if (1) such amount was incurred by the employer (without regard to section 461(h)) as of the close of the last taxable year of the VEBA, SUB, or GLSO ending before July 18, 1984, and (2) such amount was actually contributed to the VEBA, SUB, or GLSO within 8½ months following the close of such taxable year.

(b) In addition, section 512(a)(3)(E)(iii)(I) applies to existing reserves for such post-retirement benefits only to the extent that such *existing reserves* do not exceed the amount that could be accumulated under the principles set forth in Revenue Rulings 69–382, 1969–2, C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40. Thus, amounts attributable to such excess *existing reserves* are not within this transition rule eventhough they were actually set aside on July 18, 1984.

(c) All post-retirement medical or life insurance benefits (or other benefits to the extent paid with amounts set aside to provide post-retirement medical or life insurance benefits) provided after July 18, 1984 (whether or not the employer has maintained a reserve or fund for such benefits) are to be charged, first, against the *existing reserves* within this transition rule (including amounts attributable to *existing reserves* within this transition rule) for post-retirement medical benefits or for post-retirement life insurance benefits (as the case may be) and, second, against all other amounts. For this purpose, the qualified direct cost of an asset with a useful life extending substantially beyond the end of the taxable year (as determined under Q&A–6 of § 1.419–1T) will be treated as a benefit provided and thus charged against the *existing reserve* based on the extent to which such asset is used in the provision of post-retirement medical benefits or post-retirement life insurance benefits (as the case may be). All plans of an employer providing post-retirement medical benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III), and all plans of an employer providing post-retirement life insurance benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III).

(d) In calculating the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such organization, the total income of the VEBA, SUB, or GLSO for the taxable year is reduced by the income attributable to *existing reserves* within the transition rule before such income is compared to the excess of the total amount set aside as of the close of the taxable year over the qualified asset account limit for the taxable year. Thus, for example, assume that the total income of a VEBA for a taxable year is $1,000, and that the excess of the total amount of the VEBA set aside as of the close of the taxable year over the applicable qualified asset account limit is $600. Assume also that of the $1,000 of total income, $500 is attributable to *existing reserves* within the transition rule of section 512(a)(3)(E)(iii)(I). The unrelated business income of this VEBA for the taxable year is equal to the lesser of the following two amounts: (1) the total income of the VEBA for the taxable year ($1,000), reduced to the extent that such income is attributable to *existing reserves* within the transition rule ($500); or (2) the excess of the total amount set aside as of the close of the taxable year over the applicable qualified asset account limit ($600). Thus, the unrelated business income of this VEBA for the taxable year is $500.

[T.D. 8073, 51 FR 4332, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986; 51 FR 11303, April 2, 1986]

§ 1.512(b)–1 Modifications.

Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed *rent* by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents. The modifications provided in section 512(b) are as follows:

(a) *Certain Investment Income*—(1) *In general.* Dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulations 26 CFR 1.863–7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

(2) *Limitations.* The exclusions under paragraph (a)(1) of this section do not apply to income derived from and deductions in connection with debt-financed property (as defined in section 514(b)). Moreover, the exclusions under paragraph (a)(1) of this section do not apply to gains or losses from the sale, exchange, or other disposition of any property, or to gains or losses from the lapse or termination of options to buy or sell securities. For rules regarding

the treatment of these gains and losses, see section 512(b)(5) and §1.512(b)–1(d). Furthermore, the exclusions under paragraph (a)(1) of this section do not apply to interest and annuities derived from and deductions in connection with controlled organizations. For rules regarding the treatment of such amounts, see section 512(b)(13) and §1.512(b)–1(l). Finally, the exclusions under paragraph (a)(1) of this section of income from notional principal contracts and income that the Commissioner determines to be substantially similar income from ordinary and routine investments do not apply to income earned by brokers or dealers (including organizations that make a market in derivative financial products, as described in Treasury Regulations 26 CFR 1.954–2T(a)(4)(iii)(B)).

