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ALLOCATING FIXED COSTS OF DUAL-USE FACILITIES BY EXEMPT ORGANIZATIONS: ACTUAL USE OR AVAILABILITY FOR USE?

The Internal Revenue Code of 1954 (Code) generally exempts certain nonprofit organizations from federal income taxation.[1] Section 501(c)(3) of the Code provides such an exemption for qualified educational organizations.[2] This tax-free status for educational organizations has remained virtually unchanged since the establishment of the first federal income tax in the United States.[3] Extending tax exemptions to educational organizations promotes the public welfare because qualifying education organizations provide instruction to the public on subjects useful to individuals and beneficial to the community.[4] The only important limitation upon the tax-free status of educational organizations is the Code provision taxing the unrelated business income of an otherwise exempt organization.[5]

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1. *See* I.R.C. § 501(c) (West 1984). Organizations that § 501(c) exempts from federal income taxation include, among others, charitable organizations, educational institutions, scientific organizations, religious organizations, social welfare organizations, business leagues, social clubs, consumer cooperatives, labor unions, and trade associations. *Id.* Numerous qualifications, conditions, and exceptions apply to the general exemption from federal taxation for § 501(c) organizations. *See id.* §§ 501-08 (special rules apply to feeder corporations, private foundations, etc.). *See generally* Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976) (overview of relevant Code sections and analysis of justifications for allowing income tax exemptions for nonprofit organizations).

2. I.R.C. § 501(c)(3) (West 1984). Because § 501(c)(3) refers merely to "educational purposes," the proper definition of the word "educational" has been the subject of frequent litigation. *See* 6 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 34.11 (1983 rev. vol. & Supp. 1984) (overview of judicial interpretations of relevant Code and regulation sections defining "education"). The Treasury Department regulations provide that § 501(c)(3) of the Code uses the term "educational" as relating to the "instruction of the public on subjects useful to the individual and beneficial to the community." Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(b) (1960). Although the regulations also provide examples of educational organizations, the Court of Appeals for the District of Columbia has held Treasury regulation § 1.501(c)(3)-1(d)(3), defining the term "educational," as unconstitutionally vague. *See* Big Mama Rag, Inc. v. United States, 631 F.2d 1030, 1039-40 (D.C. Cir. 1980) (holding "full and fair exposition test" encompassed in regulation's definition of "education" was unconstitutionally vague); Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii), T.D. 6391, 1959-2 C.B. 139, 144 (example of educational organizations include primary or secondary schools, colleges, trade schools, public discussion groups, correspondence schools, and museums). *See generally* 6 J. MERTENS, *supra*, § 34.11, at 75-76 (analysis of *Big Mama Rag* holding).

3. *See* Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058, 1060 (2d Cir. 1984) (noting similarity between language of current and prior versions of § 501); *see also* Bittker & Rahdert, *supra* note 1, at 301-30 (background on legislative history of tax exemption for nonprofit organization).

4. *See* Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(b), T.D. 6391, 1959-2 C.B. 139, 144; *see also* Bittker & Rahdert, *supra* note 1, at 334-35 (general discussion of justifications for exempting charitable and educational organizations).

5. *See* I.R.C. § 511(a)(1) (West 1984) (tax imposed on unrelated business taxable income of § 501(c) organizations). Unrelated business taxable income is the gross income, less the directly

In 1950 Congress added the predecessor sections of 502 through 514 to the Code in response to well-publicized accounts of exempt organizations, particularly educational organizations, abusing their privileged status to generate otherwise fully taxable income in activities unrelated to their exempt function.[6] While the taxation of unrelated business income of exempt organizations is similar in theory to the computation of tax for ordinary business entities,[7] the need to allocate the income and expenses between the exempt and unrelated activities greatly complicates the determination of the proper unrelated business tax liability.[8] The allocation is often tedious and controversial, especially when an exempt organization uses the same facility both for exempt purposes and for the production of unrelated business income.[9] In *Rensselaer Polytechnic Institute v. Commissioner*,[10] the United States Court of Appeals for the Second

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connected allowable deductions from any regularly carried on trade or business, the conduct of which is not substantially related to the organization's exempt function. *Id.* § 512(a)(1); *see* Treas. Reg. § 1.512(a)-1, T.D. 7392, 1976-1 C.B. 162, 162-63 (provides more detailed definition of unrelated business taxable income); *see also* I.R.C. § 513(a) (West 1984) (defines unrelated trade or business); Treas. Reg. § 1.513-1, T.D. 6939, 1968-1 C.B. 274, 275 (elaborating § 513 definition of unrelated trade or business).

6. Revenue Act of 1950, ch. 944, §§ 301, 331, 64 Stat. 947, 957-58 (codified as amended at I.R.C. §§ 502-14 (West 1984)); *see* Moore, *Current Problems of Exempt Organizations*, 24 TAX. L. REV. 469, 469-74 (1969) (concise summary of legislative and judicial background of tax on unrelated business income). Prior to 1950, any unrelated income received by an exempt organization, regardless of the source of the income, was not taxable to the organization if the organization used the unrelated income to further the organization's exempt function. *See* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 581 (1924) (destination, not source, of income is dispositive test for taxability). Subsequent lower court decisions substantially expanded the destination-of-income test that the Supreme Court established in *Trinidad. See, e.g.*, Roche's Beach, Inc. v. Commissioner, 96 F.2d 776, 779 (2d Cir. 1938) (profits from bathing beach business feeding a charitable organization not taxable); Sam Springs Home v. Commissioner, 6 B.T.A. 198, 217 (1927) (income from greenhouse, cotton gin, and electric generating plant exempted from taxation); Appeal of Unity School of Christianity, 4 B.T.A. 61, 70 (1926) (religious organization's earnings from publications and inn income held exempt from taxation).

