C. SOCIAL CLUBS: IRC 501(c)(7) ORGANIZATIONS

1. Introduction

This section updates the 1980 EOATRI topic on social clubs. In addition, it describes a number of problem areas that have come to the attention of the National Office.

2. Public Law 94-568

The tax treatment of social clubs underwent a substantial change due to the passage of P.L. 94-568 on October 20, 1976. Prior to passage of this law, IRC 501(c)(7) provided exemption for social clubs organized exclusively for pleasure, recreation and other nonprofitable purposes. That law substituted the word "substantially" for "exclusively."

The Committee reports show that this wording change was intended to make it clear that social clubs may receive outside income, without losing their exempt status. However, the Committee reports also specified clearly defined limits on this outside income, which if exceeded then invoke the application of a facts and circumstances test. The audit standard of Rev. Proc. 71-17 has been effectively raised, as of October 21, 1976, to allow social clubs to receive up to 35% of their gross receipts, including investment income, from sources outside their membership without losing their exempt status. Within this 35%, no more than 15% of gross receipts may be derived from nonmember use of club facilities and/or services. Gross receipts are defined for this purpose as those receipts from normal and usual activities that have been traditionally conducted by the club or by other social and recreational clubs of the same general type. For example, in the case of country clubs, gross receipts include receipts from activities traditionally conducted by country clubs. Unusual amounts of income, such as from the sale of a clubhouse or similar facility are not to be included in either the gross receipts of the club or in the permitted 35 or 15 percent allowances. It should be emphasized that gross receipts from the conduct of a nontraditional business or other activity previously forbidden may not be included within the percentage guidelines. The conduct of a business not traditionally carried on by social clubs unless it is insubstantial, trivial, and nonrecurrent, should preclude exemption.

3. Facts and Circumstances Test

While the Committee reports mandate the application of a facts and circumstances test in the event that gross receipts from nonmember and/or investment income reach the prohibited levels, the Committee reports do not specify any of the relevant facts and circumstances that should be considered.

As a starting point in the resolution of a case being decided on this basis, it must be remembered that social clubs were originally exempted by Congress back in 1916 (when the income tax rate was just 2%) because Treasury reported that securing returns from these organizations had been a source of expense and annoyance and had resulted in the collection of little or no tax. This is in contrast to the justification for the majority of other exempt classifications; that is, they provide some form of community benefit or public service. Therefore, the courts have recognized that the exemption of social clubs should be strictly construed. Thus, only a limited number of facts and/or circumstances would warrant continued exempt status where the percentage guidelines are exceeded.

The single most obvious factor to be considered is the actual percentage of nonmember receipts or investment income. As the percentages increase above the permitted levels, the facts and/or circumstances in the organization's favor must increase proportionately to avoid revocation. One important factor would be the frequency of use of club facilities or services by nonmembers. An unusual or single event (that is nonrecurrent on a year to year basis) that generates all the nonmember income should be viewed more favorably than nonmember income arising from frequent use by nonmembers. The record over a period of years is also relevant. A high percentage in one year, with other years being within permitted levels, should be viewed as less unfavorable to the organization than a pattern of consistently exceeding the limits, even by relatively small amounts. In addition, whether the nonmember income generates net profits for the organization is a factor to be considered. The generation of profits from nonmembers, unless set aside, subsidizes club activities for members and should be viewed unfavorably to the organization. As the Court of Appeals in the Pittsburgh Press Club decision stated, in the context of revocation proceedings for the purpose of considering profits from nonmembers as one factor, it is proper to charge only costs directly attributable to these activities (variable costs) against the income derived. Fixed costs such as rent, depreciation, etc., should not be considered. The use of profits from nonmember income for 170(c)(4) purposes is a factor that clearly should be viewed as favorable to the organization. If excessive amounts of investment income cause the guideline to be exceeded, one factor that may be considered is an investment that happens to generate an unanticipated windfall in a particular year. This factor should be viewed favorably to the organization.

It might help to look at it this way: the policy of the tax law should be to treat as equally as possible equally situated taxpayers. Thus, the interposition of a non-taxable entity should cause neither tax advantage nor disadvantage to its members. If substantial amounts of money were paid to an individual to be used for his or her entertainment, such amounts would be taxable income to him or her. Channeling those funds through a club should not change that result, lest persons who belong to clubs be given a significant tax benefit, the right to entertain themselves with pre-tax dollars, over those who do not or cannot. On the other hand, it would be equally unfair to twice tax the income of those who pool their entertainment money, i.e., form a club for their own recreation - as opposed to those who simply spend it directly - by taxing the income when they earn it and taxing it again when it is in the treasury of their club. It is appropriate, however, to tax the additional income subsequently earned by these funds. This philosophy should underlie the Service's approach to exempt clubs.

4. IRC 501(i) and Public Law 96-601

P.L. 94-568 inserted IRC 501(i) into the Code, which provided that an organization exempt under IRC 501(c)(7) is to lose its exempt status for any taxable year if, at any time during that year, its governing instruments or written policy statements contain a provision that provides for discrimination against any person on the basis of race, color, or religion. Public Law 96-601 amended IRC 501(i), effective for taxable years beginning after October 20, 1976, to provide:

(1) An auxiliary of a fraternal beneficiary society (such as an unincorporated, subordinate lodge of the Knights of Columbus) that is exempt from taxation under IRC 501(a) as an organization described in subsection (c)(7), may limit its membership to members of a particular religion and retain its exemption from taxation if the fraternal beneficiary society is exempt from taxation under IRC 501(a) as an organization described in subsection (c)(8); and

(2) An alumni club that is exempt from taxation under IRC 501(c) as an organization described in subsection (c)(7), may limit its membership to members of a particular religion and retain its exemption from taxation, provided that the religious limitation is designed in good faith to further the teachings and principles of that religion, and not for the purpose of excluding individuals of a particular race or color.