(3) *Effective dates.* The effective dates of the rules of paragraphs (a)(1) and (a)(2) of this section that were in effect prior to August 30, 1991, remain the same. The exclusion under paragraph (a)(1) of this section of income from notional principal contracts is effective for amounts received after August 30, 1991. However, an organization may apply the exclusion under paragraph (a)(1) of this section of income from notional principal contracts prior to that date, provided that such amounts are treated consistently for all open taxable years. Unless otherwise provided by the Commissioner, the exclusion under paragraph (a)(1) of this section of income that the Commissioner determines to be substantially similar income from ordinary and routine investments is effective for amounts received after the date of the Commissioner's determination.

(b) *Royalties.* Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. However, for taxable years beginning after December 31, 1969, certain royalties from and certain deductions in connection with either, debt-financed property (as defined in section 514(b)) or controlled organizations (as defined in paragraph (l) of this section) shall be included in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. To the extent not treated as a loan under section 636, payments in discharge of mineral production payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent treated as a loan under section 636, the amount of any payment in discharge of a production payment which is the equivalent of interest shall be treated as interest for purposes of section 512(b)(1) and paragraph (a) of this section.

(c) *Rents*—(1) *Taxable years beginning before January 1, 1970.* For taxable years beginning before January 1, 1970, rents from real property (including personal property leased with the real property) and the deductions directly connected therewith shall be excluded in computing unrelated business taxable income, except that certain rents from, and certain deductions in connection with, a business lease (as defined in section 514(f)) shall be included in computing unrelated business taxable income. See subparagraph (5) of this paragraph for rules governing amounts received for the rendering of services.

(2) *Taxable years beginning after December 31, 1969*—(i) *In general.* For taxable years beginning after December 31, 1969, except as provided in subdivision (iii) of this subparagraph, rents from property described in subdivision (ii) of this subparagraph, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income. However, notwithstanding subdivision (ii) of this subparagraph, certain rents from and certain deductions in connection with either debt-financed property (as defined in section 514(b)) or property rented to controlled organizations (as defined in paragraph (l) of this section) shall be included in computing unrelated business taxable income.

(ii) *Excluded rents.* The rents which are excluded from unrelated business

income under section 512(b)(3)(A) and this paragraph are:

(*a*) *Real property*. All rents from real property; and

(*b*) *Personal property*. All rents from personal property leased with 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 sonal property are an incidental amount service by the lessee.

For purposes of the preceding sentence, rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. For example, if the rents attributable to the personal property leased are determined to be $3,000 per year, and the total rents from all property leased are $10,000 per year, then such $3,000 amount is not to be excluded from the computation of unrelated business taxable income by operation of section 512(b)(3)(A)(ii) and this paragraph, since such amount is not an incidental portion of the total rents.

(iii) *Exception*. Subdivision (ii) of this subparagraph shall not apply, if either:

(*a*) *Excess personal property rents.* More than 50 percent of the total rents are attributable to personal property, determined at the time such personal property is first placed in service by the lessee; or

(*b*) *Net profits.* The determination of the amount of such rents depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of the gross receipts or sales. For purposes of the preceding sentence, the rules contained in paragraph (b) (3) and (6) (other than paragraph (b)(6)(ii)) of § 1.856–4 shall apply.

(iv) *Illustration*. This subparagraph may be illustrated by the following example:

Example. A, an exempt organization, owns a printing factory which consists of a building housing two printing presses and other equipment necessary for printing. On January 1, 1971, A rents the building and the printing equipment to B for $10,000 a year. The lease states that $9,000 of such rent is for the building and $1,000 for the printing equipment. However, it is determined that notwithstanding the terms of the lease $4,000, or 40 percent ($4,000/$10,000), of the rent is actually attributable to the printing equipment. During 1971, A has $3,000 of deductions, all of which are properly allocable to the land and building. Under these circumstances, A shall not take into account in computing its unrelated business taxable income the $6,000 of rent attributable to the building and the $3,000 of deductions directly connected with such rent. However, the $4,000 of rent attributable to the printing equipment is not excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3)(A)(ii) or this paragraph since such rent represents more than an incidental portion of the total rents.

