

Internal Revenue Code Section 514(b)(1)

Unrelated debt-financed income

(a) Unrelated debt-financed income and deductions.

In computing under section 512 the unrelated business taxable income for any taxable year-

(1) Percentage of income taken into account.

There shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7)) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.

(2) Percentage of deductions taken into account.

There shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying (except as provided in the last sentence of this paragraph) the percentage derived under paragraph (1) to the sum determined under paragraph (3) . The percentage derived under this paragraph shall not be applied with respect to the deduction of any capital loss resulting from the carryback or carryover of net capital losses under section 1212 .

(3) Deductions allowable.

The sum referred to in paragraph (2) is the sum of the deductions under this chapter which are directly connected with the debt-financed property or the income therefrom, except that if the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167 , the allowance shall be computed only by use of the straight-line method.

(b) Definition of debt-financed property.

(1) In general.

For purposes of this section , the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition), except that such term does not include-

(A)

- (i) any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable,



educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B) , to the exercise or performance of any purpose or function designated in section 501(c)(3)), or

(ii) any property to which clause (i) does not apply, to the extent that its use is so substantially related;

(B) except in the case of income excluded under section 512(b)(5) , any property to the extent that the income from such property is taken into account in computing the gross income of any unrelated trade or business;

(C) any property to the extent that the income from such property is excluded by reason of the provisions of paragraph (7) , (8) , or (9) of section 512(b) in computing the gross income of any unrelated trade or business;

(D) any property to the extent that it is used in any trade or business described in paragraph (1) , (2) , or (3) of section 513(a) ; or

(E) any property the gain or loss from the sale, exchange, or other disposition of which would be excluded by reason of the provisions of section 512(b)(19) in computing the gross income of any unrelated trade or business.

For purposes of subparagraph (A) , substantially all the use of a property shall be considered to be substantially related to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 if such property is real property subject to a lease to a medical clinic entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 .

(2) Special rule for related uses.

For purposes of applying paragraphs (1)(A) , (C) , and (D) , the use of any property by an exempt organization which is related to an organization shall be treated as use by such organization.

(3) Special rules when land is acquired for exempt use within 10 years.

(A) Neighborhood land. If an organization acquires real property for the principal purpose of using the land (commencing within 10 years of the time of acquisition) in the manner described in paragraph (1)(A) and at the time of acquisition the property is in the neighborhood of other property owned by the organization which is used in such manner, the real property acquired for such future use shall not be treated as debt-financed property so long as the organization does not abandon its intent to so use the land within the 10-year period. The preceding sentence shall not apply for any period after the expiration of the 10-year period, and shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Secretary that it is reasonably certain that the

land will be used in the described manner before the expiration of the 10-year period.

(B) Other cases. If the first sentence of subparagraph (A) is inapplicable only because-

(i) the acquired land is not in the neighborhood referred to in subparagraph (A) , or

(ii) the organization (for the period after the first 5 years of the 10-year period) is unable to establish to the satisfaction of the Secretary that it is reasonably certain that the land will be used in the manner described in paragraph (1)(A) before the expiration of the 10-year period,

but the land is converted to such use by the organization within the 10-year period, the real property (subject to the provisions of subparagraph (D)) shall not be treated as debt-financed property for any period before such conversion. For purposes of this subparagraph, land shall not be treated as used in the manner described in paragraph (1)(A) by reason of the use made of any structure which was on the land when acquired by the organization.

(C) Limitations. Subparagraphs (A) and (B) -

(i) shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only if (and so long as) the intended future use of the land in the manner described in paragraph (1)(A) requires that the structure be demolished or removed in order to use the land in such manner;

(ii) shall not apply to structures erected on the land after the acquisition of the land; and

(iii) shall not apply to property subject to a lease which is a business lease (as defined in this section immediately before the enactment of the Tax Reform Act of 1976).

