)(9)(B)(vi) and section 514(c)(9)(E).

Note 1. Qualifying sales by financial institutions of foreclosure property or certain conservatorship or receivership property aren't included in (1) or (2) and, therefore, don't give rise to acquisition indebtedness. For more information, see section 514(c)(9)(H).

Note 2. For purposes of (3) and (4), small leases are disregarded. A small lease is one that covers no more than 25% of the leasable floor space in the property and has commercially reasonable terms.

Certain federal financing. Acquisition indebtedness doesn’t include an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low or moderate income people.

In addition, acquisition indebtedness doesn’t include indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 after October 22, 2004, if such indebtedness is evidenced by a debenture issued by such company and held or guaranteed by the Small Business Administration. However, this provision doesn’t apply to any small business investment company during any period that any organization which is exempt from tax (other than a governmental unit) owns more than 25% of the capital or profits interest in such company, or organizations which are exempt from tax (including governmental agencies other than any agency or instrumentality of the United States) own, in the aggregate, 50% or more of the capital or profits interest in such company.

Exceptions to Debt-Financed Property

Certain property is excepted from treatment as debt-financed property.

Property related to exempt purposes. If substantially all (85% or more) of the use of any property is substantially related to an organization's exempt purposes, the property isn’t treated as debt-financed property. Related use doesn’t include a use related solely to the organization's need for income, or its use of the profits. The extent to which property is used for a particular purpose is determined on the basis of all the facts. They may include:

1. A comparison of the time the property is used for exempt purposes with the total time the property is used,
2. A comparison of the part of the property that is used for exempt purposes with the part used for all purposes, or
3. Both of these comparisons.

If less than 85% of the use of any property is devoted to an organization's exempt purposes, only that part of the property used to further the organization's exempt purposes isn’t treated as debt-financed property.

Property used in an unrelated trade or business. To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, the property isn’t treated as debt-financed property. However, any gain on the disposition of the property not included in income from an unrelated trade or business is includible as gross income derived from, or on account of, debt-financed property.

The rules for debt-financed property don’t apply to rents from personal property, certain passive income from controlled organizations, and other amounts that are required by other rules to be included in computing UBTI.

Property used in research activities. Property isn’t treated as debt-financed property when it produces gross income derived from research activities otherwise excluded from the unrelated trade or business tax. See *Income from research* under *Exclusions*, earlier in this chapter.

Property used in certain excluded activities. Debt-financed property doesn’t include property used in a trade or business that is excluded from the definition of “unrelated trade or business” because:

1. It has a volunteer workforce,

2. It is conducted for the convenience of its members, or
3. It consists of selling donated merchandise.

See *Excluded Trade or Business Activities* in chapter 3.

Related exempt uses. Property owned by an exempt organization and used by a related exempt organization, or by an exempt organization related to that related exempt organization, isn’t treated as debt-financed property when the property is used by either organization to further its exempt purpose. Furthermore, property isn’t treated as debt-financed property when a related exempt organization uses it for research activities or certain excluded activities, as described above.

Related organizations. An exempt organization is related to another exempt organization only if:

1. One organization is an exempt holding company and the other receives profits derived by the exempt holding company,
2. One organization controls the other as discussed under *Income From Controlled Organizations* earlier in this chapter,
3. More than 50% of the members of one organization are members of the other, or
4. Each organization is a local organization directly affiliated with a common state, national, or international organization that also is exempt.

Medical clinics. Real property isn’t debt-financed property if it is leased to a medical clinic and the lease is entered into primarily for purposes related to the lessor's exercise or performance of its exempt purpose.

Example. An exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons. They, under the lease, agree to provide all of the hospital's outpatient medical and surgical services and to train all of the hospital's residents and interns. In this case the rents received aren’t unrelated debt-financed income.

Life income contract. If an individual transfers property to a trust or a fund with the income payable to that individual or other individuals for a period not to exceed the life of the individual or individuals, and with the remainder payable to an exempt charitable organization, the property isn’t treated as debt-financed property. This exception applies only where the payments to the individual aren’t the proceeds of a sale or exchange of the property transferred.