(3) *Definitions and special rules.* For purposes of subparagraph (2) of this paragraph:

(i) *Real property defined.* The term *real property* means all real property, including any property described in sections 1245(a)(3)(C) and 1250(c) and the regulations thereunder.

(ii) *Personal property defined.* The term *personal property* means all personal property, including any property described in section 1245(a)(3)(B) and the regulations thereunder.

(iii) *Multiple leases.* If separate leases are entered into with respect to real and personal property, and such properties have an integrated use (e.g., one or more leases for real property and another lease or leases for personal property to be used upon such real property), all such leases shall be considered as one lease.

(iv) *Placed in service.* Property is *placed in service* by the lessee when it is first subject to his use in accordance with the terms of the lease. For example, property subject to a lease entered into on November 1, 1971, for a term commencing on January 1, 1972, shall be considered as placed in service on January 1, 1972, regardless of when the property is first actually used by the lessee.

(v) *Changes in rent charged or personal property rented.* If:

(*a*) By reason of the placing of additional or substitute personal property in service, there is an increase of 100 percent or more in the rent attributable to all the personal property leased, or

(*b*) There is a modification of the lease by which there is a change in the

rent charged (whether or not there is a change in the amount of personal property rented), the rent attributable to personal property shall be recomputed to determine whether the exclusion under subparagraph (2)(ii)(*b*) of this paragraph or the exception under subparagraph (2)(iii)(*a*) of this paragraph applies. Any change in the treatment of rents, attributable to a recomputation under this subdivision, shall be effective only with respect to rents for the period beginning with the event which occasioned the recomputation.

(4) *Examples.* Subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1971, A, an exempt organization, executes two leases with B. One is for the rental of a computer, with a stated annual rent of $750. The other is for the rental of office space in which to use the computer, at a stated annual rent of $7,250. The total annual rent under both leases for 1971 is $8,000. At the time the computer is first placed in service, however, taking both leases into consideration, it is determined that notwithstanding the terms of the leases $3,000, or 37.5 percent ($3,000/$8,000), of the rent is actually attributable to the computer. Therefore, for 1971, only the $5,000 ($8,000−$3,000) attributable to the rental of the office space is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 2. Assume the facts as stated in example 1. Assume further that the leases to which the computer and office space are subject in example 1 provide that the rent may be increased or decreased, depending upon the prevailing rental value for similar computers and office space. On January 1, 1972, the total annual rent is increased in the computer lease to $2,000, and in the office space lease to $9,000. For 1972, it is determined that notwithstanding the terms of the leases $6,000, or 54.5 percent ($6,000/$11,000), of the total rent is actually attributable to the computer as of that time. Even though the rent attributable to personal property now exceeds 50 percent of the total rent, the rent attributable to real property will continue to be excluded, since there was no modification of the terms of the leases and since the increase in the rent was not attributable to the placing of new personal property in service. See subparagraph (3)(v) of this paragraph. Thus, for 1972 the $5,000 of rent attributable to the office space continues to be excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 3. Assume the facts as stated in example 1, except that on January 1, 1973, B rents a second computer from A, which is placed in service on that date. The total rent is increased to $2,000 for the computer lease and to $10,000 for the office space lease. It is determined at the time the second computer is first placed in service that notwithstanding the terms of the leases $7,000 of the rent is actually attributable to the computers. Since the rent attributable to personal property has increased by more than 100 percent ($4,000/$3,000=133 percent), a redetermination must be made pursuant to subparagraph (3)(v) (*a*) of this paragraph. As a result, 58.3 percent ($7,000/$12,000) of the total rent is determined to be attributable to personal property. Accordingly, since more than 50 percent of the total rent A receives is attributable to the personal property leased, none of the rents are excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example 4. Assume the facts as stated in example 3, except that on June 30, 1975, the lease between B and A is modified. The total rent for the computer lease is reduced to $1,500 and the total rent for the office space lease is reduced to $7,500. Pursuant to subdivision (3)(v)(*b*) of this paragraph, a redetermination is made as of June 30, 1975. As of the modification date, it is determined that notwithstanding the terms of the leases, the rent actually attributable to the computers is $4,000, or 44.4 percent ($4,000/$9,000), of the total rent. Since less than 50 percent of the total rent is now attributable to personal property, the rent attributable to real property ($5,000), for periods after June 30, 1975, is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3). However, the rent attributable to personal property ($4,000) is not excluded from unrelated business taxable income for such periods by operation of section 512(b)(3), since it represents more than an incidental portion of the total rent.

