

## **OVERVIEW OF THE UNRELATED BUSINESS INCOME TAX**

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**I. GENERAL PURPOSE OF THE UNRELATED BUSINESS INCOME TAX.**

- A. Primary Purpose.** The main objective of the unrelated business income tax is to eliminate unfair competition between exempt and nonexempt organizations. This is accomplished by subjecting the unrelated business activities of tax-exempt organizations to the same taxes as the nonexempt businesses with which they compete.
- B. Other Objectives.** The courts more recently have also noted that one of the rationales of the unrelated business income tax is that of raising revenue.

**II. APPLICATION OF THE UNRELATED BUSINESS INCOME TAX.**

- A. Organizations Subject to Tax.** The unrelated business income tax applies to organizations that are exempt from income tax under Internal Revenue Code section 501(a). This includes organizations described in Internal Revenue Code sections 401(a) and 501(c). I.R.C. § 511(a)(2)(A). It also applies to any state college or university and any corporation wholly owned by a state college or university. I.R.C. § 511(a)(2)(B). The tax also applies to churches and conventions or associations of churches for all tax years beginning after 1969. Treas. Reg. § 1.511-2(a)(3)(iii).
- B. Tax Rate.** Internal Revenue Code section 511(a)(1) imposes a tax at the rate applicable to corporations on the unrelated business taxable income of organizations exempt from tax under Internal Revenue Code section 501(a).
- C. Tax Return.** An organization described in Internal Revenue Code section 501(c) reports its unrelated business taxable income on Form 990-T.
- D. Definition of Unrelated Business Taxable Income.** "Unrelated business taxable income" is the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less any allowable deductions which are

directly connected with the carrying on of such trade or business, and computed with the modifications set forth in Internal Revenue Code section 512(b). I.R.C. § 512(a)(1).

- E. Definition of Unrelated Trade or Business.** An "unrelated trade or business" is "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits 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...." I.R.C. § 513(a).
- F. Three Criteria for Taxation.** Under the unrelated trade or business income tax provisions of the Internal Revenue Code, the following three requirements must be met for income to be subject to tax as unrelated business taxable income:
- 1. Trade or Business Requirement.** The income must be from a trade or business.
  - 2. Regularly Carried On.** The conduct of such trade or business must be regularly carried on by the organization.
  - 3. Not Substantially Related.** The conduct of the trade or business must not be substantially related (other than through the production of funds) to the organization's performance of its exempt functions. Treas. Reg. § 1.513-1(a). *See also United States v. American College of Physicians*, 475 U.S. 834 (1986).
- G. Trade or Business Requirement.** If an activity being carried on by an exempt organization is not a trade or business, any income produced by that activity is not unrelated business taxable income.

1. **Trade or Business Not Defined in Internal Revenue Code.** There is no definition of "trade or business" in the Internal Revenue Code or the underlying regulations.
2. **Internal Revenue Code Section 513 Regulations Offer Guidance.** The regulations under Internal Revenue Code section 513 offer some guidance as to what activities constitute a trade or business for purposes of the unrelated business income tax rules. Regulation section 1.513-1(b) provides: "The primary objective of the adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162,...the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162-and which, in addition, is not substantially related to the performance of exempt functions-presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term 'trade or business' has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."
3. **Trade or Business under Internal Revenue Code Section 162 and Profit Motive.** The regulations under Internal Revenue Code section 513 rely on

the definition of "trade or business" for purposes of Internal Revenue Code section 162, which is the provision that allows an income tax deduction for ordinary and necessary business expenses. A trade or business within the meaning of Internal Revenue Code section 162 is generally an activity that is engaged in for the primary purpose of generating an income or profit. *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987); *United States v. American Bar Endowment*, 477 U.S. 105, 110, n.1 (1986). Thus, the existence of a profit motive is considered the most important factor in determining whether an activity is a trade or business for purposes of the unrelated business income tax. *L.A. Credit Union League v. United States*, 693 F.2d 525 (5<sup>th</sup> Cir. 1982).