The most notorious abuse of the tax exemption provided to charitable and educational organizations involved the acquisition of the nation's largest manufacturer of noodles for the benefit of the School of Law of New York University. *See* C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 123 (3d Cir. 1951) (tax-exempt status of feeder corporation upheld), *rev'g* 14 T.C. 922 (1950). *See generally* Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280 (1968) (overview and critique of tax on unrelated business income) [hereinafter cited as *The Macaroni Monopoly*]. Sparked by the public reaction to the *Mueller* decision, Congress enacted the Revenue Act of 1950 to ease the concerns of private industry over unfair competition from exempt organizations. *See* Moore, *supra*, at 470-71 (discussion of public and congressional reaction to *Mueller*); *see also infra* notes 89-92 and accompanying text (analysis of legislative history of Revenue Act of 1950).

7. 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 103.3 (1981 & Supp. I 1984). In computing the tax on unrelated business income, the term "taxable income" as used in § 11 of the Code, which imposes a tax on corporate taxable income, reads as "unrelated business taxable income." I.R.C. § 511(a)(1) (West 1984).

8. 4 B. BITTKER, *supra* note 7, at ¶ 103.3.

9. *Id.*

10. 732 F.2d 1058 (2d Cir. 1984).

Circuit addressed this difficult allocation problem, by considering what constitutes a reasonable basis for allocating the fixed costs of a dual-use facility.[11]

Rensselaer Polytechnic Institute (Rensselaer) is a tax-exempt educational organization incorporated under the laws of the State of New York.[12] Rensselaer owned and operated a fieldhouse used both for exempt purposes[13] and for the production of unrelated business income.[14] Section 511(a)(1) of the Code subjected the unrelated business income generated by the commercial use of the fieldhouse to taxation.[15] The Commissioner of Internal Revenue (Commissioner) contested the amount of deductible expenses taken from the unrelated business gross income by Rensselaer in computing its unrelated business taxable income for the taxable year ending in 1974.[16] Rensselaer filed a petition with the United States Tax Court (Tax Court) for a redetermination of the Commissioner's assessment of a deficiency in the unrelated business tax due from Rensselaer.[17]

The Tax Court identified three types of deductible expenses related to the operation of the fieldhouse.[18] Rensselaer's direct expenses, those specifically identified with particular commercial uses, were never in dispute and clearly were deductible.[19] Additionally, the Tax Court considered the minor issue of Rensselaer's variable expenses,[20] those which varied in proportion to use but

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11. *Id.* at 1062.

12. Rensselaer Polytechnic Institute v. Commissioner, 79 T.C. 967, 968 (1982).

13. *Rensselaer*, 732 F.2d at 1059. In *Rensselaer Polytechnic Institute v. Commissioner*, the parties stipulated that the primary function of the fieldhouse was to carry out Rensselaer's educational responsibilities. *Rensselaer*, 79 T.C. at 968. Student uses of the facility included physical education, college ice hockey, student ice skating, intramurals, and commencement activities. *Id.*

14. *Rensselaer*, 79 T.C. at 968. In *Rensselaer*, the unrelated business uses of the fieldhouse included commercial ice shows and public ice skating. *Id.*

15. *Rensselaer*, 732 F.2d at 1059; *see* I.R.C. § 511(a)(1) (West 1984) (income from unrelated business activities is taxable).

16. *Rensselaer*, 79 T.C. at 968. The Tax Court in *Rensselaer* noted that the parties stipulated all the material facts. *Id.* at 968. Consequently, no factual disputes were before the Second Circuit. *Rensselaer*, 732 F.2d at 1059. Rensselaer's federal income tax period was on a fiscal year basis ending June 30, 1974. *Rensselaer*, 79 T.C. at 968.

17. *Rensselaer*, 79 T.C. at 967.

18. *Id.* at 968-69.

19. *Id.* In *Rensselaer*, the direct expenses of the fieldhouse included costs specifically identified with various events, such as contract and labor costs attributable to a specific event. *Id.* at 969 n.5. The parties agreed that Rennselaer's direct expenses totalled $371,407 for the year ending in 1974. *Id.* at 968-69. The parties did not dispute the deductibility of Rensselaer's direct expenses. *Id.* at 969; *see* I.R.C. § 512(a)(1) (West 1984); Treas. Reg. § 1.512(a)-1(b), T.D. 7392, 1976-1 C.B. 162, 162-63.

20. *Rensselaer*, 732 F.2d at 1060. The Second Circuit in *Rensselaer* noted that the Tax Court found that total variable expenses of the fieldhouse amounted to $197,210 allocable on a basis of actual use. *Id.; see* Treas. Reg. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163 (requiring allocation of expenses from dual-use facilities on reasonable basis); *see also*, Kannry, *How Hospitals Can Minimize Their Potential Exposure to the Unrelated Business Income Tax*, 43 J. TAX'N 166, 168-69 (1975) (example of application of variable expense allocation).

While the Commissioner approved of allocating variable expenses on a basis of actual use, the Commissioner contended that Rensselaer should have added certain adjustments to the total

which Rensselaer could not identify with specific events.[21] The dispute, however, centered primarily on Rensselaer's fixed expenses of operating the fieldhouse, which included those costs, such as depreciation and salaries, that did not vary in proportion to the use of the facility.[22]

Rensselaer asserted that the school legitimately could allocate fixed costs between the exempt educational use and the taxable commercial use on the basis of relative times of actual use for each purpose.[23] Rensselaer thus sought to calculate the proportion of deductible fixed expenses by dividing the total number of hours the fieldhouse was in commercial use by the total number of hours the facility was in actual use for any activity.[24] The Commissioner however, argued that the proper allocation basis was one of total time available for use, in which the fractional denominator was the total number of hours in the taxable year.[25]

The Tax Court reduced the deficiency asserted against Renesselaer, holding that allocations based on actual use were reasonable within the meaning of Treasury Department regulation section 1.512(a)-1(c).[26] The Commissioner

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hours of actual use, thus "increasing the denominator and reducing the portion of deductible expenses." *Rensselaer*, 79 T.C. at 973; *see infra* notes 23-25 and accompanying text (definitions of actual-use and availability for use allocation methods). The Tax Court upheld only one minor adjustment, which neither party appealed. *Rensselaer*, 79 T.C. at 973; *see Rensselaer*, 732 F.2d at 1060 (neither side appealed Tax Court decision regarding amount of deductible variable expenses).

