

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

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

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

is treated as unrelated debt-financed income.

(b) *Exceptions—(1) Property related to certain exempt purposes.* (i) To the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function designated in section 501(c)(3)) such property shall not be treated as *debt-financed property*. See § 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

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

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

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

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

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

Example 1. W, an exempt organization, owns a computer with respect to which there is an outstanding principal indebtedness and which is used by W in the performance of its exempt purpose. W sells time for the use of the computer to M corporation on occasions when the computer is not in full-time use by W. W uses the computer in furtherance of its

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exempt purpose more than 85 percent of the time it is in use and M uses the computer less than 15 percent of the total operating time the computer is in use. In this situation, substantially all the use of the computer is related to the performance of W's exempt purpose. Therefore, no portion of the computer is treated as debt-financed property.

Example 2. X, an exempt college, owns a four story office building which has been purchased with borrowed funds. In 1971, the lower two stories of the building are used to house computers which are used by X for administrative purposes. The top two stories are rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The gross income derived by X from the building is \$6,000, all of which is attributable to the rents paid by tenants. There are \$2,000 of expenses, allocable equally to each use of the building. The average adjusted basis of the building for 1971 is \$100,000, and the outstanding principal indebtedness throughout 1971 is \$60,000. Thus, the average acquisition indebtedness for 1971 is \$60,000. In accordance with subdivision (i) of this subparagraph, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with such income are to be taken into account in computing unrelated business taxable income. The portion of such amounts to be taken into account is determined by multiplying the \$6,000 of rental income and \$1,000 of deductions directly connected with such rental income by the debt/basis percentage. The debt/basis percentage is the ratio which the allocable part of the average acquisition indebtedness is of the allocable part of the average adjusted basis of the property, that is, the ratio which \$30,000 (one-half of \$60,000) bears to \$50,000 (one-half of \$100,000). Thus, the debt/basis percentage for 1971 is 60 percent (the ratio of \$30,000 to \$50,000). Under these circumstances, X shall include net rental income of \$3,000 in its unrelated business taxable income for 1971, computed as follows:

Total rental income	\$6,000
Deductions directly connected with rental income	\$1,000
Debt/basis percentage (\$30,000/\$50,000)	60%
Rental income treated as gross income from an unrelated trade or business (60 percent of \$6,000)	\$3,600
Less the allowable portion of deductions directly connected with such income (60 percent of \$1,000)	\$600
Net rental income included by X in computing its unrelated business taxable income pursuant to section 514	\$3,000

Example 3. Assume the facts as stated in example 2 except that on December 31, 1971, X sells the building and realizes a long-term

capital gain of \$10,000. This is X's only capital transaction for 1971. An allocable portion of this gain is subject to tax. This amount is determined by multiplying the gain related to the nonexempt use, \$5,000 (one-half of \$10,000), by the ratio which the indebtedness for the 12-month period preceding the date of sale, \$30,000 (one-half of \$60,000), is of the allocable part of the average adjusted basis, \$50,000 (one-half of \$100,000). Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 60 percent (the ratio of \$30,000 to \$50,000). Consequently, \$3,000 (60 percent of \$5,000) is a net section 1201 gain (capital gain net income for taxable years beginning after December 31, 1976). The portion of such gain which is taxable shall be determined in accordance with rules contained 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) *Property used in an unrelated trade or business—(i) In general.* To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, such property shall not be treated as *debt-financed property*. However, any gain on the disposition of such property which is not included in the income of an unrelated trade or business by reason of section 512(b)(5) is includible as gross income derived *from or on account of debt-financed property* under paragraph (a)(1) of § 1.514(a)-1.

(ii) *Amounts specifically taxable under other provisions of the Code.* Section 514 does not apply to amounts which are otherwise included in the computation of unrelated business taxable income, such as rents from personal property includible pursuant to section 512(b)(13) or rents and interest from controlled organizations includible pursuant to section 512(b)(3). See paragraph (1)(5) of § 1.512(b)-1 for the rules determining the manner in which amounts are taken into account where such amounts may be included in the computation of unrelated business taxable income by operation of more than one provision of the Code.

