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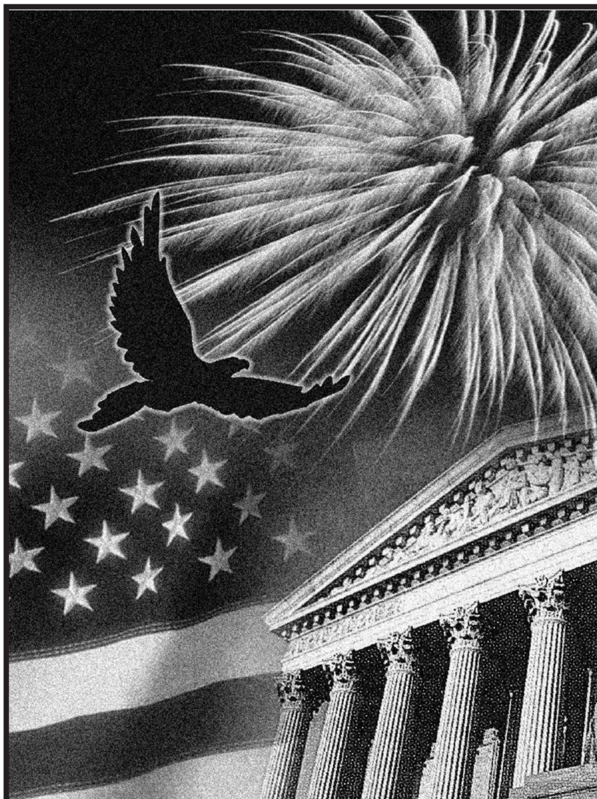
Tax on Unrelated Business Income of Exempt Organizations

Volume 2 of 2



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Example 1. U is an exempt scientific organization with 10,000 members who pay annual dues of $15. One of U's activities is publishing a monthly periodical distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmembers, who subscribe for $10 a year. Since the nonmember circulation of U's periodical represents one-third (more than 20%) of its total circulation, the subscription price charged to nonmembers is used to determine the part of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts are $100,000 ($10 times 10,000 members), and U's total circulation income for the periodical is $150,000 ($100,000 from members plus $50,000 from sales to nonmembers).

Example 2. Assume the same facts except that U sells only 500 copies of its periodical to nonmembers, at a price of $10 a year. Assume also that U's members may elect not to receive the periodical, in which case their dues are reduced from $15 a year to $6 a year, and that only 3,000 members elect to receive the periodical and pay the full dues of

$15 a year. U's stated subscription price of $9 to members consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represent only 14% of the 3,500 copies distributed, the $10 subscription price charged to nonmembers isn't used to determine the part of membership receipts allocable to the periodical. Instead, since 70% of the members elect not to receive the periodical and pay $9 less per year in dues, the $9 price is used to determine the subscription price charged to members. Thus, the allocable membership receipts will be $9 a member, or $27,000 ($9 times 3,000 copies). U's total circulation income is $32,000 ($27,000 plus the $5,000 from nonmember subscriptions).

Periodical Costs

Direct advertising costs. These are expenses, depreciation, and similar items of deduction directly connected with selling and publishing advertising in the periodical.

Examples of allowable deductions under this classification include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and office overhead directly connected with the sale of advertising lineage in the periodical. Also included are other deductions commonly classified as advertising costs under standard account classifications, such as artwork and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

In addition, direct advertising costs include the part of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includible in mechanical and distribution costs ordinarily employed in business-paper and consumer-publication accounting provide a guide for the computation. Accordingly, the mechanical and distribution costs include the part of the costs and other expenses of composition, press work, binding, mailing (including paper and wrappers used for mailing), and bulk postage attributable to the advertising lineage of the publication.

In the absence of specific and detailed records, the part of mechanical and distribution costs attributable to the periodical's advertising lineage can be based on the ratio of advertising lineage to total lineage in the periodical, if this allocation is reasonable.

Readership costs. These are all expenses, depreciation, and similar items that are directly connected with the production and distribution of the readership content of the periodical.

Costs partly attributable to other activities. Deductions properly attributable to exempt activities other than publishing the periodical may not be allocated to the periodical. When expenses are attributable both to the periodical and to the organization's other activities, an allocation must be made on a reasonable basis. The method of allocation will vary with the nature of the item, but once adopted, should be used consistently. Allocations based on dollar receipts from various exempt activities generally aren’t reasonable since receipts usually don’t accurately reflect the costs associated with specific activities that an exempt organization conducts.

