G. ALLOCATION OF COSTS TO EXEMPT ORGANIZATION PUBLICATIONS

1. Introduction

Advertising income derived by exempt organizations in connection with their publications is subject to the tax on unrelated business income (except in rare cases where the advertising contributes importantly to the organization's exempt purposes). Rules for the determination of unrelated business taxable income (UBTI) derived from the sale of advertising in exempt organization periodicals are contained in Reg. 1.512(a)-1(f). A very important aspect of the computations required in arriving at net taxable income is the allocation of expenses between the organization's other activities and the publication. In addition, it is necessary to allocate expenses of the publication between advertising costs and readership costs. This topic reviews the approaches to the allocations of those costs.

2. Background

The amount of unrelated business taxable income derived from the sale of advertising in periodicals is determined by subtracting direct advertising costs from gross advertising income. If this computation results in a loss, no further adjustments are made. The loss enters into the computation of unrelated business taxable income, and may be used as an offset to other unrelated business income. Reg. 1.512(a)-1(f)(2)(i).

However, in most cases, subtracting advertising costs from advertising income will result in a gain. In such cases, the organization is allowed to deduct against such gain the excess of readership costs over subscription income. Thus, there is no tax on the advertising income unless the overall publication is profitable. If the excess readership costs are not fully absorbed by net advertising income and result in a net loss from the publication, this loss cannot be offset against any other unrelated business income, nor can it be used in computing a net operating loss carryback or carryover. Reg. 1.512(a)-1(f)(2)(ii).

3. Discussion

As noted above, in determining UBTI from advertising, it is necessary to allocate the costs of the periodical between the direct advertising costs and the readership costs of the periodical. Additionally, in most cases an organization publishing a periodical will also engage in other exempt activities and perhaps in other related trade or business activities. In these cases, an additional allocation must be made of the organization's total expenses between periodical costs and costs attributable to the other activities of the organization.

In general, Reg. 1.512(a)-1(a) indicates that to be deductible in computing unrelated trade or 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 unrelated trade or business. "Directly connected with" means that an item of deduction must have a proximate and primary relationship to the carrying on of the unrelated trade or business. Reg. 1.512(a)-1(c) considers the dual use of facilities or personnel, and indicates that when facilities or personnel are used both to carry on exempt activities and to conduct unrelated trade or business, expenses, depreciation, and similar items attributable to such facilities shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business is proximately and primarily related to that business activity, and is allowable as a deduction in computing unrelated trade or business income.

Reg. 1.512(a)-1(f)(6)(i) specifically considers deductions attributable to periodicals of exempt organizations. The total periodical costs of an exempt organization periodical are the sum of the direct advertising costs and the readership costs of the periodical. Items of deduction properly attributable to exempt activities other than the publication of an exempt organization periodical may not be allocated to such periodical. Where items are attributable both to an exempt organization periodical and to other activities of an exempt organization, the allocation of such items must be on a reasonable basis which fairly reflects the portion of such item properly attributable to each such activity. The method of allocation will vary with the nature of each item but once adopted, a reasonable method of allocation with respect to an item must be used consistently. Allocations based on dollar receipts from various exempt activities will generally be unreasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations.

The regulations give some examples of reasonable allocations of costs between total periodical costs and other exempt organization costs. For example, salaries may generally be allocated among various activities on the basis of the time devoted to each activity. Occupancy costs such as rent, heat, and electricity may be allocated on the basis of the portion of space devoted to each activity.

Depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity. Reg. 1.512(a)-1(f)(6)(i).

The regulations further indicate that the costs of developing an organization's membership may not properly be allocated as a periodical expense. Such costs are necessary to the maintenance of the intangible asset exploited in the unrelated business activity, namely, the organization's membership, but are incurred primarily in connection with an organization's fundamental purpose as an exempt organization. Thus, such costs do not have a proximate and primary relationship to the conduct of the unrelated trade or business and do not qualify as directly connected with it. See Reg. 1.512(a)-1(e) Example. One might argue, however, that this example means only that costs related to developing a membership may not be allocated as a direct advertising cost. Arguably, such costs may be allocated to readership costs, as the readership portion of a periodical is an exempt function, and the costs of developing a membership do have a proximate and primary relationship with respect to related communications with those same members.