4. **Competition with For Profit Businesses.** Competition with for profit business activities is a consideration under the regulations for purposes of the trade or business requirement. See Rev. Rul. 68-505, 1968-2 C.B. 248. But, it is not necessary to establish evidence of actual competition to have unrelated business taxable income. *Disabled American Veterans v. United States*, 650 F.2d 1178, 1187 (Cl. Ct. 1981) ("It is concluded that what is necessary to constitute a trade or business for UBTI purposes is that an activity be operated in a competitive, commercial manner."); *L.A. Credit Union League v. United States*, 693 F.2d 525 (5<sup>th</sup> Cir. 1982). The competition factor is generally relied upon to provide evidence of a profit motive. There is some indication, however, that the Internal Revenue Service and the courts have also considered whether an activity is conducted in a competitive, commercial manner to be of more significance and inquired into the manner in which the organization conducts an activity. But, this factor is being considered not in connection

with the trade or business requirement but to dispute a contention that the activity is substantially related to the organization's tax-exempt purpose, which factor is discussed in more detail below.

**H. Regularly Carried On.** Even if an activity is a trade or business, income produced by the activity will not be unrelated business taxable income unless the activity is regularly carried on by the exempt organization. "In determining whether trade or business from which a particular amount of gross income derives is regularly carried on, within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations." Treas. Reg. § 1.513-1(c)(1).

**1. Normal Time Span of Activity.** It is necessary to look at the normal time span of activities relative to the time span during which the exempt organization engages in the activity. "Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business." Treas. Reg. § 1.513-1(c)(2)(i). See, e.g., *National Collegiate Athletic Association v. Commissioner*, 914 F.2d 1417 (10<sup>th</sup> Cir. 1990). If comparable commercial activities are usually

carried on only on a seasonal basis, the exempt organization's conduct of the activity for all or a significant portion of the season ordinarily satisfies the regularly carried on requirement. Rev. Rul. 68-505, 1968-2 C.B. 248.

- 2. Intermittent Activities.** In connection with intermittent activities, the manner in which the activities are carried on is relevant. "In determining whether or not intermittently conducted activities are regularly carried on, the manner of the conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors." Treas. Reg. § 1.513-1(c)(2)(ii). Furthermore, "[c]ertain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis." Treas. Reg. § 1.513-1(c)(2)(iii).
- 3. Preparatory Activity.** The Internal Revenue Service generally views preparatory activity as part of the business activity for purposes of determining whether a trade or business is regularly carried on. Rev. Rul. 73-424, 1973-2 C.B. 190. The courts that have been called upon to address this issue have rejected the preparatory time argument. See, e.g., *Suffolk County Patrolmen's Benevolent Association v. Commissioner*, 77 T.C. 1314, 1323 (1981).

**I. Substantially Related.** Income derived from a trade or business that is substantially related to an organization's exempt purpose is not unrelated business taxable income.

**1. Relationship Between Activity and Exempt Purposes.** To make the determination of whether the activity is substantially related, it is necessary to examine the relationship between the business activities and the accomplishment of the organization's exempt purposes. Treas. Reg. § 1.513-1(d)(1).

**2. Regulatory Guidance.** The regulations under Internal Revenue Code section 513 provide some guidance on how this determination is to be made and provide: "Trade or business is related to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is substantially related, for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an

organization is granted exemption depends in each case upon the facts and circumstances involved." Treas. Reg. § 1.513-1(d)(2).

