

# TAXATION SECTION



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## IRS Precedential Guidance for Tax-Exempt Organizations

*Prepared by the Working Group on Exempt Organization Tax Policy Issues,  
Exempt Organizations Committee, Section of Taxation*

### One-Page Summary for D.C. Bar Reviewers

The draft materials we propose to submit to the IRS Assistant Commissioner, Employee Plans and Exempt Organizations, in response to a request for proposed guidance from practitioners to be published as IRS precedential guidance, may be summarized as follows:

1. A revenue procedure allowing the submission of exemption applications directly to the IRS National Office rather than to IRS district offices in those cases reserved to the National Office under existing IRS rules.
2. A revision to IRS Publication 557 and the instructions for Forms 990 and 990-EZ to warn taxpayers that if a taxpayer not required to file Forms 990 or 990-EZ (for example, because its gross receipts are \$25,000 or less) does in fact not file a return, the statute of limitations on that tax year will never begin to run and income taxes and interest may be assessed against the organization at any time.
3. A revenue ruling providing that state and local chapters of a national exempt organization may be treated as members of the national organization for purposes of Code section 4911(d), which provides rules for treatment of legislative communications to members. The ruling also provides that chapter members, officers and directors, staff, and volunteers constitute members of the national organization for purposes of section 4911(d). Except as to volunteers, the ruling would formalize a position taken in three IRS private rulings.
4. A revenue ruling holding that reserve funds required to be held by a section 501(c)(3) organization that lends funds as part of its exempt purpose may be excluded from debt-financed property on the grounds that the reserves are related to exempt purposes. This issue is related to that in the recent Southwest Texas Farm Bureau decision on arbitrage in the tax-exempt bond context, but we believe the facts here merit a different outcome.
5. A revenue procedure providing a safe harbor, based on an IRS regulation method from the foreign tax credit area, for the allocation of expenses for an exempt organization facility that is used both for exempt purposes and for unrelated business purposes, so that unrelated business taxable income may be calculated.

# TAXATION SECTION



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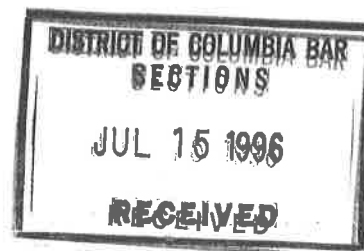
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State and Local Taxes  
Tax Audit and Litigation

July 11, 1996



Evelyn A. Petschek, Esq.  
Assistant Commissioner,  
Employee Plans and Exempt Organizations  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

Dear Ms. Petschek:

We are writing in response to Jim McGovern's request for input from tax practitioners on exempt organizations issues on which precedential guidance is needed, and for drafts of revenue rulings or other forms of plain language publications addressing those issues. On behalf of the Section of Taxation of the District of Columbia Bar,<sup>1</sup> we are enclosing two proposed revenue rulings, two proposed revenue procedures, and a proposed revision to IRS Publication 557, the instructions to Forms 990 and 990-EZ, and the standard IRS determination letter finding an organization to be tax-exempt. Each piece is accompanied by a brief technical explanation which includes a description of the issue, a review of existing precedent and/or private rulings where applicable, and the analysis underlying the proposed outcome.

<sup>1</sup>The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,500 members. These materials were prepared by the Working Group on Exempt Organization Tax Policy Issues of the Exempt Organizations Committee and approved by the Steering Committee of the Section on Taxation (Judith C. Dunn and Stephen J. Csontos having recused themselves). The members of the Working Group on Exempt Organization Tax Policy Issues are Cynthia M. Lewin, Chair, Deborah M. Beers, Edward Gonzalez, Barry J. Hart, Terrill A. Hyde, Laura Kalick, Barbara L. Kirschten, Jackie S. Levinson, Robert C. Louthian, and Edgar D. McClellan.

Evelyn A. Petschek, Esq.  
July 11, 1996  
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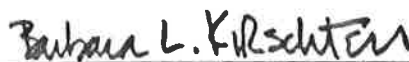
The proposed guidance included is as follows:


1. A revenue procedure allowing practitioners and applicants to submit exemption applications directly to the IRS National Office in those cases reserved to the National Office under existing revenue procedures or Internal Revenue Manual instructions.
2. A revision to IRS Publication 557 and the instructions for Forms 990 and 990-EZ to put taxpayers on notice that if a taxpayer not required to file Forms 990 or 990-EZ does in fact not file a return, the statute of limitations on that tax year will never begin to run and income taxes and interest may be assessed against the organization at any time.
3. A revenue ruling providing that state and local chapters of a national exempt organization may be treated as members of the national organization for purposes of Code section 4911(d), which provides rules for treatment of legislative communications to members. The ruling also provides that chapter members, officers and directors, staff, and volunteers constitute members of the national organization for purposes of section 4911(d).
4. A revenue ruling holding that reserve funds held by section 501(c)(3) organizations that lend funds to low-income microentrepreneurs may be excluded from debt-financed property on the grounds that the reserve funds are substantially related to their exempt purposes.
5. A revenue procedure establishing a safe harbor method for the allocation of expenses for a facility that is used both for exempt purposes and for an unrelated business purpose, so that unrelated business taxable income may be calculated, based on IRS allocation regulations in the foreign tax credit area.

Evelyn A. Petschek, Esq.  
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Please contact Cynthia Lewin, chair of the Working Group on Exempt Organization Tax Policy Issues, at (202) 328-1666 if you would like us to provide more information about any of these materials or if we can be of assistance in any other way. We very much hope these materials are helpful to you.

Sincerely,

  
Barbara L. Kirschten, Chair  
Exempt Organizations Committee  
Section of Taxation  
District of Columbia Bar

  
Cynthia M. Lewin, Chair  
Working Group on Exempt  
Organization Tax Policy Issues  
Exempt Organizations Committee  
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Enclosures

cc: Donald C. Lubick  
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PRECEDENTIAL GUIDANCE

IN THE EXEMPT ORGANIZATIONS AREA

Prepared by the Working Group on Exempt Organizations  
Tax Policy Issues, Exempt Organizations Committee  
Section of Taxation, District of Columbia Bar

- Exhibit A      Submission of Exemption Applications Directly to  
National Office
- Exhibit B      Notice that Statute of Limitations Does Not Begin  
to Run Where No Return Filed, Even if Taxpayer Not  
Required to File a Return
- Exhibit C      Treatment of Legislative Communications from  
National Exempt Organization to Its Chapters Under  
Section 4911(d)
- Exhibit D      Treatment of Loan Reserve Funds Held By Section  
501(c)(3) Organizations as Excluded From Debt-  
Financed Property
- Exhibit E      Use of the Section 861 Allocation Regulations to  
Allocate Expenses of a Dual-Use Facility

