G. DEVELOPMENTS IN THE SOCIAL CLUB AREA (IRC 501(c)(7))

1. Introduction

The purpose of this section is to provide some background and an update in the social club area, IRC 501(c)(7). The 1980 (page 83) and 1982 (page 41) CPE texts contain sections on social clubs and all prior texts have discussed recent developments in the UBI area.

2. Background

Social and recreational clubs under IRC 501(c)(7) were originally granted exemption in the Revenue Act of 1916. Congress stated that the reason for their exemption was that the experience of the Treasury Department had been that securing returns from clubs had been a source of expense and annoyance and had resulted in the collection of little or no tax. By contrast, the justification offered by Congress for the majority of other exempt classifications is that they provide some sort of community service or public benefit.

Generally, social clubs are membership organizations primarily supported by funds paid by their members. The tax exemption of social clubs has the practical effect of allowing individuals to join together to provide themselves with recreational or social facilities on a mutual basis, without further tax consequences, where the sources of income of the organization are limited to receipts from the membership. Thus, the individual member is in substantially the same position as if he or she had spent his or her income on pleasure or recreation without the intervening organization. (Note that IRC 277 provides that a membership organization not exempt from tax may deduct expenses attributable to the provision of goods or services to members only to the extent of income derived from members. The purpose of this provision is to prevent nonexempt membership organizations from effectively rendering themselves free of tax by off-setting losses from membership activities against income derived from investments or other nonmember sources to produce little or no taxable income. Were they permitted to do so, they could put themselves in a better position than exempt clubs, which are taxable on all income but "exempt function" income. See IRC 512(a)(3) and 277. The latter provision could be significant in computing the tax due from a revoked club.)

Due in part to Congress' view that the exemption of social clubs was justified principally by the logic of providing neither advantage or disadvantage to the pooling of funds for recreational purposes, rather than by any compelling public benefit clubs confer, the 1969 Tax Reform Act created an almost unique status for them. While IRC 501(c)(7) was not amended at all by the 1969 Act, enactment of IRC 512(a)(3) made clubs, in effect, only quasi-exempt and some familiarity with IRC 512(a)(3) is essential to a comprehension of the tax status of social clubs. IRC 512(a)(3) also specifically applies to voluntary employees' beneficiary associations (VEBAs) exempt under IRC 501(c)(9). Because VEBAs are usually trusts, or associations whose assets can only be used by the terms of their creating instruments for exempt purposes, the practical effect of IRC 512(a)(3) on them has been negligible so far. VEBAs are discussed in Topic F of this text.

In extending the unrelated business income tax to theretofore excluded social clubs in 1969, Congress decided that, unlike other exempt organizations, clubs should be taxed on their passive income. Since one of the central purposes of social clubs is to provide benefits such as access to social facilities (club houses, golf courses, etc.) for members, when such benefits are funded by members exemption is justified on the theory that the members will be in the same position as if they had paid for the benefits directly. However, untaxed income, such as interest on investments, operates to subsidize the recreational facilities or activities for the members. Thus, the exemption operates properly only if these passive sources of income are taxed to the organization as unrelated business taxable income.

Therefore, under IRC 512(a)(3), as a general rule, clubs are required to include all gross income as unrelated business taxable income unless it is "exempt function income." Deductions are allowed for expenses "directly connected" with the production of the gross income. Essentially, "directly connected" expenses are those that would be allowed in computing unrelated business income for other exempt organizations.

Exempt function income, defined in IRC 512(a)(3)(B), is income that arises out of the exempt activity of the club plus all income, (except unrelated business income as commonly defined for purposes of other kinds of exempt organizations), that is set aside for IRC 170(c)(4) charitable purposes. The usual sources of income from exempt activities are amounts paid by members for use of the club's facilities. Therefore, IRC 512(a)(3)(B) defines exempt function income as including dues, fees, charges, or similar amounts paid by members for goods, facilities, or services furthering the exempt purposes of the club and provided to the members, their dependents, or guests.

Special rules are provided for nonrecognition of gain from certain sales of club property (IRC 512(a)(3)(D).)

