Dual-Use Facilities – Methodologies for Allocations of Expenses

By Dave Moja, Partner

The "Exempt Organizations" section of the Service's 2016-17 Priority Guidance Plan lists 15 items on which the Service is working. Item number 8 is: "Guidance under section 512 regarding methods of allocating expenses relating to dual use facilities."[1]

This plan item apparently comes as a result of a 2014 recommendation by the Advisory Committee on Tax Exempt and Government Entities (ACT):

> The Exempt Organizations Division should work with Chief Counsel and the Treasury Department to provide formal guidance to the field regarding proper methods for allocating indirect costs where facilities and/or personnel are used to carry on exempt activities and to conduct unrelated trade or business.
>
> The IRS should develop guidance that has several elements. One is to identify methods that will be given safe harbor treatment. Another element is to identify allocation methods that are per se unreasonable. Allocation methods that are not designated for safe harbor treatment or as per se unreasonable may come under increased scrutiny and ultimately be rejected as unreasonable subject to facts and circumstances.[2]

Dual-use facilities

In guidance to taxpayers, the IRS describes the dual use of assets or facilities as follows:

> If an asset or facility necessary to the conduct of exempt functions is ... used in commercial activities, its use for exempt functions does not, by itself, make the commercial activities a related trade or business. The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of exempt purposes.[3]

The aforementioned 2014 ACT report states: "Dual use expenses are expenses incurred for both related and unrelated activities. An exempt organization must make a 'reasonable' allocation of the expenses between those activities."[4] Reg. 1.512(a)-1(c) states:

> Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses on a reasonable basis.

With respect to expenses allocable to the dual use of facilities (or personnel), Publication 598 states:

> When facilities or personnel are used both to conduct exempt functions and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis. The part of an item allocated to the unrelated trade or business is proximately and primarily related to that business and is allowable as a deduction in computing unrelated business taxable income if the expense is otherwise an allowable income tax deduction.[5]

The Code generally allows that all rents from real property are excluded from the calculation of taxable unrelated business income (UBI).[6] However, various IRS rulings state that if substantial services are included in the rental agreement, the entire rental income will be UBI.

The 2014 ACT report gives the example of a state university that leases out a basketball arena to a for profit business for a concert. The university agrees to provide utilities and security services and will operate the concession stands for the concert, which does not contribute to the university's educational activities. Due to the substantial services provides by the university, the rental income from this arrangement is UBI for the university.[7]

Allocating expenses – A two-part test.

As noted above, the IRS is clear that, in order to allocate and deduct expenses, two criteria must be met:

1. There must be a proximate and primary relationship to the business activity.
2. The method of allocation must be reasonable.

The Service's CPE text for Fiscal Year 1992 states that, first, the method must allocate "only that portion of any item of deduction that is proximately and primarily related to the business activity" to the unrelated trade or business activity. That allocation can be made only to the extent permitted by Section 162, Section 167, or another relevant provision of the Code. Second, the method must be reasonable.[8]

In looking at some characteristics of "reasonable," a good trail is laid in the CPE text for Fiscal Year 1992. One article points out that, like the regulations, the section of the Service's Internal Revenue Manual that sets out guidelines for examining social or recreational clubs also provides that "there is no approved method of allocating expenses. A method is reasonable if it results in the deduction of only those expenses that possess a proximate and primary relationship to the unrelated trade or business income they are allocated against." The Big Divot Country Club, Inc., hypothetical in the Package 990-5 provides an example of a reasonable method of allocating expenses of a social club between member income and nonmember income." [9]

Liability for UBIT – Operation vs. rental

In Rev. Rul. 80-297[10] (amplifying Rev. Rul. 76-402[11]), the IRS provided guidance on two situations in which an exempt school used its tennis facilities as a summer public tennis club open to the public. The ruling offered two situations — one in which the school operated the club with its own employees, another in which it leased the facilities for a fixed fee to a third person who operated the club.

In the first situation, for ten weeks during the summer, the school operated a tennis club. For a fee, the general public was invited to join the club and thereby use the school's tennis courts and dressing rooms during designated periods. Two employees of the school's athletic department conducted the affairs of the club, including collecting membership fees and scheduling court time. The net income from the club was used for the exempt purposes of the school.