Consolidated Periodicals

If an exempt organization publishes more than one periodical to produce income, it may treat all of them (but not less than all) as one in determining UBTI from selling advertising. It treats the gross income from all the periodicals, and the deductions directly connected with them, on a consolidated basis. Consolidated treatment, once adopted, must be followed consistently and is binding. This treatment can be changed only with the consent of the IRS.

An exempt organization's periodical is published to produce income if:

1. The periodical generates gross advertising income to the organization equal to at least 25% of its readership costs, and

2. Publishing the periodical is an activity engaged in for profit.

Whether the publication of a periodical is an activity engaged in for profit can be determined only by all the facts and circumstances in each case. The facts and circumstances must show that the organization carries on the activity for economic profit, although there may not be a profit in a particular year. For example, if an organization begins publishing a new periodical whose total costs exceed total income in the start-up years because of lack of advertising sales, that doesn't mean that the organization didn't have as its objective an economic profit. The organization may establish that it had this objective by showing it can reasonably expect advertising sales to increase, so that total income will exceed costs within a reasonable time.

Example. Y, an exempt trade association, publishes three periodicals that it distributes to its members: a weekly newsletter, a monthly magazine, and a quarterly journal. Both the monthly magazine and the quarterly journal contain advertising that accounts for gross advertising income equal to more than 25% of their respective readership costs. Similarly, the total income attributable to each periodical has exceeded the total deductions attributable to each periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price isn’t intended to cover the cost of publication. The newsletter is a service that Y distributes to all of its members in an effort to keep them informed of changes occurring in the business world. It is not engaged in for profit.

Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its UBTI. It may not consolidate the income and deductions from the newsletter with the income and deductions of its other periodicals, since the newsletter isn’t published for the production of income.

Modifications

Net operating loss deduction (NOL). The NOL deduction (as provided in section 172) is allowed in computing UBTI. The NOL deduction is limited to an amount equal to the lesser of the aggregate of NOL carryovers to such year, plus the NOL carrybacks to such year, or 80% of taxable income computed without regard to the deduction. The NOL may be carried over to each of the tax years following the tax year of the loss. An NOL cannot be carried back to any tax year preceding the tax year of such loss, except as provided in section 172. However, the NOL for any tax year, the carryovers of NOLs, and the NOL deduction are determined without taking into account any amount of income or deduction that has been specifically excluded in computing UBTI. For example, a loss from an unrelated trade or business isn’t diminished because dividend income was received.

If this were not done, organizations would, in effect, be taxed on their exempt income, since unrelated business losses then would be offset by dividends, interest, and other excluded income. This would reduce the loss that could be applied against unrelated business income of prior or future tax years. Therefore, to preserve the immunity of exempt income, all NOL computations are limited to those items of income and deductions that affect the UBTI.

In line with this concept, an NOL carryover is allowed only from a tax year for which the organization is subject to tax on unrelated business income.

However, in determining the span of years for which an NOL may be carried forward, the tax years for which the organization isn’t subject to the tax on unrelated business income are counted. For example, if an organization was subject to the tax for 2014 and had an NOL for that year, the last tax year to which any part of that loss may be carried over is 2034, regardless of whether the organization was subject to the unrelated business income tax in any of the intervening years.

Section 512(a)(6) requires an organization with more than one unrelated trade or business to calculate UBTI, including for purposes of determining any NOL deduction, separately with respect to each such trade or business for tax years beginning after 2017 (post-2017 NOLs). Any NOLs arising in tax years beginning before 2018 (pre-2018 NOLs) are not limited to the UBTI of a particular unrelated trade or business but may reduce the total UBTI of the organization. See Notice 2018-67, 2018-36 I.R.B. 409 for more information.

For more details on the NOL deduction, including property eligible for an extended carryback period, see section 172 and Pub. 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.

Charitable contributions deduction. An exempt organization is allowed to deduct its charitable contributions in computing its UBTI whether or not the contributions are directly connected with the unrelated business.

To be deductible, the contribution must be paid to another qualified organization. For example, an exempt university that operates an unrelated business may deduct a contribution made to another university for educational work but may not claim a deduction for contributions of amounts spent for carrying out its own educational program.

For purposes of the deduction, a distribution by a trust made under the trust instrument to a beneficiary, which itself is a qualified organization, is treated the same as a contribution.

Deduction limits. An exempt organization that is subject to the unrelated business income tax at corporate rates is allowed a deduction for charitable contributions up to 10% of its UBTI computed without regard to the deduction for contributions. See the Instructions for Form 990-T for more information.

An exempt trust that is subject to the unrelated business income tax at trust rates generally is allowed a deduction for charitable contributions in the same amounts as allowed for individuals. However, the limit on the deduction is determined in relation to the trust's UBTI computed without regard to the deduction, rather than in relation to adjusted gross income.

Contributions in excess of the limits just described may be carried over to the next 5 tax years. A contribution carryover isn’t allowed, however, to the extent that it increases an NOL carryover.

Suspension of deduction limits for farmers and ranchers. Deductions for farmers and ranchers. The limitations discussed above are permanently suspended for certain qualified conservation contributions of property used in agriculture or livestock production. A contribution carryover isn't allowed, however, to the extent that it increases an NOL carryover. See the Instructions for Form 990-T for details.

Specific deduction. In computing UBTI, a specific deduction of $1,000 is allowed. However, the specific deduction isn’t allowed in computing an NOL or the NOL deduction.

Generally, the deduction is limited to $1,000 regardless of the number of unrelated businesses in which the organization is engaged.

Exception. An exception is provided in the case of a diocese, province of a religious order, or a convention or association of churches that may claim a specific deduction for each parish, individual church, district, or other local unit. In these cases, the specific deduction for each local unit is limited to the lower of:

- $1,000, or
- Gross income derived from an unrelated trade or business regularly conducted by the local unit.

This exception applies only to parishes, districts, or other local units that aren't separate legal entities, but are components of a larger entity (diocese, province, convention, or association) filing Form 990-T. The parent organization must file a return reporting the unrelated business gross income and related deductions of all units that aren't separate legal entities. The local units can't file separate returns. However, each local unit that is separately incorporated must file its own return and can’t include, or be included with, any other entity. See *Title-holding corporations* in chapter 1 for a discussion of the only situation in which more than one legal entity may be included on the same Form 990-T.

Example. X is an association of churches and is divided into local units A, B, C, and D. Last year, A, B, C, and D derived gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses that they regularly conduct. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, $1,000 with respect to C, and $700 with respect to D.

Partnership Income or Loss

An organization may have unrelated business income or loss as a member of a partnership, rather than through direct business dealings with the public. If so, it must treat its share of the partnership income or loss as if it had conducted the business activity in its own capacity as a corporation or trust. No distinction is made between limited and general partners. The organization is required to notify the partnership of its tax-exempt status. See Notice 2018-67, 2018-36 I.R.B. 409, for information and transition rules under section 512(a)(6) for aggregating income from partnerships and debt-financed income from partnerships.

Thus, if an organization is a member of a partnership regularly engaged in a trade or business that is an unrelated trade or business with respect to the organization, the organization must include in its UBTI its share of the partnership's gross income from the unrelated trade or business (whether or not distributed), and the deductions attributable to it. The partnership income and deductions to be included in the organization's UBTI are figured the same way as any income and deductions from an unrelated trade or business conducted directly by the organization. The partnership is required to provide the organization this information on Schedule K-1.

Example. An exempt educational organization is a partner in a partnership that operates a factory. The partnership also holds stock in a corporation. The exempt organization must include its share of the gross income from operating the factory in its UBTI but may exclude its share of any dividends the partnership received from the corporation.

Different tax years. If the exempt organization and the partnership of which it is a member have different tax years, the partnership items that enter into the computation of the organization's UBTI must be based on the income and deductions of the partnership for the partnership's tax year that ends within the organization's tax year.

S Corporation Income or Loss

An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, and losses in figuring UBTI, regardless of the actual source or nature of the income, deductions, and losses. For example, the organization's share of the S corporation's interest and dividend income will be taxable, even though interest and dividends are normally excluded from UBTI. The organization must also take into account its gain or loss on the sale or other disposition of the S corporation stock in figuring UBTI.

Special Rules for Foreign Organizations

The UBTI of a foreign organization exempt from tax under section 501(a) consists of the organization's:

1. Unrelated business taxable income derived from sources within the United States but not effectively connected with the conduct of a trade or business within the United States, and
2. Unrelated business taxable income effectively connected with the conduct of a trade or business within the United States, whether or not this income is derived from sources within the United States.

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see sections 861 through 865 and the related regulations.

Special Rules for Social Clubs, VEBAs, and SUBs

The following discussion applies to:

- ***Social clubs*** described in section 501(c)(7),
- ***Voluntary employees' beneficiary associations (VEBAs)*** described in section 501(c)(9), and
- ***Supplemental unemployment compensation benefit trusts (SUBs)*** described in section 501(c)(17).

In general, these organizations are subject to section 512(a)(6). See Notice 2018-67, 2018-36 I.R.B. 409 for more information. However, they also must figure UBTI under special rules. Unlike other exempt organizations, they can’t exclude their investment income (dividends, interest, rents, etc.). (See *Exclusions* under *Income*, earlier.) Therefore, they are generally subject to unrelated business income tax on this income.

The UBTI of these organizations includes all gross income, less deductions directly connected with the production of that income, except that gross income for this purpose doesn’t include exempt function income. The deduction for dividends received by a corporation isn’t allowed in computing UBTI because it isn’t an expense incurred in the production of income.

Losses from nonexempt activities. Losses from nonexempt activities of these organizations can’t be used to offset investment income.

Modifications. The UBTI is modified by any NOL or charitable contributions deduction and by the specific deduction (described earlier under *Deductions*).

Exempt function income. This is gross income from dues, fees, charges, or similar items paid by members for goods, facilities, or services to the members or their dependents or guests, to further the organization's exempt purposes. Exempt function income also includes income set aside for qualified purposes.

Income that is set aside. This is income set aside to be used for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. In addition, for a VEBA or SUB it is income set aside to provide for the payment of life, sick, accident, or other benefits.

However, any amounts set aside by a VEBA or SUB that exceed the organization's qualified asset account limit (determined under section 419A) are unrelated business income. Special rules apply to the treatment of existing reserves for post-retirement medical or life insurance benefits. These rules are explained in section 512(a)(3)(E)(ii).

Income derived from an unrelated trade or business may not be set aside and therefore can’t be exempt function income. In addition, any income set aside and later spent for other purposes must be included in UBTI.

Set-aside income is generally excluded from gross income only if it is set aside in the tax year in which it is otherwise includible in gross income. However, income set aside on or before the date for filing Form 990-T, including extensions of time, may, at the election of the organization, be treated as having been set aside in the tax year for which the return was filed. The income set aside must have been includible in gross income for that earlier year.

Nonrecognition of gain. If the organization sells property used directly in performing an exempt function and purchases other property used directly in performing an exempt function, any gain on the sale is recognized only to the extent that the sales price of the old property exceeds the cost of the new property. The purchase of the new property must be made within 1 year before the date of sale of the old property or within 3 years after the date of sale.

This rule also applies to gain from an involuntary conversion of the property resulting from its destruction in whole or in part, theft, seizure, requisition, or condemnation.

Special Rules for Veterans' Organizations

Unrelated business taxable income of a veterans' organization that is exempt under section 501(c)(19) doesn’t include the net income from insurance business that is properly set aside. The organization may set aside income from payments received for life, sick, accident, or health insurance for the organization's members or their dependents for the payment of insurance benefits or reasonable costs of insurance administration, or for use exclusively for religious, charitable, scientific, literary, or educational purposes, or the prevention of cruelty to children or animals. For details, see section 512(a)(4) and the regulations under that section.

Income From Controlled Organizations

The exclusions for interest, annuities, royalties, and rents, explained earlier in this chapter under *Income*, may not apply to a payment of these items received by a controlling organization from its controlled organization. The payment is included in the controlling organization's UBTI to the extent it reduced the net unrelated income (or increased the net unrelated loss) of the controlled organization. All deductions of the controlling organization directly connected with the amount included in its UBTI are allowed.

