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the building were treated as debt-financed property, then the depreciation allowed as a deduction would be \$5,000. (See example 2 of § 1.514(b)-1(b)(1)(iii).)

(4) *Capital losses*—(i) *In general*. If the sale or exchange of debt-financed property results in a capital loss, the amount of such loss taken into account in the taxable year in which the loss arises shall be computed in accordance with paragraph (a)(1)(v) of this section. If, however, any portion of such capital loss not taken into account in such year may be carried back or carried over to another taxable year, the debt/basis percentage is not applied to determine what portion of such capital loss may be taken as a deduction in the year to which such capital loss is carried.

(ii) *Example*. This subparagraph is illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt educational organization, owns securities which are capital assets and which it has held for more than 6 months. In 1972 X sells the securities at a loss of \$20,000. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the securities is 40 percent. Thus, X has sustained a capital loss of \$8,000 (40 percent of \$20,000) with respect to the sale of the securities. For 1972 and the preceding three taxable years X has no other capital transactions. Under these circumstances, the \$8,000 of capital loss may be carried over to the succeeding 5 taxable years without further application of the debt/basis percentage.

(5) *Net operating loss*—(i) *In general*. If, after applying the debt/basis percentage to the income derived from debt-financed property and the deductions directly connected with such income, such deductions exceed such income, the organization has sustained a net operating loss for the taxable year. This amount may be carried back or carried over to other taxable years in accordance with section 512(b)(6). However, the debt/basis percentage shall not be applied in such other years to determine the amounts that may be taken as a deduction in those years.

(ii) *Example*. This subparagraph may be illustrated by the following example. For purposes of this example it is

assumed that the property is debt-financed property.

Example. During 1974, Y, an exempt organization, receives \$20,000 of rent from a building which it owns. Y has no other unrelated business taxable income for 1974. For 1974 the deductions directly connected with this building are property taxes of \$5,000, interest of \$5,000 on the acquisition indebtedness, and salary of \$15,000 to the manager of the building. The debt/basis percentage for 1974 with respect to the building is 50 percent. Under these circumstances, Y shall take into account in computing its unrelated business taxable income for 1974, \$10,000 of income (50 percent of \$20,000) and \$12,500 (50 percent of \$25,000) of the deductions directly connected with such income. Thus, for 1974 Y has sustained a net operating loss of \$2,500 (\$10,000 of income less \$12,500 of deductions) which may be carried back or carried over to other taxable years without further application of the debt/basis percentage.

[T.D. 7229, 37 FR 28143, Dec. 21, 1972]

§ 1.514(a)-2 Business lease rents and deductions for taxable years beginning before January 1, 1970.

(a) *Effective date*. This section applies to taxable years beginning before January 1, 1970.

(b) *In general*—(1) *Rents includible in gross income*. There shall be included with respect to each business lease, 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 rents derived during the taxable year under such lease as:

(i) The amount of the business lease indebtedness at the close of the taxable year of the lessor tax-exempt organization, with respect to the premises covered by such lease, is of

(ii) The adjusted basis of such premises at the close of such taxable year

For definition of business lease as a lease for a term of more than 5 years, and for rules for determining the computation of such 5-year term in certain specific situations, see § 1.514(f)-1. For definition of business lease indebtedness and allocation of business lease indebtedness where only a portion of the property is subject to a business lease, see § 1.514(g)-1.

(2) *Determination of basis*. For purposes of the unrelated business income tax the basis (unadjusted) of property

is determined under section 1012, and the adjusted basis of property is determined under section 1011. The determination of the adjusted basis of property is not affected by the fact that the organization was exempt from tax for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. Thus adjustment must be made for depreciation for all taxable years whether or not the organization was exempt from tax for any of such years. Similarly, for taxable years during which the organization is subject to the tax on unrelated business taxable income the fact that only a portion of the deduction for depreciation is taken into account under paragraph (c)(1) of this section does not affect the amount of the adjustment for depreciation.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that the taxpayer makes its returns under section 511 on the basis of the calendar year, and that the lease is not substantially related to the purpose for which the organization is granted exemption from tax.

Example 1. Assume that a tax-exempt educational organization purchased property in 1952 for \$600,000, using borrowed funds, and leased the building for a period of 20 years. Assume further that the adjusted basis of such building at the close of 1954 is \$500,000 and that, at the close of 1954, \$200,000 of the indebtedness incurred to acquire the property remains outstanding. Since the amount of the outstanding indebtedness is two-fifths of the adjusted basis of the building at the close of 1954, two-fifths of the gross rental received from the building during 1954 shall be included as an item of gross income in computing unrelated business taxable income. If, at the close of a subsequent taxable year, the outstanding indebtedness is \$100,000 and the adjusted basis of the building is \$400,000, one-fourth of the gross rental for such taxable year shall be included as an item of gross income in computing unrelated business taxable income for such taxable year.