Regs. 1.512(a)-1(f)(6)(ii) and (iii) provide guidance in allocating total periodical costs between direct advertising costs and readership costs. Expenses directly connected with the sale and publication of advertising, including those arising from dual use of facilities or personnel, constitute direct advertising costs. These include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and office overhead. Also included are art work and copy preparation, telephone, telegraph, postage and similar costs directly connected with advertising. In addition, it is necessary to determine the portion of mechanical and distribution costs attributable to advertising lineage, including the portion of the costs and other expenses of composition, press work, binding, mailing (including paper and wrappers used for mailing) and the bulk postage attributable to the advertising lineage of the publication. The portion of mechanical and distribution costs attributable to the advertising lineage of the periodical will be determined on the basis of the ratio of advertising lineage to total lineage of the periodical and the application of that ratio to the total mechanical and distribution costs of the periodical, unless records are kept in such a manner as to reflect more accurately the allocation of mechanical and distribution costs of the periodical, and there is no factor in the character of the periodical to indicate that such an allocation would be unreasonable.

Readership costs include all the items of deduction attributable to an exempt organization periodical that are not allocated to direct advertising costs under Reg. 1.512(a)-1(f)(6)(ii). This includes that portion of such items attributable to the readership content of the periodical, as opposed to the advertising content, and that portion of mechanical and distribution costs that are not attributable to advertising lineage in the periodical.

In any case, an organization must substantiate any cost allocation that it makes. If it claims that 50% of a particular employee's time is spent on advertising activities, this figure could be supported, for example, by a daily log showing the specific work done each day. In some cases an organization will claim that all of its employees spend some minimal amount of time on advertising activities, and will attempt to allocate a small portion (as little as 2 or 3%) of their salary and overhead expenses as a direct advertising cost. They may state, for example, that a secretary occasionally answers calls dealing with advertising and refers these to the appropriate employee. The regulations previously cited (Reg. 1.512(a)-1(c)) clearly permit the allocation of employees' expenses when employees are used to carry on both exempt activities and unrelated business activities. The portion of such expenses so allocated to the unrelated business is proximately and primarily related to that business. However, when a claim is made that many employees incidentally have some remote connection with a publication we do not think it is entirely clear that these employees are used "to conduct unrelated trade or business" within the meaning of the regulations. In such cases, because of the lack of published precedent, technical advice is appropriate.

In some cases, organizations will allocate expenses in such a manner that they show a loss from advertising, i.e., direct advertising costs in excess of gross advertising income, on a recurring basis. If the organization's allocations are reasonable, one must question why the organization continues to engage in a loss activity and whether this might adversely affect its exempt status. For example, if an IRC 501(c)(3) organization showed recurring advertising losses, one could question whether it was being operated exclusively for charitable purposes, as it would be using its own funds to subsidize various advertisers. On the other hand, recurring losses may show that the allocations used are unreasonable. A case by case determination must be made when faced with this type of problem. Also, Rev. Rul. 81-69, 1981-9 I.R.B. 48, should be considered. That Revenue Ruling holds that a social club, in determining its unrelated business income, may not deduct from its investment income losses incurred on sales of food and beverages to nonmembers where these sales have consistently resulted only in losses over a number of years, and there is every indication that such sales will continue to result in losses. If the advertising activity is not entered into for profit, losses resulting from the activity cannot be used to offset other UBTI.

4. Conclusion

A proper allocation of expenses between readership costs, advertising costs, and other costs of an organization is an extremely importantly element in making a proper determination of UBTI resulting from advertising in an exempt organization's publication. Such allocations are not always easy to make. This article has reviewed the relevant advertising regulations, which provide general guidelines to follow in allocating an exempt organization's expenses between advertising costs, readership costs, and other activity costs.