led by experts, are part of a coordinated educational program designed to educate tour participants about the ancient history of the Y region of Z and V's ongoing field research. Therefore, V's tour program does not constitute an unrelated trade or business within the meaning of section 513(a).

Example 7. W is an educational organization devoted to the study of the performing arts and is exempt from federal income tax under section 501(a) as an organization described in section 501(c)(3). In connection with its educational activities, W presents public performances of musical and theatrical works. Individuals become members of W by making an annual contribution to W of $q. Each year, W offers members an opportunity to travel as a group to one or more major cities in the United States or abroad. In each city, tour participants are provided tickets to attend a public performance of a play, concert or dance program each evening. W also arranges a sightseeing tour of each city and provides evening receptions for tour participants. W views its tour program as an important means to develop and strengthen bonds between W and its members, and to increase their financial and volunteer support of W. W engaged a travel agency to handle logistics such as accommodations and transportation arrangements. No educational materials are prepared by W or provided to tour participants in connection with the tours. Apart from attendance at the evening cultural events, the tours offer no scheduled instruction, organized study or group discussion. Although several members of W's administrative staff accompany each tour group, their role is to facilitate member interaction. The staff members have no special expertise in the performing arts and play no educational role in the tours. W prepared promotional materials describing the sightseeing opportunities on the tours and emphasizing the opportunity for members to socialize informally and interact with one another and with W staff members, while pursuing shared interests. Although W's tour program may foster goodwill among W members, it does not contribute importantly to W's educational purposes. W's tour program is primarily social and recreational in nature. The scheduled activities, which include sightseeing and attendance at various cultural events, are not part of a coordinated educational program. Therefore, W's tour program is an unrelated trade or business within the meaning of section 513(a).

[T.D. 8874, 65 FR 5773, Feb. 7, 2000; 65 FR 16143, Mar. 27, 2000]

§ 1.514(a)–1 Unrelated debt-financed income and deductions.

(a) *Income includible in gross income:*

(1) *Percentage of income taken into account*—(i) *In general.* For taxable years beginning after December 31, 1969, there shall be included with respect to each debt-financed property (as defined in section 514 and § 1.514(b)–1) as an item of gross income derived from an unrelated trade or business the amount of unrelated debt-financed income (as defined in subdivision (ii) of this subparagraph). See paragraph (a)(5) of § 1.514(c)–1 for special rules regarding indebtedness incurred before June 28, 1966, applicable for taxable years beginning before January 1, 1972, and for special rules applicable to churches or conventions or associations of churches.

(ii) *Unrelated debt-financed income.* The *unrelated debt-financed income* with respect to each debt-financed property is 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 subparagraph (3) of this paragraph) with respect to the property is of

(*b*) The average adjusted basis of such property (as defined in subparagraph (2) of this paragraph).

(iii) *Debt/basis percentage.* The percentage determined under subdivision (ii) of this subparagraph is hereinafter referred to as the *debt/basis percentage.*

(iv) *Example.* Subdivisions (i), (ii), and (iii) of this subparagraph are illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt trade association, owns an office building which in 1971 produces $10,000 of gross rental income. The average adjusted basis of the building for 1971 is $100,000, and the average acquisition indebtedness with respect to the building for 1971 is $50,000. Accordingly, the debt/basis percentage for 1971 is 50 percent (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building for 1971 is $5,000 (50 percent of $10,000).

(v) *Gain from sale or other disposition.* If debt-financed property is sold or otherwise disposed of, there shall be included in computing unrelated business taxable income an amount with respect to such gain (or loss) which is the same percentage (but not in excess of 100 percent) of the total gain (or loss) derived from such sale or other disposition as:

(*a*) The highest acquisition indebtedness with respect to such property during the 12-month period, preceding the date of disposition, is of

(*b*) The average adjusted basis of such property.

The tax on the amount of gain (or loss) included in unrelated business taxable income pursuant to the preceding sentence shall be determined in accordance with the rules set forth in subchapter P, chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) *Average adjusted basis*—(i) *In general.* The *average adjusted basis* of debt-financed property is the average amount of the adjusted basis of such property during that portion of the taxable year it is held by the organization. This amount is the average of:

(*a*) The adjusted basis of such property as of the first day during the taxable year that the organization holds the property, and

(*b*) The adjusted basis of such property as of the last day during the taxable year that the organization holds the property

See section 1011 and the regulations thereunder for determination of the adjusted basis of property.

(ii) *Adjustments for prior taxable years.* For purposes of subdivision (i) of this subparagraph, the determination of the average adjusted basis of debt-financed property is not affected by the fact that the organization was exempt from taxation for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. For example, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from taxation for any such years. Similarly, the fact that only a portion of the depreciation allowance may be taken into account in computing the percentage of deductions allowable under section 514(a)(2) does not affect the amount of the adjustment for depreciation which is used in determining average adjusted basis.

(iii) *Cross reference.* For the determination of the basis of debt-financed property acquired in a complete or partial liquidation of a corporation in exchange for its stock, see §1.514(d)–1.