Example 2. Assume that a tax-exempt organization owns a four-story building, that in 1954 it borrows \$100,000 which it uses to improve the whole building, and that it thereafter in 1954 rents the first and second floors of the building under six-year leases at rentals of \$4,000 a year. The third and fourth floors of the building are leased on a yearly basis during 1954. Assume, also, that the ad-

justed basis of the real property at the end of 1954 (after reflecting the expenditures for improving the building) is \$200,000, allocable equally to each of the four stories. Under these facts, only one-half of the real property is subject to a business lease since only one-half is rented under a lease for more than 5 years. See § 1.514(f)-1. The percentage of the rent under such lease which is taken into account is determined by the ratio which the allocable part of the business lease indebtedness bears to the allocable part of the adjusted basis of the real property, that is, the ratio which one-half of the \$100,000 of business lease indebtedness outstanding at the close of 1954, or \$50,000, bears to one-half of the adjusted basis of the business lease premises at the close of 1954, or \$100,000. The percentage of rent which is business lease income for 1954 is, therefore, one-half (the ratio of \$50,000 to \$100,000) of \$8,000, or \$4,000, and this amount of \$4,000 is considered an item of gross income derived from an unrelated trade or business.

(c) *Deductions*—(1) *Deductions allowable against gross income.* The same percentage is used in determining both the portion of the rent and the portion of the deductions taken into account with respect to the business lease in computing unrelated business taxable income. Such percentage is applicable only to the sum of the following deductions allowable under section 161:

(i) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the business lease;

(ii) Interest paid or accrued during the taxable year on the business lease indebtedness;

(iii) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account only those amounts of the above-listed deductions which are properly allocable to the premises covered by such lease.

(2) *Excess deductions.* The deductions allowable under subparagraph (1) of this paragraph with respect to a business lease are not limited by the amount included in gross income with respect to the rent from such lease. Any excess of such deductions over such gross income shall be applied against other items of gross income in

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computing unrelated business taxable income taxable under section 511(a).

(3) *Example.* The application of this paragraph may be illustrated by the following example:

Example. Assume the same facts as those in example 1 in paragraph (b)(3) of this section. Assume, also that for 1954 the organization pays taxes of \$4,000 on the property, interest of \$6,000 on its business lease indebtedness, and that the depreciation allowable for 1954 under section 167 is \$10,000. Under the facts set forth in such example 1 and in this example, the deductions to be taken into account for 1954 in computing unrelated business taxable income would be two-fifths of the total of the deductions of \$20,000, that is \$8,000.

[T.D. 7229, 37 FR 28145, Dec. 21, 1972]

§ 1.514(b)-1 Definition of debt-financed property.

(a) *In general.* For purposes of section 514 and the regulations thereunder, the term *debt-financed property* means any property which is held to produce income (e.g., rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. The term *income* is not limited to recurring income but applies as well to gains from the disposition of property. Consequently, when any property held to produce income by an organization which is not used in a manner described in section 514(b)(1) (A), (B), (C), or (D) is disposed of at a gain during the taxable year, and there was an acquisition indebtedness outstanding with respect to such property at any time during the 12-month period preceding the date of disposition (even though such period covers more than 1 taxable year), such property is *debt-financed property*. For example, assume that on June 1, 1972, an organization is given mortgaged, unimproved property which it does not use in a manner described in section 514(b)(1) (A), (B), (C), or (D) and that the organization assumes payment of the mortgage on such property. On July 15, 1972, the organization sells such property for a gain. Such property is *debt-financed property* and such gain is taxable as unrelated debt-financed income. See section 514(c) and § 1.514(c)-1 for rules relating

to when there is acquisition indebtedness with respect to property. See paragraph (a) of § 1.514(a)-1 for rules determining the amount of income or gain from debt-financed property which is treated as unrelated debt-financed income.

(b) *Exceptions—(1) Property related to certain exempt purposes.* (i) To the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for 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)) such property shall not be treated as *debt-financed property*. See § 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

(ii) If substantially all of any property is used in a manner described in subdivision (i) of this subparagraph, such property shall not be treated as *debt-financed property*. In general the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate):

(a) A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,

(b) A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or

(c) Both the comparisons described in (a) and (b) of this subdivision.

(iii) This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. W, an exempt organization, owns a computer with respect to which there