**Exhibit A**

**Issue: Submission of Certain Exemption Applications Directly to National Office**

A significant time delay often occurs in processing exemption applications which, under current Internal Revenue Service guidelines, are sent to the National Office. These applications often are held at the local level for a considerable period of time before being sent to the National Office. With regard to issues or areas which, under revenue procedures or Internal Revenue Manual instructions, require National Office review, we recommend that practitioners or applicants should be allowed to send the application directly to the National Office.<sup>1/</sup>

Under Revenue Procedure 90-27, 1990-1 C.B. 514, a key District Director must refer to the National Office any exemption application or ruling request that (1) presents questions, the answers to which are not specifically covered by the Code or by final Treasury regulations, or by a ruling, opinion, or court decision published in the Internal Revenue Bulletin, or (2) has been specifically reserved by revenue procedure and/or Internal Revenue Manual instructions<sup>2/</sup> for National Office handling for purposes of establishing uniformity or centralized control of

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1/ Adopting this procedure would also reduce the administrative burden on certain of the key District offices that, as of this date, are handling an increased number of exemption applications as other key District offices are being eliminated as part of the Service's exemption application centralization plan. Adopting this procedure would further relieve the administrative burden on the Cincinnati District office if that plan is implemented.

2/ See IRM at 7664.31 (11-10-94).



designated categories of cases. In such instances, the National Office reviews the application, issues a ruling directly to the organization, and sends a copy of the ruling to the key District Director. Accordingly, we recommend that with respect to issues described in (2) above, i.e., those that have been specifically reserved by revenue procedure and/or Internal Revenue Manual instructions for National Office handling, practitioners or applicants should be allowed to send such applications directly to the National Office, thus avoiding unnecessary delay at the District Office level. We further recommend that practitioners or applicants identify to the Service the revenue procedure or Internal Revenue Manual instruction that is the basis for their submitting an exemption application directly to the National Office.

A draft revenue procedure implementing this proposal follows. Practitioners or organizations submitting exemption applications directly to the National Office under this revenue procedure would write across the top of the application, "FILED UNDER REV. PROC. 96-X," and send a copy of the cover letter accompanying the exemption application to the key District Director of the district in which the organization's principal place of business is located.

Rev. Proc. \_\_\_\_\_

#### SECTION. 1. PURPOSE

This revenue procedure sets forth revised procedures with regard to submitting applications for recognition of exemption from federal income tax under sections 501 and 521 of the Internal Revenue Code. It supplements Rev. Proc. 90-27 by allowing applicants, under certain circumstances, to submit requests for rulings or determination letters directly to the National Office.

#### SEC. 2. NATURE OF CHANGES

Rev. Proc. 90-27 requires an organization seeking exempt status under sections 501 and 521 of the Internal Revenue Code to file an application with the key District Director for the Internal Revenue District in which the organization's principal place of business is located. However, under Rev. Proc. 90-27, the key District Director must forward to the National Office those applications that present questions the answers to which are not specifically covered by statute or regulations, or by a ruling, opinion, or court decision published in the Internal Revenue Bulletin. The key District Director also must forward applications that have been specifically reserved by revenue procedure and/or Internal Revenue Manual instructions for National Office handling.

This revenue procedure establishes a supplementary filing method, which permits organizations to submit directly to the National Office certain requests for rulings or determination letters which, under Rev. Proc. 90-27, a key District Director is required to forward to the National Office.

### SEC. 3. GENERAL

.01 When used in this revenue procedure, the term "key District Director" means the District Director of one of the 5 key district offices for exempt organization matters.

### SEC. 4. SUBMITTING APPLICATIONS DIRECTLY TO THE NATIONAL OFFICE

.01 Unless an exemption application falls under one of the categories specified in Section 4.02, an organization seeking recognition of exempt status under sections 501 and 521 of the Internal Revenue Code must, as specified in Rev. Proc. 90-27, file an application with the key District Director for the Internal Revenue District in which the organization's principal place of business is located.

.02 If an application for exempt status under sections 501 and 521 of the Internal Revenue Code falls under one of the following categories, an organization may submit its application to the key District Director, as specified in Rev. Proc. 90-27, or an organization may submit its exemption application directly to the National Office:

1. Applications that have been specifically reserved by revenue procedure for National Office handling.

2. Applications that have been specifically reserved by Internal Revenue Manual instructions for National Office handling, including specifically, the following:

(1) Applications submitted by prepaid health care plans.

(2) Applications submitted by organizations whose purpose is to insure share accounts of credit unions and/or savings and loan associations.

(3) Applications submitted by organizations that operate bingo games as their primary activity.

(4) All applications under Sections 501(c)(3) or 501(c)(4) of organizations that provide health care services, except:

a. Hospitals clearly covered by Revenue Ruling 69-545, 1969-2 C.B. 117 (integrated delivery systems and hospital reorganization cases described in paragraph (8) of this section, for example, are not clearly covered by Revenue Ruling 69-545).

b. Nursing homes, drug treatment clinics, and other residential facilities;

c. Home health care agencies; or

d. Faculty group practice organizations, unless they issue redeemable stock to their members.

(5) Applications submitted by organizations that support both a public charity and a private foundation if the organizations are seeking classifications as organizations described in Section 509(a)(3).

(6) All applications from Public Interest Law Firms applying for exempt status under Section 501(c)(3).

(7) All requests for rulings from operating foundations to be classified as exempt operating foundations described in Section 4940(d)(2).

(8) The following hospital reorganization applications:

a. The organization was formed as a result of a hospital reorganization in which the parent organization seeks classification under Section 509(a)(3);

b. The application is part of a ruling request on a hospital reorganization currently being considered in the National Office; and

c. The organization was formed as a result of a hospital reorganization and has been classified as other than a private foundation under Sections 509(a)(1) or 509(a)(2), and is requesting reclassification under Section 509(a)(3).

(9) Applications from the following organizations:

a. Inpatient or outpatient health care provider organizations that are involved in partnership either

directly as a general or limited partner, or indirectly through a wholly-owned subsidiary organization;

b. Inpatient or outpatient health care provider organizations that are participants in a joint venture with a for-profit entity; and

c. Parents of inpatient or outpatient health care provider organizations that are participating in a partnership or joint venture.

(10) All applications in which Section 501(m), involving provision of commercial-type insurance, is an issue.

(11) All applications from small insurance companies or associations applying for exempt status under Section 501(c)(15).

(12) All applications from title holding organizations applying for exemption under Section 501(c)(25).

(13) Applications submitted by organizations that have adopted Section 401(k) arrangements after July 2, 1986.

(14) Applications from private foundations requesting advance approval of grant making procedures that have an agreement for the administration of the scholarship program with the National Merit Scholarship Corporation.

