DEPARTMENTAL GRANT APPEALS BOARD

Department of Health and Human Services

SUBJECT: Social Science Education Consortium, Inc. DATE: April 28, 1981
Docket No. 79-141
Decision No. 163

DECISION

This is an appeal from a June 11, 1979 determination by the Principal Regional Official (PRO), Region VIII, made pursuant to the informal review procedures set forth in 45 CFR Part 75, Subpart A. The PRO affirmed the determination of the Division of Cost Allocation that rental space costs paid by Social Science Education Consortium, Inc. (SSEC) to its lessor, Education Resources Center, Inc. (ERC), to the extent it included unallowable mortgage interest, should not be included in the computation of the final indirect cost rate of 31.8 percent for the year ended December 31, 1977.

We find that the determination of the PRO should be sustained for reasons set forth more fully below.

The record on which this decision is based consists of SSEC's application for review, the Agency's response to the appeal, and SSEC's response to an Order to Show Cause issued by the Panel Chair. The Agency was not required to respond to the Order and did not do so.

I. Statement of the Facts

SSEC, a non-profit Indiana corporation, is a recipient of certain grants and contracts from the Department of Health, Education and Welfare (HEW, now Department of Health and Human Services, HHS). SSEC is located in facilities in Boulder, Colorado, and leases its space from ERC, a non-profit Colorado corporation.

On December 22, 1978 SSEC was notified by the Acting Director of the Division of Cost Allocation of Region VIII, that upon review of SSEC's indirect cost proposal, it was noted that interest costs were included in the rental payments by SSEC under its lease with ERC. This letter stated the opinion that the lease agreement was less than arms length, since both organizations were under common control through common officers, directors and members. Therefore under applicable cost principles interest costs were unallowable, and could not be included in the computation of the approved indirect cost rate.

This determination was affirmed by the Director of the Division of Cost Allocation by letter dated April 12, 1979. This stated that the Agency determination was confirmed and substantiated by an opinion rendered by the Regional Attorney which concluded that the lease arrangement in question was less than arms length based on Section G.38(d) of OASC-5 (Revised) August 1974, "A Guide for Non-Profit Institutions, Cost Principles and Procedures for Establishing Indirect Cost and Other Rates", and the HEW Grants Administration Manual, 6-10-20F, which defines "Less than Arms Length Lease."

This determination was sustained by the PRO on June 11, 1979, pursuant to the informal review procedures set forth in 45 CFR Part 75, Subpart A. He agreed that SSEC and ERC were under common control and so the rental arrangement was less than an arm's length transaction. Therefore rental charges had to be limited to those that would be allowable had SSEC owned the building. Mortgage interest would not be allowable if SSEC owned the building, and therefore must be excluded from the rent payments in determining the indirect cost rate. Having exhausted informal review, SSEC appealed the PRO's decision to this Board on July 10, 1979 pursuant to 45 CFR Part 16.

II. Discussion

A. "Less Than Arms Length Lease"

If a lease is "less than arms length", different cost principles apply in determining how much of the rental paid by a tenant under such a lease is properly chargeable to an HEW grant. The first step is therefore to determine whether the lease here is "less than arms length."

Section 6-10-20F of the Grants Administration Manual (GAM) defines a "Less than Arms Length Lease" as

> [A] lease under which one party to the lease agreement is able to control or substantially influence the actions of the other. Such leases include those between (a) divisions of an organization (b) organizations under common control through common officers, directors, or members...

SSEC argues in its application for review that the lease arrangement between SSEC and ERC is an arms length transaction, based on the organizational structure of the two organizations. SSEC, as tenant, under ERC's By-Laws, possesses only five votes of a total of sixteen votes for election of ERC directors and only so long as it is a tenant of ERC, the initial capital of ERC was raised through the sale of voting bonds, and each bond entitles the owner to one vote in the corporation. ERC, consistent with its non-profit purposes, rented space to SSEC at ERC's actual cost, ERC's articles of incorporation preclude any self-dealing, and no earnings of ERC can be paid to its officers or directors.

SSEC further asserts that the members of the Board of Directors of SSEC and ERC are distinct, that officers of each entity are individually appointed by their respective Boards, and none of the eleven voting bondholders of ERC are members of SSEC's Board of Directors. Finally, in order to show there is no common control, SSEC argues that if ERC were to determine that SSEC must be removed as a tenant or the building sold, SSEC could not stop, veto, or otherwise control this action.

The Agency contends that the lease in question is a less than arms length lease according to the definition contained in GAM § 6-10-20F, because SSEC and ERC are under common control in that either entity can control or substantially influence the actions of the other.