Neighborhood land rule. If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property that the organization uses for exempt purposes. This rule applies only if the intent to demolish any existing structures and use the land for exempt purposes within 10 years isn’t abandoned.

Property is considered in the neighborhood of property that an organization owns and uses for its exempt purposes if it is contiguous with the exempt purpose property or would be contiguous except for an intervening road, street, railroad, stream, or similar property. If it isn’t contiguous with the exempt purpose property, it still may be in the same neighborhood if it is within 1 mile of the exempt purpose property and if the facts and circumstances make it unreasonable to acquire the contiguous property.

Some issues to consider in determining whether acquiring contiguous property is unreasonable include the availability of land and the intended future use of the land.

Example. A university tries to buy land contiguous to its present campus, but can't do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university buys this land. Under these circumstances, the contiguity requirement is unreasonable and not applicable. The land bought would be considered neighborhood land.

Exceptions. For all organizations other than churches and conventions or associations of churches, discussed later under *Churches*, the neighborhood land rule doesn't apply to property after the 10 years following its acquisition. Further, the rule applies after the first 5 years only if the organization satisfies the IRS that use of the land for exempt purposes is reasonably certain before the 10-year period expires. The organization need not show binding contracts to satisfy this requirement; but it must have a definite plan detailing a specific improvement and a completion date, and it must show some affirmative action toward the fulfillment of the plan. This information should be forwarded to the IRS for a ruling at least 90 days before the end of the 5th year after acquisition of the land. Send information to:

Internal Revenue Service
Attn: CC:PA:LPD:DRU
P.O. Box 120, Ben Franklin Station
Washington, DC 20044

If a private delivery service is used, the address is:

Internal Revenue Service
Attn: CC:PA:LPD:DRU, Room 5336
1111 Constitution Ave. NW
Washington, DC 20224

The IRS may grant a reasonable extension of time for requesting the ruling if the organization can show good cause. For more information, contact the IRS.

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Actual use. If the neighborhood land rule doesn’t apply because the acquired land isn’t in the neighborhood of other land used for an organization's exempt purposes, or because the organization fails to establish after the first 5 years of the 10-year period that the property will be used for exempt purposes, but the land is used eventually by the organization for its exempt purposes within the 10-year period, the property isn’t treated as debt-financed property for any period before the conversion.

Limits. The neighborhood land rule or actual use rule applies to any structure on the land when acquired, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in this manner. Thus, during the first 5 years after acquisition (and for later years if there is a favorable ruling), improved property isn’t debt financed so long as the organization doesn’t abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. If an actual demolition of these structures occurs, the use made of the land need not be the one originally intended as long as its use furthers the organization's exempt purpose.

In addition to this limit, the neighborhood land rule and the actual use rule don’t apply to structures erected on land after its acquisition. They don’t apply to property subject to a business lease (as defined in section 1.514(f)-1 of the regulations) whether an organization acquired the property subject to the lease, or whether it executed the lease after acquisition. A business lease is any lease, with certain exceptions, of real property for a term of more than 5 years by an exempt organization if at the close of the lessor's tax year there is a business lease (acquisition) indebtedness on that property.

Refund of taxes. When the neighborhood land rule doesn’t initially apply, but the land is eventually used for exempt purposes, a refund or credit of any overpaid taxes will be allowed for a prior tax year as a result of the satisfaction of the actual use rule. A claim must be filed within 1 year after the close of the tax year in which the actual use rule is satisfied. Interest rates on any overpayment are governed by the regulations.

Example. In January 2009, Y, a calendar year exempt organization, acquired real property contiguous to other property that Y uses in furtherance of its exempt purpose. Assume that without the neighborhood land rule, the property would be debt-financed property. Y didn’t satisfy the IRS by January 2014 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 2014 until the property is converted to an exempt use, the income from the property is subject to the tax on unrelated business income. During July 2018, Y will demolish the existing structure on the land and begin using the land in furtherance of its exempt purpose. At that time, Y can file claims for refund for the open years 2015 through 2017.

