# TAX-EXEMPT ORGANIZATIONS ARE SCREAMING FOR GUIDANCE ON HOW TO ALLOCATE INDIRECT COSTS BETWEEN RELATED AND UNRELATED BUSINESS ACTIVITIES –BUT IS ANYBODY LISTENING?

KEVIN R. TABOR*

## I. INTRODUCTION

On October 1, 2008, the Internal Revenue Service (IRS) sent compliance questionnaires to over 400 U.S. colleges and universities requesting a plethora of financial information.[1] One section of the 42-page questionnaire and accompanying instructions specifically requests colleges and universities to provide information about how they calculate their unrelated business income.[2] The IRS is interested in learning about the methods the schools use to report revenues and expenses from their unrelated trade or business activities and how these organizations allocate common fixed costs.[3] They plan to release a report of their findings in 2010.[4] Lois G. Lerner, the director of the IRS Exempt Organizations Division commented that "We see oftentimes organizations filing who say, yes, we have unrelated-business income. But when they file an unrelated-business tax form with us, lo and behold, they never have to pay any tax."[5] Ms. Lerner went on to say, "This is an area that might be absolutely OK because you can allocate and you can take certain deductions and you can

---

* Juris Doctor, The Ohio State University Moritz College of Law, expected 2011. Masters of Accounting Graduate, The Ohio State University Fisher College of Business, 2008.

[1] I.R.S. News Release IR-2008-112 (Oct. 1, 2008), http://www.irs.gov/irs/article/0,,id=187328,00.html.

[2] *Id. See also* Grant Williams, *Nonprofit Pay Continues to Be Hot Topic for Government Officials*, CHRON. OF PHILANTHROPY (Oct. 29, 2009).

[3] I.R.S. News Release IR-2008-112 (Oct. 1, 2008), http://www.irs.gov/irs/article/0,,id=187328,00.html.

[4] Press Release, Association of Governing Boards of Universities and Colleges, NACUBO Release Analysis of Responses to the 2008 IRS Survey of Colleges and Universities (Dec. 17, 2009), *available at* http://agb.org/news/2009-12/agb-nacubo-release-analysis-responses-2008-irs-survey-colleges-and-universities.

[5] Williams, *supra* note 2, at 27. Ms. Lerner's comments were made at the meeting of the National Association of State Charity Officials.

move things around. But we think that it's a little bit strange and so we want to look and see how people are getting to that zero with unrelated-business income."[6] Thus, the IRS would like to know if the colleges and universities have just been successful in their tax planning or if they are not in compliance with current tax law.[7]

Several courts have acknowledged that taxpayers are free to arrange their financial affairs in order to minimize tax liability. Judge Learned Hand said in *Helvering v. Gregory*, that "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[8] In affirming the decision in *Helvering v. Gregory*, the United States Supreme Court added, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[9] The Sixth Circuit Court of Appeals admits that "a taxpayer is free to arrange his financial affairs to minimize his tax liability; [and] thus, the presence of tax avoidance motives will not nullify an otherwise bona fide transaction."[10] Thus, under the current law, exempt organizations are free to arrange their financial affairs to minimize their tax liability so long as they refrain from breaking the law.

While the tax law in this area is not new, there has not been any clear guidance from Congress or the Treasury as to how colleges, universities and similar tax-exempt organizations should allocate indirect costs between exempt and non-exempt activities. The lack of clear and decisive guidance allows for the exempt organizations to aggressively attempt to minimize their tax liability.

---

[6] *Id.*

[7] In *Superior Oil Co. v. Mississippi*, in the context of tax, the U.S. Supreme Court said that "the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it." Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930).

[8] Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[9] *Gregory*, 293 U.S. at 469.

[10] Estate of Stranahan v. Comm'r, 472 F.2d 867, 869 (6th Cir. 1973) (The taxpayer was permitted to sell his son the rights to a future dividend allowing the taxpayer to realize income in the current tax year in which the taxpayer had a large tax deduction available to use. The court found that the tax avoidance motives of the transactions did not destroy an otherwise bona fide transaction).

## II. WHAT DOES IT MEAN TO BE TAX EXEMPT?

The Internal Revenue Code (IRC) recognizes over twenty different categories of tax-exempt organizations.[11] These organizations range from federal agencies to religious, charitable, educational, scientific, and literary organizations to social clubs.[12] Examples of such organizations include The Ohio State University,[13] The National Football League,[14] and the State Teachers Retirement System of Ohio.[15] As of 2005, there were over 1.5 million tax-exempt organizations in the United States.[16] The question thus becomes, why Congress wishes for certain entities to be exempt from federal income taxation? The answer may lie in the House Report to the Revenue Act of 1938. The report states:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from the financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.[17]

Thus, Congress envisioned that tax-exempt organizations would assume a quasi-government role in society and that is what merits their exempt status. The statutes that grant certain organizations exempt status also specify their exempt function. For example, section 501(c)(3) grants tax exempt status to organizations that are "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition..., or for the prevention of cruelty to children or animals."[18] The statute also says that these organizations are not permitted to operate for the benefit of any private individual, participate in a political campaign, or influence legislation.[19] Therefore, so long as organizations

---

[11] *See* I.R.C. § 501(c) (West 2010).
[12] *See id.*
[13] Tax-exempt under I.R.C. § 501(c)(3).
[14] Tax-exempt under I.R.C. § 501(c)(6).
[15] Tax-exempt under I.R.C. § 501(c)(11).
[16] Jill R. Horwitz, *Does Nonprofit Ownership Matter*, 24 YALE J. ON REG. 139, 145 (2007).
[17] *See* H.R. REP. NO. 75-1860, at 19 (1938).
[18] I.R.C. § 501(c)(3).
[19] *Id.; see* Donald Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 GEO. L.J. 1313 (2007) (containing more information concerning 501(c)(3) organizations participating in political campaigns).

continue to substantially operate within their exempt function, they will not be in danger of losing their exempt status. However, if an organization merely strays from their exempt function, they will not lose their exempt status completely, but they could be subject to the unrelated business income tax.

## III. THE UNRELATED BUSINESS INCOME TAX

### A. *Defining Unrelated Business Income*

The unrelated business income tax was enacted by Congress in 1950 and was codified at IRC §§ 511-513.[20] The primary purpose of the unrelated business income tax is to prevent unfair competition by tax-exempt organizations that would arise if they were to receive preferential tax treatment over non-exempt organizations engaged in the same trade or business.[21] Income generated by a tax-exempt organization through activities not related to its exempt-purpose is taxed at the corporate income tax rates.[22] The unrelated business income tax generally applies to all organizations described in sections 401(a) and 501(c) of the IRC.[23] The code also makes it abundantly clear that the tax applies to all state colleges and universities.[24]

Specifically, "Unrelated Business Taxable Income" is defined in Section 512 of the I.R.C. as "the gross income derived by any organization

---

[20] Revenue Act of 1950, Ch. 994, 64 Stat. 906, 947 (1950).

[21] REVENUE ACT OF 1950, H.R. REP. NO. 81-2319, at 36 (1950) ("The tax-free status of these...organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes."); REVENUE ACT OF 1950, S. REP. NO. 81-2375, at 28 (1950) ("In neither the House bill nor your committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such business...[The] provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors.). *See also* Treas. Reg. § 1.513-1(b) (as amended in 1938).

