E. SOCIAL CLUBS - IRC 501(c)(7)

by
Mary Jo Salins and Conrad Rosenberg

1. Introduction

IRC 501(c)(7) describes as exempt, as provided under IRC 501(a), "[c]lubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder." However, under IRC 512(a)(3)(B), the Code exempts social clubs only to the extent of their "exempt function income," which is defined as the gross income from dues, fees, charges, and other income generated by club members pursuant to the organizations' nonprofitable purposes. Income received from the general public or from investments is treated as unrelated business taxable income and is taxed at general corporate rates.

This article will attempt to analyze and explain the current Service thinking and court decisions concerning the determination of a social club's unrelated business taxable income as well as the overall treatment by the Service and the courts regarding the handling of an exempt social club's outside revenue and losses.

2. Nontraditional Business Activities

The initial question to ask in any case involving exemption under IRC 501(c)(7) is whether the activities conducted by the social club further exempt purposes.

IRC 501(c)(7) was amended in 1976 by Pub. L. 94-568 to provide that IRC 501(c)(7) organizations could receive some income from sources outside the membership without losing their exempt status; the legislation changed the test for exemption from an exclusivity test ("...operated exclusively for...") to a substantiality test ("...substantially all the activities of which are..."). The legislative history of this provision indicates that Congress meant to liberalize prior Service limitations on the portion of income a social club may receive from nonmember use of its facilities and from investment income. The earlier Service limitations are discussed in Rev. Rul. 66-149, 1966-1 C.B. 146 and Rev. Proc. 71-17, 1971-1 C.B. 683.

The intent of Pub. L. 94-568 is reflected in the Senate Finance Committee Report as follows:

> It is intended that these organizations be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their membership without losing their tax-exempt status. It is also intended that within this 35 percent amount not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. ...
>
> 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) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents, and similar receipts), and normal recurring capital gains on investments...

(S. Rep. No. 1318, 94th Cong., 2d Sess. 4 (1976), 1976-2 C.B. 597, 599 (Emphasis added). See also H.R. Rep. No. 1353, 94th Cong., 2d Sess. 4 (1976).)

The Senate Finance Committee Report further declares that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in this formula. However, the Senate Report states that it is not "intended that these organizations should be permitted to receive within the 15-or 35-percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations." (S. Rep. No. 1318, 94th Cong., 2d Sess. 4 (1976)., 1976-2 C.B. 597, 599 (Emphasis added). See also H.R. Rep. 1353, 94th Cong., 2d Sess. 4 (1976).)

This language in the committee reports makes it clear that Congress did not intend the amendment to modify the longstanding position of the Service that an exempt social club could not receive income from activities not conducted in furtherance of its exempt purposes. (See, for example, Rev. Rul. 58-589, 1958-2 C.B. 266, which provided that a club engaging in business, as evidenced in that case by advertising for public patronage of its facilities, will not be considered as being organized and operated for exempt purposes; and Rev. Rul. 68-535, 1968-2 C.B. 219, which held that a social club that regularly sells liquor to its members for consumption off its premises is not entitled to exemption as described under IRC 501(c)(7).)

By stating that income received by a social club from the active conduct of businesses not traditionally carried on by social clubs is not included in the percentage limitations as receipts from normal and usual activities, the committee reports confirm the prohibition on nontraditional business activities since they do not further a club's exempt purposes. Therefore, a distinction must be drawn between permitted traditional business activities and prohibited nontraditional business activities.

One of the biggest hurdles through the years, however, has been how to define what is a "traditional business" and what is a "nontraditional business" of an exempt social club. The Service has concluded that a permitted traditional business activity is one that if engaged in with members furthers the exempt purposes of the organization. It can be conducted with nonmembers as long as the percentage limitation discussed above is not exceeded. Traditional activities also include income from investments since investing is a normal and usual activity for a social club. A prohibited nontraditional business activity does not further the exempt purpose of the organization even if conducted solely on a membership basis and exemption will be denied unless the activity is incidental, trivial, or nonrecurrent. Each activity conducted by the organization must be tested to determine if it furthers pleasure, recreation, and other nonprofitable purposes as described in IRC 501(c)(7).