3. **Size and Extent of Activities.** The regulations also require an examination of the size and extent of the activities conducted by the exempt organization relative to the nature and extent of the exempt function which they purport to serve. "Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business." Treas. Reg. § 1.513-1(d)(3). *See also* Rev. Rul. 76-94, 1976-1 C.B. 171.
4. **Same State Rule.** As a general rule, gross income from the sale of a product resulting from the performance of exempt functions is not gross income from the conduct of an unrelated trade or business if the product is sold in substantially the same state it is upon completion of the exempt functions. Treas. Reg. § 1.513-1(d)(4)(ii).
5. **Tax-Exempt Purpose a Critical Factor.** The regulations make the organization's tax-exempt purpose a critical factor in the substantial relationship equation. *L.A. Credit Union League v. United States*, 693 F.2d 525 (5<sup>th</sup> Cir. 1982).
  - a. The test focuses on the relationship of the trade or business to the accomplishment of exempt purposes and not on the nature of the activity or the manner in which it is conducted.

- b.** "The regulations...require a case-by-case identification of the exempt purpose, an analysis of how the activity contributes to that purpose and an examination of the scale on which the activity is conducted." *Hi-Plains Hospital v. United States*, 670 F.2d 528, 531 (5<sup>th</sup> Cir. 1982).
- c.** But, as policy debates over the reasonableness of the standard and the possibility of unfair competition continue, the Internal Revenue Service and some courts are focusing on whether an activity is conducted in a competitive, commercial manner. This doctrine is known as the commerciality doctrine and essentially is this: "A tax-exempt organization is engaged in a nonexempt activity where that activity is engaged in in a manner that is considered *commercial*. An act is a commercial one if it has a direct counterpart in, or is conducted in the same manner as is the case in the realm of the for-profit organizations." Hopkins, *The Law of Tax-Exempt Organizations* 629-30 (7<sup>th</sup> ed. 1998).
- d.** "In recent years, considerable attention has been accorded the phenomenon of tax-exempt organizations that are considered to be operating in a commercial manner or unfairly competing with for-profit organizations. Many of the activities that are under review as being commercial or competitive are those that are related, rather than unrelated, business." *Id.*, at 649. See, e.g., *United States v. American College of Physicians*, 475 U.S. 834, 848 (1986) (holding that Internal Revenue Code section 513 by its express terms requires an examination of the manner in which the organization conducts its business); G.C.M. 39863 (Nov. 26,

1991) ("A trade or business is considered related if operated primarily as an integral part of the educational program of the university, but is considered unrelated if operated in substantially the same manner as a commercial operation."); T.A.M. 9147008 (Aug. 19, 1991) (ruling that an activity was not substantially related because of the commercial nature in which the activity was conducted and the emphasis on revenue maximization to the exclusion of other considerations).

- 6. Relevant Factors.** Because the determination of whether a trade or business is substantially related to an organization's exempt purposes depends upon the facts and circumstances of each case, the numerous Internal Revenue Service pronouncements and judicial decisions offer limited comfort in connection with a particular organization carrying on a particular activity. But, there are a number of factors that the Internal Revenue Service and the courts have relied on in concluding that an activity is not substantially related. These factors include:
- a.** Fees charged to the general public are comparable to commercial facilities;
  - b.** Only those that purchase the goods or services are benefited and the benefits are in direct proportion to the fees charged;
  - c.** The organization furnishes and operates the facilities through its own employees who perform substantial services in providing the activity; and
  - d.** Revenue maximization is a predominant element in the exempt organization's conduct of the activity. G.C.M. 39863 (Nov. 26, 1991) (citations omitted); T.A.M. 9147008 (Aug. 19, 1991).

- J. Fragmentation Rule.** An activity will not lose its identity as an unrelated trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may or may not be related to the organization's exempt purposes. I.R.C. § 513(c).
- K. Exceptions from Definition of Unrelated Trade or Business.**
- 1. Volunteer Exception.** Unrelated trade or business does not include any trade or business in which substantially all of the work in carrying on the trade or business is performed for the organization without compensation. I.R.C. § 513(a)(1).
  - 2. Convenience Exception.** Unrelated trade or business does not include any trade or business carried on by a section 501(c)(3) organization or a state college or university primarily for the convenience of its members, students, patients, officers, or employees. I.R.C. § 513(a)(2).
  - 3. Thrift Stores.** Unrelated trade or business does not include any trade or business which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions. I.R.C. § 513(a)(3).
- L. Special Rules Relating to Unrelated Trade or Business.** Special rules apply under Internal Revenue Code section 513 for (1) qualified convention and trade show activity, (2) certain hospital services, (3) certain bingo games, (4) certain distributions of low cost articles, (5) certain exchanges and rentals of member lists, (6) certain travel and tour activities, and (7) certain sponsorship payments.
- III. MODIFICATIONS TO UNRELATED BUSINESS TAXABLE INCOME.**
- A. Income Excluded from Unrelated Business Taxable Income.** Internal Revenue Code section 512(b) excludes certain types of income from the definition of unrelated business taxable income. The following types of income are excluded:

- 1. Passive Investment Income.** Dividends, interest, payments with respect to securities loans, annuities, and other substantially similar income for routine and ordinary investments, and all deductions directly connected with any of such types of investment income, are excluded in determining unrelated business taxable income. I.R.C. § 512(b)(1); Treas. Reg. § 1.512(b)-1(a)(1). This exclusion does not apply, however, to income derived from and deductions in connection with debt-financed property (discussed below). Special rules also apply in the case of certain types of income derived from controlled organizations. Treas. Reg. § 1.512(b)-1(a)(2).
- 2. Royalties.** All royalties (including overriding royalties), whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income, are excluded from unrelated business taxable income.

  - a.** Certain royalties from debt-financed property or controlled organizations are included in computing unrelated business taxable income. Treas. Reg. § 1.512(b)-1(b).
  - b.** Mineral royalties are excluded whether measured by production or by gross or taxable income from the mineral property. But, if the organization owns a working interest in mineral property and is not relieved from its share of the development costs by the terms of any agreement with an operator, income received from such mineral interest is not excluded from unrelated business taxable income. Treas. Reg. § 1.512(b)-1(b).
- 3. Rents.** With certain exceptions, rents from real property and rents from personal property leased with such real property, if the rents attributable to

such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service, along with all deductions directly connected with such rents, are excluded in calculating unrelated business taxable income.

I.R.C. § 512(b)(3)(A) & (C). Rents attributable to personal property are generally not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. Treas. Reg. § 1.512(b)-1(c)(2)(ii).

- a.** Rents will not be excluded if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property. I.R.C. § 512(b)(3)(B)(i).
- b.** Rents will not be excluded if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the leased property (other than an amount based on a fixed percentage or percentages of gross receipts or sales). I.R.C. § 512(b)(3)(B)(ii).
- c.** Rents will not be excluded if from debt-financed property or property rented to controlled organizations. Treas. Reg. § 1.512(b)-1(c)(2)(i).
- d.** Payments for the use or occupancy of rooms and other space where services are also rendered to the occupant do not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. For example, supplying maid services would be

such a service but furnishing heat and light, cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash are not considered services rendered to the occupant. Treas. Reg. § 1.512(b)-1(c)(5).

4. **Gains and Losses from Sale of Property.** All gains or losses from the sale of property are excluded from the computation of unrelated business taxable income. I.R.C. § 512(b)(5). This exclusion does not apply, however, to the sale of stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year and property held primarily for sale to customers in the ordinary course of the trade or business. I.R.C. § 512(b)(5). This exclusion does not apply to the cutting of timber, which is considered as a sale or exchange of such timber, and to gain derived from the sale of debt-financed property. Treas. Reg. § 1.512(b)-1(d)(1).
5. **Net Operating Losses.** Subject to certain rules, the net operating loss deduction under Internal Revenue Code section 172 is allowed in computing unrelated business taxable income. I.R.C. § 512(b)(6).
6. **Research Income.** Income derived from research for any of the following:
  - a. The United States or any of its agencies or instrumentalities;
  - b. Any state or political subdivision thereof;
  - c. In the case of a college, university, or hospital, for any person; and
  - d. In the case of an organization operated primarily for purposes of carrying on fundamental research (which does not include research carried on for the primary purpose of commercial or industrial application) the results of which are freely available to

the general public. I.R.C. § 512(b)(7), (8), & (9); Treas. Reg. § 1.512(b)-1(f)(4).