(D) Refund of taxes when subparagraph (B) applies. If an organization for any taxable year has not used land in the manner to satisfy the actual use condition of subparagraph (B) before the time prescribed by law (including extensions thereof) for filing the return for such taxable year, the tax for such year shall be computed without regard to the application of subparagraph (B) , but if and when such use condition is satisfied, the provisions of subparagraph (B) shall then be applied to such taxable year. If the actual use condition of subparagraph (B) is satisfied for any taxable year after such time for filing the return, and if credit or refund of any overpayment for the taxable year resulting from the satisfaction of such use condition is prevented at the close of the taxable year in which the use condition is satisfied, by the operation of any law or rule of law (other than chapter 74, relating to closing agreements and compromises), credit or refund of such overpayment may nevertheless be allowed or made if claim therefor is filed before the expiration of 1 year after the close of the taxable year in which the use condition is satisfied.

(E) Special rule for churches. In applying this paragraph to a church or convention or association of churches, in lieu of the 10-year period referred to in subparagraphs (A) and (B) a 15-year period shall be applied, and subparagraphs (A) and (B)(ii) shall apply whether or not the acquired land meets the neighborhood test.

(c) Acquisition indebtedness.

(1) General rule.

For purposes of this section, the term "acquisition indebtedness" means, with respect to any debt-financed property, the unpaid amount of-

(A) the indebtedness incurred by the organization in acquiring or improving such property;

(B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

(2) Property acquired subject to mortgage, etc.

For purposes of this subsection -

(A) General rule. Where property (no matter how acquired) is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.

(B) Exceptions. Where property subject to a mortgage is acquired by an organization by bequest or devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of the acquisition. If an organization acquires property by gift subject to a mortgage which was placed on the property more than 5 years before the gift, which property was held by the donor more than 5 years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift. This subparagraph shall not apply if the organization, in order to acquire the equity in the property by bequest, devise, or gift, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor.

(C) Liens for taxes or assessments. Where State law provides that-

(i) a lien for taxes, or

(ii) a lien for assessments,

made by a State or a political subdivision thereof attaches to property prior to the time when such taxes or assessments become due and payable, then such lien shall be treated as similar to a mortgage (within the meaning of subparagraph (A)) but only after such taxes or assessments become due and payable and the organization has had an opportunity to pay such taxes or assessments in accordance with State law.

(3) Extension of obligations.

For purposes of this section , an extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness shall not be treated as the creation of a new indebtedness.

(4) Indebtedness incurred in performing exempt purpose.

For purposes of this section , the term "acquisition indebtedness" does not include indebtedness the incurrence of which is inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption, such as the indebtedness incurred by a credit union described in section 501(c)(14) in accepting deposits from its members.

(5) Annuities.

For purposes of this section , the term "acquisition indebtedness" does not include an obligation to pay an annuity which-

(A) is the sole consideration (other than a mortgage to which paragraph (2)(B) applies) issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90 percent of the value of the property received in the exchange,

(B) is payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time, and

(C) is payable under a contract which-

(i) does not guarantee a minimum amount of payments or specify a maximum amount of payments, and

(ii) does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

(6) Certain federal financing.

(A) In general. For purposes of this section , the term "acquisition indebtedness" does not include-

(i) an obligation, to the extent that it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or

(ii) indebtedness incurred by a small business investment company licensed after the date of the enactment of the American Jobs Creation Act of 2004 under the Small Business Investment Act of 1958 if such indebtedness is evidenced by a debenture-

(I) issued by such company under section 303(a) of such Act, and

(II) held or guaranteed by the Small Business Administration.

(B) Limitation. Subparagraph (A)(ii) shall not apply with respect to any small business investment company during any period that-

(i) any organization which is exempt from tax under this title (other than a governmental unit) owns more than 25 percent of the capital or profits interest in such company, or

(ii) organizations which are exempt from tax under this title (including governmental units other than any agency or instrumentality of the United States) own, in the aggregate, 50 percent or more of the capital or profits interest in such company.

(7) Average acquisition indebtedness.

For purposes of this section , the term "average acquisition indebtedness" for any taxable year with respect to a debt-financed property means the average amount, determined under regulations prescribed by the Secretary, of the acquisition indebtedness during the period the property is held by the organization during the taxable year, except that for the purpose of computing the percentage of any gain or loss to be taken into account on a sale or other disposition of debt-financed property, such term means the highest amount of the acquisition indebtedness with respect to such property during the 12-month period ending with the date of the sale or other disposition.

(8) Securities subject to loans.