(15) Applications from Satellite Communications Cooperatives created by Rural Electric Cooperatives exempt under Section 501(c)(12).

.03 An organization electing to submit its exemption application directly to the National Office shall identify in its application the revenue procedure or Internal Revenue Manual instruction that reserves such application for National Office handling, and shall write across the top of the first page of the application, "FILED UNDER REV. PROC. 96-X".

.04 An organization electing to submit its exemption application directly to the National Office under this revenue procedure shall send a copy of the cover letter accompanying the application to the key District Director for the Internal Revenue District in which the organization's principal place of business is located.

.05 Nothing in Section 4.02 modifies the key District Director's obligation, under Rev. Proc. 90-27, to refer certain applications for exempt status under Sections 501 and 521 of the Internal Revenue Code to the National Office.

**Exhibit B**



**Issue: Application of Section 6501 Statute of Limitations to Organizations Excepted from Filing Annual Information Returns.**

Under Section 6501(a), the statute of limitations on assessing tax (generally a three-year statute) does not begin to run until a return is filed.<sup>1/</sup> Accordingly, organizations which, under Section 6033(a)(2), fall within the mandatory and discretionary exceptions to the filing requirement of Section 6603(a)(1) and thus do not file a return (e.g., churches, or organizations whose gross receipts do not normally exceed \$25,000), may subsequently be subject to assessment for taxes and interest for an unlimited time period. Examples of instances in which taxes and interest could be assessed for an unlimited period against an organization that did not file a return include the Service's retroactive revocation of an organization's exemption,<sup>2/</sup> or the Service's characterization, upon audit, of

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<sup>1</sup> Under Section 6501(e), a six-year statute of limitations applies in the case of a return that is filed but which contains a substantial understatement of gross income. Under section 6501(c), there is no statute of limitations when a false or fraudulent return is filed.

<sup>2</sup> Note that under Section 6501(g), the good faith filing of an annual information return under Section 6033 is treated as the return of the organization for purposes of Section 6501(a) even if the Service subsequently determines that the organization is a taxable organization for the year that the return is filed. See generally Gen. Couns. Mem. 39813 (Mar. 19, 1990) for a detailed discussion of many income tax issues that can arise in connection with the retroactive revocation of the tax-exempt status of an organization engaged in commercial activities. Of course, Section 6501(a) would not apply in the case of a return to which the exceptions contained in Section 6501(c) apply (e.g., false or fraudulent returns) or to which Section 6501(e) applies (e.g., substantial omission of items or omission of Chapter 42 taxes).

certain organization income as unrelated business taxable income. See e.g., California Thoroughbred Breeders Association v. Commissioner, 47 T.C. 335 (1966) (the filing of Form 990 is sufficient to start the period of limitations with respect to the unrelated business income tax; the filing of Form 990-T is not essential);<sup>3/</sup> Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957) (retroactive revocation of exemption); Southern Maryland Agricultural Fair Association v. Commissioner, 40 B.T.A. 549 (1939) (organization whose exemption ruling was reversed is subject to income and profits taxes for all years in which it did not file a return); Rev. Rul. 77-162, 1977-1 C.B. 400 (three year period of limitations does not begin to run where organization files incomplete information return); Rev. Rul. 71-55, 1971-1 C.B. 403 (organization whose exemption was revoked is subject to income tax in all years for which it did not file a return).

Accordingly, we recommended that (1) IRS Publication 557, (2) the Instructions for Form 990 and 990-EZ, and (3) the language used in the current IRS determination letter recognizing an organization's exempt status be revised to alert organizations that fall within the mandatory or discretionary filing exceptions to this potential problem. Recommended language for these publications and IRS determination letters follows. New language is underscored.

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<sup>3</sup> Cf., Rev. Rul. 64-132, 1964-1 C.B. 501.

(1) and (2): Publication 557 and Instructions for Form 990 and 990-EZ

Publication 557 at page 6 under Item 10 in the far right-hand column; Instructions for Form 990 (1994 form at page 2 at the end of C.C.3), Instructions for Form 990-EZ (1994 form at page 3 at the end of C.C.3:

Note: The § 6501 statute of limitations on assessing tax only applies to organizations that file an information return. Accordingly, if an organization does not file a Form 990 or Form 990-EZ, even though it is not required to do so, the statute of limitations does not apply, and income taxes and interest may be assessed against the organization at any time, and for any period for which a return was not filed. If an organization files Form 990 or Form 990-EZ, even though not required to do so, the statute of limitations on assessing tax (generally a three-year statute) will begin to run.

(3) Addition to IRS Determination Letter

In the heading of this letter we have indicated whether you must file Form 990, Return of Organization Exempt From Income Tax. If yes is indicated, you are required to file Form 990 only if your gross receipts each year are normally more than \$25,000. If your gross receipts are not normally more than \$25,000 we ask that you establish that you are not required to file Form 990 by completing Part I of that Form for your first tax year.

Thereafter, you will not be required to file a return until your gross receipts normally exceed the \$25,000 minimum. For guidance in determining if your gross receipts are "normally" not more than the \$25,000 limit, see the instructions for the Form 990.

Note, however, that even if you are not required to file Form 990, and consequently, do not do so, the Section 6501 statute of limitations on assessing tax (generally, three years) will not apply. Therefore, income taxes and interest may be assessed against your organization at any time, and for any period for which a return was not filed. By filing Form 990 even if you are not required to do so, the statute of limitations on assessing tax will begin to run.

If a return is required, it must be filed by the 15th day of the fifth month after the end of your annual accounting period. A penalty of \$10 a day is charged when a return is filed late, unless there is a reasonable cause for the delay. The maximum penalty charged cannot exceed \$5,000 or 5 percent of your gross

receipts for the year, whichever is less. This penalty may also be charged if a return is not complete, so please be sure your return is complete before you file it.

Exhibit C

Proposed Revenue Ruling on Treatment of Legislative  
Communications From National Exempt Organization to Its Chapters

The issue of how legislative communications by national section 501(c)(3) organizations to their state and local chapters, divisions, or similar subordinate entities should be treated under sections 501(h) and 4911 has been a matter of great concern to numerous large national organizations, including voluntary health agencies, parent-teacher associations, and similar chapter-based national organizations. The Service addressed that concern by issuing a series of three private letter rulings, PLR 9145039 (Aug. 14, 1991); PLR 9236028 (June 8, 1992); and PLR 9332042 (May 19, 1993).

1. Holdings of Existing Private Letter Rulings

All the rulings addressed the issue of whether the subordinate entities could be treated as "members" of the national organization so that communications to them would only be treated as lobbying activity if they directly encouraged members to influence legislation, and then only as direct rather than grassroots lobbying for purposes of the section 501(h) limits. They found that where the subordinate entities contributed substantial financial support as well as time and effort to the national organization, the subordinate entities qualified as members.