[22] *See* I.R.C. § 511(a)(1) (West 2010).

[23] *See* I.R.C. § 511(a)(2)(A). Section 401(a) of the I.R.C. concerns qualified pension, profit-sharing, and stock-bonus plans. *See* I.R.C. § 401(a). Section 501(c) provides a list of tax-exempt organizations. *See* I.R.C. § 501(c).

[24] *See* I.R.C. § 511(a)(2)(B); Iowa State Univ. of Sci. & Tech. v. United States, 500 F.2d 508, 510, 523 (1974) (holding that the IRS could assess an income tax on the unrelated business income generated by the University's wholly owned television station and rejecting the university's argument of state immunity). The court in *Iowa State University* relied on *Allen v. Regents of the University System of Georgia*, in which the IRS sought to enforce an excise tax on two state universities and the court held that the when a state engages in a business that would ordinarily be taxable, the state is not immune by virtue of their sovereignty. *Allen v. Regents of the Univ. System of Ga.*, 304 U.S. 439, 450, 453 (1938).

from any unrelated trade or business regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business."[25] Treasury Regulation § 1.512(a)-1(a) further defines "directly connected with" by stating "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."[26] "Unrelated Trade or Business" is then defined by section 513 of the I.R.C. as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501."[27] Thus, unrelated business income is generally income from a trade or business that is regularly carried on by the organization (less allowable deductions) that is not substantially related to the organization's exempt purpose.

For example, if a state university operated a theater on campus during the week that was used by the film studies department for educational purposes and thus related to the university's exempt purpose (education), that activity would not be an unrelated trade or business.[28] However, if the university also operated the theater on the weekends as an ordinary motion picture theater open to the general public, this activity would be an unrelated trade or business.[29] The income generated from operating theater on the weekend would be taxed at the corporate income tax rates.[30] Furthermore, the policy behind the unrelated business income tax is abundantly clear in this example. If the university were permitted to operate the theater tax-free, for-profit theaters in the vicinity of the university would struggle to compete because the for-profit theaters' costs would automatically be higher than the university's costs since the for-profit theater would have to pay income taxes and the university would not.

---

[25] I.R.C. § 512(a)(1) (West 2010).

[26] Treas. Reg. § 1.512(a)-1(a) (2010).

[27] I.R.C. § 513(a) (West 2010). Section 513 provides more guidance on specific situations in which certain activities are deemed to either be unrelated to the exempt organizations purpose. Section 513(a)(2) is of particular relevance to universities because it states that in the case of a college or university, "unrelated trade or business" shall not include activities of the organization that are "primarily for the convenience of its members, students, patients, officers, or employees." *Id.*

[28] *See* Treas. Reg. § 1.513-1(d)(4)(example 3)(iii).

[29] *See id.*

[30] I.R.C. § 511(a)(1). Note that the income generated by the theater from the students on the weekend probably would not be "unrelated business income" because the theater is for the "convenience of the students." *See* I.R.C. § 513(a).

### B. *Exceptions: Activities That Are Not Considered to be an Unrelated Trade or Business*

Congress has provided for several exceptions of activities that otherwise would be considered an unrelated trade or business if it were not for an exception. If substantially all of the work of an unrelated activity is performed by individuals without compensation, then this activity is not considered to be an unrelated trade or business.[31] For example, if a tax-exempt orphanage operated a retail gift store and made sales to the general public, this activity would not be considered an unrelated business activity if all of the employees in the store were volunteers.[32] Another exception provides that activities engaged in by I.R.C. § 501(c)(3) organizations or by state colleges or universities are not to be considered an unrelated trade or business if the organization engages in such activity for the "convenience of its members, students, patients, officers, or employees."[33] Thus, if a state university operated a laundry to launder dormitory linens and students' clothing; this activity would not be considered an unrelated trade or business.[34] An additional exception covers sales of work-related clothes, equipment, vending machines items, and snack bar items by local associations of employees for the convenience of their members at their usual places of employment.[35] Finally, the sale of merchandise, substantially all of which was donated to the organization, is not considered to be an unrelated trade or business.[36] An example of this exception is a thrift shop that receives donations of old clothes, books, furniture, etc. to be sold to the general public.[37] There are numerous other exceptions to the unrelated business income tax pertaining to corporate sponsorships payments,[38] qualified bingo games,[39] and the distribution of low-cost articles[40] that are beyond the scope of this note.

### C. *The Dilemma of Common Sources of Income and Expenses*

Inevitably, universities, hospitals, and other large tax-exempt organizations subject to the unrelated business income tax are going to use their facilities and employees for both exempt purpose activities and for

---

[31] I.R.C. § 513(a)(1).
[32] Treas. Reg. § 1.513-1(e)(3).
[33] I.R.C. § 513(a)(2).
[34] Treas. Reg. § 1.513-1(e)(3).
[35] I.R.C. § 513(a)(2). This only applies to local associations of employees described in I.R.C. § 501(c)(4) that were organized before May 27, 1969.
[36] I.R.C. § 513(a)(3).
[37] Treas. Reg. § 1.513-1(e)(3).
[38] I.R.C. § 513(i).
[39] I.R.C. § 513(f).
[40] I.R.C. § 513(h)(1)(A).

"unrelated trade or business" or "non-exempt" activities. The question then becomes how should these organizations allocate the income and the related expenses that are generated through such activities? For example, if an exempt hospital operates a pharmacy that provides medication to both hospital patients and the general public, how should the hospital allocate expenses between related activities (providing medication to patients) and unrelated business activities (selling medication to members of the public)?[41] The pharmacy undoubtedly has to pay the pharmacist, pay a pharmacy manager, pay for utilities, and incur numerous other expenses to both provide medication to its patients and sell medication to the public. All of these expenses will need to be allocated on a reasonable basis to the "providing medication to patients" part of the business (related activity) and to the "selling medication to the public" part of the business (unrelated activity).[42]

Returning to the theater hypothetical, it should be fairly straightforward for the university to distinguish sales revenues derived from student use of the theater on the weekends and sales revenue derived from public use. The university could simply implement a policy that requires all students to show a student identification card when they purchase a movie ticket and thus separate student sales from public sales. However, how much does the university have to charge the public to view a show in the theater? Does the university have to intend to profit off of the public sales if they wish to deduct the costs associated with the activity? These questions were raised in *Portland Golf Club v. Commissioner of Internal Revenue,* a case that was decided by the United States Supreme Court in 1990.[43]

## IV. GUIDANCE FROM THE COURTS

### A. *Portland Golf Club. v. Commissioner of Internal Revenue – Intent to Profit Standard*

#### 1. *Facts & Lower Court Decisions*

In 1990, the United States Supreme Court decided the case of *Portland Golf Club v. Commissioner of Internal Revenue.*[44] Portland Golf

---

[41] An exempt hospital that regularly sells medication to the public is engaged in an unrelated trade or business activity. It does not matter if the same pharmacy that sells medication to the public also provides medication to the hospital's patients. The sales to the public are still an unrelated business activity. *See* Treas. Reg. § 1.513-1(b).

[42] *See* Treas. Reg. § 1.512(a)-1(c).