21. *Rensselaer*, 79 T.C. at 969 n.6.

22. *Id.* The Second Circuit in *Rensselaer* noted that the stipulated fixed expenses were:

Salaries and fringe benefits	$ 59,415
Depreciation	29,397
Repairs and replacements	14,031
Operating expenditures	1,356
	$104,199

Rensselaer, 732 F.2d at 1060.

23. *Rensselaer*, 732 F.2d at 1060.

24. *Id.* The college in *Rensselaer* would calculate the amount of fixed expenses properly deductible by multiplying the total amount of fixed expenses incurred by the percentage of unrelated business use to total actual use for all purposes. *Id.*

25. *Id.* In allocating the expenses attributable to a dual-use facility, taxpayer has an incentive to allocate as much of the expenses as possible to the unrelated business usage to receive a tax benefit from expenses otherwise nondeductible by an exempt organization. *See id.* at 1065 (Mansfield, J., dissenting) (noting similar incentive in home office expense allocations). By using the total number of hours in the taxable year rather than the total hours the facility actually was in use as the denominator, the Commissioner's availability for use allocation method effectively reduced the portion of expenses deductible by the college in *Rensselaer. Rensselaer*, 79 T.C. at 973.

The Second Circuit noted that the difference in tax liability between allocations based on actual use and availability for use in *Rensselaer* amounted to only $9,259. *Rensselaer*, 732 F.2d at 1060. Although the actual liability at stake in *Rensselaer* was minimal, the potential precedential value of this case of first impression did not go unnoticed. *See id.* at 1059 (amicus curiae briefs filed by American Council on Education, National Institute of Independent Colleges and Universities, and Yale University suggest importance of *Rensselaer* decision).

26. *Rensselaer*, 70 T.C. at 974; *see* Treas. Reg. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163 (educational organizations must allocate expenses attributable to dual-use facility between the exempt and non-exempt uses on "reasonable basis").

appealed the Tax Court decision to the Second Circuit,[27] asserting that allocations based on actual use fail to meet the statutory requirement that deductible expenses must be "directly connected with" the unrelated business activity.[28] The Commissioner criticized the analogy the Tax Court drew between dual-use facility allocations and home office expense allocations.[29] The Commissioner also argued that the "directly connected with" language in section 512 of the Code requires a narrow interpretation to prevent exempt organizations from abusing their privilege.[30] The Second Circuit nevertheless rejected the Commissioner's arguments and affirmed the Tax Court decision.[31]

In *Rensselaer*, the Second Circuit traced the historical origins of the tax on unrelated business income and carefully reviewed the applicable statute and regulations.[32] On the basis of this analysis, the *Rensselaer* court rejected the Commissioner's assertion that actual-use allocations result in expenses not directly connected with the unrelated business activity.[33] The Second Circuit stated that the Commissioner's position was contrary to both the underlying legislative intent in taxing unrelated business income and the applicable Treasury regulations.[34] By taxing unrelated business income, Congress primarily sought to achieve parity between exempt and non-exempt organizations engaged in similar commercial activities without jeopardizing the basic purpose of the tax exemption.[35] The Second Circuit stated that allocations based on availability for use failed to promote this type of equality between exempt and non-exempt organizations.[36] The *Rensselaer* court interpreted the Treasury regulations as providing that, when allocated on a "reasonable basis," the expenses of a facility used for both exempt and commercial purposes are "proximately and

27. *Rensselaer*, 732 F.2d at 1060. Either the Commissioner or the taxpayer may appeal a decision of the Tax Court to the appropriate United States Court of Appeals. I.R.C. § 7482(a) (West 1984). Because Rensselaer was a New York corporation, proper venue for an appeal rested in the Second Circuit. *See id.* § 7482(b)(1)(B) (for redetermination of corporate tax liability, venue lies in circuit of principal place of business of corporation).

28. *Rensselaer*, 732 F.2d at 1060. In *Rensselaer*, the Commissioner relied on § 512(a)(1) of the Code, which requires that deductible expenses by directly connected with the unrelated business activity. *Id. passim; see* I.R.C. § 512(a)(1) (West 1984) (defining unrelated business income as gross income from unrelated business activities less allowable deductions directly connected with unrelated activities).

29. *Rensselaer*, 732 F.2d at 1060-62; *see infra* notes 66-81 and accompanying text (analysis of home office expense cases).

30. *Rensselaer*, 732 F.2d at 1060-61; *see infra* notes 50-58 and accompanying text (analysis of § 512 and applicable regulations).

31. *Rensselaer*, 732 F.2d at 1062 (2d Cir. 1984), *aff'g* 79 T.C. 967 (1982).

32. *Rensselaer*, 732 F.2d at 1060-61; *see supra* note 6 and accompanying text (discussion of historical origins of tax on unrelated business income).

33. *Rensselaer*, 732 F.2d 1061-62; *see infra* notes 48-58 and accompanying text (explaining that Commissioner's position ignores clear and unambiguous statutory and regulatory language).

34. *Rensselaer*, 732 F.2d at 1061; *see infra* notes 88-97 and accompanying text (availability for use allocations inconsistent with legislative intent to achieve parity between exempt and non-exempt organizations).