The rulings also found that where the national organization could not bind the subordinates on legislative issues or require them to take particular actions, the lobbying activities of the national organization and subordinates need not be aggregated and the organizations need not be treated as an affiliated group for this purpose. Two of the rulings went on to find, however, that the organizations could still be treated as affiliated for the purpose of filing group information returns. (The third ruling did not address this issue.)

2. Proposed Revenue Ruling

The holdings of these private letter rulings continue to be important to the groups affected. Because all the rulings reached the same conclusion based on the same reasoning, even where the factual settings were somewhat different, it appears that this issue has essentially been decided by the Service, and is thus ripe for issuance in the form of precedential guidance.

The attached draft revenue ruling combines factual elements from all three rulings to try to provide guidance to as many organizations facing this particular issue as possible. Because the statutory and regulatory provisions interpreted are quite

specific in their application, however, it does not appear to us that published guidance would have widespread effect beyond the organizations at which it is aimed.

### 3. Additional Issues

The proposed revenue ruling could be of greater assistance if it addressed two additional issues.

First, it would be helpful to address whether individual members of chapters can be treated as members of the national organization even if no portion of their dues is forwarded to the national organization. When members contribute dues to the chapters which in turn devote their efforts to furthering the national organization's mission, we believe the chapter members constitute members of the national organization under the definition in Reg. § 56.4911-5(f)(1).

The second issue is the related one of whether volunteers of the chapters can be treated as members of the national organization based on their contribution of time. The private letter rulings state that chapter staff, both paid and volunteer, who are acting as agents or employees of the chapter will be treated as members. It would be helpful to clarify the status of volunteers whose relationship to a chapter may not clearly rise to the level of staff or agent. Again, we believe that given that the chapters devote their efforts to furthering the mission of the national organization, and the volunteers assist the chapters in their efforts, the volunteers should be treated as members of the national organization under Reg. § 56.4911-5(f)(1).

These points are included in the attached draft revenue ruling even though they were not addressed in the private letter rulings. If you would prefer a draft that does not include them, we would be happy to provide one.



Proposed Revenue Ruling on Treatment of Legislative  
Communications From National Exempt Organization to Its Chapters

Rev. Rul. \_\_\_\_\_

**ISSUE**

Under the facts described below, (1) do state and local chapters of A, and the members, staff, and volunteers of those chapters, qualify as "members" of A for purposes of section 4911(d) of the Internal Revenue Code? (2) Do A and its local chapters constitute an "affiliated group" within the meaning of section 4911(f)? (3) Are A and its local chapters "affiliated" within the meaning of section 1.6033-2(d) of the regulations for purposes of filing a group return?

**FACTS**

A is a national charity composed of a national organization and state and local chapters. A has been recognized as a tax-exempt public charity under sections 501(c)(3) and 509(a)(1) of the Code. Most of the chapters are separately incorporated and have been recognized as tax-exempt public charities under sections 501(c)(3) and 509(a)(1). Some operate as unincorporated associations. A and some of the chapters have made the election under section 501(h) of the Code but others have not done so. A files a single group information return each year for all of the chapters.

A receives significant financial support from its chapters. The local chapters have members who pay dues, a portion of which are remitted to A. Some chapters also have a second category of members who pay dues to the chapters which are not remitted to A. The state and local chapters also have annual fundraising drives, and pay a portion of the amounts received to A.

A grants each chapter a charter. In order to qualify as an authorized chapter, an organization must agree to be bound by A's bylaws, policies, and standards. These are silent with regard to legislative issues and activities.

Each chapter elects a board of directors. A has no right to designate chapter board members and A in fact plays no role in the selection of such board members. The chapters participate in the affairs of A through its national convention. Each chapter is entitled to elect delegates to the convention, but no chapter elects more than a small percentage of the total delegates.

Both A and the chapters are active with respect to legislation on certain issues at the federal, state, and local level. A encourages its chapters to be active legislatively on such issues, but requires that A review any position statements issued by a chapter prior to release. A also alerts the chapters to pending legislation on certain issues. Although A typically requests that the chapters contact key legislators to support or oppose the legislation, it has no power to require the chapters to take any action.

## LAW AND ANALYSIS

Sections 501(h) and 4911 were added to the Code in 1976 to permit public charitable tax-exempt organizations to elect to replace the vague "substantial part of activities" test for permissible legislative activities with a limit defined in terms of expenditures for influencing legislation. In general, section 4911 states that the permitted level of such expenditures for a year is 20 percent of the first \$500,000 of the organization's exempt purpose expenditures for the year, plus 15 percent of the second \$500,000, plus 10% of the third \$500,000, plus 5 percent of any additional expenditures, with an overall cap of \$1,000,000 for any one year. Within these limits is a separate limitation on grass roots lobbying equal to one-quarter of the lobbying non-taxable amount. An electing organization that exceeds any of these limits is subject to an excise tax of 25 percent on the excess lobbying expenditures.

Section 4911(d)(1) of the Code defines "influencing legislation" as (a) any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof (grass roots lobbying) and (b) any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation (direct lobbying).

Section 4911(d)(2)(D) provides an exception for communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members unless such communications are described in section 4911(d)(3).

Section 4911(d)(3) provides that communications with members that directly encourage those members to influence legislation are not excluded from the definition of "influencing legislation" as defined in section 4911(d)(1). However, expenditures for such communications are treated more favorably than those between organizations and the general public. Specifically, such expenditures are treated as direct lobbying expenses rather than grass roots lobbying expenses.

Section 56.4911-5(f)(1) of the regulations defines as a member of an electing public charity a person --

(1) who pays dues or makes a contribution of more than a nominal amount,

(2) who makes a contribution of more than a nominal amount of time, or

(3) who is one of a limited number of "honorary" or "life" members who have more than a nominal connection with the charity and who have been chosen for valid reasons unrelated to the charity's dissemination of information to its members.

Section 4911(f)(1) provides, in part, that if two or more organizations are members of an affiliated group, then the determination of whether excess lobbying expenditures have been made shall be made as though such affiliated group is one organization.

Section 4911(f)(2) provides that two organizations are members of an affiliated group of organizations only if --

(A) the governing instrument of one such organization requires it to be bound by decisions of the other organization on legislative issues, or

(B) the governing board of one such organization includes persons who --

(i) are specifically designated representatives of another such organization or are members of the governing board, officers, or paid executive staff members of such other organization, and

(ii) by aggregating their votes, have sufficient voting power to cause or prevent action on legislative issues by the first such organization.

Section 56.4911-7(a)(1) of the regulations indicates that two organizations are affiliated if one organization is able to control action on legislative issues by the other by reason of interlocking governing boards or by reason of provisions of the governing instruments of the controlled organization. The ability of the controlling organization to control action on legislative issues by the controlled organization is sufficient to establish that the organizations are affiliated; it is not necessary that the control be exercised.