In reference to (2) above, the statute merely refers to "a club," however it has been decided that this particular provision will only be applied to alumni clubs to give effect to the legislative history of the statute.

The National Office has recently reviewed a case concerning the application of IRC 501(i). The organization's governing instrument contained a discriminatory provision that would normally result in revocation. However, in practice the organization did not discriminate and in fact says it readily admitted to membership individuals that the discriminatory provision applied to. This issue has been the subject of strong disagreement in the National Office and has not yet been finally decided.

5. IRC 512(a)(3)

Proposed regulations under IRC 512(a)(3) were published in the Federal Register on May 13, 1971. A public hearing was held on August 31, 1971, and numerous comments were received. Since that time these regulations have undergone revision, but have not been published again in notice or final form. These proposed regulations, in conjunction with Rev. Proc. 71-17, set forth the rules for determining whether income is derived by a social club from dealings with nonmembers and, if so, is therefore subject to the unrelated business income tax. The modifications of IRC 512(b), other than (6)(10)(11) and (12) and the exceptions of IRC 513 (volunteer labor, convenience, etc.), are not applicable to the computation of the unrelated business income tax for social clubs.

Income received by a social club with respect to guests of a member is treated as income derived from members and is not taxed. However, income received from nonmembers who are not guests of a member is subject to tax. Nonmember income includes, among other things, amounts paid to a social club by visiting members of another unaffiliated social club, even though both social clubs are similar in nature and the services provided to visiting members are pursuant to a reciprocal agreement between the two social clubs requiring each social club to provide services to members of the other.

Package 990-5 contains an example of a country club that has income derived from the general public's use of its restaurant and bar. The hypothetical concerns, in part, nonmember income derived from dinner meetings held one day each month by the local chamber of commerce, some of whose members are also members of the club. In this regard, the hypothetical assumes the organization in question has kept the records required by Rev. Proc. 71-17 and thus has the

necessary facts to determine whether the nonmembers may be considered as guests of club members. Section 4.04 of Rev. Proc. 71-17 provides that if a club fails to maintain or make available the records required by Rev. Proc. 71-17, the percentage guidelines may not be used in the determination of whether the club has a non-exempt purpose.

The hypothetical uses the "facilities usage method" to allocate fixed and operational expenses for purposes of the unrelated business income tax. The "facilities usage method" takes into account the number of days of nonmember usage, the average number of hours the facility was open on these days, the total receipts from nonmembers and total receipts from all facility users on the days of nonmember usage. We believe that normally the "facilities usage method" accurately reflects a reasonable distribution of costs for the time the organization's facilities were used by nonmembers. However, as the hypothetical points out, this method cannot be regarded as the only acceptable method for allocating expenses, nor even as a preferred method. It is only one of several methods that may reasonably reflect distribution of costs in a given factual setting. Further, there may be special situations where the "facilities usage method" produces an anomalous result, in which case it would be inappropriate. The Examination Guidelines Handbook (IRM 7(10)69-Exhibit 700-1) also contains examples of allocation methods. It should be remembered that the proposed regulations only require allocation between member and nonmember use on a reasonable basis. Reasonableness is the bottom line.

6. Alumni Clubs

It has come to the attention of the National Office that numerous organizations composed of the alumni of colleges and universities have received exemption under either IRC 501(c)(3) or 501(c)(7). The activities of these organizations vary widely. Some are primarily social organizations attempting to keep alumni up to date on university developments and in touch with each other. Others may be primarily interested in supporting the athletic department of their university to promote winning teams.

Since the activities of these organizations vary widely, they should be closely scrutinized to ensure that they are properly classified. The common objective of IRC 501(c)(7) organizations must be substantially directed to providing social and recreational activities for their members. Rev. Rul. 69-257 holds that where an organization's social activities are merely incidental to primary activities that are not social or recreational in nature, it cannot be described in IRC

501(c)(7). Rev. Rul. 69-635 provides that an organization whose principal activity is the rendering of a service that is not in the nature of pleasure or recreation is not described in IRC 501(c)(7). For example, if an alumni organization's primary activity was devoted to fund-raising for the support of its university athletic program and for recognition of a university's athletic coaches and athletes, it would not be properly classified as a social club. In many situations the facts may indicate a variety of social and non-social activities. However, exemption under IRC 501(c)(7) is only available if the organization's social and recreational activities comprise substantially all its activities.

7. Revenue Ruling 81-69

It has come to the attention of the National Office that there may be a question regarding the application of Revenue Ruling 81-69, I.R.B. 1981-9 p. 48. It holds that a social club, in determining its unrelated business taxable income under IRC 512(a)(3), may not deduct losses incurred on sales of food and beverages, in certain situations, from its net investment income.

The revenue ruling states: "The social club's sales of food and beverages to nonmembers are not profit motivated because its prices are insufficient to cover costs." The question arises as to what costs are contemplated, i.e., costs of goods sold, direct costs, or all costs allocated to in question. The view currently prevailing in the National Office is that profit motivation can only be discussed accurately when the entire picture is taken into account. Thus, all costs allocated to the activity in question must be used in determining whether the activity is profit motivated. Questionable cases should be referred to the National Office for technical advice.