For purposes of this section -

(A) payments with respect to securities loans (as defined in section 512(a)(5)) shall be deemed to be derived from the securities loaned and not from collateral security or the investment of collateral security from such loans,

(B) any deductions which are directly connected with collateral security for such loan, or with the investment of collateral security, shall be deemed to be deductions which are directly connected with the securities loaned, and

(C) an obligation to return collateral security shall not be treated as acquisition indebtedness (as defined in paragraph (1)).

(9) Real property acquired by a qualified organization.

(A) In general. Except as provided in subparagraph (B) , the term "acquisition indebtedness" does not, for purposes of this section , include indebtedness incurred by a qualified organization in acquiring or improving any real property. For purposes of this paragraph , an interest in a mortgage shall in no event be treated as real property.

(B) Exceptions. The provisions of subparagraph (A) shall not apply in any case in which-

- (i) the price for the acquisition or improvement is not a fixed amount determined as of the date of the acquisition or the completion of the improvement;
- (ii) the amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, is dependent, in whole or in part, upon any revenue, income, or profits derived from such real property;
- (iii) the real property is at any time after the acquisition leased by the qualified organization to the person selling such property to such organization or to any person who bears a relationship described in section 267(b) or 707(b) to such person;
- (iv) the real property is acquired by a qualified trust from, or is at any time after the acquisition leased by such trust to, any person who-
 - (I) bears a relationship which is described in subparagraph (C) , (E) , or (G) of section 4975(e)(2) to any plan with respect to which such trust was formed, or
 - (II) bears a relationship which is described in subparagraph (F) or (H) of section 4975(e)(2) to any person described in subclause (I) ;
- (v) any person described in clause (iii) or (iv) provides the qualified organization with financing in connection with the acquisition or improvement; or
- (vi) the real property is held by a partnership unless the partnership meets the requirements of clauses (i) through (v) and unless-
 - (I) all of the partners of the partnership are qualified organizations,
 - (II) each allocation to a partner of the partnership which is a qualified organization is a qualified allocation (within the meaning of section 168(h)(6)), or
 - (III) such partnership meets the requirements of subparagraph (E)

For purposes of subclause (I) of clause (vi) , an organization shall not be treated as a qualified organization if any income of such organization is unrelated business taxable income.

(C) Qualified organization. For purposes of this paragraph , the term "qualified organization" means-

- (i) an organization described in section 170(b)(1)(A)(ii) and its affiliated support organizations described in section 509(a)(3) ;
- (ii) any trust which constitutes a qualified trust under section 401 ;

(iii) an organization described in section 501(c)(25) ; or

(iv) a retirement income account described in section 403(b)(9).

(D) Other pass-thru entities; tiered entities. Rules similar to the rules of subparagraph (B)(vi) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(E) Certain allocations permitted.

(i) In general. A partnership meets the requirements of this subparagraph if-

(I) the allocation of items to any partner which is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest, and

(II) each allocation with respect to the partnership has substantial economic effect within the meaning of section 704(b)(2) .

For purposes of this clause , items allocated under section 704(c) shall not be taken into account.

(ii) Special rules.

(I) Chargebacks. Except as provided in regulations, a partnership may without violating the requirements of this subparagraph provide for chargebacks with respect to disproportionate losses previously allocated to qualified organizations and disproportionate income previously allocated to other partners. Any chargeback referred to in the preceding sentence shall not be at a ratio in excess of the ratio under which the loss or income (as the case may be) was allocated.

(II) Preferred rates of return, etc. To the extent provided in regulations, a partnership may without violating the requirements of this subparagraph provide for reasonable preferred returns or reasonable guaranteed payments.

(iii) Regulations. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subparagraph , including regulations which may provide for exclusion or segregation of items.

(F) Special rules for organizations described in section 501(c)(25) .

(i) In general. In computing under section 512 the unrelated business taxable income of a disqualified holder of an interest in an organization described in section 501(c)(25) , there shall be taken into account-

(I) as gross income derived from an unrelated trade or business, such holder's pro rata share of the items of income described in clause (ii)(I) of such organization, and

(II) as deductions allowable in computing unrelated business taxable income, such holder's pro rata share of the items of deduction described in clause (ii)(II) of such organization.