Section 56.4911-7(b)(1) of the regulations indicates that two organizations have interlocking governing boards if one organization has a sufficient number of representatives on the

governing board of the second organization so that by aggregating their votes, the representatives of the controlling organization can cause or prevent action on legislative issues by the controlled organization.

Section 7701(a)(1) defines the term "person," as that term is used in the Code, to include a corporation.

Section 6033 of the Code requires each organization exempt under section 501(a), including organizations described in section 501(c)(3), to file an annual information return.

Section 1.6033-2(d) of the regulations permits a central organization to file a group return. Such group return may be filed for two or more of the local organizations which are (i) affiliated with such central organization at the close of its annual accounting period, (ii) subject to the general supervision or control of the central organization, and (iii) exempt from taxation under section 501(c) of the Code.

1. Issue 1 -- Do state and local chapters of A, and the members, staff, and volunteers of those chapters, qualify as "members" of A for purposes of section 4911(d) of the Internal Revenue Code?

In the facts presented, the chapters of A make financial contributions to A through remittance of both a portion of membership dues collected and a portion of amounts received through annual fundraising drives. Either of these contributions would be a contribution of more than a "nominal amount" within the meaning of the regulations. In addition, the chapters support A's mission on a full time basis through their other activities. The chapters, based on their contribution of more than nominal support to A in both time and money (either of which would be sufficient alone), are considered members of A within the meaning of section 56.4911-5(f)(1).

It is common law that corporations act through their agents and employees. Insofar as the chapter staff, both paid and volunteer, are acting as agents and/or employees of the chapters, they will also be treated as members of A for purposes of section 4911(d). Communications between A and the paid and volunteer staff, officers, board, and committee members of the chapters will, accordingly, constitute communications with members within the meaning of section 4911(d) of the Code.

Because the individual chapter members provide more than nominal support to A through their payment of dues, they also constitute members of A within the meaning of section 56.4911-5(f)(1). This result applies even to chapter members whose dues are used solely for chapter support, with no portion directly remitted to A. Because the chapters support A's mission on a

full time basis, the chapter members are considered to have contributed more than a nominal amount of money to A.

Similarly, because the chapters support A's mission on a full time basis, volunteers for the chapters who contribute more than a nominal amount of time to a chapter, including those volunteers who do not have a relationship that rises to the level of agent or employee, are considered to have contributed more than a nominal amount of time to A, and are thus treated as members of A for purposes of section 4911(d).

2. Issue 2 -- Do A and its local chapters constitute an "affiliated group" within the meaning of section 4911(f)?

None of the chapters appoints a sufficient number of representatives to A to control its governing body. Nor does A control the chapters through interlocking boards of directors. Accordingly, A and the chapters are not affiliated by virtue of interlocking governing boards.

A's governing instrument and those of the chapters are silent regarding legislative activities. A's policies require only that the chapters consult with A regarding legislative positions before releasing them; they do not bind the chapters to A's position. Thus, the chapters and A are not an affiliated group within the meaning of section 4911(f)(2)(A) of the Code and are not required to aggregate their lobbying expenses.

3. Issue 3 -- Are A and its local chapters "affiliated" within the meaning of section 1.6033-2(d) of the regulations for purposes of filing a group return?

The term "affiliated" as used in section 1.6033-2(d) of the regulations, does not have the same meaning as under section 4911 of the Code, and is, in fact, broader. The determination that A and the chapters are not an affiliated group for purposes of section 4911 does not affect our determination that the organizations are affiliated for purposes of filing group returns.

However, for purposes of determining the liability for excise tax under section 4911, a separate schedule on the group return must be completed for each organization (other than any that are part of an affiliated group as defined in section 4911(f)) that has made the section 501(h) election. Each schedule must show the lobbying expenditures, the lobbying nontaxable amount, the grass roots expenditures, and the grass roots nontaxable amount for the specific electing organization. Computation of the tax on excess expenditures under section 4911 on Form 4720 must be made for each such organization based only upon the amounts applicable to that organization, and not upon

the composite figures for the group. A separate Form 4720 must be filed for each electing organization with section 4911 excise tax liability.

**HOLDINGS**

1. The members of A within the meaning of section 56.4911-5(f)(1) of the regulations include its state and local chapters and their paid and volunteer staff, officers, board, and committee members, as well as their individual members and volunteers.

2. A and its state and local chapters are not affiliated within the meaning of section 4911(f)(2)(A) of the Code and are not required to aggregate their lobbying expenses.

3. A's state and local chapters are affiliated within the meaning of section 1.6033-2(d) of the regulations and thus may file group information returns.

Exhibit D

## TECHNICAL EXPLANATION

### **Revenue Ruling 96-\_\_ : Unrelated Debt Financed Income**

On October 19, 1995, the 5th Circuit affirmed (Op. No. 94-41125) the Tax Court's Memorandum Opinion in Southwest Texas Electric Cooperative, Inc., v. Commissioner, 68 TCM 285 (CCH 1994), holding that interest earned on U.S. Treasury Notes ("T-Notes") by a Section 501(c)(12) exempt organization was unrelated debt financed income under Section 514(a)(1).

In its opinion the 5th Circuit observed that the case was one of first impression. Based on the factual record that the purchase of the T-Notes was attributable to an immediately preceding drawdown of almost the precise amount of a loan from the Rural Electrification Administration ("REA"), the Court had little trouble concluding the REA loan was "acquisition indebtedness" within the meaning of Section 514(c)(1). Based on the organization's concession that the T-Notes were not substantially related to its exempt purpose, the conclusion that interest on the T-Notes was unrelated debt financed income inexorably followed.

The application of the unrelated debt financed provisions to other facts and circumstances can be more problematic. Perhaps based on its victory in Southwest Texas Electric Cooperative, the Service has announced it may be rethinking TAM 8738006 (June 12, 1987), which concluded that a reserve fund required to market tax-exempt revenue bonds was "inherent" in the performance or exercise of the organization's exempt purpose and function within Section 514(c)(4), and therefore the bonds were not acquisition indebtedness. Recognizing exempt organizations cannot issue bonds without a reserve or escrow fund, however, the Service has acknowledged the countervailing tax policy supporting Section 501(c)(3) financing. Until a possible legislative fix is made, the National Office apparently has instructed field agents to avoid raising this issue on audit.

