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An IRS Magnet : UBIT Expense Allocations Draw Scrutiny

The IRS pays attention to how not-for-profit organizations calculate the tax they pay on unrelated business activities. The agency is concerned that many not-for-profits may be improperly reporting losses related to these activities and thus may not be paying unrelated business income tax (UBIT).

The focus on the reporting of unrelated business income comes in the wake of an IRS compliance study of 400 public and private colleges and universities. The agency collected statistical information to determine if it needed to look further into how the organizations allocated expenses. This resulted in 30 IRS audits.

When is Unrelated Business Income Taxable?

Let's say you've determined that an activity is unrelated to your exempt purpose. For example, your not-for-profit's exempt purpose is to coordinate foster care, and you also run a coffee shop open to the general public to raise additional funds. The coffee shop would be unrelated to your exempt purpose. The excess of unrelated business income over the allowable deductions for that income results in UBIT.

When reporting unrelated income, certain expenses, such as staff costs and coffee supplies, are allowed as deductions against that income. They're categorized as directly connected expenses and dual use expenses.

What are "Directly Connected" Expenses?

Deductions incurred solely because of the unrelated business are known as *directly connected* expenses. These are expenses that wouldn't be incurred if the unrelated business didn't exist.

In the above example, the costs of maintaining a building that's used solely for the coffee shop (the unrelated business) are a directly connected expense, as are the salaries of personnel employed full-time to operate the unrelated business.

What are "Dual Use" Expenses?



Why It Matters

Here's the lowdown on what not-for-profits have to face if they inaccurately report expenses connected with unrelated business activities:

Accuracy-related penalties. The IRS may assess penalties for negligence or disregard of rules or regulations, or for a substantial understatement of income tax. The penalty is 20 percent of the underpaid tax.

Public access to Form 990-T, Exempt Organization Business Income Tax Return. Since 2006, 501(c)(3) organizations have been required to make their Form 990-T available to the public. So expect the form -- including allocations of expenses -- to be scrutinized by the public just as Form 990 has been in the past.

FASB Interpretation No. 48 (FIN48). For not-for-profits required to disclose uncertain tax positions on their financial

If expenses are incurred both to carry on exempt functions and to conduct an unrelated business, they're known as *dual use* expenses. For example, a not-for-profit's president is paid \$90,000 per year. If he devotes 90 percent of his time to the exempt activities of the not-for-profit, but 10 percent of his time to an unrelated business, the organization can take a deduction of \$9,000 (10 percent of \$90,000) as a deductible expense of the unrelated activity on Form 990-T.

statement footnotes, an incorrect or overly aggressive allocation of expenses to unrelated business income could result in a disclosure under the interpretation. This disclosure is required to be reported on Form 990.

The allocation of dual use expenses is more complex in situations where the allocation isn't as apparent as in the example above. This is particularly true of the dual use of facilities. According to U.S. Treasury regulations, when facilities are used both to carry on exempt activities and to conduct unrelated business, the expenses, depreciation and anything attributable to such facilities "shall be allocated between the two uses on a reasonable basis."

In such a situation, the not-for-profit must first identify the expenses that are incurred for the dual purpose, such as repairs and maintenance, utilities and depreciation. There are then two methods that can be applied to allocate those expenses:

1. The Rensselaer method. This is a ratio based on the number of days that the facility is used for unrelated business (numerator) in relation to the total days used for all purposes (denominator) -- for example, 64 divided by 253 (days). This method was named after the court case upon which it was based.

2. The IRS method. This is a ratio based on the number of days the facility is used for unrelated business (numerator) divided by the number of days the facility is available for use -- for instance, 64 divided by 365 (days), or 17.5 percent of the calendar year.

The Rensselaer method is more favorable for the not-for-profit because more expense is allocated to the unrelated business.

Document, Document, Document

Whether you're deducting direct expenses or allocating dual use expenses, you must produce support for them. Use time sheets to document the percentage of an employee's salary allocable to unrelated business, and keep facility use records for facilities allocations. Document your reasoning behind *any* allocations.

In its college/university compliance study, the IRS found that only 16 percent to 19 percent of participants relied on the advice of independent accountants or counsel for allocations of expenses between unrelated and exempt activities. With heightened IRS scrutiny, this may be the time to revisit this issue with your accountant.

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