IRS guidance on methods for allocating indirect costs should have several elements.

The school was exempt from federal income tax under Section 501(c)(3) and was classified as an educational organization described in Section 170(b)(1)(A)(ii). Its purposes were limited to those involving the advancement of education. The school's facilities included tennis courts and dressing rooms, which were employed during the regular academic year in the school's educational programs.

In this situation, the IRS found that "the school furnishes more than just its facilities. It operates the tennis club through its own employees, who perform substantial services for the participants in the tennis club. Accordingly, income from the school's furnishing of its tennis facilities through the operation of a tennis club in the manner described is not excluded from unrelated business taxable income as rent from real property."[12]

Note that the IRS saw conducting the affairs of the tennis club, collecting membership fees, and scheduling court time to be "substantial services" — by the school's employees — that caused the activity to be classified as a "dual-use activity."

In the second situation, the school merely made the tennis facilities available to an unrelated individual for ten weeks at a fixed fee that did not depend, in whole or in part, on the income or profits derived from the leased property. The individual formed a tennis club and hired employees to administer the affairs of the club. Under a contract with the school, the individual had to repair any damage to the facilities beyond normal wear and tear at the end of the ten weeks.

For the IRS, having an unrelated operator hiring employees to administer the affairs of the club made the difference. "Accordingly, income from the school's furnishing of its tennis facilities through an individual operator is excluded from unrelated business taxable income as rent from real property."[13]

Thus, services — even "substantial services" — performed by a third party, do not result in the classification of an activity as a dual-use facility rental.

Allocation Methodologies – The Compliance Project

In the final report on its Colleges and Universities Compliance Project ("the Compliance Project report"), the IRS further clarified "expense" allocations as follows:

> When a trade or business activity serves both exempt and unrelated purposes, the income and expenses from the activity must be allocated between the two on a reasonable basis. Allocated expenses must have a proximate and primary relationship to the activities to which they are attributed. Only the expenses allocated to an unrelated trade or business are allowable as a deduction against UBI. Expenses attributable to accomplishing an organization's exempt purpose may not be deducted because the organization is already exempt from paying tax on related income.[14]

The term "reasonable basis" has been an area of much contention over the years. Private letter rulings and court decisions abound on what is and is not a "reasonable basis" for expense allocations. Further, there can be a daunting administrative burden involved in tracking the various factors and developing a reasonable allocation methodology.

One over-the-top example might be of a university that owns, runs, and maintains a 35,000-seat football stadium. The stadium hosts seven home football games per year. In addition, in May of each year, the university hosts a big rock concert. Would a reasonable allocation of expenses (operating expenses, depreciation, overhead, etc.) to the rock concert be 1/8 of all allocable expenses (because the concert is one of eight events conducted in the venue each year)? Alternatively, as the IRS has asserted in some court cases and rulings (and the AICPA has suggested as a "safe harbor"), would a reasonable allocation be 1/365 of all allocable expenses (because the venue is given over to the concert for about one day each year)? The difference is 12.5% versus 0.274% ($125.00 per $1,000 versus $2.74 per $1,000 of allocable expenditures). Consider that difference as applied to millions of dollars of expenses and the current 35% incremental tax rate on unrelated business income.

To many, one event out of eight events may not seem reasonable. What would be a reasonable allocation? If gross revenues for the seven home football games were $11 million and the gross revenue from the rock concert $3 million, would 3/14 (21.43%) be reasonable? That would be the "gross-to-gross" method described below. But, what would count as revenue? If the entry fees for the concert were more than the cost of a seat at the football games, the gross-to-gross method would cant the allocation unfairly in the direction of the unrelated activity.

The term "reasonable basis" has been an area of much contention over the years.

Another approach might be to use the number of people attending each event. Say the seven football games brought total attendance of 210,000 and the rock concert brought 40,000. That would suggest a 16% allocation (40,000 / 250,000). This method would seem reasonable as to "use" of the facility. Also, if there were small events (i.e., weddings, parties, etc.), those attendees could be added to the numerator and denominator as appropriate.

Lessons from a college golf course

As the IRS and Treasury prepare to issue guidance, as indicated above, regarding the allocation of expenses related to dual-use facilities (per the current Priority Guidance Plan), what might "model" expense allocation methods look like? Some insight might be gained from the Compliance Project report.

> Expense deductions were disallowed on more than 60 percent of Form 990-Ts examined because they were based on improper allocations between exempt and unrelated business activities.[15]

Example. Consider a college that owns a golf course and runs a golf operation that is used by students, faculty, alumni, and the general public. Faculty and students are charged a fee of $10 per round, while alumni are charged $25 per round and members of the general public must pay $30.

The accounting team at this college knows that they have unrelated business income for the greens fees paid by the general public and alumni (but not students and faculty). They have allocated expenses to the unrelated business income on a "gross-to-gross" basis (gross revenue for unrelated golfers over total gross revenue). So, for example, if each of the four "types" of golfers above accounted for 250 rounds per year, the total gross revenue would be as follows:

General public	$30 x 250 = $7,500
Alumni	$25 x 250 = $6,250
Faculty	$10 x 250 = $2,500
Students	$10 x 250 = $2,500

Thus, the expense allocation would be the $13,750 paid by the general public and alumni ($7,500 + $6,250) divided by the $18,750 paid by all four types of golfers ($7,500 + $6,250 + $2,500 + $2,500). That comes to 73.33%.

The IRS has found that this is inherently not a reasonable allocation method. It misrepresents the expenses due to the fact that unrelated golfers paid more per round. Thus, the numerator in the cost allocation equation was skewed upward in favor of the unrelated use.

Rather than the "gross-to-gross" approach, a "unit-based" allocation method based on the number of rounds would be more reasonable. The 500 rounds played by the general public and alumni would be divided by the 1,000 total number of rounds played for an expense allocation percentage of 50.00%.

The American Institute of Certified Public Accountants (AICPA) Exempt Organizations Taxation Technical Resource Panel has proposed that the allocation of expenses relating to dual-use facilities or personnel could be based on one or more of the following:

- Square footage.
- Hours/days spent on the activity.
- The ratio of direct costs to allocable costs.
- The ratio of revenue generated in unrelated activity to total revenue earned from dual-use facility or personnel.
- Cost allocation methodology provided for universities as described in OMB Circular A-21.
- Cost allocation methodology provided for Medicare cost reporting ("step-down").[16]

Rensselaer Polytechnic Institute

One of the flagship court cases in this arena is Rensselaer Polytechnic Institute.[17] In this case, the taxpayer utilized its fieldhouse for many hours per week of functions related to its exempt purpose. In addition, the university received dual-use rental income from commercial uses, including commercial ice shows and public ice skating that did not fall within its exempt function.

Known colloquially as RPI, the school operated a field house for both its educational uses and commercial uses. In determining the expenses allocable against the commercial use, the college used a three-part methodology of (1) direct expense, (2) variable expense depending on the percentage of commercial use, and (3) fixed expenses that did not vary on actual use. The IRS argued that fixed expense percentage should be calculated on the proportion of time that commercial use bears to total time available.

The court agreed with the college's methodology and held that allocating fixed expenses on the basis of time of actual use (disregarding time of non-use) was a reasonable allocation method. While the IRS has never acquiesced in this decision, it is generally followed by the university community in allocating expenses for dual-use facilities.[18] Pointing out that the issue was one of first impression, the Second Circuit stated:

> Finding no conflict between the regulation and the statute and finding no error in the determination of the tax court that RPI's method of allocation was reasonable, we reject the commissioner's position and affirm the tax court's judgment, which approved apportioning the fieldhouse's idle time in proportion to the hours devoted to exempt and non-exempt uses.[19]

The IRS also attempted to argue that the "directly connected with" provision in Reg. 1.512(a)-1(a) provided a stricter test with regard to "reasonableness" than the provisions of Reg. 1.162-1(a), governing the deductibility of ordinary and necessary business expenses for for-profit entities. In his dissent, circuit judge Walter Mansfield noted that unlike a commercial business, a university will "always have an incentive to minimize the allocation of expenses attributed to the educational function, and thereby maximize the deduction for unrelated business activity. This incentive ... requires that there be a narrower test for deductibility for tax exempt organizations than for purely profit-seeking firms."[20]

Thus, in Rensselaer, the courts found that "reasonable" expense allocations could utilize a denominator based on actual use and not "total time available." Note that the IRS argued for "total time available" — not total days or hours in a week or month or year.