(5) *Rendering of services.* For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use of occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the

rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

(d)(1) *Gains and losses from the sale, etc. of property.* There shall also be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business. This exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a), as a sale or exchange of such timber. In addition, for taxable years beginning after December 31, 1969, this exclusion does not apply to the gain derived from the sale or other disposition of debt-financed property (as defined in section 514(b)). Otherwise, the exclusion under section 512(b)(5) applies with respect to gains and losses from involuntary conversions, casualties, etc.

(2) There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is *covered.* However, income from the lapse or termination of an option is excludable only if the option is written in connection with the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

(e) *Net operating losses.* (1) The net operating loss deduction provided in section 172 shall be allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a taxable year for which the taxpayer is subject to the provisions of section 511) shall be determined under section 172 without taking into account any amount of income or deduction which is not included under section 511 in computing unrelated business taxable income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income.

(2) For the purpose of computing the net operating loss deduction provided by section 172, any prior taxable year for which an organization was not subject to the provisions of section 511, or a corresponding provision of prior law, shall not be taken into account. Thus, if the organization was not subject to the provisions of section 511 or Supplement U of the Internal Revenue Code of 1939 for a preceding taxable year, the net operating loss is not a carryback to such preceding taxable year, and the net operating loss carryover to succeeding taxable years is not reduced by the taxable income for such preceding taxable year.

(3) A net operating loss carryback or carryover shall be allowed only from a taxable year for which the taxpayer is subject to the provisions of section 511, or a corresponding provision of prior law.

(4) In determining the span of years for which a net operating loss may be carried for purposes of section 172, taxable years in which an organization was not subject to the provisions of

section 511 or a corresponding provision of prior law shall be taken into account. Thus, for example, if an organization is subject to the provisions of section 511 for the taxable year 1955 and has a net operating loss for that year, the last taxable year to which any part thereof may be carried over is the year 1960 regardless of whether the organization is subject to the provisions of section 511 in any of the intervening taxable years.

(f) *Research.* (1) Income derived from research for the United States or any of its agencies or instrumentalities or a State or political subdivision thereof, and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(2) In the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(3) In the case of an organization operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research) the results of which are freely available to the general public, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income.

(4) For the purpose of §§1.512(a)–1, 1.512(a)–2, and this section, the term *research* does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term *fundamental research* does not include research carried on for the primary purpose of commercial or industrial application.

(g) *Charitable, etc., contributions.* (1) In computing the unrelated business taxable income of an organization described in section 511(a)(2) the deduction from gross income allowed by section 170 (relating to charitable contributions and gifts) shall be allowed, whether or not the contribution is directly connected with the carrying on of the trade or business. Section 512(b)(10) provides that this deduction shall not exceed 5 percent of the organization's unrelated business taxable income computed without regard to that deduction. The provisions of section 170(b)(2) are not applicable to contributions by the organizations described in section 511(a)(2).

(2) In computing the unrelated business taxable income of a trust described in section 511(b)(2), the deduction allowed by section 170 (relating to charitable contributions and gifts) shall be allowed whether or not the contribution is directly connected with the carrying on of the trade or business. The deduction is limited as provided in section 170(b)(1) (A) and (B), except that the amounts so allowed are determined on the basis of unrelated business taxable income computed without regard to this deduction (rather than on the basis of adjusted gross income). For purposes of this deduction, a distribution by a trust described in section 511(b)(2) made pursuant to the trust instrument to a beneficiary described in section 170 shall be treated in the same manner as gifts or contributions.