3. <u>Current Developments</u>

Recent developments in this area involve the following issues:

A. What types of activities conducted by fraternities and sororities qualify for set-aside treatment so that otherwise taxable passive income will qualify as exempt function income?

B. Under what circumstances and to what extent can a club offset losses from nonmember activities against investment income? (This is the issue addressed in Rev. Rul. 81-69.)

C. <u>Ye Mystic Krewe of Gasparilla v. Commissioner</u>, 80 T.C. 755 (1983)

   1. A club may not offset a net loss derived from an exempt activity against net income derived from a profit-motivated unrelated activity.

   2. To be deductible in computing unrelated business taxable income, expenses must be directly connected with the production of gross income.

A. <u>IRC 501(c)(7) - Set Asides</u>

Senate Report 91-522, accompanying the Tax Reform Act of 1969, stated that to the extent that an organization exempt under IRC 501(c)(7) and IRC 501(c)(9) sets aside its investment income to be used only for religious, charitable, scientific, literary, educational, etc. purposes (the purposes specified in IRC 170(c)(4)) the organization should be exempt from the tax on investment income similar to other tax exempt organizations.

It is also stated in Senate Report 91-552 that in the case of national organizations of college fraternities and sororities amounts set aside for scholarships, student loans, loans on local chapter housing, leadership, citizenship schools and services, and <u>similar activities</u> (emphasis added) will be classified as amounts used for educational or charitable purposes.

Proposed Reg. 1.512(a)-3(c)(3)(iii) states that income may be set aside for scholarships, student loans, loans on local chapter housing, leadership and citizens schools and services, and <u>similar purposes</u> (emphasis added). These Regulations were published May 13, 1971, but are not finalized.

The problem in the set aside area has been to construe the terms "similar activities" and "similar purposes."

The National Office has issued a private letter ruling in this area. It must be noted that this private letter ruling is listed here for training purposes and is not to be used or cited as precedent.

1. <u>Officer Visits to Local Chapters</u>

Income was set aside for local chapter visits by officers of a national fraternity. The National Office ruled that this was a valid set aside when the visits are directly connected to the fraternity's academic standards and charitable activities. However, not all visits by an officer of a national fraternity would necessarily qualify as educational or charitable. Private Letter Ruling 8133025.

2. <u>Expenditures for an Annual Convention</u>

The activity at a fraternity's annual convention consisted of administrative details such as reports from various committees, election of officers, reunions, and ceremonies. The convention also included leadership seminars, rap sessions, and scholarship committee reports. The National Office ruled that the annual convention was primarily for the purpose of enhancing the organization and operation of the general fraternity. Any educational and charitable effect was insubstantial and an indirect result of its organizational and operational activities. Only the portion of the expenditures which were allocated for educational and charitable activities, such as leadership seminars, rap sessions, and scholarship committee reports, could qualify as valid expenditures under IRC 170(c)(4). Private Letter Ruling 8133025.

3. <u>Administrative Expenses of a Fraternity</u>

The National Office ruled that the administrative expenses of a fraternity for the maintenance of its offices and salaries for its employees are not expenditures for educational and charitable activities, but are expenditures for the organization and operation of the fraternity. Therefore, these expenditures do not qualify as valid set asides. Private Letter Ruling 8133025.

4. Organizational Requirement

Proposed Reg. 1.512(a)-3(c)(3)(v) requires that net investment income set aside for a qualifying purpose must be specifically earmarked as such or placed in a separate account or fund. Thus, something more than a bookeeping entry is required before income will be considered to have been set aside. Any action describing the income set aside and indicating that it is to be used for one of the designated purposes is sufficient. Income that is set aside need not be permanently committed to such use either under state law or by contract. Thus, for example, it is not necessary that the organization place these funds in an irrevocable trust.

The set aside must be made on or before the due date of the tax return for that year including extensions. See Proposed Reg. 1.512(a)-3(c)(3)(vii). The set aside income of an IRC 501(c)(7) or IRC 501(c)(9) organization is reported on Schedule F of Form 990-T.

Examples of income eligible for the set aside are dividends, interest, capital gains, royalties, rents from real property, and income from a volunteer or irregular activity.