35. *See Rensselaer*, 732 F.2d at 1061 (summary of legislative intent of unrelated business income tax).

36. *Id.* at 1062.

primarily related'' to the commercial activity and, therefore, are directly connected with the unrelated business activity.[37] The regulations, therefore, make such expenses expressly deductible.[38] Like the Tax Court, the Second Circuit also found the home office expense cases analogous to *Rensselaer*, a case of first impression;[39] and deferring to the Tax Court's expertise in the application of the tax laws,[40] the Second Circuit found no error in the Tax Court's decision that Rensselaer's method of allocation was reasonable.[41]

Conversely, the dissent in *Rensselaer* primarily argued that the fundamental

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37. *Id.* at 1061. As the Second Circuit noted in *Rensselaer*, § 512 of the Code defines unrelated business income as:

> . . . the gross income derived by any [tax-exempt] organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business. . . .

I.R.C. § 512(a)(1) (West 1984); *see Rensselaer*, 732 F.2d at 1061 (noting definition of unrelated business income under § 512). The applicable regulations further provide that:

> . . . [t]o be deductible in computing unrelated business taxable income . . . 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 the unrelated trade or business . . . [with the phrase] to be 'directly connected with' . . . [meaning] an item of deduction must have proximate and primary relationship to the carrying on of that business.

Treas. Reg. § 1.512(a)-1(a), T.D. 7392; 1976-1 C.B. 162, 162. A subsequent subsection of the same regulation provides:

> (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 items so allocated to the unrelated trade or business activity *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.

Id. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163 (emphasis added). Overhead and personnel expenses are ordinary and necessary business expenses and are therefore allowable deductions pursuant to § 162 of chapter 1 of the Code. I.R.C. § 162 (West 1984). Likewise, depreciation deductions are allowable under § 167 of chapter 1 of the Code. *Id.* § 167; *see* Kannry, *supra* note 20, at 168-69 (example of application of Treas. Reg. § 1.512(a)-1).

38. Treas. Reg. § 1.512(a)-1, T.D. 7392, 1976-1 C.B. 162, 162-63.

39. *Rensselaer*, 732 F.2d at 1062; *see infra* notes 66-81 and accompanying text (analysis of home office expense cases).

40. *Rensselaer*, 732 F.2d at 1061. The Second Circuit in *Rensselaer* noted that appellate courts should not review the Tax Court's interpretation of the tax law unmindful of the Tax Court's expertise in these matters. *Id.; see* ABKCO Indus. Inc. v. Commissioner, 482 F.2d 150, 155 (3d Cir. 1973) (affirming Tax Court interpretation of tax consequences of alleged royalties contract). Courts properly may attach weight to legal decisions made by administrative bodies having special competence to deal with the subject matter. *See* Dobson v. Commissioner, 320 U.S. 489, 502 (1943) (appellate courts should give due regard to special competence of Tax Court). Tax Court resolutions of questions of tax law thus warrant deference and appellate courts should follow Tax Court decisions whenever possible. *ABKCO Indus.*, 482 F.2d at 155.

41. *Rensselaer*, 732 F.2d at 1061-62.

differences between exempt and taxable entities required a stricter standard of deductibility for exempt organizations with unrelated business income than for taxable organizations.[42] The dissent contrasted the Treasury regulation governing expense deductions for profit-seeking entities with the narrower regulations governing unrelated business income.[43] The dissent also questioned the validity of using the home office expense cases as evidence of the reasonableness of actual-use allocations, in light of the Ninth Circuit's reversal of an actual-use allocation in a home office expense case.[44] The dissent found precedent for its proposition that actual-use allocations improperly resulted in expenses not directly connected with the unrelated business activity in *Pittsburgh Press Club v. United States*.[45] In *Pittsburgh Press Club*, the Third Circuit determined a social club's unrelated business income by considering deductible only those expenses that the club would not have incurred but for the unrelated business activity.[46] The *Rensselaer* court, in affirming the Tax Court decision, however, distinguished *Pittsburgh Press Club* by noting that that case involved the possible revocation of the club's tax-exempt status for engaging in outside business activities proscribed by the Code as opposed to unrelated business income that an exempt educational organization may earn permissibly.[47]

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42. *Id.* at 1063-64 (Mansfield, J., dissenting).

43. *Id.* at 1064-65; *see* Treas. Reg. § 1.162-1(a), T.D. 6291, 1958-1 C.B. 63-64 (ordinary and necessary expenses directly connected with profit-seeking business are deductible); *id.* § 1.512(a)-1(a), T.D. 7392, 1976-1 C.B. 162, 162 (unrelated business expenses must be directly connected with unrelated activity and otherwise qualify as deductions); *see also infra* note 56 (comparison of conjunctive and disjunctive language in unrelated business income and deductible business expense regulations).

44. *Id.* at 1065-66; *see infra* notes 75-78 and accompanying text (analysis of Ninth Circuit's reversal of Tax Court's approval of actual-use allocations of home office expenses).

45. *Rensselaer*, 732 F.2d at 1066 (Mansfield, J., dissenting); *see* Pittsburgh Press Club v. United States, 579 F.2d 751 (3d Cir.), *on remand*, 462 F. Supp. 322 (W.D. Pa. 1978), *rev'd*, 615 F.2d 600 (3d Cir. 1980).

46. *Id.* at 761. In *Pittsburgh Press Club v. United States*, the Third Circuit noted that following an extensive audit the Internal Revenue Service revoked the club's exempt status and assessed income taxes on club revenues for subsequent taxable years. *Id.* at 753. The Internal Revenue Service asserted that the club's continued practice of renting its facilities for outside affairs resulted in the receipt of substantial revenues from outside sources. *Id.* This practice constituted engaging in business in violation of § 501(c)(7) of the Code, which requires a social club to operate exclusively for nonprofit purposes. *Id.* at 753-54; *see* I.R.C. § 501(c)(7) (West 1984) (exempt social clubs prohibited from engaging in outside business activities).

