June 20, 1997

Ms. Evelyn Petschek
Assistant Commissioner
Employee Plans and Exempt Organizations
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3408 IR
Washington, DC 20224

Dear Ms. Petschek:

On behalf of the National Association of College and University Business Officers (NACUBO), I am submitting the enclosed draft revenue procedure outlining an alternative approach for calculating unrelated business income for colleges and universities. The methodologies proposed in the draft revenue procedure would not be mandatory for institutions, but serve as optional "safe harbor" methods of allocating expenses. The safe harbors would ease tax preparation by colleges and universities and simplify auditing by the Service.

During the development of this proposal, NACUBO shared an outline of this approach and rationale with IRS representatives at meetings held by NACUBO in February and May of 1996 and the response was encouraging. It is our hope that the enclosed draft may serve as the groundwork for formal IRS guidance about acceptable methods colleges and universities may use to determine their unrelated business income.

Background. During the last few years, the allocation of expenses to unrelated business income (UBI) has been a difficult issue for colleges and universities undergoing Coordinated Examination Program (CEP) audits. Treasury Regulation Section 1.512(a)-1(c) states that expenses must be allocated between exempt and UBI activities on a reasonable basis where dual use facilities or employees are involved in a trade or business. Regulation Section 1.512(a)-1(a) provides that costs permitted to offset UBI activities are those which: are allowable deductions under the Code and have a proximate and primary relationship to the unrelated trade or business.

Generally, colleges and universities employ fund accounting methods which do not capture costs in the same manner as for-profit accounting does. The difference in accounting methods makes it difficult for higher education institutions to produce account data comparable to that found in profit-making businesses. Institutions seem to be faced with either setting up supplementary, duplicative cost accounting systems to track expenses that typically represent less than one percent of the institution's total expenses, or deciding not to claim deductions for expenses legitimately incurred.

Colleges and universities seek to comply with federal tax laws, but the goal may be difficult to achieve in the absence of a practical, cost effective method which fairly recognizes all applicable costs. IRS agents have frequently challenged the determination of expense allocations for UBI by colleges and universities. In the past, disputes have often been settled through negotiations that determine a dollar amount owed, without agreement on how costs should be allocated. As a result, the underlying problem remains unresolved, and the issue may be raised in subsequent audits, wasting both government and university resources.

Administrators at Kent State University (KSU) brought this issue to the attention of Christine Larger at NACUBO because audits of UBI at KSU and several other institutions in the region failed to yield any meaningful agreements on the cost accounting method to be used by institutions in their UBI determinations. As a result, in December 1995, representatives of NACUBO's Taxation Task Force, KSU, and other nearby institutions met with regional and national IRS officials to discuss ways of approaching expense allocation for UBI. It was the consensus of those present that it would be productive to examine the existing cost accounting techniques used by institutions to comply with OMB Circular A-21, *Cost Principles for Educational Institutions* (A-21), particularly since IRS agents are directed to review A-21 information in the college and university audit guidelines. Following that meeting, NACUBO convened a work group of tax and cost accounting experts from member institutions to address the allocation of UBI generating activities.

The Proposal. The NACUBO work group developed an allocation methodology, based on principles established in OMB Circular A-21, that could be used as an alternative approach to calculating allowable deductions from gross unrelated business income for colleges and universities.

The advantages of using A-21 as a foundation for the model are:

- A-21 methodology/systems already exist
  - ⇒ they are cost-based
  - ⇒ they provide an established set of rates and allocations
  - ⇒ they are generally understood and well documented

- Methodology is reviewed and audited by the federal government at institutions subject to A-21

- A-21 is more restrictive than the Internal Revenue Code
  - ⇒ does not generally permit use of accelerated depreciation
  - ⇒ trustee costs are disallowed
  - ⇒ most public relations costs are disallowed
  - ⇒ executive housing and automobiles are disallowed
  - ⇒ entertainment, club memberships, and alcohol are disallowed
  - ⇒ interest expenses are significantly limited

The two alternative methodologies set forth in the enclosed draft revenue procedure are intended to serve as safe harbor methods for determining UBI. The first method (Option 1) involves a three-tier cost allocation approach that could be utilized by institutions that are required to report indirect costs (referred to as facilities and administrative or F&A costs, beginning in 1996) using either the long- or short-form of OMB Circular A-21. Institutional examples are included.

The second method (Option 2) provides a simplified method for institutions that are not required to report research costs under OMB Circular A-21 or those that do not require the level of detail inherent in the three-tier method of calculation. Option 2 would be an alternative for all institutions electing to utilize it, whether or not the institution reports F&A costs using OMB Circular A-21. Option 2 provides separate calculations based on whether the institution is subject to the accounting standards of the Financial Accounting Standards Board (independent institutions of higher education) or the Governmental Accounting Standards Board (public colleges and universities).

Support of NACUBO Member Institutions. Following the development of its proposal, NACUBO held a special session at its July 1996 Annual Meeting in Minneapolis setting forth the proposed methodologies to a large group of college and university business officers. The response to the presentation was overwhelmingly positive. The methodology appeals to our members largely because it would eliminate much of the uncertainty that now exists in this area and provide a simple, straightforward approach to allocating costs to unrelated activities.

NACUBO issued a report to the association's full membership of more than 2,100 colleges and universities across the nation. The report, Special Action Report 96-2 (September 25, 1996), detailed the proposed methodologies developed by the work group and includes a survey on the usefulness and desirability of the two options. Survey results indicated that support for the proposed methodologies was strong among respondents. Of respondents from institutions that use A-21, 94 percent thought that Option 1 and/or Option 2 would be useful for allocating expenses. Among institutions that do not use A-21, 83 percent found Option 2 useful.

The October 1996 issue of the NACUBO monthly magazine, *Business Officer*, included a portfolio article addressing the project and proposal, and included a request for member feedback, which again proved to be supportive.

College and University Accounting. Along with the proposed revenue procedure, we have also enclosed a background paper on college and university cost allocation and an overview of the federal indirect cost processes prescribed in OMB Circular A-21. We hope the information will enhance your understanding of the methods used by colleges and universities to report F&A costs to the federal government.

NACUBO appreciates the opportunity to submit this important proposal. We would be happy to work with you to revise or rework the draft if necessary. If you have any questions or comments on the proposed revenue procedure, please contact Christine Larger, Director, Public Policy and Management Programs, at (202) 861-2540.

Sincerely,

James E Morley Jr.

James E. Morley, Jr.
President

Enclosures:
Draft Revenue Procedure: Safe Harbors for Allocation of Expenses by Colleges and Universities for Purposes of Determining Taxable Unrelated Business Income
College and University Cost Identification and Allocation

cc: Marcus Owens, Director, Exempt Organizations Division, IRS
NACUBO UBIT Expense Allocation Project Work Group members
Stewart Cobine, Chair, NACUBO Taxation Task Force
Christine Larger, Director, NACUBO Public Policy and Management Programs