Further, Y also can file a claim for refund for 2014, even though a claim for that tax year may be barred by the statute of limitations, provided the claim is filed before the close of 2019.

Churches. The neighborhood land rule as described here also applies to churches, or a convention or association of churches, but with two differences:

1. The period during which the organization must demonstrate the intent to use acquired property for exempt purposes is increased from 10 to 15 years, and
2. Acquired property doesn’t have to be in the neighborhood of other property used by the organization for exempt purposes.

Thus, if a church or association or convention of churches acquires real property for the primary purpose of using the land in the exercise or performance of its exempt purpose, within 15 years after the time of acquisition, the property isn’t treated as debt-financed property as long as the organization doesn't abandon its intent to use the land in this manner within the 15-year period.

This exception for a church or association or convention of churches doesn’t apply to any property after the 15-year period expires. Further, this rule will apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the IRS that use of the acquired land in furtherance of the organization's exempt purpose is reasonably certain before the 15-year period expires.

If a church or association or convention of churches can’t establish after the first 5 years of the 15-year period that use of acquired land for its exempt purpose is reasonably certain within the 15-year period, but the land is in fact converted to an exempt use within the 15-year period, the land isn’t treated as debt-financed property for any period before the conversion.

The same rule for demolition or removal of structures, as discussed earlier in this chapter under *Limits*, applies to a church or an association or a convention of churches.

Computation of Debt-Financed Income

For each debt-financed property, the unrelated debt-financed income is a percentage (not over 100%) of the total gross income derived during a tax year from the property. This percentage is the same percentage as the average acquisition indebtedness with respect to the property for the tax year of the property's average adjusted basis for the year (the debt/basis percentage). Thus, the formula for deriving unrelated debt-financed income is:

$$\frac{\text{average acquisition indebtedness}}{\text{average adjusted basis}} \times \text{gross income from debt-financed property}$$

Example. X, an exempt trade association, owns an office building that is debt-financed property. The building produced $10,000 of gross rental income last year. The average adjusted basis of the building during that year was $100,000, and the average acquisition indebtedness with respect to the building was $50,000. Accordingly, the debt/basis percentage was 50% (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building was $5,000 (50% of $10,000).

Gain or loss from sale or other disposition of property. If an organization sells or otherwise disposes of debt-financed property, it must include, in computing UBTI, a percentage (not over 100%) of any gain or loss. The percentage is that of the highest acquisition indebtedness with respect to the property during the 12-month period preceding the date of disposition, in relation to the property's average adjusted basis.

The tax on this percentage of gain or loss is determined according to the usual rules for capital gains and losses.

Debt-financed property exchanged for subsidiary's stock. A transfer of debt-financed property by a tax-exempt organization to its wholly owned taxable subsidiary, in exchange for additional stock in the subsidiary, isn’t considered a gain subject to the tax on unrelated business income.

Example. A tax-exempt hospital wants to build a new hospital complex to replace its present old and obsolete facility. The most desirable location for the new hospital complex is a site occupied by an apartment complex. Several years ago the hospital bought the land and apartment complex, taking title subject to a first mortgage already on the premises.

For valid business reasons, the hospital proposed to exchange the land and apartment complex, subject to the mortgage on the property, for additional stock in its wholly owned subsidiary. The exchange satisfied all the requirements of section 351(a).

The transfer of appreciated debt-financed property from the tax-exempt hospital to its wholly owned subsidiary in exchange for stock didn’t result in a gain subject to the tax on unrelated business income.

Gain or loss on disposition of certain brownfield property. Gain or loss from the qualifying sale, exchange, or other disposition of a qualifying brownfield property (as defined in section 512(b)(19)(C)), which was acquired by the organization after December 31, 2004, is excluded from UBTI and is excepted from the debt-financed rules for such property. See sections 512(b)(19) and 514(b)(1)(E).