Based on the proposed regulations under IRC 512, if amounts set aside are later used for a non-IRC 170(c)(4) purpose, the amount diverted is included in unrelated business income for the year of diversion. A diversion is assumed if the amounts are used in any manner, such as security for a loan, which is inconsistent with the purposes for which a set aside may be made.

B. Rev. Rul. 81-69

Rev. Rul. 81-69, 1981-1 C.B. 351, disallows the deduction of a portion of a social club's bar and recreational expenses allocable to nonmembers to the extent such expenses exceed nonmembership gross income from the same source. The ruling prohibits a club from offsetting such a nonmembership loss against investment net income for purposes of computing net unrelated business taxable income under IRC 512(a)(3). The ruling's rationale is that prices insufficient to cover costs, on a continuing basis, demonstrate that the bar and restaurant activity with nonmembers is not profit motivated under IRC 162. The ruling concludes that, absent such a profit motive, no trade or business exists, so that such expenses in excess of gross income are not trade or business expenses deductible under IRC 162, and are not available to offset investment income otherwise taxable under IRC 512(a)(3).

The following questions have been raised concerning Rev. Rul. 81-69:

(1) Whether the term "costs" as used in Rev. Rul. 81-69 should refer to indirect costs or direct costs.

(2) Whether expense deductions should be analyzed on an activity-by-activity basis or a total unrelated business function basis.

IRC 512(a)(3) provides a definition of unrelated business taxable income in the case of organizations described in IRC 501(c)(7) and (9). IRC 512(a)(3) provides:

> "In the case of an organization described in section 501(c)(7) or (9), the term unrelated business taxable income means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income)..."

This definition operates to tax all forms of income earned by an IRC 501(c)(7) social club, except income from exempt functions, whether or not the activities generating the income are trades or businesses regularly carried on.

IRC 512(a)(3) provides that gross income is reduced by "deductions allowed by this chapter that are directly connected with the production of gross income." The requirement that an activity must also meet the requirements of IRC 162 or 212 in order to be deductible is again stated by Proposed Reg. Section 1.512(a)-3(b)(1) which provides in part:

> "***To be deductible in computing unrelated business taxable income, expense, depreciation and similar items not only must qualify as deductions under Chapter 1 of

> the Code, but also must be directly connected with the production of gross income, (excluding exempt function income)."

In addition, Proposed Reg. Section 1.512(a)-3(b)(4) provides that:

> "Expenses, depreciation, and similar items attributable solely to items of gross income (excluding exempt function income) are directly connected with such income and shall be allowable as a deduction in computing unrelated business taxable income to the extent that they qualify as deductions under Chapter 1 of the Code." (Emphasis added).

Proposed Reg. Section 1.512(a)-3(b)(3) allows, in the case of a social club which derives gross income (excluding exempt function income) from two or more sources, aggregation of its deductions with respect to such income. However, because deductions are allowed only if they qualify as deductions under Chapter 1 of the Code and are directly connected with the production of gross income as provided in IRC 512(a)(3) and Proposed Reg. Section 512(a)-3(b)(1), a determination of whether expenses are deductible under IRC 162 or 212 must be made before aggregation. Therefore, while a determination of whether a social club regularly carries on a trade or business is not required for determining potential unrelated business taxable income, it is required for purposes of determining allowable deductions.

IRC 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Therefore, the primary consideration in making a determination of whether a deduction is allowable, is whether a trade or business exists. Neither the statute nor the regulations define the term "trade or business". Publication 334, "Tax Guide for Small Businesses", requires an analysis of the regularity of activities and transactions, the production of income, and the good faith intent to make a profit. This analysis is also present in case law. For example, see Patterson v. United States, 459 F. 2d 487 (Ct. Cl. 1972).