[43] Portland Golf Club v. Comm'r, 497 U.S. 154 (1990).

Club (the club) was a private country club and some of its income was exempt from federal income tax under I.R.C. § 501(c)(7).[45] Specifically, the club's income that came from membership dues was exempt from the federal income tax.[46] The club received unrelated business income from the sale of food and drink to nonmembers and from the return on the club's investments.[47] This income is taxable at the corporate tax rate under § 511.[48]

In 1980 and 1981, the tax years in controversy, the club had gross unrelated business income from nonmember sales of $84,422 and $106,547 respectively; however, the club generated net losses from nonmember sales of $28,433 and $69,608.[49] The club determined these losses by subtracting the variable costs associated with the sales and an allocated portion of fixed

---

[44] *Id.*

[45] *Id.* at 156. Section 501(c)(7) of the Internal Revenue Code permits a limited tax exemption for social clubs. Specifically, the statute grants an exemption to "Clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder." I.R.C. § 501(c)(7).

[46] *Portland Golf Club*, 497 U.S. at 156. It is rational to allow a social club to receive a tax-exemption for membership dues because the collection of dues just facilitates a future joint purchase of social activities. It is no different than if Taxpayer A and Taxpayer B pooled their money together to rent a suite at a football stadium. If Taxpayer B collects Taxpayer A's money to execute the purchase, Taxpayer B should not have gross income from the transaction. S. REP. NO. 91-552, at 71 (1969) (quoted in *Portland Golf Club*, 497 U.S. at 162).

[47] *Portland Golf Club*, 497 U.S. at 156. Unrelated Business Income for social clubs is defined under § 512(a)(3)(A) of the I.R.C. as "gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income)." I.R.C. § 512(a)(3)(A). The sale of food and drink to nonmembers is not "exempt function" income under I.R.C. § 512(a)(3)(B) because it is not derived from "the gross income from dues, fees, charges, or similar amounts paid by 'members' of the organization." I.R.C. § 512(a)(3)(B). Section 512(a)(3)(B) of the I.R.C. defines "exempt function income" as "the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid." *Id.*

[48] I.R.C. § 511(a); *Portland Golf Club*, 497 U.S. at 156. Section 511(a) of the I.R.C. provides in part that there shall be "imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. I.R.C. § 511(a). In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as 'unrelated business taxable income.'" Section 11 of the IRC provides the corporate income tax rates. *See* I.R.C. § 11 (West 2010).

[49] *Portland Golf Club*, 497 U.S. at 158.

costs from the gross sales.[50] The club used the gross-to-gross method in determining how much of the fixed costs should be allocated to the non-member sales.[51] The gross-to-gross method is an accounting method used to allocated fixed costs. For example, if twenty-five percent of the club's sales were to nonmembers, then twenty-five percent of the fixed costs should be allocated to the nonmembers sales. The net losses generated by the nonmember food and drink sales were then netted against the club's investment income of $11,752 in 1980 and $21,414 in 1981, which results in the club not having to report any unrelated business income in either of those years.[52] However, the IRS contends that the club incorrectly used the losses from the food and drink sales to nonmembers to offset the club's investment income because the club did not demonstrate the intent to profit from the nonmember sales.[53]

The U.S. Tax Court found that Portland Golf did demonstrate a profit motive because the gross receipts from the nonmember sales exceeded the variable costs of those sales.[54] The court believed that this was the best way to determine the "intent to profit" because fixed costs should be disregarded since they would be incurred regardless of nonmember sales.[55] The court thus allowed the club to offset its investment income with its loss from nonmember food and drink sales – assuming that fixed costs were allocated to nonmember food and drink sales in a manner in which the IRS finds acceptable.[56] The Ninth Circuit Court of Appeals reversed the Tax Court's decision and relied on its holding in the case of *North Ridge Country Club v. Commissioner* in which they defined intent to

---

[50] *Id.* at 157. A variable cost is defined as "changes in total in proportion to changes in the related level of total activity or volume." CHARLES T. HORNGREN, SRIKANT M. DATAR & GEORGE FOSTER, COST ACCOUNTING: A MANAGERIAL EMPHASIS 30 (12th ed. 2006). Fixed costs "remain unchanged in total for a given time period, despite wide changed in the related level of total activity or volume." *Id.* For example, if the club were selling hot dogs, the actual cost of the hot dog would be considered a variable cost, assuming that activity is defined as the amount of hot dogs sold to customers, because as the amount of hot dog sales increases or decreases, the total cost of the hot dogs will increase or decrease proportionally. The depreciation expense of the building that the hot dogs are sold in would be a fixed cost since the amount of this cost does not vary as the amount of hot dogs sold increases or decreases.

[51] *Portland Golf Club*, 497 U.S. at 157.

[52] *Id.*

[53] *Id.* at 158.

[54] *Id.* at 159.

[55] *Id.* at 166-67.

[56] *Id.* at 159. The IRS's position on the allocation of common fixed costs between exempt and non-exempt activities is addressed at length later in the note.

profit as the, "production of gains in excess of all direct and indirect costs."[57]

### 2. *Supreme Court's Holding*

Both the U.S. Tax Court and the Ninth Circuit Court of Appeals agreed that the club needed to demonstrate the "intent to profit" in order to deduct the losses derived from the nonmember food and drink sales from the investment income. However, the courts differed as to how "intent to profit" should be defined. Thus, the Supreme Court considered the club's two main arguments in resolving the following issues: (1) whether a social club must show intent to profit from its unrelated business activities in order to deduct losses derived from those activities and (2) if a social club must show intent to profit, did Portland Golf Club sufficiently demonstrate that intent?[58]

The Supreme Court agreed with the two lower courts and held that the club "may offset losses incurred in sales to nonmembers against investment income only if its nonmember sales are motivated by intent to profit."[59] The court reasoned that since unrelated business income under § 512(a)(3)(A) is defined as "gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding the exempt function income)," the "deductions allowed by this chapter," that the club seeks to take, are deductions under § 162 of the IRC.[60] The U.S. Supreme Court has previously held that taxpayers are only permitted a deduction under § 162 if an intent to profit can be demonstrated and thus there is no reason to deviate from that standard.[61]

Instead of proscribing a particular method to determine if there was the "intent to profit", the Supreme Court held that Portland Golf must use the same method to determine whether they intended to profit that they use to calculate "actual profit or loss" from unrelated business activities on their tax return.[62] The court neglected to hold that any particular method should

---

[57] *Id.* (quoting N. Ridge Country Club v. Comm'r, 877 F.2d 750 (9th Cir. 1989)).
[58] *Portland Golf Club*, 497 U.S. at 163.
[59] *Id.* at 166.
[60] *Id.* at 164. Section 162 of the I.R.C. provides in part "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162 (2009).
[61] *Portland Golf Club*, 497 U.S. at 164. *See* Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987) (holding that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.").
[62] *Portland Golf Club*, 497 U.S. at 171.