A working definition of "total time available" could be taken from Rev. Rul. 62-180.[21] This ruling deals with how much (for federal income tax purposes) an individual might deduct for expenses attributable to a home office. (Note that comparing tax law for individual taxpayers with that for tax-exempt organizations is not an apples-to-apples comparison.) Example 5 of Rev. Rul. 62-180 involves a den that is available for family use but that the taxpayer uses for business purposes for an average of two hours a day. Therefore, the IRS ruled that two twenty-fourths of the expense allocable to the den is deductible as a business expense.

Note that the courts (in Rensselaer and other decisions) have ruled against "total time available" as being 24 hours a day or 365 per year in favor of a methodology based on actual use. Further, the courts elected to disregard time of "non-use."

Further, the 1992 CPE Text is forthright in its assessment that: "During the litigation of the Rensselaer case, the Service admitted that there is well-reasoned precedent supporting the view that allocating based on actual usage is reasonable in cases of facilities used only on an intermittent basis."[22]

Draft revenue procedure

In 1997, the National Association of College and University Business Officers (NACUBO) offered the IRS a draft revenue procedure on the allocation of expenses by colleges and universities for UBIT purposes.[23] The draft stated that its purpose was to explain "optional methodologies" that colleges and universities could employ for allocating of direct and indirect expenses for the purpose of determining taxable unrelated business income (UBI). The methodologies described would not be mandatory for any college or university that was liable for UBIT, but instead would serve as "optional safe harbors that set forth a reasonable basis for allocation of costs to unrelated activities."

The draft proposes two safe harbor options for expense allocations regarding unrelated business activities. "Option 1" is a three-tier approach (direct costs, allocated departmental administration costs, and allocated institutional costs). Option 2 is a "simplified alternative method." The draft is descriptive and provides steps, forms, and examples on applying these methods.

The draft uses some of the methodology from OMB Circular A-21 as a foundation for its proposals. Although the NACUBO draft covers all types of expenses, the IRS would do well to closely consider this 1997 draft as it endeavors to provide the dual-use guidance specified in the priority guidance plan.

Information regarding the prevalence of indirect expense allocations might be gleaned from the Service's Colleges and Universities Compliance Project, which began in 2008 and concluded in 2013. Across the board, more than two-thirds of the reporting colleges and universities utilized some allocation of indirect expenses in computing net unrelated business income. In the Compliance Project questionnaire, Question 28 asked respondents to break down the total expenses, including direct and indirect, reported for all activities on their Form 990-T for the tax year ending in 2006 or the most recent year in which they filed a Form 990-T. As reported in the interim report, the results were:

- Large institutions – 80%.
- Medium institutions – 60%.
- Small institutions – 56%.24

AICPA 2016 Recommendations

Last June, the AICPA submitted a letter to the IRS outlining recommended guidelines addressing UBIT expense allocations for dual-use facilities. The six recommended guidelines for the allocation of indirect expenses were as follows:

1. Deductible expenses must bear a proximate and primary relationship to the conduct of the activity.
2. Deductible expenses include both direct costs and indirect costs.
3. Indirect costs include fixed expenses (those that do not change when the unrelated activity is conducted or not conducted) and variable expenses (those that increase or decrease when the unrelated activity is conducted or not conducted).
4. The methodology for allocating expenses relating to dual-use facilities or personnel must be reasonable and consistently followed from year to year, and should not cause the double-counting of any expense.
5. The methodology for allocating expenses relating to dual-use facilities or personnel must be based on the character of the expense involved. Facility costs (rent, mortgage interest, insurance, taxes, security, and utilities) are apportioned based on the portion of the facility used (square footage and time) for each activity. Personnel costs (salary, benefits, and taxes) are apportioned based on the time spent on each activity. Information technology costs (software, computer services, and the Internet) are apportioned based on the allocation of personnel to activity.
6. Office expenses (supplies, printing, postage, and subscriptions) are apportioned based on allocation of personnel to activity.[25]

In its letter to the IRS Chief Counsel's Office mentioned above, the AICPA also suggested three potential methods for allocating facility expenses based on the number of days the facility is used for unrelated activities.