Excess qualifying specified payments. Excess qualifying specified payments received or accrued from a controlled entity are included in a controlling exempt organization's UBTI only to the extent of the amount that exceeds that which would have been paid or accrued if the payments had been determined under section

482. Qualifying specified payments means any payments of interest, annuities, royalties, or rents received or accrued from the controlled organization pursuant to a binding written contract in effect on August 17, 2006, or to a contract which is a renewal, under substantially similar terms of a binding written contract in effect on August 17, 2006, and the payments are received or accrued after December 31, 2014.

If a controlled participant isn’t required to file a U.S. income tax return, the participant must ensure that the copy or copies of the Regulations section 1.482-7 Cost Sharing Arrangement Statement and any updates are attached to Schedule M of any Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, any Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, or any Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, filed for that participant.

Addition to tax for valuation misstatements. Under section 512(b)(13)(E)(ii), the tax imposed on a controlling organization will be increased by 20% of the excess qualifying specified payments that are determined with or without any amendments or supplements to a return of tax, whichever is larger. See section 512(b) (13)(E)(ii) for more information.

Net unrelated income. This is:

- For an exempt organization, its UBTI, or
- For a nonexempt organization, the part of its taxable income that would be UBTI if it were exempt and had the same exempt purposes as the controlling organization.

Net unrelated loss. This is:

- For an exempt organization, its NOL, or
- For a nonexempt organization, the part of its NOL that would be its NOL if it were exempt and had the same exempt purposes as the controlling organization.

Control. An organization is controlled if:

- For a corporation, the controlling organization owns (by vote or value) more than 50% of the stock,
- For a partnership, the controlling organization owns more than 50% of the profits or capital interests, or
- For any other organization, the controlling organization owns more than 50% of the beneficial interest.

For this purpose, constructive ownership of stock (determined under section 318) or other interests is taken into account.

As a result, an exempt parent organization is treated as controlling any subsidiary in which it holds more than 50% of the voting power or value, whether directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

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). It includes 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 incurred 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 <u>*Note 1*</u> 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.

For any updates to these addresses go to IRS.gov/Pub598.

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 used eventually 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 2006, 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 2011 that the existing structure would be demolished, and the land would be used in furtherance of its exempt purpose. From 2011 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 2015, 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 2012 through 2014.

Further, Y also can file a claim for refund for 2011, 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 2016.

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 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 day of 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 dis- position 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 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 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 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

5.

How To Get Tax Help

If you have questions about a tax issue, need help preparing your tax return, or want to download free publications, forms, or instructions, go to IRS.gov and find resources that can help you right away.

Tax reform. Major tax reform legislation impacting individuals, businesses, and tax-exempt entities was enacted by Congress in the Tax Cuts and Jobs Act on December 22, 2017. Go to *IRS.gov/TaxReform* for information and updates on how this legislation affects your taxes.

Preparing and filing your tax return. Find free options to prepare and file your return on IRS.gov or in your local community if you qualify.

The Volunteer Income Tax Assistance (VITA) program offers free tax help to people who generally make $55,000 or less, persons with disabilities, and limited-English-speaking taxpayers who need help preparing their own tax returns. The Tax Counseling for the Elderly (TCE) program offers free tax help for all taxpayers, particularly those who are 60 years of age and older. TCE volunteers specialize in answering questions about pensions and retirement-related issues unique to seniors.

You can go to IRS.gov to see your options for preparing and filing your return which include the following.

- **Free File.** Go to *IRS.gov/FreeFile* to see if you qualify to use brand-name software to prepare and *e-file* your federal tax return for free.
- **VITA.** Go to *IRS.gov/VITA*, download the free IRS2Go app, or call 800-906-9887 to find the nearest VITA location for free tax preparation.
- **TCE.** Go to *IRS.gov/TCE*, download the free IRS2Go app, or call 888-227-7669 to find the nearest TCE location for free tax preparation.

Getting answers to your tax questions. On IRS.gov, get answers to your tax questions anytime, anywhere.

- Go to *IRS.gov/Help* for a variety of tools that will help you get answers to some of the most common tax questions.
- Go to *IRS.gov/ITA* for the Interactive Tax Assistant, a tool that will ask you questions on a number of tax law topics and provide answers. You can print the

entire interview and the final response for your records.

- Go to *IRS.gov/Pub17* to get Pub. 17, Your Federal Income Tax for Individuals, which features details on tax-saving opportunities, recent tax changes, and thousands of interactive links to help you find answers to your questions. View it online in HTML, as a PDF, or download it to your mobile device as an eBook.
- You may also be able to access tax law information in your electronic filing software.

