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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.

Whether the incurrence of an indebtedness is reasonably foreseeable depends upon the facts and circumstances of each situation. The fact that an organization did not actually foresee the need for the incurrence of an indebtedness prior to the acquisition or improvement does not necessarily mean that the subsequent incurrence of indebtedness was not reasonably foreseeable.

(2) *Examples.* The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. X, an exempt organization, pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase an office building which it leases to the public for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D). The outstanding principal indebtedness with respect to the loan constitutes acquisition indebtedness incurred prior to the acquisition which would not have been incurred but for such acquisition.

Example 2. Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building which Y rents to an insurance company for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The indebtedness is *acquisition indebtedness* since such indebtedness, though incurred subsequent to the improvement of the office building, would not have been incurred but for such improvement, and the indebtedness was reasonably foreseeable when, to make such improvement, Y reduced its working capital below the amount necessary to continue current operations.

Example 3. (a) U, an exempt private preparatory school, as its sole educational facility owns a classroom building which no longer meets the needs of U's students. In 1971, U sells this building for \$3 million to Y, a corporation which it does not control. U receives \$1 million as a down payment from Y and takes back a purchase money mortgage of \$2 million which bears interest at 10 percent per annum. At the time U became the mortgagee of the \$2 million purchase money mortgage, U realized that it would have to construct a new classroom building and knew that it would have to incur an indebtedness in the construction of the new classroom building. In 1972, U builds a new classroom building for a cost of \$4 million. In connection with the construction of this building, U borrows \$2.5 million from X Bank pursuant to a deed of trust bearing interest at 6 percent per annum. Under these circumstances, \$2 million of the \$2.5 million borrowed to finance construction of the new

classroom building would not have been borrowed but for the retention of the \$2 million purchase money mortgage. Since such indebtedness was reasonably foreseeable, \$2 million of the \$2.5 million borrowed to finance the construction of the new classroom building is acquisition indebtedness with respect to the purchase money mortgage and the purchase money mortgage is debt-financed property.

(b) In 1972, U receives \$200,000 in interest from Y (10 percent of \$2 million) and makes a \$150,000 interest payment to X (6 percent of \$2.5 million). In addition, assume that for 1972 the debt/basis percentage is 100 percent (\$2 million/\$2 million). Accordingly, all the interest and all the deductions directly connected with such interest income are to be taken into account in computing unrelated business taxable income. Thus, \$200,000 of interest income and \$120,000 (\$150,000×\$2 million/\$2.5 million) of deductions directly connected with such interest income are taken into account. Under these circumstances, U shall include net interest income of \$80,000 (\$200,000 of income less \$120,000 of deductions directly connected with such income) in its unrelated business taxable income for 1972.

Example 4. In 1972 X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners shall share equally in the profits of the partnership, shall each invest \$3 million, and that X shall be a limited partner. X invests \$1 million of its own funds in the partnership and \$2 million of borrowed funds. The partnership purchases as its sole asset an office building which is leased to the general public for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D). The office building cost the partnership \$24 million of which \$15 million is borrowed from Y bank. This loan is secured by a mortgage on the entire office building. By agreement with Y bank, X is held not to be personally liable for payment of such mortgage. By reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner. Therefore, a portion of X's income from the building is debt-financed income. Under these circumstances, since both the \$2 million indebtedness incurred by X in acquiring its partnership interest and \$5 million, the allocable portion of the partnership's indebtedness incurred with respect to acquiring the office building which is attributable to X in computing the debt/basis percentage (one-third of \$15 million), were incurred in acquiring income-producing property, X has acquisition indebtedness of \$7 million (\$2 million plus \$5 million). Similarly, the allocable portion of the partnership's adjusted basis in the office building

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which is attributable to X in computing the debt-basis percentage is \$8 million (one-third of \$24 million). Assuming no payment with respect to either indebtedness and no adjustments to basis in 1972, X's average acquisition indebtedness is \$7 million and X's average adjusted basis is \$8 million for such year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for 1972 is 87.5 percent (\$7 million/\$8 million).