- Method #1 is a simplified "safe harbor" method for use by an organization lacking detailed records to support the number of days the facility is actually used or available for use in all activities. The allocation ratio is the number of days of use for unrelated activities, divided by 365 (or the number of days in the tax year, if less).
- Method #2 is for use by an organization that lacks detailed records to support the number of days the facility is actually used for all activities, but has records to support the number of days the facility was available for use. The allocation ratio computation in this case is the number of days of use for unrelated activities, divided by the number of days of availability for use in all activities.
- Method #3 is for use by an organization that has detailed records to support the number of days the facility is actually used for all activities. The allocation ratio is the number of days of use for unrelated activities, divided by the number of days of actual use for all activities.[26]

If a reasonable safe harbor were to be created, what would it look like?

Another possible approach?

Rensselaer stated that it would not be fair or accurate to presume that "total time available" used in allocating expenses actually meant 24 hours a day, 365 days a year. If a reasonable safe harbor were to be created, what would it look like? To what denominator of time available should the numerator of actual hours of use be compared?

Looking at the AICPA's suggestions above, methods #2 and #3 (based on actual use) ring true and are in line with Rensselaer. It is the "safe harbor," method #1, that may give some pause. It appears that using 365 days as a denominator is problematic for at least three reasons:

1. It does not incorporate current law as directed in Rensselaer.
2. It goes all the way to the strictest definition of "available for use"; based on the home office example in the regulations.
3. How would it define a "day" in the numerator? Is it 24 hours of use? If the unrelated use is two hours per day, does it take 12 days to equal one "day"?

What would be a balanced, reasonable, and fair approach? The 168 hours per week/365 days per year model does not seem quite right. The less-than-90 hours per week from Rensselaer and the tennis camp example above feels uncomfortable as well.

As mentioned above, dual-use property issues tend to involve colleges and universities. It is there that many of the rulings and cases arise. In addition, qualified education organizations have the Section Section 514(c)(9) "exclusion" from debt-financed real estate rules, so dual use can be more of an issue with "schools."

In the "higher education" context, what might be a reasonable weekly and/or annual denominator for use as a reasonable starting point in calculating dual-use expenses percentages? Are facilities available less than 168 hours a week? More than 40 hours a week? What about annually?

The author surveyed academic schedules, or the number of "school days," for several colleges and found an approximate average of 200 days. That is the number of days that their facilities are generally "open" and "available" for use related to their exempt purpose.

The author also took a quick look at the average hours per week during which 20 higher education institutions opened their field houses/recreation centers. (Their libraries' hours could have been examined, but Rensselaer is the leading court case in this area and it involved a field house). In the spirit of the Service's Colleges and Universities Compliance Project, the author examined ten schools with less than 5,000 students, five that had between 5,000 and 14,999 students, and five that reported enrollments of over 15,000 students. On average, those schools' facilities were open 101 hours per week. That 101 hours, divided by 168 total hours per week, means that those schools' facilities were open for 60.1% of each week.

In light of these statistics, might 60% be a good basis for a "safe harbor?" Using the same 60% figure in a days-per-year allocation would mean treating the facilities as being available for use 219 days per year. Thus, the safe harbor could assume that a school's facilities were "available for use" 219 of 365 days a year or 101 of 168 hours per week. That should be used as the denominator in calculating the percentage of expenses treated as attributable to use for other than exempt function activities.

Those figures could be rounded off to create a safe harbor of either (1) 60% of total time, (2) 100 hours per week, or (3) 220 days per year.

That seems to be a balanced place between Rensselaer and 24-7-365.

