

Debt-Financed unrelated income; mineral production payments. The income derived by an exempt organization from mineral production payments purchased with borrowed funds constitutes unrelated business taxable income to the extent specified in section 514 of the Code.

Advice has been requested whether, under the circumstances described below, income derived by an exempt organization from mineral production payments acquired with borrowed funds constitutes unrelated business taxable income to the extent specified in section 514(a) of the Internal Revenue Code of 1954.

The organization is exempt from Federal income tax under section 501(c)(3) of the Code and carries out its charitable purpose by making grants to other charitable organizations. To obtain income for its charitable program, the organization purchases mineral production payments with borrowed funds. From each production payment, the organization receives the difference between the aggregate amount payable to the lender of the borrowed funds and the total amount of the mineral production payment, which difference generally amounts to one-sixteenth of 1 percent of each production payment purchased.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from Federal income tax under section 501(c)(3).

Sections 512(b)(4) and 514(a)(1) of the Code provide that a portion of the income derived from, or on account of, each debt-financed property shall be included as an item of gross income derived from an unrelated trade or business.

Section 514(b) of the Code defines 'debt-financed property' to mean, with certain exceptions not here relevant, any property which is held to produce income and with respect to which there is an 'acquisition indebtedness' at any time during the taxable year.

Section 514(c) of the Code defines 'acquisition indebtedness' as the unpaid amount of indebtedness incurred in acquiring or improving the property.

In this case, the organization incurs indebtedness to purchase mineral production payments. Therefore, the indebtedness constitutes an 'acquisition indebtedness' within the meaning of section 514(c) of the Code. Accordingly, the mineral production payments are debt-financed property within the meaning of section 514(b) and the income derived therefrom is unrelated business taxable income to the extent specified in section 514(a).