A similar cloud covers Section 501(c)(3) exempt organizations which serve as financial intermediaries to microentrepreneurs described in the enclosed proposed revenue ruling. These exempt organizations receive U.S. Federal Government loans and private foundation program-related investments ("PRI's") constituting loans. As a requirement of such loans, the exempt organizations set up reserve funds of five percent to ten percent of the face amount of the PRI. The reserve funds consist of either a portion of the PRI or a contemporaneous grant. In both cases the PRI's are in turn lent to low-income microentrepreneurs, a well-established exempt purpose. See Rev. Rul. 68-117, 1968-1 C.B. 251; cf. Treas. Reg. § 53.4944-3(b), Ex. (1). However, there appears to be no similar National Office audit directive to the field not to raise the unrelated debt-financed issue in the case of such financial intermediaries.

To say that U.S. Federal Government loans and PRI's are "inherent" in the performance or exercise of the exempt functions of these financial intermediaries within the meaning of Section 514(c)(4) may be inappropriate, absent express statutory or regulation citation, as with credit unions. However, it is not inappropriate for the Service to conclude that U.S. Federal Government loans and PRI's may, on the basis of the particular exempt organiza-



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tion's facts and circumstances, be excluded from debt-financed property under Section 514(b)(1)(A)(i) on the grounds such property, *i.e.*, the loans and PRI's, is substantially related (aside from the need of the organization to income or funds) to the exercise or performance of the organization's exempt functions.

To avoid the possible implication that a rethinking of TAM 8738006 may necessarily preclude independent resort to Section 514(b)(1)(A)(i) by exempt organizations serving as financial intermediaries, the Service is urged to consider issuing the enclosed ruling.

**REV. RUL. 96-\_\_, 1996-\_\_ C.B. \_\_\_\_.**

A Section 501(c)(3) organization is generally exempt from unrelated business income tax ("UBIT") on certain investment income described in Section 512(b)(1), (2), (3), and (5). In the case of "debt-financed property" (defined in Section 514), however, the above exemptions do not apply pursuant to Section 512(b)(4), and the investment income attributable to such debt-financed property is subject to UBIT.

\* \* \*

**ISSUE**

Advice has been requested whether property attributable to (i) program-related investments ("PRI") (defined in Section 4944(c)) made by private foundations, and (ii) loans from U.S. federal government agencies may be characterized as debt-financed property.

**HOLDING**

Provided the property attributable to PRI and government agency loans received by the Section 501(c)(3) organization is substantially related to the exercise or performance of its exempt purposes (aside from the need for income or funds for such purposes), such property will

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not be considered debt-financed property, and hence the investment income derived from such property will not be subject to UBIT.

### FACTS

A Section 501(c)(3) organization was formed to provide grants, loans and access to credit (collectively, "financial assistance") to low income and disadvantaged individuals within and without the United States. The purpose of the financial assistance is to help such individuals establish and maintain small businesses in economically distressed areas, thereby reducing poverty and unemployment. Such individuals are referred to as microentrepreneurs, and financial assistance in the form of a loan is referred to as a microenterprise loan.

The microenterprise loan program may take one or more of the following forms. The Section 501(c)(3) organization may provide (i) a microenterprise loan directly to a microentrepreneur at a market or slightly below market rate, or (ii) credit support by guaranteeing a loan from an unrelated commercial bank to the microentrepreneur. Alternatively, the Section 501(c)(3) organization may provide loans to unrelated but cooperating Section 501(c)(3) organizations ("Affiliates"), or credit support to the Affiliates by guaranteeing loans from unrelated commercial banks to the Affiliates. The Affiliates in turn make microenterprise loans to a microentrepreneur. Absent a microenterprise loan the microentrepreneur would not have access to capital at commercially reasonable rates.

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The Section 501(c)(3) organization obtains funds, which it uses to provide financial assistance to microentrepreneurs from individual and corporate contributions, private foundation grants and PRI, and loans from U.S. Federal Government agencies (collectively, the "Fund"). The PRI and U.S. Government loans are typically term loans and usually carry a nominal interest rate, although some U.S. Government agency loans carry an interest rate tied to U.S. Treasury obligations.

The Fund is maintained in a custody account at Bank A and invested in U.S. Treasury obligations, high grade commercial paper issued by government-sponsored enterprises and for-profit corporations, and foreign governmental debt. The portion of the Fund not used to make microenterprise loans directly to entrepreneurs or Affiliates serves as collateral for Bank A to issue standby letters of credit ("L/C") in favor of other commercial banks to make available lines of credit to Affiliates for on-lending to microentrepreneurs. The ordinary and customary terms and conditions of PRI and U.S. Government loans require the Fund to set aside generally five percent to ten percent of the principal thereof as a loan loss reserve, to be invested as described above. The loan loss reserve is funded either by a contemporaneous grant to the Fund, or by reducing the amount of the PRI and U.S. Government loans available directly or indirectly for microenterprise purposes.

The Section 501(c)(3) organization's gross income from the Fund consists of (i) interest on microenterprise loans to individuals and Affiliates, (ii) fees from such individuals

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and Affiliates for credit support attributable to the L/C's, and (iii) investments made by the Fund, including the loan loss reserve. Expenses largely consist of interest on PRI and U.S. Government loans, and fees to Bank A for issuing the L/C's. Substantially all the net income derived by the Fund is reinvested in the Fund to provide financial assistance to microentrepreneurs, with a portion defraying general and administrative expenses of the Section 501(c)(3) organization.

The PRI and U.S. Government loans received by the Fund from time to time do not exceed the reasonable capacity of the exempt organization to utilize such amounts in a timely manner to support its exempt purposes and functions. In addition, (i) the terms and conditions of the PRI and U.S. Government loans, including the loan loss reserve requirement, (ii) the investment practices of the Fund, and (iii) the microenterprise activities of the exempt organization, are individually or in the aggregate ordinary and customary.

#### DISCUSSION

Section 511(a) of the Code imposes a tax on the unrelated business taxable income (as defined in Section 512) of every organization described in Section 501(a).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as

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defined in Section 513) regularly carried on by it, less the deductions allowed by Chapter 1 of the Code which are directly connected with the modifications provided in Section 512(b).

Section 512(b)(1) of the Code excludes from the term "unrelated business taxable income" all dividends, interest, and annuities, and all deductions directly connected with such income. However, Section 512(b)(4) provides that, notwithstanding these exclusions, in case of debt-financed property as defined in Section 514, there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under Section 514(a)(1) (relating to the percentage of income from debt-financed property that is taken into account), and there shall be allowed, as a deduction, the amount ascertained under Section 514(a)(2) (relating to the percentage of deductions taken into account with respect to debt-financed property).

Section 514(b)(1) of the Code defines "debt-financed property" as any property that is held to produce income and with respect to which there is an acquisition indebtedness (as defined in Section 514(c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition). Section 514(c) provides, in part, that acquisition indebtedness means with respect to any debt-financed property, the unpaid amount of indebtedness incurred by the organization in acquiring or improving such property.

