CAPINCROUSE LLP

Dual-Use Property Issues

What are *dual use facilities*? Treasury Regulation 1.512(a)-1(c) states, “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.”

The term *reasonable basis* has been an area of contention over the years. Private Letter Rulings and court decisions abound on what is and is not a reasonable basis for expense allocations.

One example might be a university that owns, operates, and maintains a football stadium. The stadium hosts 7 home football games per year. In addition, each May, the university hosts a big rock concert. Would a reasonable allocation of expenses to the rock concert be 1/8 of all allocable expenses (for example, depreciation, overhead, and similar items) because the concert is 1 of 8 events conducted per year? Or, as the IRS has asserted in some court cases and rulings, should the expenses allocable to the rock concert be 1/365 of all allocable expenses because the concert takes place approximately 1 out of 365 days per year? The difference would be 12.5 percent versus .274 percent, or $125.00 per $1,000 versus $2.74 per $1,000 of allocable expenditures—quite a difference in terms of millions of dollars of expenses.

One of the main court cases in this arena is *Rensselaer Polytechnic Institute v. Commissioner* from 1984. In this case, the taxpayer used its fieldhouse many hours per week for functions related to its exempt purpose. In addition, the university received dual-use rental income from a hockey team. The taxpayer calculated allocations for fixed expenses of the fieldhouse based upon the relative times of actual use between exempt and taxable activities. The IRS argued that the appropriate method of allocating fixed costs between exempt and non-exempt activities should be based upon the total time available for use. The Second Circuit affirmed the tax court’s decision that Rensselaer’s allocation method was “reasonable.”

Debt-Financed Property

Although there is an exemption from UBIT for rentals of real property, debt-financed property rentals are generally subject to UBIT. There are several exclusions regarding debt-financed property, including an exclusion for qualified educational institutions, substantially related use, and the neighborhood land rule.

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The delineation of whether a property is “debt-financed” concerns whether the asset is subject to acquisition indebtedness. *Acquisition indebtedness* is defined in IRC Section 514(c)—with respect to any debt-financed property—as the unpaid amount of

A. the indebtedness incurred by the organization in acquiring or improving such property;
B. the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and
C. the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Acquisition indebtedness is figured on the basis of each property or facility owned by an organization. There may be situations when a certain property is not “secured” by the acquisition indebtedness but would still be considered debt-financed property.

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