(v) If during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of the first lease will not be added to the second lease to determine whether such second lease is a lease for more than 5 years for purposes of subdivision (i) of this subparagraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. In 1954 an educational organization, which is on the calendar year basis, begins the erection of an 11-story apartment building using funds borrowed for that purpose, and immediately leases for a 10-year term the first floor to a real estate development company to sublet for stores and shops. As fast as the new apartments are completed, they are rented on an annual basis. At the end of 1959 all except the 10th and 11th floors are rented. Those two floors are completed during 1960 and rented. Assume that for 1954 and each subsequent taxable year through 1959, and for the taxable year 1963, the gross rental for the first floor represents more than 10 percent of the total gross rents derived during the taxable year from the building. Under this set of facts the 10-year lease of the first floor would be considered to be a business lease for all except the taxable years 1961, 1962, and 1964.

[T.D. 7229, 37 FR 28154, Dec. 21, 1972]

§ 1.514(g)–1 Business lease indebtedness.

(a) Definition. The term business lease indebtedness means, with respect to any real property leased by a tax-exempt organization for a term of more than 5 years, the unpaid amount of:

(1) The indebtedness incurred by the lessor tax-exempt organization in acquiring or improving such property;

(2) The indebtedness incurred by the lessor tax-exempt organization prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred by the lessor tax-exempt organization subsequent to 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 the indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

See paragraph (1) of this section with respect to subsidiary corporations.

(b) Examples. The rules of section 514(g) respecting business leases also cover certain cases where the leased property itself is not subject to an indebtedness. For example, they apply to cases such as the following:

Example 1. A university pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase (either directly or through a subsidiary corporation) a building, which building is subject to a lease that then has more than 5 years to run. This would be an example of a business lease indebtedness incurred prior to the acquisition of the property which would not have been incurred but for such acquisition.

Example 2. If the building itself in example 1 in this paragraph is later mortgaged to raise funds to release the pledged securities, the lease would continue to be a business lease.

Example 3. If a scientific organization mortgaged its laboratory building to replace working capital used in remodeling another one of its buildings or a building held by its subsidiary corporation, which other building is free of indebtedness and is subject to a lease that then has more than 5 years to run, the lease would be a business lease inasmuch as the indebtedness though incurred subsequent to the improvement of such property would not have been incurred but for such improvement, and the incurrence of the indebtedness was reasonably foreseeable when, to make such improvement, the organization reduced its working capital below the amount necessary to continue current operations.

(c) Property acquired subject to lien. Where real property is acquired subject to a mortgage or similar lien, whether the acquisition be by gift, bequest, devise, or purchase, the amount of the indebtedness secured by such mortgage or lien is a business lease indebtedness (unless paragraph (d)(1) of this section applies) even though the lessor does not assume or agree to pay the indebtedness. For example, a university pays $100,000 for real estate valued at $300,000 and subject to a $200,000 mortgage. For the purpose of the tax on unrelated business taxable income, the result is the same as if $200,000 of borrowed funds had been used to buy the property.
(d) Certain property acquired by gifts, etc. (1) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor tax-exempt organization incurred in acquiring such property. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(2) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as indebtedness described in section 514(g) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(e) Certain corporations described in section 501(c)(2). In the case of a title holding corporation described in section 501(c)(2), all of the stock of which was acquired before July 1, 1950, by an organization described in section 501(c)(3), (5), or (6) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, shall not be considered as indebtedness described in section 514(g) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(f) Certain trusts described in section 401(a). In the case of a trust described in section 401(a), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before March 1, 1954, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(g) Business lease on portion of property. Where only a portion of the real property is subject to a business lease, proper allocation of the indebtedness applicable to the whole property must be made to the premises covered by the lease. See example 2 of paragraph (b)(3) of §1.514(a)–2.

(h) Special rule applicable to trusts described in section 401(a). If an employees’ trust described in section 401(a) lends any money to another such employees’ trust of the same employer, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust:

(1) Incurs any indebtedness in order to make such loan;

(2) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(3) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

(1) Subsidiary corporations. The provisions of section 514(f), (g), and (h) are applicable whether or not a subsidiary corporation of the type described in section 501(c)(2) is availed of in making the business lease. For example, assume a parent organization borrows funds to purchase realty and sets up a separate section 501(c)(2) corporation as a subsidiary to hold the property. Such subsidiary corporation leases the property for a period of more than 5 years, collects the rents and pays over all of the income, less expenses, to the parent organization, the parent organization being liable for the indebtedness. Under these assumed facts, the lease by section 501(c)(2) subsidiary corporation would be a business lease with respect to such subsidiary corporation, and the rental income would be subject to the tax, whether or not
the subsidiary itself assumes the indebtedness and whether or not the property is subject to the indebtedness.

(j) Certain trusts described in section 501(c)(17). (1) In the case of a supplemental unemployment benefit trust described in section 501(c)(17), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before January 1, 1960, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(2) If a supplemental unemployment benefit trust described in section 501(c)(17) lends any money to another such supplemental unemployment benefit trust forming part of the same plan, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust:

(i) Incurs any indebtedness in order to make such loan;

(ii) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(iii) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

[T.D. 7229, 37 FR 28155, Dec. 21, 1972]

FARMERS’ COOPERATIVES

§ 1.521–1 Farmers’ cooperative marketing and purchasing associations; requirements for exemption under section 521.

(a)(1) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of either the quantity or the value of the products furnished by them, are exempt from income tax except as otherwise provided in section 522, or part I, subchapter T chapter 1 of the Code, and the regulations thereunder. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of either the quantity or the value of milk or of butterfat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are