47. *Rensselaer*, 732 F.2d at 1062. In distinguishing *Pittsburgh Press Club*, the Second Circuit in *Rensselaer* noted that § 501(c)(7) of the Code prohibits an exempt social club from engaging in any outside business activity. *Id.; see* I.R.C. § 501(c)(7) (West 1984) (substantially all activities of social clubs must be for pleasure, recreation, and other nonprofitable purposes); Treas. Reg. § 1.501(c)(7)-1(b) (1958) (clubs engaging in business, such as making their facilities available for public rental, are not exempt from taxation under § 501(a)); *see also supra* note 46 (discussion of Commissioner's position in *Pittsburgh Press Club*). In fact, the only outside profits permitted under § 501(c)(7) of the Code are those profits strictly incidental to the club's activities and that are either negligible or nonrecurring. *See* United States v. Fort Worth Club of Fort Worth, Texas, 345 F.2d 52, 57-58 (5th Cir.) (rental income deemed substantial and profitable business and not

The Second Circuit in *Rensselaer* correctly noted that the Commissioner ignored his own definition of the concept of "directly connected with" included in the regulations.[48] By expressly including depreciation, personnel expenses, and overhead, the Treasury regulation pertaining to exempt organizations' dual use of facilities or personnel is directly applicable to all the fixed expenses related to Renssalaer's fieldhouse.[49] Although the Code and Treasury regulations require a narrow interpretation of what constitutes a deductible expense for an exempt organization,[50] the dual-use regulation explicitly states that the portion of fixed expenses allocated on a reasonable basis is proximately and primarily related to the unrelated business activity.[51] In turn, regulation section 1.512(a)-1(a) defines the concept "directly connected with" as requiring an item of deduction to have a proximate and primary relationship to the conduct of the unrelated business activity.[52] Reasonably allocated fixed expenses, consequently, have the requisite direct connection with the unrelated business activity.[53] In an administrative ruling prior to *Rensselaer*, the Internal Revenue Service reached the identical conclusion.[54] The Commissioner and the dissent in *Rensselaer* ardently strived to avoid giving section 512 and the applicable regulations their natural reading.[55] Nevertheless, the distinction drawn between the deductibility requirements of exempt organizations and profit-seeking businesses,[56] as well as, the dissent's statutory construction

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permissibly derived from club's social activities or services usually provided to members), *modified and aff'd on rehearing*, 348 F.2d 891 (5th Cir. 1965). In *Pittsburgh Press Club*, the Third Circuit held that when measuring the amount of outside profits allowable under § 501(c)(7), a social club may not reduce its net profit by costs that the club would not have incurred but for the unrelated business activity. 579 F.2d at 761-62. The *Pittsburgh Press Club* court explicitly limited its holding to situations in which courts inquire into the propriety of the revocation of a social club's exemption. *Id.* at 762.

48. *See Rensselaer*, 732 F.2d at 1062.

49. *See* Treas. Reg. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163; *supra* note 22 (list of fixed expenses related to Rensselaer's fieldhouse).

50. *See* I.R.C. § 512(a)(1) (West 1984) (expenses must be otherwise deductible and directly connected with the unrelated business activity); Treas. Reg. § 1.512(a)-1(a), T.D. 7392, 1976-1 C.B. 162, 162 (same).

51. Treas. Reg. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163.

52. Treas. Reg. § 1.512(a)-1(a), T.D. 7392, 1976-1 C.B. 162, 162.

53. *See id.* § 1.512(a)-1(a), (c), T.D. 7392, 1976-1 C.B. 162, 162-63 (direct connection of reasonably allocated fixed expenses follows from complete reading of relevant regulations).

54. *See* Rev. Rul. 76-402, 1976-2 C.B. 177, 178 (summer tennis camp's use of exempt school's facilities resulted in dual use of facilities, with allocable portion of expenses deductible in computing unrelated business taxable income).

55. *See Rensselaer*, 732 F.2d at 1064-65 (Mansfield, J., dissenting) (discussing, with approval, Commissioner's position).

56. *Id.* The *Rensselaer* dissent contrasted the disjunctive language in the regulation governing business deductions for profit-seeking organizations with the conjunctive wording in the regulation relating to the tax on unrelated business income. *Id. Compare* Treas. Reg. § 1.162-1(a), T.D. 6291, 1958-1 C.B. 63.64 (expenses deductible by profit-seeking organizations include ordinary and necessary expenditures directly connected with or pertaining to taxpayer's business) *with* Treas. Reg. § 1.512(a)-1(a), T.D. 7392, 1976-1 C.B. 162, 162 (expenses not only must qualify as deductions allowed by chapter 1 of Code, but also must be directly connected with unrelated business activity).

argument[57] fails in light of the clear and unambiguous language of the statute and regulations.[58] Accordingly, the dispositive issue in *Rensselaer*, as the Second Circuit noted, was whether the college's actual-use allocation method was reasonable.[59]

Taxpayers determine their income for tax purposes according to the regular method of accounting used in keeping their financial books.[60] Taxpayers, furthermore, have the discretion to choose the methods best adapted to their requirements, as long as the method clearly reflects taxable income.[61] Availability for use and actual-use allocations are differing accounting methods analogous to straight-line and service-hours depreciation methods, respectively.[62] Like their theoretical equivalents, allocations of the fixed costs of a dual-use facility based on both availability for use and actual use may clearly reflect income in a given fact situation.[63] In *Rensselaer*, the Commissioner did not claim that the college's allocation method was unreasonable as applied to the facts.[64] Accordingly, nothing prohibited *Rensselaer* from exercising its discretion in choosing actual-use allocation as its accounting method.[65]

Both the Tax Court and the Second Circuit analogized the *Rensselaer* facts to the home office expense cases.[66] The rationales used in allocating home

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57. *Rensselaer*, 732 F.2d at 1065 (Mansfield, J., dissenting). The dissent in *Rensselaer* implied that the more general provision of Treas. Reg. § 1.512(a)-1(a) somehow negates the more specific provision in subsection (c), which permits allocations of expenses on a reasonable basis. *Id.; see* Treas. Reg. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163.

58. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200-01, 214 (1976) (statutory language controls if sufficiently clear in this context); *see also* Commissioner v. Portland Cement Co., 450 U.S. 156, 169 (1981) (Treasury regulations sustained unless unreasonable and plainly inconsistent with Code); Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948) (Treasury regulations overruled only for significant reasons).

59. *Rensselaer*, 732 F.2d at 1061; *see* Treas. Reg. § 1.512(a)-1(c), T.D. 7392, 1976-1 C.B. 162, 163 (mandating allocation of dual-use expenses on reasonable basis).

60. *See* I.R.C. § 446(a) (West 1984) (taxable income computed under taxpayer's method of accounting unless such method does not clearly reflect income); Treas. Reg. § 1.446-1(a)-(1) & (2) T.D. 6282, 1958-1 C.B. 215, 217 (same).

61. *See* I.R.C. § 446(b) (West 1984) (taxpayer has discretion to choose accounting method that clearly reflects income); Treas. Reg. § 1.446-1(1) & (2), T.D. 6282, 1958-1 C.B. 215, 217 (same).

62. *Cf. Rensselaer*, 732 F.2d at 1065 n.3. (Mansfield, J., dissenting) (analyzing depreciation methods to argue majority decision improperly allowed expense deductions when fieldhouse was not in commercial use). Straight-line depreciation is a function of the passage of time and is conceptually most accurate when the availability of the asset is more important than the actual use of the asset. E. SPILLER, FINANCIAL ACCOUNTING 276 (1971). Conversely, service-hours depreciation is a function of actual usage in a period relative to projected total usage and is more appropriate when physical use is the most important factor in the determination of an asset's useful life. *Id.* at 278.

63. *Compare* I.R.C. § 280A(c)(4)(C) (West 1984) (availability for use used in allocations of home day care center facilities) *with id.* § 280A(e)(1) (actual-use allocation used for rental vacation homes).

64. *Rensselaer*, 732 F.2d at 1062.

65. *See supra* note 61 and accompanying text (taxpayer has discretion over choice of accounting methods if such methods clearly reflect income).

66. *See Rensselaer*, 732 F.2d at 1062; *Rensselaer*, 70 T.C. at 970-72; *see also infra* note

office expenses between business and personal use are helpful in judging the reasonableness of actual-use allocations in the unrelated business income context.[67] Even the *Rensselaer* dissent agreed that the home office allocations are somewhat comparable to the allocations required of exempt organizations engaged in unrelated business activities.[68] Prior to the enactment of the Tax Reform Act of 1976,[69] home office expenses were deductible even though the business use of that portion of the house was not exclusive.[70] Taxpayers thus had to allocate the home office expenses between the deductible business and nondeductible personal use.[71] The Tax Court's approval of taxpayers allocating the home office expenses on the more beneficial actual-use basis remained unchallenged until *Gino v. Commissioner*.[72] In *Gino*, the Tax Court set out the rationale of the preceding home office expense case: that allocation of home office expenses on an actual-use basis more clearly reflects the proper business deductions allowed than allocations based on availability for use.[73] The Tax Court reasoned that allocations based on availability for use rest on the erroneous and misleading assumption that the portion of the house used for dual purposes, when idle, is not equally available for either business or personal use.[74] Nevertheless, the Ninth Circuit in *Gino* reversed the Tax Court decision.[75] Noting that the regulation proscribing deductions of personal expenses did not specify how to allocate expenses attributable to

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70 (list of home office expense cases).

67. *Rensselear*, 732 F.2d at 1065 (Mansfield, J., dissenting). With both home office expense and unrelated business income allocations, an incentive exists to allocate as much of the expenses as possible to the taxable activity. *Id.; see supra* note 25 (incentive to reduce tax liability and receive tax benefit for otherwise nondeductible expenses).

68. *Rensselaer*, 732 F.2d at 1065 (Mansfield, J., dissenting).

69. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified as amended in scattered sections of 26 U.S.C.).

70. *See, e.g.*, Browne v. Commissioner, 73 T.C. 723, 728-29 (1980) (self-employed taxpayer performed craft work, painting, medical and legal transcribing, and tax return preparation in portion of house); Gino v. Commissioner, 60 T.C. 304, 313-15 (1973) (taxpayers were high school teachers who performed nonclassroom duties at home), *rev'd*, 538 F.2d 833 (9th Cir.), *cert. denied*, 429 U.S. 979 (1976); International Artists, Ltd. v. Commissioner, 55 T.C. 94, 107-08 (1970) (proportionate cost of home office and studio deductible by self-employed entertainer). *See generally* Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 912-15 (1974) (analysis of home office expenses in context of general nondeductibility of personal expenses).

71. *See* I.R.C. § 262 (West 1984) (personal expenses not deductible); *id.* § 162 (ordinary and necessary business expenses generally deductible). The expenses related to the portion of the house used as an office are deductible. *See id.* The expenses involved in maintaining a personal residence, however, are generally nondeductible personal expenses. *See id.* § 262.

72. 538 F.2d 833 (9th Cir. 1976), *rev'g* 60 T.C. 304 (1973), *cert. denied*, 429 U.S. 979 (1976).

73. *See Gino*, 60 T.C. at 315 (availability of use allocations based on erroneous assumption).