(3) *Changes in use of property.* Since property used in a manner described in section 514(b)(1) (A), (B), (C), or (D) is not considered debt-financed property, indebtedness with respect to such property is not acquisition indebtedness. However, if an organization converts such property to a use which is not described in section 514(b)(1) (A), (B), (C), or (D) and such property is otherwise treated as debt-financed property, the outstanding principal indebtedness with respect to such property will thereafter be treated as *acquisition indebtedness*. For example, assume that in 1971 a university borrows funds to acquire an apartment building as housing for married students. In 1974 the university rents the apartment building to the public for purposes not described in section 514(b)(1) (A), (B), (C), or (D). The outstanding principal indebtedness is *acquisition indebtedness* as of the time in 1974 when the building is first rented to the public.

(4) *Continued indebtedness.* If:

(i) An organization sells or exchanges property, subject to an indebtedness (incurred in a manner described in subparagraph (1) of this paragraph),

(ii) Acquires another property without retiring the indebtedness, and

(iii) The newly acquired property is otherwise treated as debt-financed property,

the outstanding principal indebtedness with respect to the acquired property is *acquisition indebtedness*, even though the original property was not debt-financed property. For example, to house its administrative offices, an exempt organization purchases a building with \$600,000 of its own funds and \$400,000 of borrowed funds secured by a pledge of its securities. It later sells the building for \$1,000,000 without redeeming the pledge. It uses these proceeds to purchase an apartment building which it rents to the public for purposes not described in section 514(b)(1) (A), (B), (C),

or (D). The indebtedness of \$400,000 is *acquisition indebtedness* with respect to the apartment building even though the office building was not debt-financed property.

(5) *Indebtedness incurred before June 28, 1966.* For taxable years beginning before January 1, 1972, *acquisition indebtedness* does not include any indebtedness incurred before June 28, 1966, unless such indebtedness was incurred on rental real property subject to a business lease and such indebtedness constituted business lease indebtedness. Furthermore, in the case of a church or convention or association of churches, the preceding sentence applies without regard to whether the indebtedness incurred before June 28, 1966, constituted business lease indebtedness.

(b) *Property acquired subject to lien—*
(1) *Mortgages.* Except as provided in subparagraphs (3) and (4) of this paragraph, whenever property is acquired subject to a mortgage, the amount of the outstanding principal indebtedness secured by such mortgage is treated as *acquisition indebtedness* with respect to such property even though the organization did not assume or agree to pay such indebtedness. The preceding sentence applies whether property is acquired by purchase, gift, devise, bequest, or any other means. Thus, for example, assume that an exempt organization pays \$50,000 for real property valued at \$150,000 and subject to a \$100,000 mortgage. The \$100,000 of outstanding principal indebtedness is *acquisition indebtedness* just as though the organization had borrowed \$100,000 to buy the property.

(2) *Other liens.* For purposes of this paragraph, liens similar to mortgages shall be treated as mortgages. A lien is similar to a mortgage if title to property is encumbered by the lien for the benefit of a creditor. However, in the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an opportunity to pay such lien in accordance with State law. Liens similar to mortgages include (but are not limited to):

- (i) Deeds of trust,
- (ii) Conditional sales contracts,
- (iii) Chattel mortgages,
- (iv) Security interests under the Uniform Commercial Code,
- (v) Pledges,
- (vi) Agreements to hold title in escrow, and
- (vii) Tax liens (other than those described in the third sentence of this subparagraph).

(3) *Certain encumbered property acquired by gift, bequest or devise*—(i) *Bequest or devise*. Where property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal indebtedness secured by such mortgage is not to be treated as *acquisition indebtedness* during the 10-year period following the date of acquisition. For purposes of the preceding sentence, the date of acquisition is the date the organization receives the property.

(ii) *Gifts*. If an organization acquires property by gift subject to a mortgage, the outstanding principal indebtedness secured by such mortgage shall not be treated as *acquisition indebtedness* during the 10-year period following the date of such gift, so long as:

(a) The mortgage was placed on the property more than 5 years before the date of the gift, and

(b) The property was held by the donor for more than 5 years before the date of the gift.

For purposes of the preceding sentence, the date of the gift is the date the organization receives the property.

(iii) *Limitation*. Subdivisions (i) and (ii) of this subparagraph shall not apply if:

(a) The organization assumes and agrees to pay all or any part of the indebtedness secured by the mortgage, or

(b) The organization makes any payment for the equity owned by the decedent or the donor in the property (other than a payment pursuant to an annuity excluded from the definition of *acquisition indebtedness* by paragraph (e) of this section).

Whether an organization has assumed and agreed to pay all or any part of an indebtedness in order to acquire the property shall be determined by the facts and circumstances of each situation.

(iv) *Examples*. The application of this subparagraph may be illustrated by the following examples:

Example 1. A dies on January 1, 1971. His will devises an office building subject to a mortgage to U, an exempt organization described in section 501(c)(3). U does not at any time assume the mortgage. For the period 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not acquisition indebtedness. However, after December 31, 1980, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

Example 2. Assume the facts as stated in example 1 except that on January 1, 1975, U assumes the mortgage. After January 1, 1975, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

(4) *Bargain sale before October 9, 1969*. Where property subject to a mortgage is acquired by an organization before October 9, 1969, the outstanding principal indebtedness secured by such mortgage is not to be treated as *acquisition indebtedness* during the 10-year period following the date of acquisition if:

(i) The mortgage was placed on the property more than 5 years before the purchase, and

(ii) The organization paid the seller a total amount no greater than the amount of the seller's cost (including attorney's fees) directly related to the transfer of such property to the organization, but in any event no more than 10 percent of the value of the seller's equity in the property transferred.

(c) *Extension of obligations*—(1) *In general*. An extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness is considered as a continuation of the old indebtedness to the extent the outstanding principal amount thereof is not increased. Where the principal amount of the modified obligation exceeds the outstanding principal amount of the preexisting indebtedness, the excess shall be treated as a separate indebtedness for purposes of section 514 and the regulations thereunder. For example, if the interest rate on an obligation incurred prior to June 28, 1966, by an exempt university is modified subsequent to such date, the modified obligation

shall be deemed to have been incurred prior to June 28, 1966. Thus, such an indebtedness will not be treated as acquisition indebtedness for taxable years beginning before January 1, 1972, unless the original indebtedness was business lease indebtedness (as defined in § 1.514(g)-1).

(2) *Extension or renewal.* In general, any modification or substitution of the terms of an obligation by the organization shall be an extension or renewal of the original obligation, rather than the creation of a new indebtedness to the extent that the outstanding principal amount of the indebtedness is not increased. The following are examples of acts which result in the extension or renewal of an obligation:

- (i) Substitution of liens to secure the obligation;
- (ii) Substitution of obligees, whether or not with the consent of the organization;
- (iii) Renewal, extension or acceleration of the payment terms of the obligation; and
- (iv) Addition, deletion, or substitution of sureties or other primary or secondary obligors.

(3) *Allocation.* In cases where the outstanding principal amount of the modified obligation exceeds the outstanding principal amount of the unmodified obligation and only a portion of such refinanced indebtedness is to be treated as acquisition indebtedness, payments on the amount of the refinanced indebtedness shall be apportioned prorata between the amount of the preexisting indebtedness and the excess amount. For example, assume that an organization has an outstanding principal indebtedness of \$500,000 which is treated as acquisition indebtedness. It borrows another \$100,000, which is not acquisition indebtedness, from the same lending institution and gives the lender a \$600,000 note for its total obligation. In this situation, a payment of \$60,000 on the amount of the total obligation would reduce the acquisition indebtedness by \$50,000 and the excess indebtedness by \$10,000.

(d) *Indebtedness incurred in performing exempt purpose.* Acquisition indebtedness does not include the incurrence of an indebtedness inherent in the performance or exercise of the purpose or func-

tion constituting the basis of the organization's exemption. Thus, *acquisition indebtedness* does not include the indebtedness incurred by an exempt credit union in accepting deposits from its members or the obligation incurred by an exempt organization in accepting payments from its members to provide such members with insurance, retirement or other similar benefits.

(e) *Annuities—(1) Requirements.* The obligation to make payment of an annuity is not *acquisition indebtedness* if the annuity meets all the following requirements:

(i) It must be the sole consideration (other than a mortgage to which paragraph (b)(3) of this section applies) issued in exchange for the property acquired;

(ii) At the time of the exchange, the present value of the annuity (determined in accordance with subparagraph (2) of this paragraph) must be less than 90 percent of the value of the prior owner's equity in the property received in the exchange;

(iii) The annuity must be payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time; and

(iv) The annuity must be payable under a contract which:

(a) Does not guarantee a minimum number of payments or specify a maximum number of payments, and

(b) 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.

(2) *Valuation.* For purposes of this paragraph, the value of an annuity at the time of exchange shall be computed in accordance with section 1011(b), § 1.1011-2(e)(1)(iii)(b)(2), and section 3 of Rev. Rul. 62-216, C.B. 1962-2, 30.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property transferred is used for purposes other than those described in section 514(b)(1) (A), (B), (C), or (D).

Example 1. On January 1, 1971, X, an exempt organization, receives property valued at \$100,000 from donor A, a male aged 60. In return X promises to pay A \$6,000 a year for

the rest of A's life, with neither a minimum nor maximum number of payments specified. The annuity is payable on December 31, of each year. The amounts paid under the annuity are not dependent on the income derived from the property transferred to X. The present value of this annuity is \$81,156, determined in accordance with Table A of Rev. Rul. 62-216. Since the value of the annuity is less than 90 percent of A's equity in the property transferred and the annuity meets all the other requirements of subparagraph (1) of this paragraph, the obligation to make annuity payments is not acquisition indebtedness.

Example 2. On January 1, 1971, B transfers an office building to Y, an exempt university, subject to a mortgage. In return Y agrees to pay B \$5,000 a year for the rest of his life, with neither a minimum nor maximum number of payments specified. The amounts paid under the annuity are not dependent on the income derived from the property transferred to Y. It is determined that the actual value of the annuity is less than 90 percent of the value of B's equity in the property transferred. Y does not assume the mortgage. For the taxable years 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not treated as acquisition indebtedness. Further, Y's obligation to make annuity payments to B never constitutes acquisition indebtedness.

(f) *Certain Federal financing. Acquisition indebtedness* does not include an obligation to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons to the extent that it is insured by the Federal Housing Administration. Thus, for example, to the extent that an obligation is insured by the Federal Housing Administration under section 221(d)(3) (12 U.S.C. 1715(I)(d)(3)) or section 236 (12 U.S.C. 1715z-1) of title II of the National Housing Act, as amended, the obligation is not *acquisition indebtedness*.

(g) *Certain obligations of charitable remainder trusts.* For purposes of section 664(c) and §1.664-1(c), a charitable remainder trust (as defined in §1.664-1(a)(1)(iii)(a)) does not incur *acquisition indebtedness* when the sole consideration it is required to pay in exchange for unencumbered property is an *annuity amount* or a *unitrust amount* (as defined in §1.664-1(a)(1)(iii)(b) and (c)).

[T.D. 7229, 37 FR 28151, Dec. 21, 1972; 38 FR 21918, Aug. 14, 1973; T.D. 7698, 45 FR 33973, May 21, 1980]

§ 1.514(c)-2 Permitted allocations under section 514(c)(9)(E).

(a) *Table of contents.* This paragraph contains a listing of the major headings of this §1.514(c)-2.

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