be used in determining whether a social club had the intent to profit on an unrelated business activity.[63] In this case, since Portland Golf stipulated to using the gross-to-gross method to allocate fixed costs and determine their actual loss, the gross-to-gross method must also be used to determine whether Portland Golf had the intent to profit.[64] Since the gross-to-gross method shows Portland Golf incurring a loss on the nonmember sales of $28,433 in 1980 and $69,608 in 1981, the court concluded that Portland Golf did not demonstrate the intent to profit and thus cannot use these losses to offset their investment income.[65] In a footnote, the court explains that a lack of the intent to profit does not have to be inferred from the fact that an organization failed to generate a profit under a particular accounting method, however Portland Golf failed to make any arguments as to why the court should not make that inference.[66]

### 3. *Result of the Portland Golf Case*

Social clubs and probably other tax-exempt organizations subject to the unrelated business income tax must make sure they are able to demonstrate the intent to profit in order to net losses from one unrelated business activity against income generated by another unrelated business activity. It is worth emphasizing that the court's holding only requires that the same accounting method be used to determine an organization's actual profit or loss from unrelated business activities and to determine the organization's intent to profit.[67] Thus, if Portland Golf had instead used the "actual use" method instead of the "gross-to-gross" method in determining their actual profit or loss, Portland Golf would have shown a profit, and thus had a stronger argument that they had the "intent to profit."[68] The court's holding also only seems to prevent organizations that cannot demonstrate the intent to profit with respect to an unrelated business

---

[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.* Treasury Regulation § 1.183-2(b) lists several factors that should be considered in determining whether an intent to profit exists. Among the factors listed included (1) manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer of his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) expectation that assets used in activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history on income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; (9) elements of personal pleasure or recreation. Treas. Reg. § 1.183-2(b) (2010).
[67] *Portland Golf Club*, 497 U.S. at 170 n.21.
[68] *Id.* at 173 (Kennedy, J., concurring).

activity from using losses from that activity to offset income from a different unrelated business activity.[69] It remains unclear as to whether losses generated by an unrelated business activity can offset income generated by that same unrelated business activity if the intent to profit has not been proven. [70]

In the *Portland Golf Club* case, the club and the IRS stipulated that the gross-to-gross method was a permissible accounting method to allocate fixed costs between exempt activities and non-exempt activities.[71] Thus, assuming the parties did not stipulate, the next question becomes, what is permissible fixed cost allocation method.

Once again, returning to the theater hypothetical, if the university wished to take a deduction for depreciation from the building the theater is located in to offset unrelated business income, how much of a deduction is the university entitled since the building is being used for both its exempt purpose (education) and for an unrelated trade or business activity (weekend public theater sales)? Section 512(a)(1) clearly states that unrelated business taxable income is unrelated business income "less the deductions allowed by this chapter which are directly connected with the carrying on of such trade of business."[72] Depreciation is a deduction allowed under Section 162.[73] Treas. Reg. § 1.512(a)-1(a) says that "directly connected with" means that the deduction must have a "proximate and primary relationship" to the business.[74] Finally, Treas. Reg. § 1.512(a)-1(c) attempts to settle the issue by saying that where facilities and personnel are used to carry on both exempt activities and unrelated business activities, fixed costs "shall be allocated between the two uses on a *reasonable basis*."[75] The Second Circuit Court of Appeals is the only court that has attempted to define what "reasonable basis" means, and it did so in Rensselaer *Polytechnic Institute v. Commissioner.*

## B. *Rensselaer Polytechnic Institute v. Commissioner – Fixed Cost Allocation Methods*

### 1. *Facts*

The Second Circuit Court of Appeals is the only circuit court to date to grapple with the allocation of fixed costs between exempt activities

---

[69] *Id.* at 176.
[70] *Id.* For example, could Portland Golf use losses from nonmember sales to offset income from nonmember sales?
[71] *Portland Golf Club*, 497 U.S. at 158 n.4.
[72] I.R.C. § 512(a)(1).
[73] *See* I.R.C. § 162 (West 2010).
[74] Treas. Reg. § 1.512(a)-1(a).
[75] Treas. Reg. § 1.512(a)-1(c).

and unrelated business activities at a university. Rensselaer Polytechnic Institute (RPI) is a non-profit school of higher education that is entitled to tax-exempt status under I.R.C. § 501(c)(3).[76] The school owns and operates a field house that is used by its students for activities such as ice hockey, ice skating, and other activities that are related to RPI's tax-exempt purpose.[77] However, the school also uses the field house for commercial ice shows and public ice skating which do not fall within the school's tax-exempt purpose.[78] Thus, it is unquestioned that the income that is derived from the commercial activities at the field house is taxable unrelated business income.[79] The issue in the case was what amount of the fixed costs related to the operation of the field house, such as depreciation, is allocable to the non-exempt activities and thus deductible from unrelated business income?[80]

### 2. *Fixed Cost Allocation*

Treasury Regulation § 1.512(a)-1(c) requires tax-exempt organizations to allocate fixed costs "on a reasonable basis" if the tax-exempt organization uses a facility for both exempt and non-exempt purposes.[81] The regulation gives an example of a reasonable allocation that multiplies an employee's salary (a fixed cost) by the fraction of the amount of time a salaried employee of a tax-exempt organization works on non-exempt activities divided by the total amount of time the employee works

---

[76] Rensselaer Polytechnic Inst. v. Comm'r, 732 F.2d 1058, 1059 (2d Cir. 1984).
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] Treas. Reg. § 1.512(a)-1(c).

> "(c) Dual use of facilities or personnel. 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. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) 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 activity is proximately and primarily related to that business activity, 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 provisions of the Code."

*Id.*

for the organization.[82] The resulting dollar amount is the amount of the tax-exempt organization's deduction from unrelated business income.[83]

RPI's method of fixed cost allocation is analogous to the Treasury Regulation. RPI multiplies the total amount of the fixed expenses related to the operation of the field house by the fraction of the amount of time the facility is used for non-exempt activities divided by the total amount of time the facility is used for both exempt activities and non-exempt activities.[84] Thus, both the example in the Treasury Regulations and RPI's method use the total amount of time the facility was "used" in the denominator of the fraction. This is known as the "actual-use" method.[85]

However, the IRS argues that the allocation of the fixed costs should not be made on the basis of the total amount of time the facility was used, but instead should be allocated on the basis of total time available for use.[86] Thus, the IRS contends that the denominator should be the total amount of hours in the taxable year and not the total amount of hours that the facility is actually in use.[87] As a result of this argument, the deduction would be minimized because the denominator cannot become any larger than the actual amount of hours in a taxable year. The IRS argues that the organization should not be permitted to take depreciation deductions while the facility is idle because this would violate the requirement that that the

---

[82] *Id.* "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 activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of $2,000 (10 percent of $20,000), would be allowable for the salary paid to its president."

[83] *Id.*

[84] *Rensselaer Polytechnic Inst.*, 732 F.2d at 1060. For example, if the total amount of fixed costs were $100,000, the field house was used for a total of 2000 hours during the taxable year, and 500 of the 2000 hours was used for public skating and other non-exempt purposes, then the school would argue that it is entitled to deduct $25,000 of the fixed costs from unrelated business income. [(500/2000) × $100,000].