7. **Specific Deduction.** In general, all organizations are allowed a specific deduction of \$1,000. I.R.C. § 512(b)(12).

**B. Certain Income from Controlled Organizations.**

1. **General Rule.** If an organization (the "controlling organization") receives a "specified payment" from another entity which it controls (the "controlled entity"), the controlling organization must include such payment as an item of gross income in computing its unrelated business taxable income and may deduct any deductions directly connected with such amounts. I.R.C. § 512(b)(13)(A).
2. **Calculation of Taxable Income.** Special rules apply for determining the amount subject to tax depending upon whether the controlled entity is an exempt organization. See I.R.C. § 512(b)(13)(B).
3. **Definition of Specified Payment.** The term "specified payment" means any interest, annuity, royalty, or rent. I.R.C. § 512(b)(13)(C).
4. **Definition of Control.** For purposes of this rule, the term "control" means:
  - a. In the case of a corporation, ownership, by vote or value, of more than 50 percent of the stock in the corporation.
  - b. In the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in the partnership.
  - c. In the case of any other entity, ownership of more than 50 percent of the beneficial interests in the entity. I.R.C. § 512(b)(13)(D)(i).
  - d. In the case of a nonstock corporation, at least 50 percent of the directors or trustees of the entity are trustees, directors, agents, or employees of the controlling organization or the controlling

organization has the power to remove at least 50 percent of the directors or trustees of the entity and appoint new directors or trustees. Treas. Reg. § 1.512(b)-1(l)(4)(i)(b).

5. **Constructive Ownership.** Constructive ownership rules similar to those of Internal Revenue Code section 318 apply for determining control. I.R.C. § 512(b)(13)(D)(ii).
- C. **Special Rules for Partnership Income.** If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization must include the gross income of the partnership from such unrelated trade or business as well as the deductions from the partnership directly connected with such income in computing its unrelated business taxable income. I.R.C. § 512(c)(1).
- D. **Special Rules for S Corporation Income.**
1. **Tax-Exempt Charitable Organizations as S Corporation Shareholders.** Organizations described in Internal Revenue Code section 501(c)(3) and exempt from federal income tax under Internal Revenue Code section 501(a) are permissible shareholders of an S corporation. I.R.C. § 1361(a)(6).
  2. **S Corporation Treated as Unrelated Trade or Business.** An interest held by a section 501(c)(3) organization in an S corporation is treated as an unrelated trade or business. I.R.C. § 512(e)(1)(A).
  3. **Treatment of Income from S Corporation.** All items of income, loss, or deduction from the S corporation as well as any gain or loss on the disposition of stock in the S corporation are taken into account in determining unrelated business taxable income. I.R.C. § 512(e)(2)(B).

#### IV. DEBT-FINANCED INCOME.

- A. General Rule.** Internal Revenue Code section 514 requires certain income and deductions to be included in the computation of unrelated business taxable income, even though such amounts would otherwise be excluded from unrelated business taxable income. This inclusion is required in the case of debt-financed property.
- B. Income and Deductions from Debt-Financed Property.** For purposes of computing unrelated business taxable income for any taxable year under Internal Revenue Code section 512, there is included a proportion of the gross income derived from debt-financed property, including gains from the disposition of the property, and there is allowed proportionate deductions with respect to each such debt-financed property. I.R.C. § 514(a)(1) & (2); Treas. Reg. § 1.514(b)-1(a). The allowable deductions are those directly connected with the debt-financed property or the income therefrom, but the allowance for depreciation may be computed only by use of the straight-line method. I.R.C. § 514(a)(3).
- C. Amount Included in Unrelated Business Taxable Income.** The amount included as unrelated debt-financed income is a portion of the income from debt-financed property determined by the ratio of the average acquisition indebtedness on the property to the average adjusted basis of the property. For example, an organization paid \$100,000 for the property, but borrowed \$50,000 to acquire the property. The organization received \$20,000 of rental income from the property during the tax year. Thus, the amount of the rent included as unrelated business taxable income is  $\$20,000 \times (\$50,000/\$100,000)$  or \$10,000.
- D. Definition of Debt-Financed Property.** In general, to be classified as debt-financed property under Internal Revenue Code section 514, (1) the property must be held

for the production of income, and (2) there must be acquisition indebtedness with respect to the property at any time during the taxable year. I.R.C. § 514(b)(1).