74. *Id.* As homeowner, the taxpayer may choose to use a portion of his house at his discretion for either business or personal reasons. *Id.* If the facility was equally available at all times for both uses, a taxpayer may allocate reasonably a portion of the fixed expenses of the facility, while not in use, should be allocated to both purposes. *Cf.* Browne v. Commissioner, 73 T.C. 723, 730 (1980) (Hall, J., concurring) (no statutory warrant for applying more severe proration test for qualifying home office expenses than for expenses of any other dual-use facility).

75. *Gino*, 538 F.2d at 835.

deductible home office expenses,[76] the Ninth Circuit deferred to a revenue ruling that illustrated and applied the Internal Revenue Service's availability for use allocation method.[77] While the Ninth Circuit did reverse the Tax Court's approval of actual-use allocations in *Gino*, it was the only circuit to so rule.[78] The Tax Court also specifically reaffirmed its position in *Browne v. Commissioner*[79] holding that the fraction applicable to allocating home office expenses was the total time the taxpayer used her home for business divided by the time the taxpayer actually used the space for all purposes.[80] As the concurring opinion in *Browne* noted, the Ninth Circuit did not base its reversal in *Gino* on the merits of availability for use allocation, but rather on administrative deference to a revenue ruling.[81] Since *Browne*, the addition to the Code of section 280A with its exclusivity requirement effectively has preempted any further judicial development of the allocation issue for home office expenses.[82]

In addition to questioning the validity of the home office expense analogy following the Ninth Circuit's decision in *Gino*,[83] the dissent in *Rensselaer* argued that the analogy was flawed because a homeowner could use his home for any purpose he chooses while an exempt educational organization must dedicate its facilities to exempt purposes, undercutting the reasonableness in allocating idle time proportionally.[84] The dissent's argument, however, fails to recognize that an educational organization does not jeopardize its exempt status if the organization uses some facilities for dual purposes.[85] Under dual usage, a

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76. *See* Treas. Reg. § 1.262-1(b)(3), T.D. 6313, 1958-2 C.B. 113, 115 (portion of expenses properly attributable to business is deductible as business expense).

77. *Gino*, 538 F.2d at 835; *see* Rev. Rul. 62-180, 1962-2 C.B. 52 (Example 5 illustrates computation of allowable deduction for portion of expenses attributable to business use of home).

78. *See Gino*, 538 F.2d at 835.

79. *Gino*, 73 T.C. 723, 728-29 (1980).

80. *Id.*

81. *Id.* at 730-31 (Hall, J., concurring). The concurring opinion in *Browne v. Commissioner* expressly refused to uphold the Commissioner's position on availability for use allocations, even though an existing revenue ruling outlined that position. *Id.* A revenue ruling is merely the legal opinion of an Internal Revenue Service attorney and lacks the force or effect of law. *See, e.g.*, Bartels v. Birmingham, 332 U.S. 126, 132 (1947) (interpretative rulings of Treasury regulations regarding definition of independent contractors for social security tax purposes ignored); Idaho Power Co. v. Commissioner, 477 F.2d 688, 696 n.10 (9th Cir. 1973) (revenue ruling on nondeductibility of depreciation on equipment owned by taxpayer and used in self-construction of capital improvements deemed in conflict with revenue statutes and, therefore, was without any force), *rev'd on other grounds*, 418 U.S. 1 (1974); Stubbs, Overbeck & Assocs., Inc. v. United States, 445 F.2d 1142, 1146-47 (5th Cir. 1971) (ignoring revenue ruling defining per diem living allowances at remote job site as wages for income tax withholding purposes).

82. I.R.C. § 280A (c) (West 1984). Section 280A(c) limits allowable deductions for home office expenses to those portions of the home used exclusively and on a regular basis for business purposes. *Id.* Section 280A(c), therefore, eliminated the need to allocate expenses between the dual uses. *See id.*

83. *Rensselaer*, 732 F.2d at 1065-66 (Mansfield, J., dissenting).

84. *Id.* at 1065.

85. *See* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 581 (1924) (entity organized

facility's idle time arguably is equally available for both exempt and commercial activities.[86] An educational institution, therefore, reasonably could allocate fixed expenses during idle time in proportion to the actual use of the facility.[87]

Allocating the fixed expenses of a dual-use facility on the basis of actual use would better effectuate the legislative purpose of taxing unrelated business income.[88] While the general purpose of the Revenue Act of 1950 was to raise revenues,[89] the legislative history indicates that Congress had a more specific intent in enacting the provisions regarding the tax on unrelated business income.[90] Congress sought to eliminate the unfair competitive advantage exempt organizations enjoyed over their profit-seeking counterparts[91] and to achieve

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and operated exclusively for religious, charitable, scientific, or educational purposes still may have net income); C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 122 (3d Cir. 1951) (upholding exemption for feeder corporation generating business income unrelated to educational function of donee). *See generally* Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 TAX. L. REV. 53 (1965) (overview of separation of qualification for exemption and taxation of unrelated business income); 6 J. MERTENS, *supra* note 2, § 34.07, at 35-36 (judicial interpretations of "exclusively" have allowed some activities not directly furthering organization's exempt function).

86. *But cf. Rensselaer*, 732 F.2d at 1065 (Mansfield, J., dissenting) (court cannot reasonably assume that fieldhouse's idle time was equally available because Rensselaer would not have received its exemption in first place). *See supra* note 85 and accompanying text (exempt organizations allowed some unrelated activities without risking loss of exemption).

87. *Cf. supra* note 67-68 & 74 and accompanying text (unrelated business income allocations analogous to home office expense allocations).

88. *Cf., Rensselaer*, 732 F.2d at 1062 (Commissioner's interpretation of § 512 does not fulfill congressional intent in passing statute).

