American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

February 23, 2017

Ms. Victoria Judson
Associate Chief Counsel (TE/GE)
Office of Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Ms. Janine Cook
Deputy Associate Chief Counsel (TE/GE)
Office of Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Unrelated Business Income Expense Allocation Methodologies for Dual Use Facilities

Dear Mmes. Judson and Cook:

The American Institute of CPAs (AICPA) appreciates the efforts by the Internal Revenue Service (IRS) Office of Chief Counsel to issue guidance for tax preparers and taxpayers on how a tax-exempt organization should allocate expenses attributable to facilities and/or personnel which are used for both tax-exempt activities and unrelated trade or business activities.

To further this mission, we submit this letter with guidelines and examples for your consideration in addressing how to allocate unrelated business income (UBI) expenses for dual use facilities.

Guidelines for allocation of indirect expenses

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 which do not change when the unrelated activity is conducted or not conducted) and *variable* expenses (those which increase or decrease when the unrelated activity is conducted or not conducted).

4. The methodology for allocating expenses relating to dual use facilities/personnel is reasonable and consistently[1] 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/personnel is based on the character of the expense involved.

    a. Facility costs (rent, mortgage interest, insurance, taxes, security, and utilities) apportioned based on portion of facility used (square footage and time) for each activity.

    b. Personnel costs (salary, benefits, and taxes) apportioned based on time spent on each activity.

    c. Information technology costs (software, computer services, and internet) apportioned based on allocation of personnel to activity.

    d. Office expenses (supplies, printing, postage, and subscriptions) are apportioned based on allocation of personnel to activity.

6. The AICPA recommends that the IRS permit the use of gross revenue, from each respective activity, to allocate direct and/or indirect expenses if there is no difference in the prices charged to earn unrelated versus related revenue. This provision is intended for use by organizations that are unable,[2] or for which it is administratively impractical, to maintain or create records with respect to activities in which dual use facilities/personnel are used and the associated expenses are clearly distinguished as related or unrelated.

7. The AICPA recommends that the IRS provide a simplified method for small businesses to determine expenses which are deductible against unrelated business income. Small organizations lack the resources to adequately document the information needed to identify expenses pertaining to dual use facilities/personnel used in related and unrelated activities.

<u>Examples</u>

<u>Example 1</u>: Exempt Organization (EO) owns an office building which is subject to a mortgage. The portion of the building which is not used by the EO is rented to unrelated

[1] Allocation methods are revised from time to time as the organization's activities and related expenses evolve over time. Such changes that enhance the accuracy of expense allocations do not violate the consistency principle.
[2] See Examples 3 and 5 for cases in which an organization, despite reasonable efforts, is unable to create or maintain records segregating facility/personnel usage between related and unrelated uses due to the nature of the activity.

third parties. Tenants have separately contracted for utilities. The EO's office manager is responsible for collecting rents and responding to the tenants' requests for repairs. Under Internal Revenue Code (IRC or "Code") section 514,[3] a portion of the rent earned by the EO is treated as unrelated business taxable income. (This example is for purposes of illustrating the calculation to determine the costs attributable to the activity, and therefore, does not include the calculations required by section 514 to allocate a percentage of the revenue and expenses to UBTI based on the average debt/basis ratio.)

<u>Allocation of building costs based on square footage</u>

Total building square footage: 5,000
Rented square footage: 1,500
Annual building depreciation: $50,000
Annual building insurance: $20,000
Annual mortgage interest: $60,000

Allocated expenses:
Depreciation = $50,000 × (1,500 ÷ 5,000) = $15,000
Insurance = $20,000 × (1,500 ÷ 5,000) = $6,000
Interest = $60,000 × (1,500 ÷ 5,000) = $18,000

<u>Allocation of personnel time devoted to rental activity based on time spent</u>

Annual office manager compensation: $75,000
% time devoted to rental activities: 15%

Allocated expenses:
Personnel = $75,000 × 15% = $11,250

<u>Allocation of overhead devoted to rental activity based on related personnel's office space</u>

Office manager's office square footage: 100
Annual utilities: $40,000

Allocated expenses:
Depreciation = $50,000 × (100 ÷ 5,000) × 15% = $150
Insurance = $20,000 × (100 ÷ 5,000) × 15% = $60
Interest = $60,000 × (100 ÷ 5,000) × 15% = $180
Utilities = $40,000 × (100 ÷ 5,000) × 15% = $120

Total allocated expenses = $50,760

---

[3] All references herein to "section" or "§" are to the Internal Revenue Code (IRC) of 1986, as amended, or the Treasury Regulations promulgated thereunder.

Example 2: EO owns an office building which is subject to a mortgage. The building has a ballroom which is sometimes used by the EO for events related to its mission and at other times is rented to unrelated third parties. Under section 514, a portion of the rent earned by the EO is treated as unrelated business taxable income. (This example is for purposes of illustrating the calculation to determine the costs attributable to the activity and therefore does not include the calculations required by section 514 to allocate a percentage of the revenue and expenses to UBTI based on the average debt/basis ratio.)