- 1. Exceptions.** Debt-financed property does not include:
  - a.** Property the use of which is substantially related to the exercise or performance by an organization of its exempt purpose or function constituting the basis for its exemption under Internal Revenue Code section 501, but only to the extent of such use. Treas. Reg. § 1.514(b)-1(b)(1)(i).
  - b.** Property substantially all, which is defined as at least 85 percent, of the use of which is substantially related to the exercise or performance by an organization of its exempt purpose or function. Treas. Reg. § 1.514(b)-1(b)(1)(ii). This determination must be made on the basis of all of the facts and circumstances, which may include: (i) a comparison of the portion of time such property is used for exempt purposes with the total time such property is used, (ii) 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 (iii) both. Treas. Reg. § 1.514(b)-1(b)(1)(ii).
  - c.** Property used in an unrelated trade or business. But, gain on the disposition of such property that is not otherwise includible in unrelated business taxable income is includible as gross income derived from debt-financed property. Treas. Reg. § 1.514(b)-1(b)(2)(i).
  - d.** Income that is otherwise included in unrelated business taxable income. Treas. Reg. § 1.514(b)-1(b)(2)(ii).

- e. Property the gross income from which is derived from research activities excluded from unrelated business taxable income under Internal Revenue Code section 512(b)(7), (8), or (9). Treas. Reg. § 1.514(b)-1(b)(4).
  - f. Property used in any trade or business excepted from the definition of unrelated trade or business under the volunteer exception, convenience of employees, or thrift shop exceptions of Internal Revenue Code section 513(a). Treas. Reg. § 1.514(b)-1(b)(5).
2. **Definition of Acquisition Indebtedness.** Under Internal Revenue Code section 514(c)(1), 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 the 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.
3. **Property Acquired Subject to Mortgage.** If property is acquired in any manner subject to a mortgage, the amount of indebtedness secured by such mortgage is considered to be indebtedness of the organization incurred in acquiring such property even if the organization did not assume or agree to pay such indebtedness. I.R.C. § 514(c)(2)(A). But, if

such mortgaged property is acquired by bequest or devise, the indebtedness secured by the mortgage is not acquisition indebtedness for a period of 10 years after the date of the bequest or devise. I.R.C. § 514(c)(2)(B). If the organization receives property by gift subject to a mortgage that was placed on the property more than five years before the gift and the property was held by the donor for more than five years before the gift, the indebtedness secured by the mortgage is not acquisition indebtedness for a period of 10 years after the date of the gift. Neither of these exceptions applies, however, if in order to acquire the equity in the property the organization assumes and agrees to pay the indebtedness secured by the mortgage or makes any payment for the equity in the property. I.R.C. § 514(c)(2)(B).

4. **Performing Exempt Purpose.** Acquisition indebtedness does not include indebtedness the incurrence of which is inherent in the performance or exercise of the organization's exempt purpose or function. I.R.C. § 514(c)(4).
5. **Charitable Gift Annuities.** Acquisition indebtedness does not include any obligation under a gift annuity contract if:
  - a. the obligation is the sole consideration issued in exchange for property;
  - b. the value of the annuity is less than 90 percent of the value of the property received in exchange;
  - c. the obligation is payable over the life or lives of one or two individuals in being at the time the annuity is issued; and
  - d. the obligation is payable under a contract that does not guarantee a minimum amount of payments or specify a maximum amount of

payments and 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. I.R.C. § 514(c)(5).