[85] Recall that this method was considered in the *Portland Golf Club* case and in that case would have resulted in Portland Golf showing a profit from their unrelated business activities. *See Portland Golf Club*, 497 U.S. at 158. Instead, both parties in that case stipulated to use the gross-to-gross method of allocation. *Id.*

[86] *Rensselaer Polytechnic Inst.*, 732 F.2d at 1060. Continuing the example from footnote 36, the IRS would argue that there are 8760 hours available to use the field house in a year [24 hours per day × 365 days]. Thus, assuming all of the other facts in footnote 26, the school would only be able to deduct $5,707.76. [(500/8760) × $100,000]. In this example, the two different fixed cost allocation methods yield a difference in the allowable deduction from unrelated business income of $19,292.24. [25,000 - 5,707.76].

[87] *Id.* There are 8760 hours in the taxable year.

deductible expenses be "directly connected with" the unrelated business activities.[88] The court rebuts this argument by explaining that depreciation deductions are already permitted to be taken during idle time.[89]

The court finds for RPI and holds that "apportioning indirect expenses such as depreciation on the basis of the actual hours the facility was used for both exempt and taxable purposes sensibly distributes the cost of the facility among the activities that benefit from its use."[90] Furthermore, the court acknowledges that to hold otherwise and allocate fixed costs on the basis of the total amount of time the facility is available during the taxable year would be inconsistent with home office deductions.[91]

The court says that the argument that RPI's allocation method, now validated by the court, will encourage educational institutions to abuse their tax-exempt status is a "red herring."[92] The court states that the "use of educational facilities for producing unrelated business income is not tax abuse."[93] Thus, the court does not seem to think that trying to allocate as many fixed costs as possible to non-exempt activities amounts to tax abuse.

## V. HOW DO CHARITABLE ORGANIZATIONS INTERPRET THE "REASONABLE" STANDARD?

The court's approval of RPI's allocation method as "reasonable" provided some guidance on the issue of fixed cost allocation for tax-exempt organizations. In the Second Circuit at least, allocating common fixed costs based on actual use rather than available capacity to use is one definition of a "reasonable" allocation method. The IRS does not acquiesce to this decision, but acknowledged their position is weak due to the existing Treasury Regulations that allow for taxpayer to use a "reasonable" allocation method.[94] Thus, the IRS said that they will not litigate the issue

---

[88] *Id.* at 1062.
[89] *Id.*
[90] *Id.* at 1061-62
[91] *Id.* at 1062. Home offices are a common "dual-use" facility in which taxpayers are permitted a deduction for the "office" portion of the home office. *See* I.R.C. 280A(c) (West 2010).
[92] *Rensselaer Polytechnic Inst.*, 732 F.2d at 1062.
[93] *Id.*
[94] *Rensselaer Polytechnic Inst.*, 732 F.2d 1058 (2d Cir. 1984), *action on dec.*, 1987-014 (June 18, 1987). In a Field Service Advice Memorandum released in 1992, the IRS said that their position is still not to litigate the issue of reasonable cost allocation out of a fear that more adverse decisions could make later amendments to the regulations more difficult. I.R.S. Field Serv. Adv. Mem. 5304-92 (Apr. 1, 1992).

again until the Treasury Regulations are amended.[95] In a private letter ruling, the IRS reiterated their position in *Rensselaer Polytechnic Institute v. Commissioner* and stated that the "actual use" allocation method is not a "reasonable basis" to allocate common fixed costs because it "distorts the amount of fixed expenses attributable to the taxable activity because if the facility's primary purpose is to carry out the exempt organization's exempt functions, then expenses that are not primarily and proximately related to taxable activities should not be used to offset taxable income."[96] The IRS takes the position that expenses should be allocated between exempt and non-exempt activities on the basis of the twenty-four-hour-a-day/twelve-month-a-year period or actual capacity use rule.[97]

According to the most recent statistics compiled by the IRS, 50.8% of tax-exempt organizations that engage in an unrelated business activity do not pay any unrelated business income tax because they are able to completely offset unrelated business income with deductions and credits.[98] In fact, the amount of taxpayers that actually pay unrelated business income taxes has steadily decreased from 2002 to 2006.[99] Steven T. Miller, Commissioner of the IRS's Tax-Exempt and Government-Entities Division, said that the IRS was concerned about these statistics at a Congressional hearing in 2007.[100]

---

[95] I.R.S. Field Serv. Adv. Mem. 5304-92.

[96] I.R.S. Priv. Ltr. Rul. 91-49-006 (Aug. 12, 1991).

[97] *Id.* (The taxpayer, a non-profit tax-exempt organization under § 501(c)(3) operated a facility for livestock shows two months of the year and rented the facility (generating UBI) for ten months a year. The taxpayer, following *Rensselaer Polytechnic Institute v. Commissioner*, allocated 1/6 of the expenses to the exempt livestock shows and 5/6 of the expenses to the non-exempt rental activity. Instead, the IRS says the taxpayer must divide the total amount of hours the facility was rented by the total amount of hours in the year and multiply that ratio by the total amount of common fixed costs to determine the amount of expenses to allocate to the non-exempt activity. *Rensselaer Polytechnic Inst.*, 732 F.2d at 1060.

[98] Statistics of Income Division, IRS, http://www.irs.gov/taxstats/charitablestats/article/0,,id=97210,00.html#2 (last visited Mar. 25, 2010).

[99] *Id.*

[100] Peter Panepento & Grant Williams, *A Question of Calculation*, CHRON. OF PHILANTHROPY, Feb. 7, 2008, at 33.

| Unrelated Business Income Tax Reporting[101] | | | |
|---|---|---|---|
| **Year** | **Number of Returns** | **Number of Returns Showing UBIT Due** | **Percent of Returns Showing UBIT Due** |
| 1997 | 39,302 | 20,724 | 47.3% |
| 1998 | 46,208 | 24,172 | 47.7% |
| 1999 | 42,151 | 20,438 | 51.5% |
| 2000 | 38,567 | 19,340 | 49.9% |
| 2001 | 35,540 | 15,308 | 56.9% |
| 2002 | 35,103 | 14,511 | 58.7% |
| 2003 | 36,064 | 15,524 | 57.0% |
| 2004 | 38,040 | 18,022 | 52.6% |
| 2005 | 40,676 | 20,360 | 49.9% |
| 2006 | 43,520 | 22,107 | 49.2% |

Several reasons can be offered to explain why approximately half of all tax-exempt organizations that engage in unrelated business activities do not actually pay any unrelated business income tax. The IRS itself offered seven reasons on its forty-two page questionnaire sent to universities including (1) business was starting-up; (2) actual costs were significantly greater than anticipated; (3) competitive pressures prevented pricing to allow for full recovery of costs; (4) less demand for the product or service than expected; (5) business cycle downturn; (6) operating at breakeven or a loss contributes to the organization's exempt mission; and (7) the business was winding-up.[102] Ronald J. Schultz, a senior advisor to the commissioner of the IRS's Tax Exempt and Government Entities Division, agreed that there could be "a number of very legitimate reasons," why a tax-exempt organization might lose money on an unrelated business activity.[103] However, Mr. Schultz was quick to point out that some tax-exempt organizations may be showing losses or no income from their unrelated business activities because they are "misallocating" some of their expenses.[104] In support of Mr. Schultz's theory, one researcher has found

[101] Statistics of Income Division, *supra* note 98.
[102] IRS Form 14018, at 7, *available at* http://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf.
[103] Grant Williams, *IRS Plans Close Look at Charity Business Activities*, CHRON. OF PHILANTHROPY, Apr. 3, 2008, at 42.
[104] *Id.*

evidence that tax-exempt organizations purposely reallocate expenses attributable to exempt function activities to non-exempt function activities to minimize their tax liability.

