

§ 1.512(a)-1 Definition.

(a) *In general.* Section 512 defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions and limitations referred to in § 1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on

of unrelated trade or business. Except as provided in subparagraph (2) of paragraph (d) of this section, to be "directly connected with" the conduct of unrelated business, for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities.

(b) *Expenses attributable solely to unrelated business.* Expenses, depreciation and similar items attributable solely to the conduct of unrelated business are proximately and primarily related to that business and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Internal Revenue Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business are directly connected with the conduct of the unrelated business and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business would be an allowable deduction to the extent otherwise permitted by section 167.

(c) *Dual use of facilities or personnel.* Where facilities or personnel are used both to carry on exempt functions and to conduct unrelated trade or business, expenses, depreciation, and similar items attributable to such facilities or personnel (as, for example, items of overhead) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business is proximately and primarily related to that business,

and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant sections of the Internal Revenue Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of \$20,000 a year. X derives gross income from the conduct of unrelated trade or business. The president devotes approximately 10 percent of his time during the year to the unrelated business. For purposes of computing X's unrelated business taxable income, a deduction of \$2,000 (\$20,000 times 10 percent) would be allowable for the salary paid to its president.

(d) *Exploitation of exempt functions—(1) In general.* In certain cases, gross income may be derived from unrelated trade or business which exploits an exempt function. Except as specified in subparagraph (2) of this paragraph, in such cases expenses, depreciation and similar items attributable to the conduct of the exempt function are not

deductible in computing unrelated business taxable income. Since such items are incident to a function of the type which it is the chief purpose of the organization to conduct, they do not possess proximate and primary relationship to the unrelated trade or business. Therefore, they do not qualify as directly connected with that business.

(2) *Allowable deductions.* Where unrelated trade or business is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of such business, the expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the related activities; and

(ii) The allocation of such excess to the unrelated activities does not result in a loss from such unrelated trade or business.

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt function must be allocated first to the exempt function to the extent of the income derived from or attributable to the performance of that function. Furthermore, such items are in no event allocable to the unrelated business