(3) *Examples.* Subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example 1. X, an exempt scientific organization, owns a 10-story office building. During 1972, four stories are occupied by X's administrative offices, and the remaining six stories are rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). On December 31, 1972, the building is sold and X realizes a long-term capital gain of \$100,000. This is X's only capital transaction for 1972. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 30 percent. Since 40 percent of the building was used for X's exempt purpose, only 60 percent of the building is debt-financed property. Thus, only \$60,000 of the gain (60 percent of \$100,000) is subject to this section. Consequently, the amount of gain treated as unrelated debt-financed income is \$18,000 (\$60,000 multiplied by the debt/basis percentage of 30 percent). The portion of such \$18,000 which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

Example 2. Y, an exempt organization, owns two properties, a restaurant and an office building. In 1972, all the space in the office building, except for the portion utilized by Y to house the administrative offices of the restaurant, is rented to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The average adjusted basis of the office building for 1972 is \$2 million. The outstanding principal indebtedness throughout 1972 is \$1 million. Thus, the highest acquisition indebtedness in the calendar year of 1972 is \$1 million. It is determined that 30 percent of the space in the office building is used for the administrative functions engaged in by the employees of the organization with respect to the restaurant. Since the income attributable to the restaurant is attributable to the conduct of an unrelated trade or business, only 70 percent of the building is treated as debt-financed property for purposes of determining the portion of the rental income which is unrelated debt-financed income. On December 31, 1972, the office building is sold and Y realizes a long-term capital gain of \$250,000. This is Y's only capital transaction for 1972. In accordance with subparagraph (2)(i) of this paragraph, all the gain derived from this sale is taken into account in computing the amount of such gain subject to tax. The portion of such gain which is taxable is determined by multiplying the \$250,000 gain by the debt/basis percentage. The debt/basis percentage is the ratio which the highest acquisition indebtedness for the 12-month period preceding the date of sale, \$1 million, is of the average adjusted basis, \$2 million. Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the

sale of the building is 50 percent (the ratio of \$1 million to \$2 million). Consequently, \$125,000 (50 percent of \$250,000) is a net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976). The amount of such gain which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder.

Example 3. (a) Z, an exempt university, owns all the stock of M, a nonexempt corporation. During 1971 M leases from Z University a factory unrelated to Z's exempt purpose and a dormitory for the students of Z, for a total annual rent of \$100,000: \$80,000 for the factory and \$20,000 for the dormitory. During 1971, M has \$500,000 of taxable income, disregarding the rent paid to Z: \$150,000 from the dormitory and \$350,000 from the factory. The factory is subject to a mortgage of \$150,000. Its average adjusted basis for 1971 is determined to be \$300,000. Z's deductions for 1971 with respect to the leased property are \$4,000 for the dormitory and \$16,000 for the factory. In accordance with subdivision (ii) of this subparagraph, section 514 applies only to that portion of the rent which is excluded from the computation of unrelated business taxable income by operation of section 512(b)(3) and not included in such computation pursuant to section 512(b)(13). Since all the rent received by Z is derived from real property, section 512(b)(3) would exclude all such rent from computation of Z's unrelated business taxable income. However, 70 percent of the rent paid to Z with respect to the factory and 70 percent of the deductions directly connected with such rent shall be taken into account by Z in determining its unrelated business taxable income pursuant to section 512(b)(15), computed as follows:

M's taxable income (disregarding rent paid to Z)	\$500,000
Less taxable income from dormitory	\$150,000
Excess taxable income	\$350,000
Ratio (\$350,000/\$500,000)	$\frac{7}{10}$
Total rent paid to Z	\$100,000
Total deductions (\$4,000+\$16,000)	\$20,000
Rental income treated under section 512(b)(15) as gross income from an unrelated trade or business ($\frac{7}{10}$ of \$100,000)	\$70,000
Less deductions directly connected with such income ($\frac{7}{10}$ of \$20,000)	\$14,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 512(b)(15)	\$56,000