The study found that on average, medical and educational tax-exempt organizations reallocated $400,000 of their expenses from exempt activities to non-exempt activities while other charitable tax-exempt organizations did not reallocate any expenses.[105] The author concluded that recurring losses reported by tax-exempt organizations are at least partially due to the intentional shifting of expenses from exempt activities to non-exempt activities, and that the unrelated business income tax is not functioning as it was intended.[106] Thus, maybe the argument that universities intentionally use certain fixed cost allocation methods to abuse their tax-exempt status is not the "red herring" that the second circuit claims it to be.[107]

## VI. SOLVING THE PROBLEM OF FIXED COST ALLOCATION BETWEEN ACTIVITIES RELATED TO EXEMPT PURPOSE AND UNRELATED BUSINESS ACTIVITIES

### A. *National Association of College and University Business Officers Proposal*

Disputes concerning the definition of a "reasonable" allocation method between the IRS and universities are often resolved by agreeing to a specific dollar amount of taxes owed rather than truly agreeing on a permissible "reasonable" allocation method.[108] This lack of a clear definition of a "reasonable" allocation method has cost both the IRS and several universities valuable time and resources.[109] Furthermore, many universities, which must use fund accounting methods rather than traditional accounting methods used by for-profit institutions, would need to create an entirely new accounting system to correctly account for (in the opinion of the IRS) their unrelated business income and associated expenses.[110] Creating a peripheral accounting system would be cost

---

[105] Robert J. Yetman, *Tax-Motivated Cost Shifting by Tax-Exempt Organizations*, 76 ACCT. REV. 297, 310 (July 2001).
[106] *Id.*
[107] *See Rensselaer Polytechnic Inst.*, 732 F.2d at 1062.
[108] Letter from James E. Morley, Jr., President of the Nat'l Ass'n of Coll. & Univ. Offices, to Evelyn Petschek, Assistant Comm'r of the Internal Revenue Serv. 1-2 (June 20, 1997), *available at* http://www.nacubo.org/Documents/business_topics/UBITcover%20ltr%20from%20Jay-FINAL.pdf.
[109] *Id.* at 2.
[110] *Id.* at 1-2.

prohibitive because unrelated business income amounts to a tiny fraction of any universities' overall budget.[111] Thus, universities are essentially forced to not allocate any indirect costs to their unrelated business activities.[112]

In hope of bringing some clarity to the definition of a "reasonable" allocation method, the National Association of College and University Business Officers (NACUBO) drafted a proposed revenue procedure that detailed a "safe harbor" provision to allocate indirect costs between exempt activities and unrelated trade or business activities.[113] The proposed revenue procedure authored by NACUBO gives colleges and universities a safe harbor method for allocating their indirect costs in determining their unrelated business income by mimicking the cost allocation rules set forth in Office of Management and Budget-Circular A-21 (OMB-Circular A-21).[114] The majority of educational institutions must already abide by OMB-Circular A-21 as a condition to receiving federal funds for research and other sponsored activities.[115]

---

[111] *Id.*

[112] *Id.* at 2.

[113] NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, DRAFT REVENUE PROCEDURE: SAFE HARBORS FOR ALLOCATING EXPENSES BY COLLEGES AND UNIVERSITIES FOR PURPOSES OF DETERMINING TAXABLE UNRELATED INCOME (1997), *available at* http://www.nacubo.org/Documents/business_topics/DraftRevenueProcedureFINAL.pdf. "The National Association of College and University Business Officers (NACUBO) is a professional membership association serving chief business and financial officers of member colleges and universities. Its purpose is to develop, promote, and improve business and financial principles and practices in the administration of higher education, as well as to foster professional ideals and standards among its members. NACUBO provides these benefits to its members primarily through meetings, workshops and publications. These activities are funded primarily through membership dues, conference and workshop fees and publication sales." NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, NACUBA 2008 FINANCIAL STATEMENT 29 (Sept. 19, 2008), *available at* http://www.nacubo.org/documents/bom/BOM1108_Financials_FINAL.pdf.

[114] NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, *supra* note 113, at 1; *see also* Letter from James E. Morely, Jr., *supra* note 108, at 3.

[115] NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, *supra* note 113, at 2. OMB Circular A-21 is titled "Cost Principles for Educational Institutions" and its stated purpose is to establish "principles for determining costs applicable to grants, contracts, and other agreements with educational institutions." The principles in this circular apply to "[a]ll federal agencies that sponsor research and development, training, and other work at educational institutions." OFFICE OF MGMT. & BUDGET, OMB CIRCULAR A-21, COST PRINCIPLES FOR EDUCATIONAL INSTITUTIONS 1 (2004), *available at* http://www.whitehouse.gov/omb/assets/omb/circulars/a021/a21_2004.pdf.

The revenue procedure describes two different options to allocate indirect costs depending on the size of the organization and the amount of federal funding they receive.[116] If an organization is subject to the rules under OMB-Circular A-21, then option #1 should be used, and if the organization is not subject to the rules under OMB-Circular A-21 option #2 should be used.[117] Under both options, direct costs and allocated indirect costs are to be considered "proximate and primary costs" as described in the Treasury Regulations.[118]

Under option #1, costs are divided into three different categories: (1) direct costs; (2) allocated departmental administration costs; (3) and allocated institutional indirect costs.[119] A direct cost is a cost that can be directly traced or easily assigned to a specific unrelated business activity.[120] Allocated departmental administration costs are department level overhead that should be allocated in part to a specific unrelated business activity.[121] Finally, allocated institutional direct costs are institutional level overhead that need to be allocated in part to a specific unrelated business activity. The allocations are to be made based upon Circular A-21 methodologies.[122]

Once again, returning to the ongoing theater hypothetical will help to better explain three categories of costs outlined in the proposed revenue procedure.[123] First, the revenue generated from sales to the students (related activity) must be separated from the revenue generated from sales to the public (unrelated activity) as shown in the table below. Assuming that the price charged to the students is the same as the price charged to the public, the ratio of revenue from public sales to total sales can be used as the allocation rate for all costs. The direct costs, items that can directly be

---

[116] DRAFT REVENUE PROCEDURE, *supra* note 113 at 3.

[117] *Id.*

[118] *Id.*

> 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 paragraph (d)(2) 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 . . .

Treas. Reg. § 1.512(a)-1(a).

[119] NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, *supra* note 113, at 3.

