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Solving the Next Rubrik's Cube: A Panel Discussion of Best Practices on Reporting UBTI in Silos on the Form 990-T and Managing Related Risks

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DRAFT REVENUE PROCEDURE:
Safe Harbors for Allocation of Expenses by Colleges and Universities for Purposes of Determining Taxable Unrelated Business Income

SECTION 1. PURPOSE

This revenue procedure explains optional methodologies that colleges and universities may employ for the allocation of direct and indirect expenses for the purpose of determining taxable unrelated business income (UBI). The methodologies described herein will not be mandatory for any college or university liable for unrelated business income tax, but instead serve as optional safe harbors that set forth a reasonable basis for allocation of costs to unrelated activities.

SECTION 2. BACKGROUND

Section 1.512(a)-1(a) of the Income Tax Regulations (Regulations) defines unrelated business income as the gross income derived from any unrelated trade or business regularly carried on, less those deductions which are directly connected with the carrying on of such trade or business, subject to certain modifications. To be deductible in computing taxable unrelated business income, expenses must (a) be directly connected with the revenue source and (2) have a proximate and primary relationship to that source.

Section 1.512(a)-1(c) of the regulations provides that if a deductible expense is related to both an exempt activity and an unrelated business, the deduction must be allocated between the two activities on a "reasonable basis."

This revenue procedure sets forth safe harbor models for the allocation of expenses that the IRS will accept as reasonable and on which taxpayers may rely. If either of these methods (Option 1 or Option 2) is applied properly (and corresponding documentation retained), the IRS will accept the safe harbor allocation methods as reasonable.

SECTION 3. DEFINITIONS

For purposes of this revenue procedure, the terms listed below are defined as follows:

1. A "university" is an institution for higher learning with teaching and research facilities comprising an undergraduate school that awards baccalaureate degrees and one or more graduate schools that award master or doctorate degrees.

2. A "college" is an institution of higher learning that grants associate, baccalaureate, and/or higher level degrees, although the term is also frequently used by institutions to describe undergraduate divisions or schools of a university that offer courses and grant degrees in a particular field such as liberal arts or law. "College" as used in this revenue procedure also includes institutions that offer two-year education programs, such as junior or community colleges.

3. An "institution" is either of the above.

4. A “department” refers to a clearly and consistently identified set of associated activities or functions within an institution, essential to provide for managerial and financial responsibility.

5. “A-21”refers to Office of Management and Budget Circular A-21, *Cost Principles for Educational Institutions*. Most federal funds for research or sponsored programs received by an institution are subject to A-21. Generally, A-21 dictates that for any cost to be allowable to a federal project it must first be reasonable, it must be allocable, it must be given consistent treatment through the application of generally accepted accounting principles, and it must conform to any limitations set forth in A-21 or by the funding agency.

6. “Direct costs’’ are costs that can be identified specifically with a particular sponsored project, an instructional activity, or any institutional activity, or that can be directly assigned to such activities relatively easily with a high degree of accuracy. [As defined in A-21.]

7. “Indirect costs” (also referred to as facilities and administrative or F&A costs) are costs that are incurred for common or joint objectives and therefore cannot be identified readily and specifically with a particular sponsored project, an instructional activity, or any other institutional activity. At educational institutions such costs normally are classified under the following indirect cost categories: depreciation and use allowances (buildings, improvements, and equipment), interest expense, general administrative and general expenses, sponsored projects administration expenses, operation and maintenance expenses, library expenses, departmental administration expenses, and student administration and services. [As defined in A-21.]

8. “Long form” refers to the process for A-21 reporting that is required for institutions with covered costs in excess of $10 million annually.

9. “Short form” refers to the process for A-21 reporting that is required for institutions with covered costs of less than $10 million annually.

10. “MTDC” refers to Modified Total Direct Costs. According to A-21, most expenses under the administration category are allocated on the basis of MTDC, which consists of all the direct costs of a given function less specific exclusions, such as capital equipment, charges for patient care, rental costs, scholarships, and fellowships. MTDC constitutes the final denominator by which allocated indirect costs are to be divided to determine the indirect cost rate.

11. “OIA” refers to Other Institutional Activities, a functional component of the MTDC base. OIA includes the operation of residence halls, bookstores, dining halls, student unions, intercollegiate athletics, public museums, and other similar auxiliary enterprises. Other activities may also be included in the OIA base, such as costs that are separately identified as “unallowable” to sponsored agreements. The inclusion of these costs in the OIA base inflates the denominator of the rate calculation, thereby lowering the rate.

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