Getting tax forms and publications. Go to *IRS.gov/Forms* to view, download, or print all of the forms and publications you may need. You can also download and view popular tax publications and instructions (including the 1040 instructions) on mobile devices as an eBook at no charge. Or you can go to *IRS.gov/OrderForms* to place an order and have forms mailed to you within 10 business days.

Access your online account (individual taxpayers only). Go to *IRS.gov/Account* to securely access information about your federal tax account.

- View the amount you owe, pay online, or set up an online payment agreement.
- Access your tax records online.
- Review the past 18 months of your payment history.
- Go to *IRS.gov/SecureAccess* to review the required identity authentication process.

Using direct deposit. The fastest way to receive a tax refund is to combine direct deposit and IRS *e-file*. Direct deposit securely and electronically transfers your refund directly into your financial account. Eight in 10 taxpayers use direct deposit to receive their refund. The IRS issues more than 90% of refunds in less than 21 days.

Delayed refund for returns claiming certain credits. Due to changes in the law, the IRS can't issue refunds before mid-February 2019 for returns that properly claimed the earned income credit (EIC) or the additional child tax credit (ACTC). This applies to the entire refund, not just the portion associated with these credits.

Getting a transcript or copy of a return. The quickest way to get a copy of your tax transcript is to go to *IRS.gov/Transcripts*. Click on either "Get Transcript Online" or "Get Transcript by Mail" to order a copy of your transcript. If you prefer, you can:

- Order your transcript by calling 800-908-9946, or
- Mail Form 4506-T or Form 4506T-EZ (both available on IRS.gov).

Using online tools to help prepare your return. Go to *IRS.gov/Tools* for the following.

- The *Earned Income Tax Credit Assistant* (*IRS.gov/EIC*) determines if you’re eligible for the EIC.
- The *Online EIN Application* (*IRS.gov/EIN*) helps you get an employer identification number.

- The *IRS Withholding Calculator* (*IRS.gov/W4App*) estimates the amount you should have withheld from your paycheck for federal income tax purposes and can help you perform a "paycheck checkup."
- The *First Time Homebuyer Credit Account Look-up* (*IRS.gov/HomeBuyer*) tool provides information on your repayments and account balance.
- The *Sales Tax Deduction Calculator* (*IRS.gov/SalesTax*) figures the amount you can claim if you itemize deductions on Schedule A (Form 1040), choose not to claim state and local income taxes, and you didn't save your receipts showing the sales tax you paid.

Resolving tax-related identity theft issues.

- The IRS doesn't initiate contact with taxpayers by email or telephone to request personal or financial information. This includes any type of electronic communication, such as text messages and social media channels.

- Go to *IRS.gov/IDProtection* for information.
- If your SSN has been lost or stolen or you suspect you're a victim of tax-related identity theft, visit *IRS.gov/IdentityTheft* to learn what steps you should take.

Checking on the status of your refund.

- Go to *IRS.gov/Refunds*.
- Due to changes in the law, the IRS can't issue refunds before mid-February 2019 for returns that properly claimed the EIC or the ACTC. This applies to the entire refund, not just the portion associated with these credits.
- Download the official IRS2Go app to your mobile device to check your refund status.
- Call the automated refund hotline at 800-829-1954.

Making a tax payment. The IRS uses the latest encryption technology to ensure your electronic payments are safe and secure. You can make electronic payments online, by phone, and from a mobile device using the IRS2Go app. Paying electronically is quick, easy, and faster than mailing in a check or money order. Go to *IRS.gov/Payments* to make a payment using any of the following options.

- *IRS Direct Pay*: Pay your individual tax bill or estimated tax payment directly from your checking or savings account at no cost to you.
- **Debit or credit card:** Choose an approved payment processor to pay online, by phone, and by mobile device.
- **Electronic Funds Withdrawal**: Offered only when filing your federal taxes using tax preparation software or through a tax professional.
- **Electronic Federal Tax Payment System:** Best option for businesses. Enrollment is required.

- **Check or money order**: Mail your payment to the address listed on the notice or instructions.
- **Cash**: You may be able to pay your taxes with cash at a participating retail store.

What if I can't pay now? Go to *IRS.gov/Payments* for more information about your options.