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] The following example is based on example C of the draft revenue procedure, NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, *supra* note 113, at 13 ex.C. The draft revenue procedure includes three detailed examples. *Id.* at 8-13.

traced to theater operations such as employee wages and purchases of movie projectors and other supplies, can then be divided between the related and unrelated activity. Next, the theater must be allocated part of the Department of Arts' administrative costs to recognize the fact that the director of the Arts department oversees the manager of the theater sub-department. This allocated cost must then also be apportioned between related and unrelated activities. Finally, the theater must be allocated a portion of the universities' costs since the theater benefits from university-wide services such as maintenance. The amount of the university's costs allocated to the theater must then be split between related and unrelated activities. The result is what NACBUO would call a "reasonable" allocation of the indirect costs.

| **Theater Sub-Department** | | | |
|---|---|---|---|
| | Total | Public (Unrelated Activity) | Student (Related Activity) |
| Ratio of Unrelated to Related Activity based on Revenue | | 37.5% | 62.5% |
| Revenue | $ 400,000 | $ 150,000 | $ 250,000 |
| Direct Costs (movies, wages, supplies) | 125,000 | 46,875 | 78,125 |
| Allocated Department of Arts Administrative Indirect Costs | 28,061 | 10,523 | 17,538 |
| Total Direct Costs and Allocated Department of Arts Admin. Costs | $ 153,061 | $ 57,398 | $ 95,663 |
| Allocated University Indirect Costs (President's Salary, Maintenance) | 18,597 | 6,974 | 11,623 |
| Total Costs | $ 171,658 | $ 64,372 | $ 107,286 |
| **Net Income** | $ 228,342 | $ 85,628 | $ 142,714 |

124

| **Calculation of Allocated Department of Arts Administrative Indirect Costs** | |
|---|---|
| Department of Arts Total Costs | $300,000 |
| Department of Arts Administrative Costs | $55,000 |
| Department of Arts Non-Administrative Costs | $245,000 |
| Administrative to Non-Administrative Rate | 22% |
| Direct Costs (Theater Sub-Department) | $125,000 |
| **Allocation to Theater Sub-Department** | $28,061 |

125

[124] Adapted from NAT'L ASS'N. OF COLL. & UNIV. BUS. OFFICERS, *supra* note 113, at 13 ex.C.

[125] *Id.*

| Calculation of Allocated University Indirect Costs | | |
|---|---|---|
| | Amount | Rate (Determined by University Cost Study |
| Building Depreciation | $ 100,000 | 0.40% |
| Equipment Depreciation | 25,000 | 0.05% |
| Maintenance | 10,000 | 3.50% |
| Administrative | 200,000 | 8.20% |
| Modified Total Direct (MTDC) | $ 335,000 | 12.15% |
| | | |
| Total Direct Costs and Allocated Department of Arts Admin. Costs | $153,061 | |
| University Overhead Rate | 12.15% | |
| **Allocation to Theater** | $ 18,597 | |

126

Option #2 is a more simplified approach designed for smaller institutions that do not have to comply with OMB-Circular A-21.[127] This approach approximates the allocation rate that is calculated under OMB-Circular A-21 by simply using already prepared financial statements.[128] The revenue procedure accommodates both private institutions that must satisfy the Financial Accounting Standards Board (FASB) and public institutions that must satisfy the Governmental Accounting Standards Board (GASB).[129]

While NACUBO's draft revenue procedure tries to clarify the meaning of a "reasonable" allocation method, the IRS has yet to respond with any guidance of their own in the twelve years since they received the draft revenue procedure.[130] Perhaps the IRS's current study in which they sent the forty-two page questionnaire to various universities and colleges across the country will finally lead to some clear guidance.

## B. *Current Status of the IRS Questionnaires*

Part II of the questionnaires sent out by the IRS to colleges and universities requests significant information about their unrelated business activities.[131] First, organizations must identify every unrelated business

---

[126] *Id.*
[127] *Id.* at 5.
[128] *Id.*
[129] *Id.*
[130] NAT'L ASS'N OF COLL. & UNIV. BUS., BUSINESS AND POLICY AREAS, UNRELATED BUSINESS INCOME, http://www.nacubo.org/Business_and_Policy_Areas/Tax/Unrelated_Business_Income.html (last visited on Mar. 10, 2010).
[131] IRS Form 14018, *supra* note 102, at 7.

activity they engage in and note things such as whether that activity has generated a loss in three out of the last five years, the predominant reason for that loss, and whether a future profit is expected.[132] Next, organizations must report how they calculate unrelated business income for each activity and specifically note the expense allocation method used.[133] The form suggests four different methods in which an organization may have allocated expenses: (1) Gross receipts for facility costs; (2) Actual time in use for fixed facility costs; (3) Time available for use for fixed facility costs; and (4) Other.[134]

The IRS is expected to release a report on their findings sometime during 2010.[135] At the January 2009 American Bar Association Tax Section Exempt Organization Committee meeting, Lois Lerner, the Director of Exempt Organizations at the IRS, commented and answered questions about the status of the questionnaires. Ms. Lerner indicated that the IRS has been bombarded with numerous inquiries as to how certain questions on the questionnaire should be answered "as though there was a right or wrong answer."[136] She said that the IRS is "just trying to gather

---

[132] *Id.* The history of losses and reason for those losses are to be considered in trying to determine whether an activity is being engaged in with the intent to profit according to Treas. Reg. § 1.183-2(b)(6) which states:

> The taxpayer's history of income or losses with respect to the activity. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

Treas. Reg. § 1.183-2(b)(6).

[133] IRS Form 14018, *supra* note 102, at 15.

[134] *Id.*

[135] Eric Kelderman, *Survey of College Finances Finds Good Stewardship, but Some Possible Red Flags*, CHRON. OF HIGHER EDUCATION, Dec. 17, 2009, http://chronicle.com/article/Survey-of-College-Finances/62622/.

[136] Lois Lerner, Director of Exempt Organizations at the IRS, Remarks at the ABA Tax Section Exempt Organizations Committee Meeting (Jan. 9, 2009).

information...there are no right or wrong answers."[137] However, when later asked a question about unrelated business income audits, Ms. Lerner said that the "we [the IRS] will be selecting the organizations for examination based on responses to the questionnaires."[138] Thus, Ms. Lerner admitted that in relation to possible audits, the "answers to the questionnaire matter."[139] Rob Choi, the Director of Exempt Organization Rulings and Agreements at the IRS, speaking at September 2009 American Bar Association Tax Section Exempt Organizations Committee Meeting, confirmed that the unrelated business income tax and executive compensation, two items included on the questionnaires, would be a "focus" in fiscal year 2010.[140]

In response to another question, Ms. Lerner clarified that the specific responses of any particular questionnaire will not be released to the public.[141] Thus, specific colleges and universities do not have to worry about their responses to the IRS's questionnaire becoming easily attainable by any member of the public. Ms. Lerner added that the IRS will only report "aggregate trends" such as "this many schools or this percentage of schools did X."[142]

While the IRS's report on the information gathered from these questionnaires has not yet been released as of this writing, a parallel report was issued by NACUBO and the Association of Governing Boards of Universities and Colleges (AGB) on December 17, 2009.[143] NACUBO and