(3) The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

(h) *Specific deduction*—(1) *In general.* In computing unrelated business taxable income a specific deduction from gross income of $1,000 is allowed. However, for taxable years beginning after December 31, 1969, such specific deduction is not allowed in computing the net operating loss under section 172 and paragraph (6) of section 512(b).

(2) *Special rule for a diocese, province of a religious order, or a convention or association of churches.* (i) In the case of a

diocese, province of a religious order, or a convention or association of churches, there shall be allowed with respect to each parish, individual church, district, or other local unit a specific deduction equal to the lower of $1,000 or the gross income derived from an unrelated trade or business regularly conducted by such local unit. However, a diocese, province of a religious order, or a convention or association of churches shall not be entitled to a specific deduction for a local unit which, for a taxable year, files a separate return. In the case of a local unit which, for a taxable year, files a separate return, such local unit may claim a specific deduction equal to the lower of $1,000 or the gross income derived from any unrelated trade or business which it regularly conducts.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. X is an association of churches on the calendar year basis. X is divided into local units A, B, C, and D. During 1973, A, B, C, and D derive gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses which they regularly conduct. Furthermore, for such taxable year, D files a separate return. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, and $1,000 with respect to C. X may not claim a specific deduction with respect to D. D, however, may claim a specific deduction of $700 on its return.

(i) *Transitional period for churches.* (1)(i) In the case of an unrelated trade or business (as defined in section 513) carried on before May 27, 1969, by a church or convention or association of churches (as defined in §1.511–2(a)(3)(ii)), or by the predecessor of a church or convention or association of churches which predecessor was itself a church or convention or association of churches, all gross income derived from such unrelated trade or business and all deductions directly connected with the carrying on of such unrelated trade or business shall be excluded from the determination of unrelated business taxable income under section 512(a) for all taxable years beginning before January 1, 1976. Notwithstanding the preceding sentence, in the case of income from debt-financed property (and the deductions attributable thereto), as defined in section 514, of a church or convention or association of churches or by the predecessor of a church or convention or association of churches, the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b) shall apply for taxable years beginning after December 31, 1969.

(ii) The provisions of subdivision (i) may be illustrated by the following example:

Example. X, a church as defined in §1.511–2(a)(3)(ii), realizes gross income from an unrelated business (as defined in section 513) of $100,000 for calendar year 1972. X's predecessor church, Y, began conducting such unrelated business in January 1, 1968. Of the $100,000 realized for calendar year 1972, $40,000 is attributable to debt-financed property (as defined in section 514). Since the unrelated business was conducted by Y prior to May 27, 1969, and since X's taxable year begins before January 1, 1976, that amount of the income realized from such business (and all deductions directly connected therewith) which is not attributable to debt-financed property shall be excluded from the determination of unrelated business taxable income under section 512(a). Therefore, of the $100,000 realized, $60,000 ($100,000 less $40,000 attributable to debt-financed property), and all deductions directly connected therewith shall be excluded from the determination of such unrelated business taxable income for purposes of imposition of the tax under section 511(a). The remaining $40,000 and the deductions attributable thereto shall be subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(2) This paragraph shall not apply in the case of income from property, or deductions directly connected with such income, if title to the property is held by a corporation described in section 501(c)(2) for a church or convention or association of churches. Thus, if such income is derived from an unrelated trade or business, the corporation shall be liable for tax imposed by section 511(a) on such income.

(j) *Special rule for certain unrelated trades or businesses carried on by a religious order or by an educational institution maintained by such order.* (1) Except as provided in subparagraph (2) of this paragraph, gross income realized by a religious order (or an educational organization described in section 170(b)(1)(A)(ii) maintained by such

order) from an unrelated trade or business, together with all deductions directly connected therewith, shall be excluded from the determination of unrelated business taxable income under section 512(a), if:

(i) The trade or business has been operated by such order or by such institution since before May 27, 1959,

(ii) The trade or business consists of providing services under a license issued by a Federal regulatory agency,

(iii) More than 90 percent of the net income from the business is, for each taxable year for which gross income from such business is so excluded by reason of section 512(b)(15) and this paragraph, devoted to religious, charitable, or educational purposes, and

(iv) It is established to the satisfaction of an officer no lower than the Regional Commissioner that the rates or other charges for such services are fully competitive with rates or other charges charged for such services by persons not exempt from taxation. Rates or other charges for such services shall be considered as fully competitive with rates or other charges charged for such services by persons not exempt from taxation if the rates charged by such unrelated trade or business are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

(2) The provisions of this paragraph shall not apply with respect to income from debt-financed property (as defined in section 514) and the deductions attributable thereto. For taxable years beginning after December 31, 1969, such income and deductions are subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(k) *Income and deductions from debt-financed property.* For taxable years beginning after December 31, 1969, in the case of debt-financed property (as defined in section 514(b)), there shall be included in the unrelated business taxable income of an exempt organization, as an item of gross income derived from an unrelated trade or business, the amount of unrelated debt-financed income determined under section 514(a)(1) and §1.514(a)–1(a), and there shall be allowed, as a deduction with respect to such income, the amount determined under section 514(a)(2) and §1.514(a)–1(b).

(l) *Interest, annuities, royalties, and rents from controlled organizations*—(1) *In general.* For taxable years beginning after December 31, 1969, if an exempt organization (hereinafter referred to as the *controlling organization*) has control (as defined in subparagraph (4) of this paragraph) of another organization (hereinafter referred to as the *controlled organization*), the controlling organization shall include as an item of gross income in computing its unrelated business taxable income, the amount of interest, annuities, royalties, and rents derived from the controlled organization determined under subparagraph (2) or (3) of this paragraph. The preceding sentence shall apply whether or not the activity conducted by the controlling organization to derive such amounts represents a trade or business or is regularly carried on. Thus, amounts received by a controlling organization from the rental of its real property to a controlled organization may be included in the unrelated business taxable income of the controlling organization, even though the rental of such property is not an activity regularly carried on by the controlling organization.

(2) *Exempt controlled organization*—(i) *In general.* If the controlled organization is exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the unrelated business taxable income of the controlled organization bears to whichever of the following amounts is the greater:

(*a*) The taxable income of the controlled organization, computed as though the controlled organization were not exempt from taxation under section 501(a), or

(*b*) The unrelated business taxable income of the controlled organization,

both determined without regard to any amounts paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions directly connected with

amounts included in gross income under the preceding sentence.

(ii) *Examples.* This subparagraph may be illustrated by the following examples:

Example 1. A, an exempt scientific organization described in section 501(c)(3), owns all the stock of B, another exempt scientific organization described in section 501(c)(3). During 1971, A rents space for a laboratory to B for $15,000 a year. A's total deductions for 1971 with respect to the leased property are $3,000: $1,000 for maintenance and $2,000 for depreciation. If B were not an exempt organization, its total taxable income would be $300,000, disregarding rent paid to A. B's unrelated business taxable income, disregarding rent paid to A, is $100,000. Under these circumstances, $4,000 of the rent paid by B will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

B's unrelated business taxable income (disregarding rent paid to A)	$100,000
B's taxable income (computed as though B were not exempt and disregarding rent paid to A)	300,000
Ratio ($100,000/$300,000)	1/3
Total rent	15,000
Total deductions	3,000
Rental income treated as gross income from an unrelated trade or business (1/3 of $15,000)	5,000
Less deductions directly connected with such income (1/3 of $3,000)	1,000
Net rental income included by A in computing its unrelated business taxable income	$4,000

Example 2. Assume the facts as stated in example 1, except that B's taxable income is $90,000 (computed as though B were not an exempt organization, and disregarding rents paid to A). B's unrelated business taxable income ($100,000) is therefore greater than its taxable income ($90,000). Thus, the ratio used to determine the portion of rent received by A which is to be taken into account is one since both the numerator and denominator of such ratio is B's unrelated business taxable income. Consequently, all the rent received by A from B ($15,000), and all the deductions directly connected therewith ($3,000), are included by A in computing its unrelated business taxable income.

(3) *Nonexempt controlled organization*—(i) *In general.* If the controlled organization is not exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the *excess taxable income* (as defined in subdivision (ii) of this subparagraph) of the controlled organization bears to whichever of the following amounts is the greater:

(*a*) The taxable income of the controlled organization, or

(*b*) The excess taxable income of the controlled organization,

both determined without regard to any amount paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions which are directly connected with amounts included in gross income under the preceding sentence.

(ii) *Excess taxable income.* For purposes of this paragraph, the term *excess taxable income* means the excess of the controlled organization's taxable income over the amount of such taxable income which, if derived directly by the controlling organization, would not be unrelated business taxable income.

(iii) *Examples.* This subparagraph may be illustrated by the following examples:

Example 1. A, an exempt university described in section 501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A: $150,000 from a dormitory for students of A university, and $350,000 from the operation of a factory which is a business unrelated to A's exempt purpose. A's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

M's taxable income (disregarding rent paid to A)	$500,000
Less taxable income from dormitory	150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7/10
Total rent paid to A	$100,000
Total deductions ($4,000+$16,000)	20,000
Rental income treated as gross income from an unrelated trade or business (7/10 of $100,000)	70,000
Less deductions directly connected with such income (7/10 of $20,000)	14,000
Net rental income included by A in computing its unrelated business taxable income	$56,000

Example 2. Assume the facts as stated in example 1, except that M's taxable income

(disregarding rent paid to A) is $300,000, consisting of $350,000 from the operation of the factory and a $50,000 loss from the operation of the dormitory. Thus, M's *excess taxable income* is also $300,000, since none of M's taxable income would be excluded from the computation of A's unrelated business taxable income if received directly by A. The ratio of M's *excess taxable income* to its taxable income is therefore one ($300,000/$300,000). Thus, all the rent received by A from M ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of A's unrelated business taxable income.

(4) *Control*—(i) *In general.* For purposes of this paragraph—

(*a) Stock corporation.* In the case of an organization which is a stock corporation, the term *control* means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

(*b) Nonstock organization.* In the case of a nonstock organization, the term *control* means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.

(ii) *Gain or loss of control.* If control of an organization (as defined in subdivision (i) of this subparagraph) is acquired or relinquished during the taxable year, only the interest, annuities, royalties, and rents paid or accrued to the controlling organization in accordance with its method of accounting for that portion of the taxable year it has control shall be subject to the tax on unrelated business income.

(5) *Amounts taxable under other provisions of the Code*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, section 512(b)(13) and this paragraph do not apply to amounts which are included in the computation of unrelated business taxable income by operation of any other provision of the Code. However, amounts which are not included in unrelated business taxable income by operation of section 512(a)(1), or which are excluded by operation of section 512(b) (1), (2), or (3), may be included in unrelated business taxable income by operation of section 512(b)(13) and this paragraph.

(ii) *Debt-financed property.* Rents derived from the lease of debt-financed property by a controlling organization to a controlled organization are subject to the rules contained in section 512(b)(13) and this paragraph. Thus, if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization's unrelated business taxable income shall first be determined under section 512(b)(13) and this paragraph, and only the portion of such rents not taken into account by operation of section 512(b)(13) are taken into account by operation of section 514. See example 3 of § 1.514(b)–1(b)(3).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7177, 37 FR 7089, Apr. 8, 1972; T.D. 7183, 37 FR 7885, Apr. 21, 1972; T.D. 7261, 38 FR 5466, Mar. 1, 1973; 38 FR 6387, Mar. 9, 1973; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7767, 46 FR 11265, Feb. 6, 1981; T.D. 8423, 57 FR 33443, July 29, 1992; 57 FR 42490, Sept. 15, 1992]

§ 1.512(c)–1 Special rules applicable to partnerships; in general.

In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)–1. For example, if an exempt educational institution is a