Rev. Rul. 81-69 relies only on a consistent series of losses in determining whether there is a good faith intent to make a profit. That factor is relevant, but not necessarily conclusive. See, for example, Bessenyey v. Commissioner, 45 T.C. 261 (1965), aff'd 379 F. 2d 252 (2nd Cir. 1967), cert. denied, 389 U.S. 931 (1968), which provides that a profit motivation may in fact exist even in the face of a history of losses unaccompanied by any gains whatsoever. Therefore, in determining whether there is a good faith intent to make a profit, all the facts and circumstances should be taken into account. Jasionowski v. Commissioner, 66 T.C. 321 (1976). The National Office's position is that the rules and case law developed under IRC 162 and 183 provide the necessary guidance in making a determination of whether a profit motivation exists.

When considering the factor of whether costs consistently exceed income, all costs should be taken into account, including such items as depreciation and overhead. As previously noted, in the case of IRC 501(c)(7) social clubs, all costs that are "directly connected to the production of income" are taken into account for purposes of deductions from income. Proposed Reg. Section 1.512(a)-3(b)(4) specifically includes depreciation as being "directly connected." Because the proposed regulations specifically provide that these kinds of indirect costs are taken into account for tax accounting purposes, the National Office has taken the position that these items are to be taken into account for purposes of determining whether "costs" consistently exceed income in the profit motivation context. In the cases we have seen, social clubs consistently deduct an allocable portion of indirect costs from nonmember income. We do not believe that there is any support for treating indirect costs inconsistently for tax accounting purposes as opposed to determining whether a profit motivation exists. Thus, where nonmember business is undertaken by social clubs, and indirect costs are necessary to support that undertaking, the National Office believes it is appropriate to determine whether that business is expected to generate enough income to recover all costs allocable to it, including indirect costs.

In addition to requiring an analysis of the profit motivation of each activity for purposes of determining if deductions are allowable, the National Office believes that the unrelated business income tax, for social clubs, should be determined on an activity by activity or business by business basis so that a social club is not permitted to offset investment income against losses from nonmember activities, unless the activity is found to be profit motivated. The Tax Reform Act of 1969 added IRC 512(a)(3) to the Code to impose taxation on the unrelated business income of social clubs. According to Senate Report 91-552, 1969-3 C.B. 471, the tax exemption for social clubs and other groups was designed to allow individuals to join together to provide recreational facilities on a mutual basis without tax consequences. Therefore, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. The Senate Report explains the reason for treating exempt function income separately from nonexempt income:

> "However, where the organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation to its membership."

Therefore, if a social club is permitted to operate a nonexempt activity at a loss and without a profit motive in order to avoid paying tax on investment income, Congressional intent is defeated.

To summarize this section, Rev. Rul. 81-69 provides that if sales of goods and services to nonmembers are not profit motivated, a social club may not, in determining its unrelated business taxable income, deduct from its net investment income its losses from such sales to nonmembers.

The determination of whether an activity is considered to be a trade or business is necessary for the purpose of determining whether expense deductions relating to a particular activity are allowable under IRC 162 or 212. Any activity lacking a profit motivation does not constitute a trade or business, but a consistent series of losses is just one factor to look at in determining whether a profit motivation exists. All the facts and circumstances should be taken into account.

In the case of a social club that derives unrelated business income from two or more sources, its unrelated business taxable income is computed by aggregating its gross income from all such sources and by aggregating its deductions allowed with respect to such gross income. However, expense deductions must be analyzed on a business by business or activity by activity basis to determine if such deductions are allowed under Chapter 1 of the Code before determining the total unrelated business taxable income.

C. Ye Mystic Krewe of Gasparilla v. Commissioner, 80 T.C. 755 (1983)

The above case provides authority for the proposition that an exempt social club may not offset a net loss derived from an exempt social club activity against net income derived from a profit-motivated unrelated business.

The club staged a mock invasion of Tampa, Florida, each year, which was followed by a parade. The club received income from the sale of concession rights along the parade route and from the sale of "official logbooks".

The Tax Court held that income from the concessions and logbooks was unrelated business taxable income under IRC 512(a)(3)(A), and the expenses of staging the invasion and parade were not directly connected with the production of the concession and logbook income, and were therefore not deductible in computing net income from the latter activities.

The Court stated that the purpose of IRC 512(a)(3) is to tax the income a social club receives from nonmember sources. If the club could offset the nonmember income received from the concessions and logbooks with the expenses of the exempt function invasion and parade, the nonmember income could go untaxed, frustrating the congressional intent of IRC 512(a)(3) to tax nonmember income.