89. *See* H.R. REP. No. 2319, 81st Cong., 2d Sess. 1 (1950) *reprinted in* 1950-2 C.B. 380, 380 (1950) [hereinafter cited as H.R. REP. No. 2319]. The House Ways and Means Committee stated that the various revenue raising provisions in their Revenue Act of 1950 tax bill were to recoup partially the loss from the substantial reductions in war excise taxes. *Id.* The bill included changes in the tax treatment of charitable and educational organizations as one of the revenue raising provisions. *Id.* at 381. After the House passed its version of the bill, substantial increases in defense expenditures related to the United States' military involvement in Korea compelled the Senate to convert the excise tax reduction bill into a revenue producing measure. *See* S. REP. No. 2375, 81st Cong., 2d Sess. 28 (1950) *reprinted in* 1950-2 C.B. 483, 484 (1950).

90. *See infra* notes 91-92 and accompanying text (primary purpose for imposition of tax on unrelated business income was elimination of unfair competition and inequity in tax system); *See also* Louisiana Credit Union League v. United States, 693 F.2d 525, 539-41 (5th Cir. 1982) (discussion of history of 1950 tax legislation); Veterans' Found. v. United States, 281 F.2d 912, 913-14 (10th Cir. 1960) (same); United States v. Community Serv. Inc., 189 F.2d 421, 425-27 (4th Cir. 1951) (same).

91. *See* H.R. REP. No. 2319, *supra* note 89, *reprinted in* 1950-2 C.B. at 409 (1950) (unrelated business tax provisions primarily directed at problem of unfair competition); Treas. Reg. § 1.513-1(b), T.D. 6939, 1968-1 C.B. 274, 275 (same); *see also* Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 YALE L.J. 851, 875 (1951) (primary purpose of unrelated business tax was elimination of unfair competition between taxable and tax-exempt businesses). The specific competitive advantage possessed by an exempt business is a higher rate of return on the business' capital, which allows the exempt business to expand operations and compete more effectively against nonexempt businesses. *See The Macaroni Monopoly, supra* note 6, at 1281-82. *See generally* Bittker & Rahdert, *supra* note 1, at 318-20 (critical analysis of alleged competitive threat posed by exempt organizations).

equity in the tax system by closing the loophole that allowed exempt organizations to engage in otherwise taxable activities at no tax cost.[92] While both allocation methods eliminate the inherent inequity that previously existed in the Code, only actual-use allocations encourage the achievement of parity between exempt and non-exempt organizations engaged in similar commercial endeavors.[93] Actual-use allocations distribute a ratable share of the fixed costs to those periods when the facility is not in use.[94] This distribution mirrors the treatment the Code allows to non-exempt businesses.[95] Conversely, under availability for use allocations, an exempt organization could not allocate any of its fixed costs to the facility's idle time.[96] Rather than achieving parity, therefore, availability for use allocations would place exempt organizations at a competitive disadvantage with its non-exempt counterparts.[97]

In affirming the Tax Court decision, the Second Circuit properly held that Rensselaer's method of allocating the fixed expenses of its fieldhouse was reasonable within the meaning of the applicable regulations.[98] Allocations based on actual use satisfy the regulatory requirement of allocation on a reasonable basis[99] and fulfill the legislative intent of the unrelated business income tax provisions of the Code.[100] Moreover, with general public policy providing privileged status to educational organizations, preference should go to the allocation method that is more beneficial to the exempt institution when choosing between two reasonable accounting methods. The approval of allocating the fixed costs of a dual-use facility on an actual-use basis could have a beneficial impact nationwide on all organizations exempt from federal income taxation by section 501(c)(3).[101] With the increasing difficulty that educational

92. *See* Treas. Reg. § 1.513-1(c), T.D. 6939, 1968-1 C.B. 274, 275 (purpose of unrelated business tax was to place exempt organization commercial activities on same tax basis as taxable organizations); 96 Cong. Rec. 769, 770 (1950) (President Truman's message to Congress regarding Revenue Act of 1950 stressed need to improve equity in tax system by closing certain loopholes).

93. *See infra* notes 96-97 and accompanying text (availability for use allocations place exempt organizations at competitive disadvantage).

94. *See Rensselaer*, 79 T.C. at 971-72 (with fieldhouse equally available for exempt or non-exempt purpose during idle time, actual-use allocation distributes expenses in proportion to use).

95. *See* DAVIDSON, HANDBOOK OF MODERN ACCOUNTING 18-10, 18-11 (1970) (straight-line depreciation is function of time allocating cost regardless of asset usage); I.R.C. § 167(b)(1) (West 1984) (straight-line depreciation explicitly approved).

96. *Rensselaer*, 732 F.2d at 1062.

97. *Id.* Unlike any taxable business using a depreciation method based on time, an exempt organization allocating the fixed expenses of its dual-use facility on the basis of availability for use could not distribute any fixed expenses to the facility's idle time. *Id.*

98. *See supra* notes 48-53 and accompanying text (actual-use allocations satisfy requisite direct connection to unrelated activity as mandated by statute); *supra* notes 85-87 and accompanying text (with fieldhouse equally available for either exempt or nonexempt functions, actual-use allocations reasonable).

99. *See supra* notes 60-65 and accompanying text (actual-use allocation is reasonable accounting method which taxpayer has discretion to choose).

100. *See supra* notes 88-97 and accompanying text (actual-use allocations allow exempt organization to match taxable entities in allocating position of costs to idle time of assets, thus fulfilling legislative intent to eliminate unfair competition and Code inequities).

101. *See supra* note 25 (importance of potential precedential value reflected in filing of numerous amicus curiae briefs).

and charitable organizations encounter in raising the necessary funds to maintain their level of service, such organizations will welcome the opportunity to save some of their limited resources by reducing their unrelated business income tax liability.

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