



allocating costs when calculating ubti - let's be "reasonable"

MSK Client Alert

April 19, 2012

It seems an increasing number of tax-exempt organizations are supplementing revenue through branching out into new activities. When an exempt organization uses its infrastructure partly for commercial purposes, related fixed costs must be allocated between exempt and nonexempt activities. *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), *aff'd* 79 T.C. 967 (1982) upheld a pro-taxpayer method of allocation. Nevertheless, short of litigation, the IRS does not appear to be following the *Rensselaer* decisions.

Although an organization is granted exempt status, it can be subject to income tax on business income not directly related to its exempt purpose. Gross income from such activities, reduced by allowable deductions, is an organization's "Unrelated Business Taxable Income" (UBTI).

For example, a tax-exempt school might use its auditorium on occasion to host concerts and other events for the general public. If these events are not directly related to the school's exempt purpose, the net income could be considered UBTI, taxable to the school.

Deductible variable costs specifically relating to nonexempt use of the facility, such as additional security, may be taken into account entirely in computing UBTI.

The school would incur other costs, such as administrative overhead and depreciation, a portion of which are appropriately attributable to the facility but do not vary with its use. As organizations and activities vary widely, no single method of allocation is mandated. Instead, the Treasury Regulations provide that these costs are to be allocated "on a reasonable basis" between the exempt and nonexempt uses. Whether a method is reasonable depends on the specific facts and circumstances.

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In *Rensselaer*, a university used its field house for exempt activities, such as intramural sports and commencement activities, as well as for nonexempt purposes, including third-party ice skating exhibitions which the general public paid to attend.

The university allocated the fixed costs of its field house based on the relative time it was used by the exempt and nonexempt activities, in relation to the time the facility was used for all activities.

The IRS did not quarrel with an allocation based on time used. However, it contended that the university's method overstated the expenditures allocated to the nonexempt activity, because it did not take into account the time that the field house remained idle. Instead, the IRS took the position that an allocation to the nonexempt activity based on its time of use compared to the total time the facility *was available for use* (24 hours a day, 7 days a week) was reasonable.

Affirming a Tax Court decision, the Court of Appeal in *Rensselaer* found for the university, holding that its allocation based on total time of actual use (rather than time available for use) was "a reasonable" method of allocation.

Despite its losses in *Rensselaer*, the IRS only follows the decisions up to a point. In an Action on Decision on *Rensselaer*, the IRS expressed its view that the university's allocation method was not "a reasonable method," but that the IRS method was. Nevertheless, the IRS advised it would not litigate the issue until the allocation rules in the Treasury Regulations were changed. To date, the Regulations have not been amended.

The IRS position on *Rensselaer* can lead to conflicting results. Short of litigation, the IRS has continued to take the position that allocating infrastructure costs based on total actual use (rather than availability for use) is not "a reasonable" method.

For example, a subsequent General Counsel Memorandum and related private letter ruling addressed another university's use of its auditorium for rock concerts and other entertainment events. The IRS found that the total actual use method of allocation proposed by the taxpayer – and approved in *Rensselaer* – would not be appropriate (and that the IRS method based on total available time is "the appropriate method of allocation"). The IRS came to the same conclusion in a private letter ruling in the context of an organization the exempt purpose of which was to conduct annual livestock shows. After a discussion of *Rensselaer*, the IRS nevertheless required the organization to allocate its facilities costs under the IRS "available for use" method, rather than the "actual use" method.

Also after *Rensselaer*, the IRS issued Examination Guidelines for its agents' use in conducting audits of colleges and universities. Among the activities listed that might result in UBTI is the use of "university facilities in unrelated activities." Notably, as authority on this point it refers to the General Counsel Memorandum discussed above.

Moreover, in a 1999 Field Service Advice, the IRS addressed the manner in which the allocation issue was to be handled in the context of a specific audit in progress. The IRS reconfirmed its disagreement with the *Rensselaer* method used by the taxpayer but, in light of its position of not litigating the issue, advised that settlement would be appropriate.



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Many bona fide tax issues arise in a tax-exempt organization's use of its infrastructure for nonexempt purposes, ranging in scope from other UBTI allocation issues (such as whether costs of a hospital pharmacy operated exclusively for the general public can include costs as reported for Medicare purposes) to whether an organization's nonexempt activities are so significant as to jeopardize its tax exemption. The IRS positions on these issues are infrequently in direct conflict with case law. Nevertheless, in the absence of litigation, it seems the IRS may continue to reject the pro-taxpayer decisions in *Rensselaer*.

Please contact any member of our Charitable Sector practice group if you would like to discuss the way these rules might apply to your specific situation.