Average acquisition indebtedness. This is the average amount of outstanding principal debt during the part of the tax year that the organization holds the property.

Average acquisition indebtedness is computed by determining how much principal debt is outstanding on the first day in each calendar month during the tax year that the organization holds the property, adding these amounts, and dividing the sum by the number of months during the year that the organization held the property. Part of a month is treated as a full month in computing average acquisition indebtedness.

Indeterminate price. If an organization acquires or improves property for an indeterminate price (that is, neither the price nor the debt is certain), the unadjusted basis and the initial acquisition indebtedness are determined as follows, unless the organization obtains the IRS's consent to use another method:

- The unadjusted basis is the fair market value of the property or improvement on the date of acquisition or completion of the improvement.
- The initial acquisition indebtedness is the fair market value of the property or improvement on the date of acquisition or completion of the improvement, less any down payment or other initial payment applied to the principal debt.

Average adjusted basis. The average adjusted basis of debt-financed property is the average of the adjusted basis of the property as of the first day and as of the last day that the organization holds the property during the tax year.

Determining the average adjusted basis of the debt-financed property isn't affected if the organization was exempt from tax for prior tax years. The basis of the property must be adjusted properly for the entire period after the property was acquired. As an example, adjustment must be made for depreciation during all prior tax years whether or not the organization was tax-exempt. If only part of the depreciation allowance may be taken into account in computing the percentage of deductions allowable for each debt-financed property, that doesn't affect the amount of the depreciation adjustment to use in determining average adjusted basis.

Basis for debt-financed property acquired in corporate liquidation. If an exempt organization acquires debt-financed property in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in the property is the same as it would be in the hands of the transferor corporation. This basis is increased by the gain recognized to the transferor corporation upon the distribution and by the amount of any gain that, because of the distribution, is includible in the organization's gross income as unrelated debt-financed income.

Computation of debt/basis percentage. The following example shows how to compute the debt/basis percentage by first determining the average acquisition indebtedness and average adjusted basis.

Example. On July 7, an exempt organization buys an office building for $510,000 using $300,000 of borrowed funds. The organization files its return on a calendar year basis. During the year the only adjustment to basis is $20,000 for depreciation. Starting July 28, the organization pays $20,000 each month on the mortgage principal plus interest. The debt/basis percentage for the year is calculated as follows:

Month	Debt on first dayof each month property is held
July....................	$300,000
August..................	280,000
September................	260,000
October..................	240,000
November................	220,000
December................	200,000
Total	$1,500,000
Average acquisition indebtedness: $1,500,000 ÷ 6 months	$250,000

	Basis
As of July 7...............	$510,000
As of December 31..........	490,000
Total	$1,000,000
Average adjusted basis:$1,000,000 ÷ 2	$500,000

Debt/basis percentage

$250,000 ÷ $500,000 = 50%

Deductions for Debt-Financed Property

The deductions allowed for each debt-financed property are determined by applying the debt/ basis percentage to the sum of allowable deductions.

The allowable deductions are those directly connected with the debt-financed property or with the income from it (including the dividends-received deduction), except that:

1. The allowable deductions are subject to the modifications for computation of the UBTI (discussed earlier in this chapter); and
2. The depreciation deduction, if allowable, is computed only by use of the straight-line method.

To be directly connected with debt-financed property or with the income from it, a deductible item must have proximate and primary relationship to the property or income. Expenses, depreciation, and similar items attributable solely to the property qualify for deduction, to the extent they meet the requirements of an allowable deduction.

For example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization can deduct depreciation of $10,000 if the entire building is debt-financed property. However, if only half of the building is debt-financed property, the depreciation allowed as a deduction is $5,000.

Capital losses. If a sale or exchange of debt-financed property results in a capital loss, the loss taken into account in the tax year in which the loss arises is computed as provided earlier. See *Gain or loss from sale or other disposition of property* under *Computation of Debt-Financed Income*, earlier.