The record shows that there are common officers and directors of SSEC and ERC. The Grantee supports its arguments against there being common control by the fact that no member of the Board of Directors of either corporation was on the Board of the other. This was arguably correct at the time of the submission of this information, although Irving Morrissett as Executive Director of SSEC was ex officio a member of its Board as well as being on the Board of ERC. In addition, Mr. Morrissett was an incorporator and a member of the first Board of Directors of SSEC. (See Attachment G, Application for Review.) Three officers of SSEC are directors of ERC (out of a total of five) and are also officers of ERC as well. In addition to Morrissett, who is Vice President of ERC as well as Executive Director of SSEC, Marcia Hutson is Secretary of SSEC and President of ERC, and James E. Davis is Associate Director of SSEC and Secretary and Executive Director of ERC.

The control of the voting power of ERC is firmly entrenched in SSEC. The ERC By-Laws limit voting membership to the individual bondholders of the corporation, on the basis of one bond, one vote. The only exception is that SSEC is entitled to five votes without purchase of any bonds so long as it remains a tenant of ERC. There are in all sixteen votes for election of directors of ERC, five by SSEC and eleven by individual bondholders. The individual officers of SSEC (who are also officers and directors of ERC) have five of these bondholder votes; Morrissett has three bonds and therefore three votes, and Hutson and Davis each have one. (See affidavit of William R. Allen, an employee of the Division of Cost Allocation, Attachment No. 2 of the Agency's Response to the Application for Review describing a conversation with the Business Manager of SSEC.) Thus SSEC, through its directors and officers, controls ten of the sixteen votes, five as an organization, and five through its individual officers.

The Board agrees with the Agency's contention that the two organizations are under common control and the lease between them is therefore less than arm's length.

B. Applicable Cost Principles.

Section 6-10-30D. of the GAM states that the policy in dealing with "Less than Arms Length Leases" is:

> In all cases, rental costs under less than arms length leases are allowable only up to the amount that would be allowed under applicable HEW cost principles had title to the property vested in the lessee.

This same principle is set forth in Appendix F, Section G.38.d of 45 CFR Part 74, revised as of October 1, 1977, which provides the principles for determining allowable costs to grants conducted by certain non-profit organizations. That section, which is made applicable to non-profit grantees by 45 CFR § 74.174(a), states as follows:

> Rentals for land, building and equipment and other personal property owned by affiliated organizations including corporations or by stockholders, members, directors, trustees, officers or other key personnel of the institution or their families either directly or through corporations, trusts or similar arrangements in which they hold a more than token interest are allowable only to the extent that such rentals do not exceed the amount the institution would have received had legal title to the facilities been vested in it.

SSEC can therefore not have any more of the rental it paid under its lease allowed as a cost under the grant than it would have been allowed as a cost if it were the owner of the rental space. There is no contention by SSEC that the rent charged it by ERC was any less than ERC's actual costs for the rental space, including specifically mortgage interest. This is admitted in Grantee's Application for Review, p.3:

> As will be shown by the matters set forth below, the rental charges to SSEC by ERC, which is assessed at ERC's actual cost...

As owner it would have been allowed its applicable costs associated with ownership except interest. 45 CFR Part 74, Appendix F, Section G-18. states:

> Interest and other financial costs. (a) Costs incurred for interest on borrowed capital... are not allowable.

The GAM spells this out in Section 6-10-30 in its consideration of whether under a long-term lease, rental costs are allowable only up to the amount lessee would be allowed under applicable HEW cost principles had it purchased the property, or whether there may be a justification for charging rental costs in excess or what would be allowed an owner. In performing a comparative cost analysis, there should be included

> ....all applicable costs associated with ownership of the property (e.g. operation, maintenance, insurance, taxes, depreciation or use charges etc.) except interest and other unallowable costs stipulated in applicable HEW cost principles...(emphasis supplied)

Therefore since the actual rental paid by SSEC exceeded the amount it would have been allowed as costs if it owned the building by the amount of the mortgage interest, the Agency was correct in disallowing this interest in computing the indirect cost rate.

C. Other Arguments

In the alternative, SSEC argues that the Agency's policy with respect to less than arms length leases should not be applicable here because the rigid adherence and technical application of the regulations allows no consideration of individual case by case review. It is undisputed by the Agency that the lease arrangement between SSEC and ERC resulted in a savings of $164,947 to the federal government over a seven year period over the market price of rent for comparable space.

SSEC recognizes that the Agency has taken the position that a cost savings in one case does not mean that there would be an overall cost savings to the Agency in all cases, but asserts that the exercise of discretion in individual case by case review by the Agency is not an uncommon practice in requests for indirect cost recovery. SSEC argues that to assert that the regulations with respect to lease and rental arrangements do not allow for such latitude, appears to thwart the very intent and purpose of Agency review of grantee cost activities. SSEC, therefore, requests this Board to direct the Agency to reconsider its decision.

SSEC questions whether the policy of disallowance of interest was ever intended to preclude reimbursement of mortgage interest. SSEC contends that several authorities have argued that the policy of disallowance of interest was probably not intended to preclude reimbursement of mortgage interest because this creates a negative incentive to own property.

SSEC cites American Chemical Society v. United States, 438 F.2d 597 (1971) for the proposition that interest is not universally disallowable. That case, however, is distinguishable from the case before us in that in American Chemical Society the subject was a fixed fee contract, the fixed fee being interest. The contract was specifically negotiated so that the fee represented mortgage interest and nothing else. The case indicates that such interest would be unallowable in a cost-reimbursable type contract. This case also points out that the subsequently promulgated costs principles would apply to a cost portion of a contract but not to be fixed fee portion. In the instant case, we have a grant and not a fixed fee contract and are bound by the applicable regulations. In American Chemical Society, at the time the contract was entered into, there were no regulations promulgated concerning cost principles.

In response to SSEC's arguments that HEW should not apply its grant administration procedures in this case, the Agency alleges that there is no evidence that other property is not available at the same or lesser rate. The GAM clearly sets forth the policy that in lease arrangements at less than arms length, mortgage interest is not an includable cost. This GAM provision is designed to insure that grantees not be able to do indirectly (be reimbursed for mortgage interest where there is common control) that which they cannot do directly. Finally, the Agency claims that this is a rationally based classification, the purpose of which is to reduce grant costs; the fact that there may be cost savings to the grantor by disregarding its policy in a particular case does not mean that there would be overall cost savings to the grantor.

Although the Grantee makes a persuasive argument that the technical application of the regulations in this instance may substantially increase costs to the federal government if the Grantee is forced to pay fair market value or move its offices, the meaning of the regulation is clear on its face. Furthermore, although SSEC would like the Board to find an intent or provision within the regulations which would allow for case by case review, it is not the Board's responsibility to act as an advocate for one of the parties by advancing possible justifications for SSEC's actions.

The Board recognizes that the Agency does sometimes execise its discretion in review of requests for indirect cost recovery. The Board is not reviewing the question whether the Agency has the authority to do what the Grantee asks. The Agency has chosen not to act as SSEC requests, and we find no evidence in the record of any abuse of discretion.

The Board has in three prior cases had before it disallowances of interest charges on the purchase price of computers. The grantees offered convincing evidence that purchasing the computers, rather than leasing them and paying rent, saved very substantial sums of money. Nevertheless, the Board in each case upheld the disallowances, where pertinent regulations did not allow such interest costs to be included in a cost allocation plan. Oregon State-wide Cost Allocation Plan, Decision No. 22, June 25, 1976; Oregon State-wide Allocation Plan, Decision No. 75, January 31, 1980; Vermont State-wide Cost Allocation Plan, Decision No. 84, February 26, 1980.

SSEC argues that apart from its other contentions concerning the question of whether the lease agreement is arms length, the interest costs in question should be included in the indirect cost rate because a prior provisional indirect cost rate negotiated with the National Science Foundation (NSF) in 1971 included mortgage interest as an allowable and actual cost of ERC chargeable to SSEC in lieu of rent. SSEC contends that it has used this same basis for calculating the office space rental since 1971.

Grantee's argument concerning its prior provisional indirect cost rate with NSF is unpersuasive given the applicable procedures for establishing an indirect cost rate and given the fact that at the time NSF made a provisional indirect cost rate with SSEC, there were no cost principles promulgated by regulation applicable to allowability of mortgage interest in rental rates. In order to establish an indirect cost rate as set forth in OASC-5 (Revised) August 1974, "A Guide for Non-Profit Institutions," a grantee is required to submit an indirect cost rate proposal. If a grantee has previously established an indirect cost rate with another federal agency, it is supposed to submit a copy of the negotiation agreement with that agency to HHS at the time it submits its proposal. It is the responsibility of the Assistant Regional Director for Financial Management to determine if the rates established by another agency are appropriate for use on HHS awards. In this instance the Assistant Regional Director has determined that the interest costs are not appropriate because these costs are unallowable under applicable Department policy and regulations. The Board will not substitute its discretion for that of the Agency where the Agency's decision is in accordance with the rules and the Agency's exercise of its discretion is reasonable. (Oregon State-wide Allocation Plan, Decision No. 22, June 25, 1976.)

Conclusion

For the reasons set forth above, we conclude that the PRO acted reasonably in affirming the decision of the Division of Cost Allocation that the rental space costs paid by SSEC to ERC, to the extent they included unallowable

mortgage interest, should not be included in the computation of the indirect cost rate of 31.8 percent for the year ended December 31, 1977. The appeal is denied.

/s/ Cecilia Sparks Ford

/s/ Norval D. (John) Settle

/s/ Alexander G. Teitz, Panel Chair