Such amounts shall be taken into account for the taxable year of the holder in which (or with which) the taxable year of such organization ends.

(ii) Description of amounts. For purposes of clause (i) -

(I) gross income is described in this clause to the extent such income would (but for this paragraph) be treated under subsection (a) as derived from an unrelated trade or business, and

(II) any deduction is described in this clause to the extent it would (but for this paragraph) be allowable under subsection (a)(2) in computing unrelated business taxable income.

(iii) Disqualified holder. For purposes of this subparagraph , the term "disqualified holder" means any shareholder (or beneficiary) which is not described in clause (i) or (ii) of subparagraph (C) .

(G) Special rules for purposes of the exceptions. Except as otherwise provided by regulations-

(i) Small leases disregarded. For purposes of clauses (iii) and (iv) of subparagraph (B) , a lease to a person described in such clause (iii) or (iv) shall be disregarded if no more than 25 percent of the leasable floor space in a building (or complex of buildings) is covered by the lease and if the lease is on commercially reasonable terms.

(ii) Commercially reasonable financing. Clause (v) of subparagraph (B) shall not apply if the financing is on commercially reasonable terms.

(H) Qualifying sales by financial institutions.

(i) In general. In the case of a qualifying sale by a financial institution, except as provided in regulations, clauses (i) and (ii) of subparagraph (B) shall not apply with respect to financing provided by such institution for such sale.

(ii) Qualifying sale. For purposes of this clause, there is a qualifying sale by a financial institution if-

(I) a qualified organization acquires property described in clause (iii) from a financial institution and any gain recognized by the financial institution with respect to the property is ordinary income,

(II) the stated principal amount of the financing provided by the financial institution does not exceed the amount of the outstanding indebtedness (including accrued but unpaid interest) of the financial institution with respect to the property described in clause

(iii) immediately before the acquisition referred to in clause (iii) or (v) , whichever is applicable, and

(III) the present value (determined as of the time of the sale and by using the applicable Federal rate determined under section 1274(d)) of the maximum amount payable pursuant to the financing that is determined by reference to the revenue, income, or profits derived from the property cannot exceed 30 percent of the total purchase price of the property (including the contingent payments).

(iii) Property to which subparagraph applies. Property is described in this clause if such property is foreclosure property, or is real property which-

(I) was acquired by the qualified organization from a financial institution which is in conservatorship or receivership, or from the conservator or receiver of such an institution, and

(II) was held by the financial institution at the time it entered into conservatorship or receivership.

(iv) Financial institution. For purposes of this subparagraph , the term "financial institution" means-

(I) any financial institution described in section 581 or 591(a) ,

(II) any other corporation which is a direct or indirect subsidiary of an institution referred to in subclause (I) but only if, by virtue of being affiliated with such institution, such other corporation is subject to supervision and examination by a Federal or State agency which regulates institutions referred to in subclause (I) , and

(III) any person acting as a conservator or receiver of an entity referred to in subclause (I) or (II) (or any government agency or corporation succeeding to the rights or interest of such person).

(v) Foreclosure property. For purposes of this subparagraph , the term "foreclosure property" means any real property acquired by the financial institution as the result of having bid on such property at foreclosure, or by operation of an agreement or process of law, after there was a default (or a default was imminent) on indebtedness which such property secured.

(d) Basis of debt-financed property acquired in corporate liquidation.

For purposes of this subtitle, if the property was acquired in a complete or partial liquidation of a corporation in exchange for its stock, the basis of the property shall be the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain to the organization which was included, on account of such distribution, in unrelated business taxable income under subsection (a) .

(e) Allocation rules.

Where debt-financed property is held for purposes described in subsection (b)(1)(A) , (B) , (C) , or (D) as well as for other purposes, proper allocation shall be made with respect to basis, indebtedness, and income and deductions. The allocations required by this section shall be made in accordance with regulations prescribed by the Secretary to the extent proper to carry out the purposes of this section.

(f) Personal property leased with real property.

For purposes of this section , the term "real property" includes personal property of the lessor leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate.

(g) Regulations.

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section , including regulations to prevent the circumvention of any provision of this section through the use of segregated asset accounts.