4. Public Law 94-568

Public Law 94-568, passed October 20, 1976, amended IRC 501(c)(7) to allow exemption for social clubs "substantially all of the activities of which" are for pleasure, recreation, and other nonprofitable purposes. The Committee Reports indicate that Congress intended to make it clear that exempt social clubs may receive some outside income, including investment income, and to permit clubs to derive a higher percentage of gross receipts from the use of their facilities and services by nonmembers than would have been permitted under published Service guidelines (Rev. Proc. 71-17). The law, as amplified by the Committee Reports, allows IRC 501(c)(7) organizations to receive up to 35 percent of their gross receipts, including investment income, from sources outside their membership without losing their exempt status. Within this 35 percent, not more than 15 percent of gross receipts should be nonmember income. Gross receipts are defined, for this purpose, in the Reports as:

> "...those receipts from normal and usual activities of the club (that is, those activities they had traditionally conducted) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents and similar receipts) and normal recurring capital gains on investment, but excluding initiation fees and capital contributions."

In order to determine what income would be subject to the 15 percent test for business with nonmembers, it was necessary for Congress to distinguish between income from permissible businesses and that from prohibited businesses. For purposes of income subject to the 15 and 35 percent limitations, the Committee Reports defined such gross receipts in virtually the same manner as in Rev. Proc. 71-17 for purposes of the 5 percent limitation (now 15 percent.) The Senate Report at 1976-2 C.B. 599 states:

> "Gross receipts are defined for this purpose as those receipts from normal and usual activities of the club (that is, those activities they have traditionally conducted) ..." [Emphasis added]

Rev. Proc. 71-17 defines gross receipts as"

> "...receipts from normal and usual activities of the club ..." [Emphasis added]

Rev. Proc. 64-36, 1964-2 C.B. 962, predecessor of Rev. Proc. 71-17, provided the following definition:

> "Gross receipts ...[are] defined as those from normal and usual activities of the club ... [Emphasis added]

In defining "gross receipts," the Committee Reports borrowed virtually the same language used in Rev. Proc. 71-17. Both definitions include receipts "from normal and usual activities" with the Report adding "(that is, those activities they have traditionally conducted)."

It is reasonably clear that the meaning given to the phrase "normal and usual activities" in the Committee Report is the meaning intended to be given to the same term in Rev. Proc. 71-17. In that revenue procedure "normal and usual activities" of a social club appears to encompass those social and recreational activities upon which the club's exemption is based. Extension of these traditionally exempt social club activities to the general public gave rise to unrelated business income; they resulted in revocation of exemption only if the 5-percent limitation of Rev. Proc. 71-17 (now 15 percent) was exceeded (and, additionally, if a facts and circumstances test was not satisfied).

The Committee Reports incorporate this view and note that the 15 and 35 percent limitations do not include "income from the active conduct of business not traditionally carried on by [section 501(c)(7)] organizations." The definition of "nontraditional business" is therefore the same definition as applied prior to 1976 and is premised on Congressional intent to retain existing law with respect to the Service's meaning of the term "normal and usual activities."

A nontraditional business is any business which, if conducted on a membership basis, would not further the club's exempt purposes. For example, the sale of liquor to members for consumption off the club's premises has been held to be "neither related to nor in furtherance of a social club's exempt purposes." Rev. Rul. 68-535, 1968-2 C.B. 219. Such sales would thus not be a "normal and usual activity" and would constitute a "nontraditional business." Clearly, the phrase would apply to businesses conducted with either members or nonmembers.

Nontraditional businesses, investments, and nonmembership use of club facilities and services represent the universe of income-producing nonexempt activities for social clubs. As indicated above, a social club may have, within certain limits, income from investments and nonmembership use of club facilities and services; however, it may have no income (other than a de minimis amount) from non-traditional businesses, which are all other nonexempt activities.

Application of the principles discussed above is essentially a factual question. Does the activity in question further the social club's exempt purpose? If it does not, the activity is nontraditional and the club should not be exempt.