If any part of the allowable capital loss isn't taken into account in the current tax year, it may be carried back or carried over to another tax year as provided in section 1212 , without application of the debt/basis percentage for that year.

Example. X, an exempt educational organization, owned debt-financed securities that were capital assets. Last year, X sold the securities at a loss of $20,000. The debt/basis percentage for computing the loss from the sale of the securities is 40%. Thus, X sustained a capital loss of $8,000 (40% of $20,000) on the sale of the securities. Last year and the preceding 3 tax years, X had no other capital transactions. Under these circumstances, the $8,000 of capital loss may be carried over to succeeding years (subject to limitations under section 1212) without further application of the debt/basis percentage.

NOL. If, after applying the debt/basis percentage to the income from debt-financed property and the deductions directly connected with this income, the deductions exceed the income, an organization has an NOL for the tax year. This amount may be carried over to other tax years in the same manner as any other NOL of an organization with UBTI. (For a discussion of the NOL deduction, see *Modifications* under *Deductions*, earlier in this chapter.) However, the debt/basis percentage is not applied in those other tax years to determine the deductions that may be taken in those years.

Example. Last year, Y, an exempt organization, received $20,000 of rent from a debt-financed building that it owns. Y had no other UBTI for the year. The deductions directly connected with this building were property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the building manager. The debt/basis percentage with respect to the building was 50%. Under these circumstances, Y must take into account, in computing its UBTI, $10,000 (50% of $20,000) of income and $12,500 (50% of $25,000) of the deductions directly connected with that income.

Thus, Y sustained an NOL of $2,500 ($10,000 of income less $12,500 of deductions), which may be carried back or carried over to other tax years (as provided in section 172) without further application of the debt/ basis percentage.

Allocation Rules

When only part of the property is debt-financed property, proper allocation of the basis, debt, income, and deductions with respect to the property must be made to determine how much income or gain derived from the property to treat as unrelated debt-financed income.

Example. X, an exempt college, owns a four-story office building that it bought with borrowed funds (assumed to be acquisition indebtedness). During the year, the lower two stories of the building were used to house computers that X uses for administrative purposes. The two upper stories were rented to the public and used for nonexempt purposes.

The gross income X derived from the building was $6,000, all of which was attributable to the rents paid by tenants. The expenses were $2,000 and were equally allocable to each use of the building. The average adjusted basis of the building for the year was $100,000 and the average acquisition indebtedness for the year was $60,000.

Since the two lower stories were used for exempt purposes, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with this income are taken into account in computing UBTI. The part taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with the rental income by the debt/basis percentage.

The debt/basis percentage is the ratio of the allocable part of the average acquisition indebtedness to the allocable part of the property's average adjusted basis: that is, in this case, the ratio of $30,000 (one-half of $60,000) to $50,000 (one-half of $100,000). Thus, the debt/ basis percentage for the year is 60% (the ratio of $30,000 to $50,000).

Under these circumstances, X must include net rental income of $3,000 in its UBTI for the year, computed as follows:

Rental income treated as gross income from an unrelated trade or business (60% of $6,000)..............	$3,600
Less the allowable portion of deductions directly connected with that income (60% of $1,000).........	600
Net rental income included by X in computing its UBTI from debt-financed property....................	$3,000

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How To Get Tax Help

Photographs of Missing Children. The IRS is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Phone Help. If you have questions and/or need help completing this form, please call 877-829-5500. This toll-free telephone service is available Monday through Friday.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at IRS.gov to:

- Download forms and publications.
- Order IRS products online.

- Research your tax questions online.
- Search publications online by topic or keyword.
- Use the online Internal Revenue Code (IRC), Regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Sign up to receive local and national tax news by email. To subscribe, visit *IRS.gov/ Charities*.

Ordering Forms and Publications. Visit *IRS.gov/FormsPubs* to download forms and publications. Otherwise, you can go to *IRS.gov/ OrderForms* to order current and prior-year forms and instructions. Your order should arrive within 10 business days.

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To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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