Allocation of fixed building costs to ballroom based on square footage

Total building square footage: 10,000
Rented square footage: 2,000
Annual building depreciation: $40,000
Annual building insurance: $10,000
Annual mortgage interest: $30,000

Allocated expenses:
Depreciation = $40,000 × (2,000 ÷ 10,000) = $8,000
Insurance = $10,000 × (2,000 ÷ 10,000) = $2,000
Interest = $30,000 × (2,000 ÷ 10,000) = $6,000

Allocation of fixed ballroom costs based on usage

Days used by EO for its own exempt activities: 100
Days used by unrelated third parties for non-exempt purposes: 20
Total Days Used: 120

Allocated expenses[4]:
Depreciation = $8,000 × (20 ÷ 120) = $1,333
Insurance = $2,000 × (20 ÷ 120) = $333
Interest = $6,000 × (20 ÷ 120) = $1,000

Allocation of variable ballroom costs based on usage
(The costs below are attributable to the ballroom only and are incurred only when it is used)

Janitorial services = $12,000
Utilities = $6,000

Allocated expenses:
Janitorial services = $12,000 × (20 ÷ 120) = $2,000
Utilities = $6,000 × (20 ÷ 120) = $1,000

[4] Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1984).

Total allocated expenses = $5,666

Example 3: EO operates a facility which processes laboratory services for patients at its hospital facility and non-patients. The revenue earned from non-patient lab services is treated as unrelated business taxable income. Although customers are eligible for different discounts, the gross charges for each service are the same regardless of who receives the services. Assume the profit margin is consistent.

Allocation of expenses based on revenue

Total patient service revenue: $100,000
Gross revenue attributable to patient services: $80,000
Gross revenue attributable to non-patient services: $20,000
Total facility expenses: $75,000

Allocated expenses:
Facility expenses = $75,000 × ($20,000 ÷ $100,000) = $15,000

Total allocated expenses = $15,000

Example 4: EO operates a laundry facility which processes laundry for affiliated organizations and unrelated third parties. The revenue earned from unrelated third parties is treated as unrelated business taxable income. Charges for laundry services are based on the number of pounds processed.

Allocation of expenses based on units of service

Total annual pounds of laundry processed: 80,000
Annual pounds of laundry processed for affiliated organizations: 50,000
Annual pounds of laundry processed for unrelated third parties: 30,000
Total facility expenses: $200,000

Allocated expenses:
Facility expenses: $200,000 × (30,000 ÷ 80,000) = $75,000

Total allocated expenses = $75,000

Example 5: EO operates a café which is accessible to those visiting the EO's museum exhibits as well as the general public. There is no difference in the amounts charged to museum visitors and the general public. Revenue from those customers not visiting the museum's exhibits is treated as unrelated business taxable income and coded by the café cashiers as such.

Allocation of expenses based on revenue:

Total gross revenue: $500,000
Gross revenue attributable to museum visitors: $400,000
Gross revenue attributable to general public: $100,000
Total food costs: $200,000
Total personnel costs: $150,000
Total facility expenses: $75,000

Allocated expenses:
Food costs = $200,000 × ($100,000 ÷ $500,000) = $40,000
Personnel costs = $150,000 × ($100,000 ÷ $500,000) = $30,000
Facility expenses = $75,000 × ($100,000 ÷ $500,000) = $15,000

Total allocated expenses = $85,000

Example 6: EO is a country club that includes a golf course, swimming pool, restaurant, and tennis facilities. Members pay monthly dues that allow them access to all of these amenities. Non-members are permitted to use the golf course. Non-members pay a standard greens fee for 18 holes of golf. The greens fees are treated as unrelated business taxable income.

Certain golf course operating and maintenance expenses are allocable to the non-member use of the golf course. Since members' dues pay for access to all of the amenities, the allocation of golf course expenses based on revenues (members' dues/non-member's greens fees) does not produce an equitable method. Instead, expenses are allocated based on the number of rounds played by members compared to the number of rounds played by non-members.

Allocation of expenses based on number of rounds

Total number of rounds played: 10,000
Number of rounds played by members: 8,500
Number of rounds played by non-members: 1,500
Total personnel costs: $35,000
Total maintenance & fertilizer costs: $20,000
Total insurance costs: $8,000
Total depreciation expense: $15,000

Allocated expenses:
Personnel = $35,000 x (1,500 ÷ 10,000) = $5,250
Maintenance & Fertilizer = $20,000 x (1,500 ÷ 10,000) = $3,000
Insurance = $8,000 x (1,500 ÷ 10,000) = $1,200
Depreciation = $15,000 x (1,500 ÷ 10,000) = $2,250

Total allocated expenses = $11,700

******

The comments and recommendations included in this letter were developed by the AICPA Exempt Organizations Taxation Technical Resource Panel and approved by the AICPA Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our recommendation and welcome the opportunity to discuss this issue further. If you have any questions, please feel free to contact me at (408) 924-3508, or annette.nellen@sjsu.edu; Elizabeth E. Krisher, Chair, AICPA Exempt Organizations Taxation Technical Resource Panel, at (412) 535 5503, or bkrisher@md-cpas.com; or Ogochukwu Eke-Okoro, Lead Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or ogo.eke-okoro@aicpa-cima.com.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee