B. UNRELATED BUSINESS INCOME ALLOCATIONS

by
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1. Introduction

In the Revenue Act of 1950, Congress enacted a basic statutory scheme for imposing tax on unrelated business income. The tax was directed at the problem of unfair competition. Prior to 1950, exempt organizations could use their tax-free profits to expand operations, including the purchasing of ordinary businesses, while their competitors could expand only with the profits remaining after taxes. Senate Report No. 2375, 1950-2 C.B. 483. The general provisions enacted to address this problem are carried over into the Internal Revenue Code of 1986 under sections 511 through 515.

The Tax Reform Act of 1969 added a special rule for taxing the unrelated business income of social clubs, voluntary employee beneficiary associations and certain other exempt organizations. This provision was enacted to ensure that the tax exempt status of these organizations did not provide the organizations' members with a substantial tax advantage by allowing tax-free dollars to be used for the purpose of their personal recreation or pleasure.

From the enactment of these provisions, the notion that exempt organizations should pay tax on their unrelated business income has spawned considerable conflict between exempt organizations and the Service. In certain cases, the organizations have attempted to reduce their tax liability by overallocating or misallocating expenses between exempt and unrelated business activities. It is most important, therefore, that the Service be able to identify improper allocations. This article will examine different methods of allocation as well as the standards applied by the Service to test allocations.

2. The Statutory Scheme

Virtually all exempt organizations must pay federal income tax on their "unrelated business taxable income." IRC 512(a)(1) provides the general rule that the term "unrelated business taxable income" means gross income derived by any organization 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, both computed with certain modifications.

Section 512(a)(3) also provides special definitional rules for the term "unrelated business taxable income" as applied to organizations described in IRC 501(c)(7), (9), (17) and (20). In the case of such organizations, the term "unrelated business taxable income" means the 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), both computed with certain modifications. IRC 512(a)(3)(A).

In Portland Golf Club v. Commissioner, 110 S. Ct. 2780 (1990), Justice Blackmun observed that "... IRC 512(a)(1) (which applies to most exempt organizations) limits 'unrelated business taxable income' to income derived from a 'trade or business,' while IRC 512(a)(3)(A) (which applies to social clubs) contains no such limitation. Thus, a social club's investment income is subject to federal income tax, while the investment income of most other exempt organizations is not."

In Disabled American Veterans v. United States, 704 F.2d 1570 (Fed. Cir. 1983), the question was raised whether or not Congress contemplated that certain expenses would be allocated when determining deductibility under IRC 512(a)(1). The Federal Circuit found that the "allowed by this chapter" language of IRC 512(a)(1) refers to the deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" allowed by IRC 162(a). Writing for the three judge panel, Circuit Judge Edward S. Smith stated, "It is settled that section 162(a) in other contexts requires allocation of expenses between the part that is used for business and the part that is not. There is no reason for or logic in deleting the general allocation requirement in the present context." See Griffin & Co. v. United States, 389 F.2d 802 (Ct. Cl. 1968). The court also concluded that the propriety of allocating expenses is reinforced by the "directly connected" language of IRC 512(a)(1). Thus, IRC 512(a)(1) provides for a general allocation requirement without defining the requirement.

3. IRS Published Guidelines

Although the applicable provisions of the Code do not specifically address how expenses are to be allocated when exempt organizations are computing their "unrelated business taxable income," the regulations promulgated under section 512 provide general guidelines for the apportionment of expenses as follows:

[Reg. 1.512(a)-1(a)]. In general. Except as otherwise provided in [Reg.] 1.512(a)-3, 1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in [Reg.] 1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in 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. (Emphasis added.)

[Reg. 1.512(a)-1(b)]. Expenses attributable solely to unrelated business activities. Expenses, depreciation and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore, qualify for deduction to the extent that they meet the requirements of section 162, section 167 or other relevant provisions of the Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167. (Emphasis added.)

[Reg. 1.512(a)-1(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 activities 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. 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. (Emphasis added).

Similar to the regulations, the section of the Exempt Organizations Examination Guidelines Handbook, section 720(7) of IRM 7(10)69, which sets forth 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 posses 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. See, section 5, Applying the Test to Specific Items of Expense, infra at p. 24.

4. Allocating Expenses: Two Part Test

Based on the Service's published guidelines, two broad, overlapping standards for testing a method of apportioning expenses emerge. First, the method must allocate to unrelated trade or business activity only that portion of any item of deduction that is proximately and primarily related to the business activity and only to the extent permitted by section 162, section 167 or other relevant provisions of the Code. Reg. 1.512(a)-(1)(a). Secondly, the method must be reasonable. Reg. 1.512(a)-1(c).

Court decisions have set forth two criteria for determining whether or not the first standard's proximate and primary relationship test has been met. The first criterion is that the method must not permit the amalgamation of profit and nonprofit activities. In Iowa State University of Science and Technology v. United States, 500 F.2d 508 (Ct. Cl. 1974), the Court of Claims held that an educational institution could not offset expenses from a university's nonprofit radio station against the unrelated business income from its for-profit television station. In its opinion, the court stated that "a nonprofit endeavor, even if operated by a profit-making concern, does not constitute a trade or business for the purposes of deduction of expenses under IRC 162," supra at 521.

The second criterion of the proximate and primary relationship test is that the method must require that only expenses associated with profit motivated activities may be deducted. In Portland Golf Club v. Commissioner, supra at 2787, the court held that deductions claimed by an IRC 501(c)(7) club were allowable, if at all, only under IRC 162. Since the court had previously ruled that a taxpayer's activities fall within the scope of IRC 162 only if an intent to profit has been shown, the court found that expenses will be deductible only if the income producing activity was performed with an intent to profit. See also, Commissioner v. Groetzinger, 480 U.S. 23 (1987).

Reg. 1.512(a)-1(b) and (c) also provide some guidance for applying the proximately and primarily related test. First, a method of allocation meets the proximately and primarily related test if the expenses allocated are attributable solely to the conduct of unrelated business activities. Reg. 1.512(a)-1(b). Secondly, in the case of a dual use facility, the proximately and primarily related test is met if the method allocates the expenses on a reasonable basis. It should be noted, however, that when determining if a method of allocation between two uses is reasonable, consideration should be given to whether or not the allocated expense is proximately and primarily related to the business, among other facts and circumstances.

By definition, the second "reasonableness" standard set forth in Reg. 1.512(a)-1(c) indicates that more than one method of allocation was anticipated by the Service. Thus, a reasonable method of apportioning expenses must be allowed even though it may not be the best method.

Whether or not a method of allocating expenses is a reasonable one is a factual determination. Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1984). Based on section 720(7) of IRM 7(10)69, it appears that an exempt organization is allowed to compute and claim deductions from unrelated business income on the basis of a reasonable allocation formula, even if the formula could not be precisely substantiated by source documentation. In Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930), the Second Circuit Court of Appeals held that a taxpayer was entitled to some deduction in his theatrical managing business for substantial entertainment expenses incurred in his business even though he had not and "probably could not" substantiate the exact amount of such expenses. The court found that the taxpayer had spent substantial sums for entertainment and that these expenses were allowable deductions. Any allocation, though, should be made "bearing heavily against the taxpayer whose inexactitude is [its] own making."

This does not alter the fact, however, that it is still necessary for an organization to substantiate its deductions and keep records so as to establish the amount of gross income and deductions in accordance with Reg. 1.6001-1(c). In CORE Special Purpose Fund v. Commissioner, T.C. Memo 1985-48 (January 30, 1985), the Tax Court ruled that it could not apply the Cohan rule in a case where an IRC 501(c)(3) organization provided "no satisfactory basis for estimating the amount of a particular expense or for determining that a particular expenditure is in fact deductible. The Fund's burden of proof extended beyond merely showing that it actually incurred expenses during the period in issue; it also had to show that such expenses were deductible business expenses under section 162 or 167, and most importantly, that such expenses were 'directly connected with' the Fund's unrelated advertising activity." The court disallowed deductions for depreciation, supplies, travel, conferences and conventions, building maintenance, and membership dues and subscriptions because of a complete failure of proof.

The court in CORE Special Purpose Fund also disallowed deduction of rent expenses where the only evidence of record with respect to the expense was "insufficiently specific" testimony from the organization's Chairman of the Board of Trustees. The Chairman's testimony did not reveal whether rent was accounted for as a direct expense or as an indirect expense allocated among the several activities conducted in the office. Furthermore, although the Fund indicated that the method of allocation was based upon the percentage of time which Fund employees devoted to the magazine publishing activities, it did not reveal the names of the employees or the percentage used in allocating any of its overhead expenses. Based on these facts and circumstances, the court found that "it is impossible to make the allocation required by Reg. 1.512(a)-1(c) on such meager evidence," supra at 633.

5. Applying the Test to Specific Items of Expense

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. In making such allocations, the Service isolated certain expenses which are strictly period or "fixed" expenses, i.e., expenses that bear no relationship to the sales volume of the club's restaurant and bar and which are incurred instead as a function of time. These expenses include depreciation, real estate taxes, interest expense, permits, professional fees, and fire, theft, and liability insurance. These expenses were allocated to nonmember income on the basis of the weighted number of days of nonmember usage and the total days in the year.

The Service also isolated certain operating costs, or "variable" expenses, which vary to some degree in accordance with sales volume but which are more closely associated with the number of days the restaurant and bar are open. These expenses include salaries, payroll taxes, utilities, uniforms and laundry, telephone, postage, printing, employee health and other insurance, operating supplies, interior maintenance and cleaning expenses, and miscellaneous expenses. These expenses were allocated by taking into account the weighted number of days of nonmember usage and the total days of member and nonmember usage within the year.

The gross-to-gross method of allocation was used only to allocate cost of goods sold since that is the only expense in the hypothetical that is directly and primarily related to sales volume. The cost of goods sold attributable to nonmember sales will typically be viewed as a deductible "direct" expense since it is attributable solely to the conduct of unrelated business activities.

A. Characterization of Expenses

The terms "direct," "indirect," "variable" and "fixed" have been employed by the Service and various courts to classify expenses depending on the facts of a particular case.

In Atlanta Athletic Club v. Commissioner, T.C. Memo 1991-83 (Feb. 28, 1991), the terms "direct" and "indirect" were succinctly defined by the Tax Court. The court stated that direct expenses were "those which increase in direct proportion to the volume of that undertaking. Each dollar of direct expense is traceable to a particular undertaking and would not have been incurred but for that undertaking." On the other hand, indirect expenses are overhead and fixed expenses that are not traceable to the undertaking. See also, CORE Special Purpose Fund.

The Second Circuit in Rensselaer defined the terms "variable" and "fixed" expenses in a manner that was also consistent with the direct/indirect characterization of expenses. Deductible expenses were designated as either direct expenses, variable expenses or fixed expenses. Direct expenses were expenses that can be specifically identified with particular commercial uses. Expenses that vary in proportion to actual use of the facility, but which could not be identified with particular events were classified as variable expenses. Fixed expenses were those expenses that did not vary in proportion to actual use of the facility. This characterization of expenses closely reflects the manner in which the Service characterized expenses in the Big Divot Country Club, Inc., hypothetical.

In Inter-Com Club, Inc. v. United States, 721 F. Supp. 1112 (D.C. Neb. 1989), the court stated that "the allocation factors depend on whether an expense is variable or fixed, not whether the expense is direct or indirect." Despite this statement, the court's approach does not differ significantly from the Rensselaer approach since neither court accepted the indirect classification without further specifying whether the expense is a variable or fixed expense.

In other instances, however, a court may be faced with a case where these terms have been given a different meaning by the parties. For example, in Portland Golf Club, the terms direct or variable and indirect or fixed were used interchangeably by the petitioner.

The courts have agreed in most respects with the Service's characterization of expenses for the purpose of allocating expenses. Close attention should be given to how these terms are being used in any particular case, however, since they are not always defined in the same manner.

B. Fixed Expenses

The Service's position that fixed costs should be allocated to nonmember income based on the weighted number of days of nonmember usage and the total days in the year has not been universally accepted by the courts.

In Rensselaer, a university utilized its fieldhouse at near maximum usage for tax exempt purposes and for the production of unrelated business income. The Service argued that the appropriate method of allocating fixed costs between exempt and nonexempt purposes should be based on the total time available for use. See, Rev. Rul. 62-180, 1962-2 C.B. 52; Lewis v. Commissioner, 560 F.2d 1973 (9th Cir. 1977); Gino v. Commissioner, 538 F.2d 883 (9th Cir. 1976), cert. denied, 429 U.S. 979 (1976); Hoggard III v. Commissioner, 67-2 U.S.T.C. 9741 (E.D. Va. 1967); Henderson v. Commissioner, T.C.M. 1968-22. The taxpayer asserted that fixed expenses should be allocated on the basis of relative times of actual use between exempt and taxable activities. See, Browne v. Commissioner, 73 T.C. 723 (1980); International Artists, Ltd. v. Commissioner, 55 T.C. 94 (1970). The Second Circuit held for the taxpayer, affirming the Tax Court's decision (79 T.C. 967 (1982)), that the organization's allocation method was "reasonable."

The Service had argued that, although the method of allocation would be reasonable for a wholly profit-oriented endeavor, it fails both the "proximately and primarily related" test and the "reasonableness" test because it mixes profit and nonprofit activities and allows for the deduction of expenses which relate to nonprofit activities. The Service contended that, since the fixed expense items (such as depreciation) do not occur only during periods of use of the fieldhouse, such items cannot reasonably be said to be "proximately and primarily related" to the unrelated activities based on actual use. The University's method of allocation cannot be reasonable when applied to a dual use situation since it does not take into consideration the expenses' direct connection with the unrelated business activities. See, Pittsburgh Press Club v. United States, 579 F.2d 751 (3rd. Cir. 1978).

Judge Pratt, in the majority opinion in Rensselaer, disagreed with the Service's application of both tests. Judge Pratt found that the "reasonableness" test was met since "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." In addition, the method was found to be reasonable since the "method is consistent with that followed by the Tax Court in the most common dual-use situation, home office deduction cases," supra at 1062.

The Service's position regarding the "reasonableness" test was also rejected by the court because it disagreed with the Service's view that the "directly connected with" provision of Reg. 1.512(a)-1(a) was more strict than the provisions of 1.162-1(a) governing the deductibility of ordinary and necessary business expenses. The court decided that if the deduction is permitted under chapter 1, it should be allowed under IRC 512. The court stated that the logical extension of the Service's position would be "to deny depreciation deductions to all businesses for those periods when their assets are idle," supra at 1062.

The court found that the "proximately and primarily related" test is met because the method of allocation employed met the "reasonableness" test. The court stated, "Thus, when allocated 'on a reasonable basis,' expenses attributable to such facilities or personnel - which expressly include such 'indirect expense' as depreciation and overhead - are by definition 'proximately and primarily related' to the business," supra at 1063.

In a dissenting opinion, Judge Mansfield stated that the majority's opinion was flawed because it assumed that tax exempt organizations are governed by the same standards for tax deduction purposes as those governing taxable businesses. "That assumption conflicts with legislative intent, economic reality, and the express wording of the pertinent statute and regulations," concluded Judge Mansfield, supra at 1063. Unlike commercial businesses, a university will 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 "purely profit-seeking firms."

Judge Mansfield emphasized that "the directly connected with" provision of IRC 512 is an additional requirement for tax-exempt institutions not faced by purely profit-oriented businesses. Furthermore, the regulations governing business deductions for profit-seeking corporations are distinctly different from the regulations governing deductions allowed tax exempt organizations under IRC 512. Unlike IRC 512, Reg. 1.162-1(a) is stated in the disjunctive: "Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business." The requirement of Reg. 1.512(a)-1 that to be "directly connected with" the conduct of unrelated business for the purposes of IRC 512, an item of deduction must have proximate and primary relationship to the carrying on of that business is a far cry from the requirement that the item be "merely 'pertinent to' the business operation." Judge Mansfield asserted, "I find no such direct proximate connection between the expense and the conduct of the unrelated commercial business at issue in the present case where the depreciation is incurred for a period of idle time when the commercial activity is not being conducted on the premises being depreciated," supra at 1065.

As set forth in A.O.D. 1438 (June 18, 1987), the Service continues to take the position that, under the circumstances described in Rensselaer, fixed expenses should not be allocated on the basis of actual usage. The result of such an allocation is a subsidy to the taxpayer. In the Service's review, allocating based on the total available time is the method of allocating fixed expenses that meets the "reasonableness" standard of Reg. 1.512(a)-1(c), when the dual use facility is receiving near maximum use.

The Action on Decision also stated that this issue should not be litigated until the "reasonableness" test of Reg. 1.512(a)-1(c) is amended. Amendment of the regulations, however, does not appear likely in the near future. It is possible that this issue will again be litigated at some future date.

It is also uncertain whether or not the Service would find the allocation of fixed expenses based on actual usage unreasonable if a dual use facility is used infrequently. 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. See IRC 280A(e) which codifies this body of law in the case of a vacation home, which by the term "vacation," contemplates only intermittent use of the home.

C. Variable Expenses

Allocating variable expenses which are directly connected to nonmember activity by taking into account the weighted number of days of nonmember usage and the total days of member and nonmember usage within the year as set forth in the Big Divot Country Club, Inc., example has been widely accepted as a reasonable method of allocating this type of expense.

There has been some dispute, however, concerning the definition of the term "usage." In Rensselaer, direct and variable expenses in operating the fieldhouse consisted of event costs and certain advertising, equipment rental, security, wages, repair and maintenance costs. There was no question that the event costs were properly deductible direct expenses within the meaning of Reg. 1.512(a)-1(b). With respect to the variable expenses that could not be directly attributed to a particular event, the amount attributable to unrelated business activity depended on the court's definition of the term usage. The Service had argued that the allocation must be based upon the facility's total hours of usage which includes actual use, preparation for use, and enhancement or promotion of the use of the facility. The university, however, stated that the allocation should be based on actual usage only. The Tax Court found that the university's allocation method based on actual use was reasonable. The Service did not appeal this part of the decision to the Second Circuit.

D. Gross-to-Gross Method

The gross-to-gross method of allocation is based in the social club setting on a ratio of gross receipts from nonmembers served to gross receipts from total persons served. Although the Big Divot Country Club, Inc., example indicates that this method properly allocates cost of goods sold, this method may not be a reasonable method of allocation in other contexts.

Reg. 1.512(a)-1(f)(6) provides, "Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations." The gross-to-gross method of allocation will typically not meet the "proximately and primarily related" test or the "reasonableness" test since the method allocates expense items to unrelated trade or business without regard to their connection to any business activity.

The use of the gross-to-gross method may be unreasonable for other reasons also. In the instance where a social club charges nonmembers more than members, allocations based on gross receipts will improperly apportion more of the expenses to nonmember income than to member income.

Assume that an exempt social club serves food and beverages to members and nonmembers alike in its restaurant and lounge. Equal numbers of members and nonmembers are served the same meal and charged the same amount ($2.00). Variable expenses and fixed expenses totaling $4,000 are allocated based on nonmember usage of the facilities, which is the ratio of nonmembers served to the total number of persons served. Under these circumstances, there is no difference between allocating expenses based on the ratio of nonmember gross receipts to total receipts and allocating them based on the ratio of nonmembers served to total persons served.

If, however, charges were such that members paid $1.50 for a meal and nonmembers $2.50 per meal, the gross receipts method of allocation would apportion $1,000 more of the expenses to nonmember income than to member income, although an equal number of members were served, and they were served the very same meal. Obviously, this allocation understates the amount of expenses attributed to the exempt function and correspondingly overstates the deduction for unrelated business activity.

The nature of the unrelated business activity may also be a factor to be considered. If nonmember income is received from banquets or other affairs and member income from ordinary meals, the gross-to-gross method may not be appropriate since banquet activity often has greater receipts per person served as well as greater markup in price. Also, when high nonmember income is derived over a short period of time, such as during a golf tournament, the gross-to-gross method would overallocate fixed expenses to nonmember income.

In Portland Golf Club, supra at 2783, the Supreme Court acknowledged in footnote 4, that "it seems likely that the gross-to-gross method overstates the percentage of fixed costs properly attributable to nonmember sales." In this particular case, however, the Service had stipulated that the gross-to-gross method was reasonable.

It should be noted, however, that in Disabled American Veterans, supra, the government proposed an allocation based on receipts. The Disabled American Veterans had argued that all of the direct expenses of a charitable solicitations program should be allocated to the taxable portion of the program, and that the regulations did not permit allocation of these expenses. The Federal Circuit affirmed the Court of Claims holding that both direct and indirect expenses had been properly allocated based on the gross-to-gross method. Direct expenses including the cost of premiums, postage, and handling were allocated based on a ratio of receipts from the taxable portion of the program to total gross receipts from the program. For indirect expenses including salaries and general overhead, the taxable portion was compared to DAV's total receipts. The holding of this case should be limited to its facts.

In general, it appears that in appropriate circumstances the gross-to-gross method of allocation may not be a reasonable one. Such circumstances might be present where a social club uses a gross-to-gross method based on the ratio of gross receipts from nonmembers served to gross receipts from total persons served to allocate fixed or variable expenses.

6. Use of Different Allocation Methods

In Portland Golf Club, Justice Blackmun in an opinion joined in its entirety by five other Justices and concurred in, in part, by the other three Justices held that the same allocation method must be employed by a social club when both determining whether an exempt organization's activity was entered into with an intent to profit and computing its actual profit or loss. As stipulated among the parties, Portland Golf Club used the gross-to-gross method in calculating the losses incurred in selling food and drink to nonmembers. Given this assumption that a portion of the Club's expenses is properly regarded as attributable to the production of income from nonmember sales, the Court found that the Club could not demonstrate an intent to profit since the Club's gross receipts from nonmember sales did not exceed its total (fixed plus variable) costs when the Club's fixed costs were allocated based on the gross-to-gross method. The Court noted in footnote 21, "Had petitioner employed the actual-use method, or ignored fixed costs entirely, it could have established its intent to profit, but it would have realized a net gain from nonmember sales and its 'unrelated business taxable income' would have been higher," supra at 2790. Therefore, the Club lost the use of losses from its nonmember sales as an offset against its investment income but insured that it would not incur tax on its nonmember sales.

In a concurring opinion joined by Justice O'Connor and Justice Scalia, Justice Kennedy disagreed with the Court's conclusion that the Club could not use different allocation methods when determining profit motive and actual profit and loss. Justice Kennedy stated, "A taxpayer's profit motive, in my view, cannot turn upon the particular accounting method by which it reports its ordinary and necessary expenses to the Internal Revenue Service (IRS)," supra at 2791.

A peripheral issue raised but not answered by the Court in Portland Golf Club was whether or not all of the deductions of an activity not conducted with a profit motive should be disallowed, or should only the loss from the activity be disallowed. In accordance with section 183, a taxpayer is permitted to offset expenses incurred in a not-for-profit activity against income from that activity up to the amount of the income. As noted in Portland Golf Club, footnote 15, although section 183 is not applicable to nonprofit organizations, including social clubs, the Service has followed longstanding tax principles in permitting the deduction of expenses incurred in nonmember sales up to the amount of a social club's receipts from nonmembers. Justice Kennedy, however, stated that the respondent's statement that "... the IRS has allowed an offset of expenses against gross receipts out of its own 'generosity,' [is] a characteristic as rare as it is implausible," supra at 2793. Justice Kennedy also indicated his concern that in oral argument the IRS asserted the authority to disallow the offset in the future. Tr. of Oral Arg. at 44.

7. Conclusion

The integrity of the statutory scheme for taxing the unrelated business income of exempt organizations is, in part, dependent on exempt organizations using reasonable methods of allocating expenses between their exempt and unrelated business activities. Thus, proper administration of the applicable provisions requires that methods of allocation employed by exempt organizations be scrutinized by the Service. This article has endeavored to set forth the standards and "recap the rules" applicable in this area. It has also discussed how these standards have been applied by the courts and the Service in the past. In the final analysis, however, whether or not a method of allocating expenses is a reasonable one is a determination that hinges on the facts and circumstances of each individual case.