(b) Since only that portion of the rent derived from the factory and the deductions directly connected with such rent not taken into account pursuant to section 512(b)(15) may be included in computing unrelated business taxable income by operation of section 514, only \$10,000 (\$80,000 minus \$70,000) of

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rent and \$2,000 (\$16,000 minus \$14,000) of deductions are so taken into account. The portion of such amounts to be taken into account is determined by multiplying the \$10,000 of income and \$2,000 of deductions by the debt/basis percentage. The debt/basis percentage is the ratio which the average acquisition indebtedness (\$150,000) is of the average adjusted basis of the property (\$300,000). Thus, the debt/basis percentage for 1971 is 50 percent (the ratio of \$150,000 to \$300,000). Under these circumstances, Z shall include net rental income of \$4,000 in its unrelated business taxable income for 1971, computed as follows:

Total rents	\$10,000
Deductions directly connected with such rents ...	\$2,000
Debt/basis percentage (\$150,000/\$300,000)	50%
Rental income treated as gross income from an unrelated trade or business (50 percent of \$10,000)	\$5,000
Less the allowable portion of deductions directly connected with such income (50 percent of \$2,000)	\$1,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 514	\$4,000

(4) *Property related to research activities.* To the extent that the gross income from any property is derived from research activities excluded from the tax on unrelated business income by paragraph (7), (8), or (9) of section 512(b), such property shall not be treated as *debt-financed property*.

(5) *Property used in thrift shops, etc.* To the extent that property is used in any trade or business which is excepted from the definition of *unrelated trade or business* by paragraph (1), (2), or (3) of section 513(a), such property shall not be treated as *debt-financed property*.

(6) *Use by a related organization.* For purposes of subparagraph (1), (4), or (5) of this paragraph, use of property by a related exempt organization (as defined in paragraph (c)(2)(ii) of this section) for a purpose described in such subparagraphs shall be taken into account in order to determine the extent to which such property is used for a purpose described in such subparagraphs.

(c) *Special rules—(1) Medical clinic.* Property is not debt-financed property if it is real property subject to a lease to a medical clinic, and the lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by the lessor of its charitable, educational, or other purpose or

function constituting the basis for its exemption under section 501. For example, assume that an exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons who, by the provisions of the lease, agree to provide all of the hospital's out-patient medical and surgical services and to train all of the hospital's residents and interns. In this situation, the rents received by the hospital from this clinic are not to be treated as unrelated debt-financed income.

(2) *Related exempt uses—(i) In general.* Property owned by a related exempt organization and used by a related exempt organization or by an exempt organization related to such related exempt organization shall not be treated as *debt-financed property* to the extent such property is used by either organization in furtherance of the purpose constituting the basis for its exemption under section 501. Furthermore, property shall not be treated as *debt-financed property* to the extent such property is used by a related exempt organization for a purpose described in paragraph (b)(4) or (5) of this section.

(ii) *Related organizations.* For purposes of subdivision (i) of this subparagraph, an exempt organization is related to another exempt organization only if:

(a) One organization is an exempt holding company described in section 501(c)(2) and the other organization receives the profits derived by such exempt holding company,

(b) One organization has control of the other organization within the meaning of paragraph (1)(4) of § 1.512(b)-1,

(c) More than 50 percent of the members of one organization are members of the other organization, or

(d) Each organization is a local organization which is directly affiliated with a common state, national, or international organization which is also exempt.

