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

1. Introduction

This section updates the 1984 CPE topic (pp. 118-132) on social clubs and that portion of the 1988 CPE topic (pp. 89-93) on unrelated business taxable income that specifically concerned social clubs.

2. Revenue Ruling 81-69

Previous CPE texts and classroom presentations have emphasized that the Service continues to follow the position stated in Rev. Rul. 81-69 1981-1 C.B. 351, that a social club cannot offset losses from unrelated businesses against taxable income from other unrelated businesses absent a profit motive in respect to the loss activity. This remains our position.

A conflict currently exists between the Sixth Circuit (Cleveland Athletic Club v. United States, 779 F.2d 1160 (6th Cir. 1985) and the Second Circuit (The Brook, Inc. v. Commissioner, 779 F. 2d 833 (2nd Cir. 1986) on this issue.

The Sixth Circuit has held that a social club could offset the loss created by excess expenses against other income to determine its unrelated business taxable income, even though the loss activity lacked a profit objective. The court held that ordinary and necessary business expenses are allowed to be deducted against unrelated business taxable income where the basic purpose of the activity is "economic gain" and that a profit motive is not required. In this context, merely providing some additional revenue to apply against fixed costs is viewed as meeting the "economic gain" test. The Second Circuit expressly rejected the "economic gain" test and adopted a traditional "trade or business test" requiring profit motivation.

The Tax Court has sided with the Sixth Circuit on this issue in two recent decisions. See North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987) and Portland Golf Club v. Commissioner, T.C.M. 1988-767 (February 24, 1988).

The Service is in the process of appealing both North Ridge and Portland to the Ninth Circuit and it appears very likely that this issue will ultimately be resolved by the Supreme Court, no matter what the outcome is at the levels below it.

It should again be emphasized that the Service currently follows Rev. Rul. 81-69, even in cases arising in the venue of the Sixth Circuit.

In a related matter, the Tax Court recently held in West Virginia Medical Association v. Commissioner, 91 T.C. 41 (1988), that a 501(c)(6) organization could not offset advertising losses against unrelated business taxable income. The organization's advertising activity did not constitute a trade or business because it lacked a profit objective. In this case direct advertising cost exceeded advertising revenue for 21 consecutive years.

The Tax Court stated that it did not have to resolve the conflict between the Sixth and Second Circuits since those cases involved social clubs under IRC 501(c)(7), and turned on IRC 512(a)(3)(A), while the case under consideration was a business league under IRC 501(c)(6), which involves IRC 512(a)(1). Although the language of the two sections differs, we believe both require profit motivation for an activity to be characterized as a trade or business.

3. Sales of Assets by Social Clubs

The 1988 CPE text discussed on pp. 91-93 the decision in Framingham Country Club v. United States, 659 F.Supp. 650 (D. Mass. 1987). The article mentioned that, although the case was decided in the government's favor on other grounds (not relevant to this discussion) that were sufficient in themselves, the court also offered an alternative rationale to sustain the same result, and that the latter might be inconsistent with a somewhat more liberal reading of the law expressed before Framingham in certain private letter rulings concerning non-recognition of gain by clubs under IRC 512(a)(3)(D). We have reviewed our ruling position in light of the decision in Framingham and the following discussion has been prepared to update current Service thinking on this subject.

IRC 512(a)(3)(A) provides special rules for certain organizations described in IRC 501(c), and defines "unrelated business taxable income" for purposes of organizations described in IRC 501(c)(7) as gross income (excluding exempt function income), less the deductions directly connected with the production of the gross income (excluding exempt function income).

IRC 512(a)(3)(B) defines "exempt function income" as gross income from dues, fees, charges, or similar amounts paid by members.

IRC 512(a)(3)(D) provides for nonrecognition of gain on the sale of assets in certain instances, and reads, in part:

> "D) Nonrecognition of Gain.-- If property used directly in the performance of the exempt function of an organization described in paragraph (7), (9), (17), or (2) of IRC 501(c) is sold by such organization, and within a period beginning 1 year before the date of such sale, and ending 3 years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property...."
> **(Emphasis added.)**

The Senate Finance Committee set forth the following rationale for enacting IRC 512(a)(3), S. Rept. 91-552 (1969), 1969-3 C.B. 423:

> "Present law. -- Under the present law the investment income of social clubs, fraternal beneficiary societies, and employees' beneficiary associations is exempt from income tax. General reasons for change. -- Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization. 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 (or other benefits) to its membership. For example, if a social club were to receive $10,000 of untaxed income from investment in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial

additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose. [1969-3 C.B. at 469-70.]

The Senate Finance Committee Report also explains the reasons for enactment of IRC 512(a)(3)(D):

"In addition, the committee's bill provides that the tax on investment income is not to apply to the gain on the sale of assets used by the organizations in the performance of their exempt functions to the extent the proceeds are reinvested in assets used for such purposes within a period beginning 1 year before the date of sale and ending three years after that date. This provision is to be implemented by rules similar to those provided where a taxpayer sells or exchanges his residence (sec. 1034). The committee believes that it is appropriate not to apply the tax on investment income in this case because the organization is merely reinvesting the funds formerly used for the benefit of its members in other types of assets to be used for the same purpose. They are not being withdrawn for gain by the members of the organization." [1969-3 C.B. 470-471.]