(iv) *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. On July 10, 1970, X, an exempt educational organization, purchased an office building for $510,000, using $300,000 of borrowed funds. During 1970 the only adjustment to basis is $20,000 for depreciation. As of December 31, 1970, the adjusted basis of the building is $490,000 and the indebtedness is still $300,000. X files its return on a calendar year basis. Under these circumstances, the debt/basis percentage for 1970 is 60 percent, calculated in the following manner:

	Basis
As of July 10, 1970 (acquisition date)	$510,000
As of December 31, 1970	490,000
Total	1,000,000

Average Adjusted basis:

$$\$1,000,000 \div 2 = \$500,000$$

Debt/basis percentage:

Average acquisition indebtedness ($300,000)/ Average adjusted basis ($500,000)=60 percent

For an illustration of the determination of the debt/basis percentage as changes in the acquisition indebtedness occur, see example 1 of subparagraph (3)(iii) of this paragraph.

(3) *Average acquisition indebtedness*—(i) *In general.* The *average acquisition indebtedness* with respect to debt-financed property is the average amount of the outstanding principal indebtedness during that portion of the taxable year the property is held by the organization.

(ii) *Computation.* The average acquisition indebtedness is computed by determining the amount of the outstanding principal indebtedness on the first day in each calendar month during the taxable year that the organization holds the property, adding these amounts together, and then dividing this sum by the total number of months during the taxable year that the organization held such property. A fractional part of a month shall be treated as a full month in computing average acquisition indebtedness.

(iii) *Examples.* The application of this subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property is debt-financed property.

Example 1. Assume the facts as stated in the example in subparagraph (2)(iv) of this paragraph, except that beginning July 20, 1970, the organization makes payments of $21,000 a month ($20,000 of which is attributable to principal and $1,000 to interest). In this situation, the average acquisition indebtedness for 1970 is $250,000. Thus, the debt/basis percentage for 1970 is 50 percent, calculated in the following manner:

	Indebtedness on the first day in each calendar month that the property is held
Month:	
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

Debt/basis percentage:
Average acquisition indebtedness ($250,000)/ Average adjusted basis ($500,000)=50 percent

Example 2. Y, an exempt organization, owns stock in a corporation which it does not control. At the beginning of the year, Y has an outstanding principal indebtedness with respect to such stock of $12,000. Such indebtedness is paid off at the rate of $2,000 per month beginning January 30, so that it is retired at the end of 6 months. The average acquisition indebtedness for the taxable year is $3,500, calculated in the following manner:

	Indebtedness on the first day in each calendar month that the property is held
Month:	
January	$12,000
February	10,000
March	8,000
April	6,000
May	4,000
June	2,000
July thru December	0
Total	42,000

Average acquisition indebtedness:

$$\$42{,}000 \div 6 \text{ months} = \$3{,}500$$

(4) *Indeterminate price*—(i) *In general.* If an exempt organization acquires (or improves) property for an indeterminate price, the initial acquisition indebtedness and the unadjusted basis shall be determined in accordance with subdivisions (ii) and (iii) of this paragraph, unless the organization has obtained the consent of the Commissioner to use another method to compute such amounts.

(ii) *Unadjusted basis.* For purposes of this subparagraph, the unadjusted basis of property (or of an improvement) is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement). The average adjusted basis of such property shall be determined in accordance with paragraph (a)(2) of this section.

(iii) *Initial acquisition indebtedness.* For purposes of this subparagraph, the initial acquisition indebtedness is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement) less any down payment or other initial payment applied to the principal indebtedness. The average acquisition indebtednessith respect to such property shall be computed in accordance with paragraph (a)(3) of this section.

(iv) *Example.* The application of 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. On January 1, 1971, X, an exempt trade association, acquires an office building for a down payment of $310,000 and an agreement to pay 10 percent of the income generated by the building for 10 years. Neither the sales price nor the amount which X is obligated to pay in the future is certain. The fair market value of the building on the date of acquisition is $600,000. The depreciation allowance for 1971 is $40,000. Unless X obtains the consent of the Commissioner to use another method, the unadjusted basis of the property is $600,000 (the fair market value of the property on the date of acquisition), and the initial acquisition indebtedness is $290,000 (fair market value of $600,000 less initial payment of $310,000). Under these circumstances, the average adjusted basis of the property for 1971 is $580,000, calculated as follows:

[Initial fair market value+(initial fair market value less depreciation)] ÷2=[$600,000+($600,000 − $40,000)] ÷2=$580,000.

If no payment other than the initial payment is made in 1971, the average acquisition indebtedness for 1971 is $290,000. Thus, the debt/basis percentage for 1971 is 50 percent, calculated as follows:

Average acquisition indebtedness ÷average adjusted basis=$290,000 ÷$580,000=50 percent

(b) *Deductions*—(1) *Percentage of deductions taken into account.* Except as provided in subparagraphs (4) and (5) of this paragraph, there shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying the debt/basis percentage to the sum of the deductions allowable under subparagraph (2) of this paragraph.

(2) *Deductions allowable.* The deductions allowable are those items allowed as deductions by chapter 1 of the Code which are directly connected with the debt-financed property or the income therefrom (including the dividends received deductions allowed by sections 243, 244, and 245), except that:

(i) The allowable deductions are subject to the modifications provided by section 512(b) on computation of the unrelated business taxable income, and

(ii) If the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, such allowance shall be computed only by use of the straight-line method of depreciation.

(3) *Directly connected with.* To be *directly connected with* debt-financed property or the income therefrom, an item of deduction must have proximate and primary relationship to such property or the income therefrom. Expenses, depreciation, and similar items attributable solely to such property are proximately and primarily related to such property or the income therefrom, and therefore qualify for deduction, to the extent they meet the requirements of subparagraph (2) of this paragraph. Thus, for example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization would be allowed a deduction for depreciation of $10,000 if the entire building were debt-financed property. However, if only one-half of 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 adjusted 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