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However, Section 514(c)(4) provides that the term "acquisition indebtedness" does not include indebtedness the incurrence of which is inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption, such as the indebtedness incurred by a credit union described in Section 501(c)(14) in accepting deposits from its members.

Furthermore, Section 514(b)(1)(A)(i) excludes from debt-financed property any property substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purposes or function constituting the basis for its exemption under Section 501. Section 1.514(b)-1(b)(i) of the Income Tax Regulations refers to Section 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purposes of the organization.

Section 1.513-1(d)(2) of the regulations states that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income), and is "substantially related", for purposes of Section 513, only if the causal relationship is a substantial one. Thus, the activities from which gross income is derived must contribute importantly to the accomplishment of those purposes. Whether such activities contribute importantly to the accomplishment of those purposes depends in each case on the facts and circumstances involved.

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In Southwest Texas Electric Cooperative v. Comm., 68 T.C.M. 285 (CCH) (1994), aff'd. 67 F.3d 87 (5th Cir. 1995), the taxpayer, a Section 501(c)(12) organization, received a U.S. government loan from the Rural Electrification Administration ("REA") to expand and upgrade its facilities used in the performance of its exempt purposes. A portion of such loan was used to purchase U.S. Treasury Notes ("T-Notes") in lieu of further upgrading its facilities. In holding that the interest on the T-Notes was unrelated debt-financed income under Section 514(a)(1), the Tax Court found (i) the REA loan was not indebtedness "inherent" in the performance of the organization's exempt purpose or function within the meaning of Section 514(c)(4), and (ii) the T-Notes themselves were not property "substantially related" to the performance of the organization's exempt purpose or function within the meaning of Section 514(b)(1)(A)(i).

The Section 501(c)(3) organization's exempt purposes include the reduction of unemployment and alleviation of poverty among disadvantaged individuals in part by (i) the making of microenterprise loans either directly to such individuals or indirectly through the Affiliates, and (ii) the Fund serving as collateral for L/C's issued by Bank A in support of the microenterprise program. Essentially, the basis for the Section 501(c)(3) organization's exemption is its function as a financial intermediary between microentrepreneurs and private foundations making PRI and U.S. government agencies making loans.



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As in Southwest Texas Electric Cooperative, supra, the PRI's and U.S. Government loans are not, however, inherent in the performance of the Section 501(c)(3) organization's exempt purpose or function within the meaning of Section 514(c)(4). That is, the Section 501(c)(3) organization's incurrence of the PRI and U.S. Government loans was not essential to its exempt purpose or function, even though both sources of funds may have been appropriate and helpful. The Section 501(c)(3) organization could have performed its exempt function by relying exclusively on contributions and grants.

Nonetheless, the Section 501(c)(3) organization's loans to microentrepreneurs and Affiliates are substantially related within the meaning of Section 514(b)(1)(A)(i) to its exempt purpose or function of providing financial assistance to disadvantaged individuals. These loans contribute importantly to the Section 501(c)(3) organization's performance of its exempt purposes. Similarly, the Fund, as collateral for L/C's issued in support of the microenterprise program, contributes importantly to such exempt purposes. See Rev. Rul. 68-117, 1968-1 C.B. 251; cf. Section 53.4944-3(b), Example (1) of the Regulations.

Accordingly, based on the above facts and circumstances, the Section 501(c)(3) organization's loans to microentrepreneurs and Affiliates and investments comprising the Fund do not constitute debt-financed property within Section 514(b)(1). Income on the loans made by the Section 501(c)(3) organization and income earned by the Fund do not constitute unrelated business taxable income under Section 512(a)(1).

**Exhibit E**

Use of the Section 861 Allocation Regulations to  
Allocate Expenses of a Dual-Use Facility

Exempt organizations have long struggled with the issue of how to allocate expenses between related and unrelated activities in cases where facilities, employees, or other resources are used for both kinds of activities. IRS regulations provide that for purposes of calculating the unrelated business income tax, such dual use expenses must be allocated between the two uses "on a reasonable basis." Treas. Reg. § 1.512(a)-1(c). In the absence of any clear guidance, however, the question of what is a "reasonable basis" has been the subject of some debate between taxpayers and the IRS.

The problem of how to allocate items of income or expense between categories for tax purposes is not unique to the tax-exempt arena. In particular, similar issues arise in allocating items of income, expense, and credit between U.S. source income and income from foreign countries. The regulations promulgated under section 861 of the Internal Revenue Code provide a methodology for this allocation, which could provide a framework for the allocation of expenses by exempt organizations.<sup>1</sup>

The 861 regulations provide a basic four-step method of allocating expenses based on a ratio of U.S. and foreign gross revenues. See Treas. Reg. § 1.861-8. They provide rules for the determination of sources of income and allocation of expense for income "within the United States, without the United States, and partly within and partly without the United States." Treas. Reg. § 1.861-1. These three categories can be analogized respectively to related, unrelated, and dual use income and expenses of exempt organizations.

Furthermore, the 861 regulations take into account that foreign tax systems differ from the United States tax system and certain adjustments must be made so that only items which are deductible for U.S. tax purposes are taken into account in allocations. Analogous adjustments must be made in the exempt organizations context to convert expenses shown on cost reports and other financial documents prepared for business purposes to expenses which are deductible for federal tax purposes. For example, different depreciation schedules are required for tax and Medicare purposes. Similarly, capital expenditures with a useful life greater than one year, bad debt allowances, and

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<sup>1</sup>See Laura Kalick, "Allocation of Expenses - A Foreign Solution," 11 Exempt Organization Tax Review 283 (February 1995).

nonqualified deferred compensation are not deductible for tax purposes, but may appear on cost reports.

The attached proposed revenue procedure adapts the section 861 regulation four-step method to the exempt organization context to provide a safe harbor "reasonable basis" method for the allocation of dual-use expenses by exempt organizations. The IRS's issuance of a safe harbor procedure in this area would be of great benefit to the exempt organization community.

This revenue procedure sets forth a safe harbor method for tax-exempt organizations to use in allocating expenses between exempt activities and unrelated business activities where facilities, employees, or other resources are used in both kinds of activities. An example showing an application of the method is also provided.

### **Background**

IRS regulations provide that expenses related to both exempt activities and unrelated business activities must be allocated between the two activities on a reasonable basis in order to identify deductible business expenses for purposes of calculating unrelated business income tax. Treas. Reg. § 1.512(a)-1(c). Limited guidance exists on which allocation methods qualify as reasonable for this purpose. This revenue procedure sets forth a method for allocating expenses between exempt and unrelated business activities that the IRS will accept as reasonable and on which taxpayers may rely. If this safe harbor method is applied properly (and appropriate documentation retained to demonstrate that it was applied properly), the IRS will accept the allocation as reasonable. However, this method should not be viewed as the only reasonable method for allocation of expenses; other reasonable methods may also be used.