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

Example 1. M, an exempt trade association described in section 501(c)(6), leases 70 percent of the space of an office building for furtherance of its exempt purpose. The title to such building is held by N, an exempt holding company described in section 501(c)(2), which acquired title to the building with borrowed funds. The other 30 percent of the space in this office building is leased to L, a nonstock exempt trade association described in section 501(c)(6). L uses such office space in furtherance of its exempt purpose. The members of L's Board of Trustees serves for fixed terms and M's Board of Directors has the power to select all such members. N pays over to M all the profits it derives from the leasing of space in this building to M and L. Accordingly, M is *related* to N (as such term is defined in subdivision (i)(a) of this subparagraph) and L is *related* to M (as such term is defined in subdivision (i)(b) of this subparagraph). Under these circumstances, since all the available space in the building is leased to either an exempt organization related to the exempt organization holding title to the building or an exempt organization related to such related exempt organization, no portion of the building is treated as debt-financed property.

Example 2. W, an exempt labor union described in section 501(c)(5), owns a 10-story office building which has been purchased with borrowed funds. Five floors of the building are used by W in furtherance of its exempt purpose. Four of the other floors are rented to X which is an exempt voluntary employees' beneficiary association described in section 501(c)(9), operated for the benefit of W's members. X uses such office space in furtherance of its exempt purpose. Seventy percent of the members of W are also members of X. Accordingly, X is *related* to W (as such term is defined in subdivision (i)(c) of this subparagraph). The remaining floor of the building is rented to the general public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). Under these circumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose. See paragraph (b)(1) of this section for rules relating to the use of property substantially related to an exempt purpose. See paragraph (b)(6) of this section for rules relating to uses by related exempt organizations.

Example 3. Assume the same facts as in example 2, except that W and X are each exempt local labor unions described in section 501(c)(5) having no common membership and are each affiliated with N, an exempt international labor union described in section 501(c)(5). Under these circumstances, no portion of this building is treated as debt-fi-

nanced property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose.

Example 4. Assume the same facts as in example 3, except that W and X are directly affiliated with different exempt international labor unions and that W and X are not otherwise affiliated with, or members of, a common exempt organization, other than an association of international labor unions. Under these circumstances, the portions of this building which are rented to X and to the general public are treated as debt-financed property since X is not related to W and W uses less than 85 percent of the building for its exempt purpose.

(3) *Life income contracts.* (i) Property shall not be treated as *debt-financed property* when:

(a) An individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to him or other individuals or both for a period of time not to exceed the life of such individual or individuals in a transaction in which the payments to the individual or individuals do not constitute the proceeds of a sale or exchange of the property so transferred, and

(b) The remainder interest is payable to an exempt organization described in section 501(c)(3).

(ii) Subdivision (i) of this subparagraph is illustrated by the following example.

Example. On January 1, 1967, A transfers property to X, an exempt organization described in section 501(c)(3), which immediately places the property in a fund. On January 1, 1971, A transfers additional property to X, which property is also placed in the fund. In exchange for each transfer, A receives income participation fund certificates which entitle him to a proportionate part of the fund's income for his life and for the life of another individual. None of the payments made by X are treated by the recipients as the proceeds of a sale or exchange of the property transferred. In this situation, none of the property received by X from A is treated as debt-financed property.

(d) *Property acquired for prospective exempt use—(1) Neighborhood land—* (i) *In general.* If an organization acquires real property for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 10 years of the time of acquisition, such property will not be

treated as debt-financed property, so long as (a) such property is in the neighborhood of other property owned by the organization which is used in the performance of its exempt purpose, and (b) the organization does not abandon its intent to use the land in such a manner within the 10-year period. The rule expressed in this subdivision is hereinafter referred to as the *neighborhood land rule*.

(ii) *Neighborhood* defined. Property shall be considered in the *neighborhood* of property owned and used by the organization in the performance of its exempt purpose if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property. If the acquired property is not contiguous with exempt function property, it may still be in the *neighborhood* of such property, but only if it is within 1 mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. Some of the criteria to consider in determining this question include the availability of land and the intended future use of the land. For example, a university attempts to purchase land contiguous to its present campus but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university purchases such land. Under these circumstances, the contiguity requirement is unreasonable and the land purchased would be considered *neighborhood land*.

(iii) *Exception*. The neighborhood land rule shall not apply to any property after the expiration of 10 years from the date of acquisition. Further, the neighborhood land rule shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Commissioner that future use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 10-year period is reasonably certain. In order to satisfy the Commissioner, the organization does not necessarily have to show binding

contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative action toward the fulfillment of such a plan. This information shall be forwarded to the Commissioner of Internal Revenue, Washington, DC 20224, for a ruling at least 90 days before the end of the fifth year after acquisition of the land.

(2) *Actual use*. If the neighborhood land rule is inapplicable because:

(i) The acquired land is not in the neighborhood of other property used by the organization in performance of its exempt purpose, or

(ii) The organization (for the period after the first 5 years of the 10-year period) is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purposes within the 10-year period is reasonably certain,

but the land is actually used by the organization in furtherance of its exempt purpose within the 10-year period, such property (subject to the provisions of subparagraph (4) of this paragraph) shall not be treated as debt-financed property for any period prior to such conversion.

(3) *Limitations*—(i) *Demolition or removal required*. (a) Subparagraphs (1) and (2) of this paragraph shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in such a manner. Thus, during the first 5 years after acquisition (and for subsequent years if there is a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph) improved property is not debt-financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. Furthermore, if there is an actual demolition of such structures, the use made of the land need not be the one originally intended. Therefore, the actual use requirement of this subdivision may be

satisfied by using the land in any manner which furthers the exempt purpose of the organization.

(b) Subdivision (i)(a) of this subparagraph may be illustrated by the following examples. For purposes of the following examples it is assumed that but for the application of the neighborhood land rule such property would be debt-financed property.

Example 1. An exempt university acquires a contiguous tract of land on which there is an apartment building. The university intends to demolish the apartment building and build classrooms and does not abandon this intent during the first 4 years after acquisition. In the fifth year after acquisition it abandons the intent to demolish and sells the apartment building. Under these circumstances, such property is not debt-financed property for the first 4 years after acquisition even though there was no eventual demolition or use made of such land in furtherance of the university's exempt purpose. However, such property is debt-financed property as of the time in the fifth year that the intent to demolish the building is abandoned and any gain on the sale of property is subject to section 514.

Example 2. Assume the facts as stated in Example 1 except that the university did not abandon its intent to demolish the existing building and construct a classroom building until the eighth year after acquisition when it sells the property. Assume further that the university did not receive a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is debt-financed property for the sixth, seventh, and eighth years. It is not, however, treated as debt-financed property for the first 5 years after acquisition.

Example 3. Assume the facts as stated in Example 2 except that the university received a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is not debt-financed property for the first 7 years after acquisition. It only becomes debt-financed property as of the time in the eighth year when the university abandoned its intent to demolish the existing structure.

Example 4. (1) Assume that a university acquires a contiguous tract of land containing an office building for the principal purpose of demolishing the office building and building a modern dormitory. Five years later the dormitory has not been constructed, and the university has failed to satisfy the Commissioner that the office building will be demolished and the land will be used in furtherance of its exempt purpose (and consequently has failed to obtain a favorable ruling under subparagraph (1)(iii) of this paragraph). In

the ninth taxable year after acquisition the university converts the office building into an administration building. Under these circumstances, during the sixth, seventh, and eighth years after acquisition, the office building is treated as debt-financed property because the office building was not demolished or removed. Therefore, the income derived from such property during these years shall be subject to the tax on unrelated business income.

(2) Assume that instead of converting the office building to an administration building, the university demolishes the office building in the ninth taxable year after acquisition and then constructs a new administration building. Under these circumstances, the land would not be considered debt-financed property for any period following the acquisition, and the university would be entitled to a refund of taxes paid on the income derived from such property for the sixth through eighth taxable years after the acquisition in accordance with subparagraph (4) of this paragraph.

(ii) *Subsequent construction.* Subparagraphs (1) and (2) of this paragraph do not apply to structures erected on the land after the acquisition of the land.

(iii) *Property subject to business lease.* Subparagraphs (1) and (2) of this paragraph do not apply to property subject to a lease which is a business lease (as defined in § 1.514(f)-1) whether the organization acquired the property subject to the lease or whether it executed the lease subsequent to acquisition. If only a portion of the real property is subject to a lease, paragraph (c) of § 1.514(f)-1 applies in determining whether such lease is a business lease.

(4) *Refund of taxes.* (i) If an organization has not satisfied the actual use condition of subparagraph (2) of this paragraph or paragraph (e)(3) of this section before the date prescribed by law (including extensions) for filing the return for the taxable year, the tax for such year shall be computed without regard to the application of such actual use condition. However, if:

(a) A credit or refund of any overpayment of taxes is allowable for a prior taxable year as a result of the satisfaction of such actual use condition, and

(b) Such credit or refund is prevented by the operation of any law or rule of law (other than chapter 74, relating to closing agreements and compromises), such credit or refund may nevertheless be allowed or made, if a claim is filed

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within 1 year after the close of the taxable year in which such actual use condition is satisfied. For a special rule with respect to the payment of interest at the rate of 4 percent per annum, see section 514(b)(3)(D), prior to its amendment by section 7(b) of the Act of January 3, 1975 (Pub. L. 93-625, 88 Stat. 2115).

(ii) This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that but for the neighborhood land rule such property would be debt-financed property.

Example. Y, a calendar year exempt organization, acquires real property in January 1970, which is contiguous with other property used by Y in furtherance of its exempt purpose. However, Y does not satisfy the Commissioner by January 1975, that the existing structure will be demolished and the land will be used in furtherance of its exempt purpose. In accordance with this subparagraph, from 1975 until the property is converted to an exempt use, the income derived from such property shall be subject to the tax on unrelated business income. During July 1979, Y demolishes the existing structure on the land and begins using the land in furtherance of its exempt purpose. At this time Y may file claims for refund for the open years 1976 through 1978. Further, in accordance with this subparagraph, Y may also file a claim for refund for 1975, even though a claim for such taxable year may be barred by the statute of limitations, provided such claim is filed before the close of 1980.

(e) *Churches*—(1) *In general.* If a church or association or convention of churches acquires real property, for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 15 years of the time of acquisition, such property shall not be treated as debt-financed property so long as the organization does not abandon its intent to use the land in such a manner within the 15-year period.

(2) *Exception.* This paragraph shall not apply to any property after the expiration of the 15-year period. Further, this paragraph shall apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the Commissioner that use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 15-year pe-

riod is reasonably certain. For purposes of the preceding sentence, the rules contained in paragraph (d)(1)(iii) of this section with respect to satisfying the Commissioner that the exempt organization intends to use the land within the prescribed time in furtherance of its exempt purpose shall apply.

(3) *Actual use.* If the church or association or convention of churches for the period after the first 5 years of the 15-year period is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purpose within the 15-year period is reasonably certain, but such land is in fact converted to an exempt use within the 15-year period, the land (subject to the provisions of paragraph (d)(4) of this section) shall not be treated as debt-financed property for any period prior to such conversion.

(4) *Limitations.* The limitations stated in paragraph (d)(3)(i) and (ii) of this section shall similarly apply to the rules contained in this paragraph.

[T.D. 7229, 37 FR 28146, Dec. 21, 1972; 39 FR 6607, Feb. 21, 1974, as amended by T.D. 7384, 40 FR 49322, Oct. 22, 1975; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§ 1.514(c)-1 Acquisition indebtedness.

(a) *In general*—(1) *Definition of acquisition indebtedness.* For purposes of section 514 and the regulations thereunder, the term *acquisition indebtedness* means, with respect to any debt-financed property, the outstanding amount of:

(i) The principal indebtedness incurred by the organization in acquiring or improving such property.

(ii) The principal 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

(iii) The principal 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.