Conclusion

The IRS has a tough task on their hands in defining and publishing “guidance under section 512 regarding methods of allocating expenses relating to dual use facilities.” As this is being contemplated, the Service should look closely at methodologies that are in practice currently (gained from their audits of 34 colleges and universities in the Colleges and Universities Compliance Project), historical guidance from court rulings (such as Rensselaer), and information provided by interested and invested stakeholders (i.e., the NACUBO Draft Revenue Procedure from 1997 and the AICPA's 2016 letter). Other interested stakeholders should make their thoughts known to the IRS and through other channels.

Note that the 2014 ACT Report charged the IRS and Treasury with identifying allocation methods that are per se unreasonable. This discussion has not specifically identified what those methods might look like, although readers should be able discern from some of the situations given that those examples do exist.

There are many ways to skin a cat. But there does seem to be something to about 60% of “total available time” as a potential reasonable starting place for building a “safe harbor” that provides a reasonable guideline to allocating expenses of dual-use facilities. Call it compromise. Call it bell curve-driven decision making. Call it reasonable.

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[1]www.irs.gov/pub/irs-utl/2016-2017_pgp_1st_quarter_update.pdf, page 10.
[2]Advisory Committee on Tax Exempt and Government Entities (ACT), 2014 Report of Recommendations, section on "Exempt Organizations: Analysis and Recommendations Regarding Unrelated Business Income Tax Compliance of Colleges and Universities," (hereinafter "2014 ACT report"), available at www.irs.gov/pub/irs-tege/tege_act_rpt13.pdf, Recommendation #2, p. 81.
[3]IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations, p. 4. (Rev. January 2015).
[4]2014 ACT report, supra note 2 at p. 114.
[5]IRS Publication 598, supra note 3 at p. 11.
[6]Section 512(b)(3)
[7]2014 ACT report, supra note 2 at p. 180, Situation 2. See also Reg. 1.512(b)-1(c)(5) on the "rendering of services."
[8]Gannett and Barrett, "Unrelated Business Income Allocations," Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1992 (1991) ("1992 CPE Text"), p. 4, available at www.irs.gov/pub/irs-tege/eotopicb92.pdf, citing Reg. 1.512(a)-(1)(a), Reg. 1.512(a)-1(c).
[9]1992 CPE Text, supra note 8. As an illustration, the CPR Text recommends the example of "The Big Divot Country Club, Inc." given in the Internal Revenue Manual. See IRM 4.76.16.9.4(4).
[10]1980-2 CB 196.
[11]1976-2 CB 177.
[12]Rev. Rul. 80-297, supra note 10, citing Section 512(b)(3) and Reg. 1.512(b)-1(c)(5)
[13]Id.
[14]IRS Colleges and Universities Compliance Project Final Report, (IR-2013-44, 4/25/13), p. 13, www.irs.gov/pub/irs-tege/CUCP_FinalRpt_050213.pdf.
[15]Id.
[16]AICPA letter to IRS Office of Chief Counsel regarding allocation methodologies for dual-use facilities, dated 12/2/15, available at www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/2015-12-02-aicpa-comment-letter-eo-ubi-dual-use-facility-expense-allocation-methodologies.pdf
[17]732 F.2d 1058 53 AFTR2d 84-1167 (CA-2, 1984).
[18]2014 ACT report, supra note 2 at p. 114, fn. 115.
[19]Rensselaer Polytechnic Institute, supra note 17 at 53 AFTR2d 84-1168.
[20]Id. at 84-1172.
[21]1962-2 CB 52.
[22]1992 CPE Text, supra note 8 at p. 10.
[23]NACUBO, "Draft Revenue Procedure: Safe Harbors Allocations of Expenses by Colleges and Universities for Purposes of Determining Taxable Unrelated Business Income," 6/20/97, available at www.nacubo.org/documents/business_topics/DraftRevenueProcedureFINAL.pdf.
[24]"IRS Exempt Organizations Colleges and Universities Compliance Project Interim Report," 5/7/10, figure 28 on p. 31, available at https://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf.
[25]AICPA press release, "Recommended Guidelines and Examples Provided to IRS by AICPA For Tax-Exempt Organizations Reporting Unrelated Business Income," available at www.aicpa.org/Press/PressReleases/2016/Pages/Recommended-Guide-lines-and-Examples-Provided-to-IRS-by-AICPA
[26]Letter to IRS Office of Chief Counsel, supra note 16.