### **Safe Harbor Method**

The safe harbor method consists of four steps: identification of specific expenses and elimination of expenses solely related to exempt activities; adjustments; calculation of total dual-use expenses; and apportionment.

#### **Step One - Identify Specific Expenses and Eliminate Solely Related Expenses**

The first step is to identify expenses which are directly related to unrelated business activities and those which are directly related to exempt activities, if any. This step must be executed for each dual-use activity and for overhead expenses. Care must be taken to ensure that a rational basis exists for the allocation of any overhead expense to a specific activity.

Certain expenses of a dual-use facility may relate solely to exempt income and cannot be used to offset unrelated business income. These expenses should be identified and eliminated from use in further calculations. Other expenses may relate solely to the production of unrelated business income. These expenses can be used in their entirety to offset unrelated business income. The remaining expenses are dual-use expenses that must be apportioned under Step Four of this method.

## **Step Two - Adjustments**

The next step is to make two types of adjustments. First, adjustments to gross revenues must be made so that similar items of revenue are being compared under Step Four, when a ratio of unrelated business revenues to total revenues is used to apportion expenses. Second, any adjustments necessary to ensure that all expenses identified under Step One are deductible for federal income tax purposes must be made.

**(a) Adjustments to Gross Revenues** - Because this allocation system uses gross revenue as a basis on which to apportion expenses for dual-use facilities and personnel, gross revenue will need to be either discounted or grossed up if different user groups (e.g., members and nonmembers, patients and non-patients) are charged different amounts for a dual-use resource. For example, to apportion the costs of a hospital laboratory based on gross revenues from patients and non-patients, if the laboratory charges patients less than non-patients for a particular test, the fees received from patients must be grossed up to the amount they would have been if charged at the non-patient rate. (It should be noted that in many situations, using a gross revenue approach may be difficult at best where members, students, or other favored user groups are not charged for the use of a facility or the use is sporadic.)

**(b) Adjustments Related to Federal Tax Deductibility** - Adjustments must be made to ensure that all expenses identified in Step One are deductible for federal income tax purposes. Cost reports and other financial materials may report expenses that are not deductible or are only partially deductible for federal income tax purposes. These must be adjusted as necessary to determine the appropriate tax-deductible amount or be eliminated from the calculation of deductible expenses.

## **Step Three - Calculate Total Dual-Use Expenses**

After expenses have been adjusted under Step Two, the adjusted dual-use overhead and adjusted dual-use direct expenses must be added together to calculate total dual-use expenses.

## **Step Four - Apportionment**

The final step is to apportion the total dual-use expenses calculated in Step Three. The apportionment is made on the basis of adjusted gross revenue as calculated in Step Two. A ratio of adjusted gross revenue from the unrelated business activity to total adjusted gross revenues is calculated, and this ratio is applied to total dual-use expenses. The resulting amount is the portion of dual-use expenses allocable to the unrelated business activity. To this amount must then be added the solely unrelated business expenses calculated pursuant to Step One. The sum of

these two categories of expenses is the total expense that can be taken as a deduction against unrelated business income.

**Example of Application of Safe Harbor Method**

**Facts**

A hospital has laboratory income of \$10 million and direct laboratory expenses of \$7 million. The patient revenue is \$9 million (90% of lab income). The other \$1 million is non-patient revenue which is assumed to be unrelated business income for purposes of this revenue procedure. The issue is which expenses may be taken as deductions against this unrelated business income.

The overall overhead expense of the hospital is \$20 million. Patient charges are discounted by 20% as compared to charges to non-patients. Based on sample testing, the mix of tests done for patients is roughly equivalent to those done for non-patients.

Of the \$7 million of laboratory expenses, \$300,00 is solely related to unrelated business activity (e.g., advertising targeted at non-patients) and \$700,000 is solely related to exempt activity (e.g., medical teaching in the laboratory). Of the \$20 million of overhead expenses, \$17 million is solely related to exempt activities only (e.g., fundraising expenses, medical staff compensation related solely to patient care, malpractice litigation expense, and interest and insurance expenses related to medical equipment used solely for patient care). None is solely related to unrelated business activities.

The cost reports of the hospital include depreciation deductions calculated based on the allowable useful lives under Medicare regulations, which are inconsistent with IRS useful life schedules. They also include deductions for nonqualified deferred compensation and a bad debt allowance, neither of which are allowable business deductions under IRS rules.

**Application of Safe Harbor Method**

**Step One - Identify Expenses and Eliminate Solely Related Expenses**

	<u>Total Expense</u>	<u>Related Expense</u>	<u>Unrelated Expense</u>	<u>Dual-Use</u>
Lab	\$ 7,000,000	\$ 700,000	\$300,000	\$6,000,000
Overhead	20,000,000	17,000,000	0	3,000,000

**Step Two - Adjustments**

a. Adjust gross revenue:

	<u>Patient</u>	<u>Non-Patient</u>
Revenue	\$9,000,000	\$1,000,000
Discount	20%	0
Adjusted Gross Revenue	\$11,250,000	\$1,000,000

b. Adjust for federal income tax deductibility:

	<u>100% Unrelated Expense</u>	<u>Dual-Use Lab</u>	<u>Dual-Use Overhead</u>
Before Adjustments	\$300,000	\$6,000,000	\$3,000,000
Adjustments for:			
depreciation	-\$50,000	-\$600,000	-\$300,000
personnel	-20,000	-300,000	-150,000
bad debts	<u>-10,000</u>	<u>-135,000</u>	<u>-65,000</u>
total adjustments	-\$80,000	-\$1,035,000	-\$515,000
After Adjustments	\$220,000	\$4,965,000	\$2,485,000

**Step Three - Allocate adjusted dual-use overhead expense to lab and add to adjusted dual-use lab expenses**

\$2,485,000 adjusted dual-use overhead expenses  
+4,965,000 adjusted dual-use lab expense  
Total Adjusted  
Dual-Use Expense: \$7,450,000

**Step Four - Apportion adjusted expenses based on adjusted gross revenue**

a. Determine non-patient percentage of dual-use expenses:

$$\frac{\$1,000,000 \text{ non-patient revenue}}{\$12,250,000 \text{ total adjusted revenue}} = .081$$



b. Determine total adjusted	\$7,450,000
unrelated dual-use	<u>x .081</u>
expense:	\$ 603,450

c. Add unrelated portion of dual-use expenses to unrelated expenses and subtract from unrelated income to arrive at taxable unrelated business income.

$$\$603,450 + \$220,000 = \$823,450$$

(UBI) \$1,000,000 - (UBI deductible expenses) \$823,450 = \$176,550  
Taxable unrelated business income