- Apply for an *online payment agreement* (*IRS.gov/OPA*) to meet your tax obligation in monthly installments if you can't pay your taxes in full today. Once you complete the online process, you will receive immediate notification of whether your agreement has been approved.
- Use the *Offer in Compromise Pre-Qualifier* (*IRS.gov/OIC*) to see if you can settle your tax debt for less than the full amount you owe.

Checking the status of an amended return. Go to *IRS.gov/WMAR* to track the status of Form 1040X amended returns. Please note that it can take up to 3 weeks from the date you mailed your amended return for it to show up in our system and processing it can take up to 16 weeks.

Understanding an IRS notice or letter. Go to *IRS.gov/Notices* to find additional information about responding to an IRS notice or letter.

Contacting your local IRS office. Keep in mind, many questions can be answered on IRS.gov without visiting an IRS Tax Assistance Center (TAC). Go to *IRS.gov/LetUsHelp* for the topics people ask about most. If you still need help, IRS TACs provide tax help when a tax issue can't be handled online or by phone. All TACs now provide service by appointment so you'll know in advance that you can get the service you need without long wait times. Before you visit, go to *IRS.gov/TACLocator* to find the nearest TAC, check hours, available services, and appointment options. Or, on the IRS2Go app, under the Stay Connected tab, choose the Contact Us option and click on "Local Offices."

Watching IRS videos. The IRS Video portal (*IRSVideos.gov*) contains video and audio presentations for individuals, small businesses, and tax professionals.

Getting tax information in other languages. For taxpayers whose native language isn't English, we have the following resources available. Taxpayers can find information on IRS.gov in the following languages.

- *Spanish (IRS.gov/Spanish).*
- *Chinese (IRS.gov/Chinese).*
- *Vietnamese (IRS.gov/Vietnamese).*
- *Korean (IRS.gov/Korean).*
- *Russian (IRS.gov/Russian).*

The IRS TACs provide over-the-phone interpreter service in over 170 languages, and the service is available free to taxpayers.

The Taxpayer Advocate Service Is Here To Help You

What is TAS?

TAS is an ***independent*** organization within the IRS that helps taxpayers and protects taxpayer rights. Their job is to ensure that every taxpayer is treated fairly and that you know and understand your rights under the *Taxpayer Bill of Rights.*

How Can You Learn About Your Taxpayer Rights?

The Taxpayer Bill of Rights describes 10 basic rights that all taxpayers have when dealing with the IRS. Go to *TaxpayerAdvocate.IRS.gov* to help you understand *what these rights mean to you* and how they apply. These are ***your*** rights. Know them. Use them.

What Can TAS Do For You?

TAS can help you resolve problems that you can’t resolve with the IRS. And their service is free. If you qualify for their assistance, you will be assigned to one advocate who will work with you throughout the process and will do everything possible to resolve your issue. TAS can help you if:

- Your problem is causing financial difficulty for you, your family, or your business;

- You face (or your business is facing) an immediate threat of adverse action; or
- You've tried repeatedly to contact the IRS but no one has responded, or the IRS hasn't responded by the date promised.

How Can You Reach TAS?

TAS has offices *in every state, the District of Columbia, and Puerto Rico*. Your local advocate's number is in your local directory and at *TaxpayerAdvocate.IRS.gov/Contact-Us*. You can also call them at 877-777-4778.

How Else Does TAS Help Taxpayers?

TAS works to resolve large-scale problems that affect many taxpayers. If you know of one of these broad issues, please report it to them at *IRS.gov/SAMS.*

TAS also has a website, *Tax Reform Changes*, which shows you how the new tax law may change your future tax filings and helps you plan for these changes. The information is categorized by tax topic in the order of the IRS Form 1040. Go to *TaxChanges.us* for more information.

Low Income Taxpayer Clinics

Low Income Taxpayer Clinics (LITCs) are independent from the IRS. LITCs represent individuals whose income is below a certain level and need to resolve tax problems with the IRS, such as audits, appeals, and tax collection disputes. In addition, clinics can provide information about taxpayer rights and responsibilities in different languages for individuals who speak English as a second language. Services are offered for free or a small fee. To find a clinic near you, visit *TaxpayerAdvocate.IRS.gov/LITCmap* or see IRS Pub. 4134, *Low Income Taxpayer Clinic List*.

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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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