The Committee Report also provided an example of a sale and purchase where application of IRC 512(a)(3)(D) would be considered appropriate:

"...where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years." [1969-3 C.B. at 471.]

In its alternative rationale in Framingham Country Club v. United States, 659 F. Supp. 650 (D. Mass. 1987), the court stated:

"Although the plaintiff may have purchased the original 120 acres of land with the intention of providing expanded golf facilities, the plaintiff never actually used the 60 acres in question for that purpose. The deposition of Thomas D. Burke, former Treasurer of the Club, indicates that up until January of 1986 the land 'was in use for anything' and that the club's greens keeper lived in a house on the property.... Burke also stated that 'large equipment' was stored on the

> land.... This Court would hesitate to find, on the basis of this rather inconclusive deposition testimony, that the use of a home by a greens keeper and the storage of some 'large equipment' directly facilitated the performance of the exempt function of the Club." [659 F. Supp. at 653.] **(Emphasis added.)**

Thus, the court clearly indicated that such use was insufficiently related to the club's performance of its exempt function to come within the IRC 512(a)(3)(D) exception, and that the intent of the taxpayer in acquiring the property was not relevant. The taxpayer had not used the land that was sold directly in the performance of its exempt function.

A social club's sale of land is an activity unrelated to its exempt function, as defined in IRC 512(a)(3), and therefore, is generally subject to unrelated business income tax under IRC 511.

However, IRC 512(a)(3)(D) provides an exception to the general rule of IRC 512(a)(3). If the property sold was used directly in the performance of the exempt function of the organization, the gain will not be subject to unrelated business income tax.

IRC 512(a)(3)(D) refers to "direct use." The legislative history of IRC 512(a)(3)(D) is helpful in interpreting this phrase. The example cited in the committee report indicates that the sale of an organization's clubhouse will qualify for nonrecognition of gain when the proceeds are used to build or purchase a larger clubhouse. The committee reports state that this result is desired because the proceeds are not being withdrawn for gain by the organization. We believe that this example suggests that Congress intended a limited exception to the general rule that the unrelated business income tax applies to all income of a social club other than exempt function income.

The example in the committee reports involves the sale of an essential part of the exempt function of a social club. The sale of a country club's golf course or clubhouse and consequent purchase and/or creation of a similar facility would clearly qualify for non-recognition of gain; however, the sale of property used by the social club for anything less than an essential part of the organization's exempt activities should be carefully scrutinized to determine whether all the facts and circumstances warrant application of the exception. This position is supported by the legislative history as previously cited and the alternative rationale in the Framingham case.

The Code and the legislative history refer to the social club's actual use of the property to determine the applicability of IRC 512(a)(3)(D). We believe that Congress meant to exclude gain only on property that was in actual, direct recreational use. The alternative rationale expressed by the court in Framingham amounts to a recognition that the club had failed to supply sufficiently convincing evidence of such direct use. Decisions will probably turn on such factual determinations; clear presentations of the facts will be critical.

4. Set Asides

The 1984 CPE text topic on social clubs included a section on set asides (pp. 121-123). In the case of Phi Delta Theta Fraternity v. Commissioner, 90 T.C. 1033 (1988), the Tax Court held that a fraternity magazine which disseminated information of particular importance only to its members was not educational within the meaning of IRC 170(c)(4). Thus, investment income from an endowment fund for the magazine could not be set-aside under IRC 512(a)(3)(B)(i), and therefore was not exempt function income, but rather was subject to unrelated business income tax.

The court stated that Congress intended the exempt purposes contained in IRC 501(c)(3) and 170 to have the same meaning in both sections, since the stated exempt purposes are identical. The court then analyzed the term "educational" in line with Reg. 1.501(a)(3)-1(d)(3)(i).

The editorial philosophy of the magazine as stated by the petitioner was as follows: (1) to provide readers with information on developments and issues within the fraternity; (2) to provide readers with information about the achievements of undergraduates and alumni; (3) to feature prominent alumni and their accomplishments; and (4) to provide readers with educational information about society and higher education. The court noted that, even though the magazine has been published continuously for over 100 years, not one of the recipients was a nonmember except the universities and libraries that are given free copies. Thus, the court observed that the word "members" could logically be substituted for the word "readers" wherever it appears in the foregoing statement of editorial philosophy, and that reaching such a select group does not satisfy the public interest requirements of Reg. 1.501(c)(3)-1(d)(3)(i). The court found that, although there may be some educational purpose served by the magazine, such a purpose is merely incidental to a substantial purpose of disseminating fraternity news to its members. The publication therefore fails the well-established exclusive purpose test of Better Business Bureau, 327 U.S. 279.