---

[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] Rob Choi, Director of Exempt Organizations Rulings and Agreements at the IRS, Remarks at the ABA Tax Section Exempt Organizations Committee Meeting, (Sept. 18, 2009).
[141] *Id.*
[142] *Id.*
[143] NAT'L ASS'N OF GOVERNING BOARDS OF UNIV. & COLL., STATEMENT ON THE IRS COMPLIANCE QUESTIONNAIRE FOR COLLEGES AND UNIVERSITIES 4 (Dec. 17, 2009), *available at* http://agb.org/sites/agb.org/files/u3/AGB_NACUBO_IRS_Compliance_2009.pdf. The Association of Governing Boards of Universities and Colleges (AGB) is a national association that serves the interests of academic governing boards, institutionally related foundation boards, campus CEOs and other senior campus administrators on issues relating to higher education governance and leadership. Over 1200 colleges and universities are member institutions. ASS'N OF GOVERNING BOARDS OF UNIV. & COLL., ABOUT AGB, *available at* http://agb.org/about-agb (last visited Mar. 12, 2010). Officials from NACBUO and AGB maintain that they did not undertake a parallel to study as a counterpoint to the IRS's study but because "we too wanted to be sure that our colleges and universities are applying appropriate standards in governance and transparency and accountability,...and we felt we owed it to our respective constituencies to do our own analysis." Doug

AGB were successful in obtaining 146 completed questionnaires from colleges and universities across the United States, which represents approximately one-third of all the questionnaires that were sent out by the IRS.[144] NACUBO and AGB engaged Ernst and Young, an international accounting firm, to analyze the individual questionnaires and produce a report of their findings.[145]

According to the report, sixty percent of the institutions that submitted their questionnaire to Ernst & Young were public institutions.[146] However, only twenty-nine percent of colleges and universities nationwide are public.[147] Thus, the report acknowledges that either the IRS was targeting public institutions when it sent out the questionnaires or public institutions were more willing to submit their completed questionnaires to Ernst and Young and be included in the joint study by NACUBO and AGB.[148] Furthermore, nineteen percent of the institutions that submitted a questionnaire to Ernst and Young had a student enrollment of over 20,000; while nationwide, only four percent of institutions have an enrollment over 20,000.[149] Once again this shows that either the IRS was targeting larger institutions or that the larger institutions were more likely to participate in this parallel study.[150]

It is possible that the public universities were more willing to submit their questionnaires to the Ernst and Young study because they are more accustomed than private institutions to releasing information and may have determined that this information would eventually be made public through public records requests.[151] Furthermore, the data in the sample also suffers from self-selection bias since the institutions voluntarily submitted the questionnaires.[152] Republican Senator Charles Grassley, from Iowa, believes that the study is limited since "reflects data from about one-third of the 400 respondents . . . and it was commissioned by two higher education groups."[153] The Senator suggests that "the colleges that provided their

---

Lederman, *Coming Attractions of IRS Scrutiny*, INSIDE HIGHER ED., Dec. 18, 2009, http://www.insidehighered.com/news/2009/12/18/irs.

[144] ASS'N OF GOVERNING BOARDS OF UNIV. & COLL., *supra*, note 143, at 4.

[145] *Id.* Ernst & Young is an international accounting firm that provides assurance, tax, transaction, and advisory services. *See* Ernst & Young, http://www.ey.com/US/EN/About-us (last visited May 15, 2010).

[146] ASS'N OF GOVERNING BOARDS OF UNIV. & COLL., *supra*, note 143, at 5.

[147] *Id.*

[148] *Id.*

[149] *Id.*

[150] *Id.*

[151] Lederman, *supra* note 143.

[152] *Id.*

[153] *Id.*

responses for this study could make them public for independent, objective analysis."[154]

The report found that of the forty-seven specific unrelated business activities listed on the questionnaire, thirteen of those activities were engaged in by more than one-third of all respondents.[155] Specifically, some the activities that were the most widely participated in were facility rentals, operating a bookstore, and food services.[156] The report details that while many institutions report participating in unrelated business activities, few institutions report actually deriving unrelated business income from those unrelated activities.[157] Unfortunately, Ernst and Young's report did not include any findings as to how the respondents claimed to have calculated their unrelated business income and the specific allocation method they used. All that was reported was that the respondents had a total of $146 million in gross receipts from unrelated business activities and a net operating loss of $5 million.[158] Tax experts were reportedly surprised by the small amount of unrelated business income reported as well as the vast difference between the many institutions that reported engaging in an unrelated business activity and the few institutions that reported actually producing unrelated business income from that unrelated activity.[159]

## VII. THE FUTURE OF THE UNRELATED BUSINESS INCOME TAX

While the IRS, colleges, universities, and other exempt organizations are still trying to sort out the complexities of the unrelated business income tax, one solution might be to repeal the tax altogether. After all, the unrelated business income tax has only been in existence for the last sixty years.[160] However, there continues to be pressure and increasing scrutiny on the non-profit sector. Lois Lerner, Director of Exempt Organizations at the IRS, believes it is ever more important to be watchful of tax-exempt organizations during economic downturns and

---

[154] *Id.*

[155] ASS'N OF GOVERNING BOARDS OF UNIV. & COLL., *supra* note 143, at 15.

[156] *Id.* According to the report ninety percent of all respondents rented a facility, sixty-one percent operated a bookstore, and fifty-nine percent were involved in food services. A table listing the top thirteen unrelated business activities most widely engaged in and the percentage of institutions participating in each of those activities can be found on page 15 of the Ernst & Young report. *Id.*

[157] *Id.* For example, while ninety percent of all respondents claim to have engaged in the unrelated business activity of renting a facility, only thirty-four percent of institutions actually produced unrelated business income from renting a facility.

[158] *Id.* at 3.

[159] Lederman, *supra* note 143.

[160] *See* Revenue Act of 1950, 64 Stat. at 947.

make sure that they are in the best position to serve the public interest when their services are in such high demand.[161]

Senator Grassley has been critical of tax-exempt organizations over the past several years. In 2006, Sen. Grassely, the then Chairman of the Senate Finance Committee, demanded that the IRS provide him with an account of what actions the agency is taking to punish charitable organizations that violate tax laws.[162] In 2008, in response to IRS statistics that show that the majority of all charities that engage in unrelated business activities pay zero unrelated business income tax, Sen. Grassley said it needed to be "looked at more by charity boards, Congress, and the Treasury Department.[163] The Senator added that a similar study conducted by the Chronicle of Philanthropy raises the questions of "whether a charity should be engaged in a loss-making enterprise that may take funds away from their charitable mission," and "whether charities are inappropriately lowering their tax bills by assigning costs from the charitable activities to the business activities."[164] As one unidentified official from the IRS put it, the current rules regarding the unrelated business income tax may allow for "excess flexibility" for exempt organizations in the ways they are permitted to calculate their unrelated business income.[165]

Tax-exempt organizations, specifically colleges and universities are under the magnifying glass of the IRS and Congress. The upcoming release of the IRS's report on their questionnaires should shed more light on how exempt organizations are calculating their unrelated business income. Hopefully, the report will culminate with an understanding as to what exactly will pass as a "reasonable" allocation method for fixed costs. However, right now, the best exempt-organizations can do is identify their unrelated business activities, demonstrate the intent to profit with respect to those activities, and have a good argument as to why a particular allocation method is "reasonable."

---

[161] Eric Kelderman, *IRS Discloses 2009 Plans for Nonprofit Review*, CHRON. OF PHILANTHROPY, Dec. 11, 2008, at 31.
[162] Elizabeth Schwinn, *Senator Chides IRS on Enforcing Charity Laws*, CHRON. OF PHILANTHROPY, June 15, 2006, at 38.
[163] Panepento & Williams, *supra* note 100.
[164] *Id.*
[165] *Id.*