G.C.M. 39115 (January 12, 1984), as modified by G.C.M. 39412 (September 19, 1985), sets forth this Service definition of "nontraditional business activity of an exempt social club" and discusses a social club that conducted some permitted traditional business activities as well as prohibited nontraditional business activities. In G.C.M. 39115, the issue presented was whether the provision by a social club of certain personal services to its members constitutes the active conduct of businesses not traditionally carried on by exempt social clubs. G.C.M. 39115 concluded that the club is not entitled to exemption because it conducts prohibited nontraditional activities that are not insubstantial, trivial, or nonrecurrent. G.C.M.'s are cited herein for instructional purposes only and may not be used or cited as precedent. (See IRC 6110(j)(3).)

The following illustrates the principles espoused in G.C.M. 39115:

> An organization is formed exclusively for social and recreational purposes. It owns a multi-story building located in a major urban center in which it provides athletic facilities, dining rooms, meeting rooms, and libraries for its members and their guests. The building also contains a large number of hotel style rooms that are rented to members who stay in town after an evening

attending club functions. However, at least 10 percent of the rooms are rented to members for use as their principal residence.

In addition, because parking in the surrounding area is scarce, a parking garage and gas station are located in the basement. The parking garage is provided for a fee to members attending club functions and to members for monthly parking while at work. The gas station provides typical gas station services for a fee. Further, the lobby of the building contains a number of shops and stores including a barber shop, flower shop, and liquor store. Access to all club facilities is restricted to members and their guests.

The gas station, flower shop, liquor store, and barber shop are prohibited nontraditional business activities that do not further the pleasure and recreational needs of club members. The primary purpose of these activities is to provide commercial services to club members. They do not facilitate the use of the club for mutual recreational and social activity; rather, they are services commonly needed whether or not the individual is participating in the social or recreational activities provided by the club. The fact that these activities are conducted solely with members does not change the conclusion that they are prohibited nontraditional business activities.

Athletic facilities, dining rooms, meeting rooms, and libraries are activities that further the pleasure and recreational needs of club members. Therefore, they are permitted traditional activities. However, income generated from their use by nonmembers is subject to the percentage limitation set by Congress.

The rental of rooms to members for occasional use when club activities end late in the evening furthers IRC 501(c)(7) purposes by allowing members to participate fully in club events. But the long-term rental of rooms to members primarily serves to provide housing and does not further recreational purposes. The provision of parking facilities is a traditional business activity when the facility is necessary to provide access to club events. Use of the parking facility to provide parking while a member is at work is a nontraditional business activity because it does not further exempt purposes.

The Service continues to utilize this interpretation of what constitutes a "nontraditional business activity." Chief Counsel concluded in G.C.M. 39688 (December 18, 1987) that the sale of timber by an exempt social club, under the facts presented in the memorandum, does not constitute the conduct of a business not traditionally carried on by a social club because it furthers the exempt purposes of the organization. The information provided indicated that the harvesting of pine timber was necessary to preserve the usefulness of the organization's property as a wilderness and wildlife habitat. The organization conducted hunting, fishing and wildlife preservation activities.

The G.C.M. further concluded, however, that the sale of the timber will generate unrelated business taxable income because it will not be exempt function income as defined in IRC 512(a)(3)(B). Its exempt status remains intact, since the projected income from the sale of timber (combined with other unrelated business income), did not exceed 35 percent of the social club's gross receipts for the year in which the cutting occurs.

3. <u>Offsetting Investment Income with Losses from Nonmember Activities</u>

Through the years there has been a continuing controversy among the Service and the Circuit Courts concerning the determination of social clubs' ability to net gains and losses from their unrelated business activities for tax purposes. The Supreme Court recently resolved that controversy in <u>Portland Golf Club v. Commissioner</u>.[1]

A. Background

1) Code Provisions

The exemption provided to social and recreational clubs is not based on any notion that clubs provide community service or public benefit. Rather, the tax exemption of social clubs allows individuals to join together for recreation or pleasure on a mutual basis, without tax consequences. In theory, the individual member should be in the same position he or she would have been in had he or she purchased recreation on an individual basis -- not better or worse. To achieve this, Congress intended that the sources of income of the organization should be restricted to receipts from the membership.

It is for this reason that Congress, in the Tax Reform Act of 1969, created an almost unique status for tax-exempt clubs through the enactment of IRC 512(a)(3). Familiarity with IRC 512(a)(3) is essential to a comprehension of the tax status of social clubs.

Under IRC 511, organizations exempt under IRC 501(c) are subject to tax on any unrelated business taxable income (UBTI). IRC 512(a)(1) defines UBTI as "the gross income derived by any organization from any unrelated trade or

[1] __U.S.__, 110 S. Ct. 2780 (1990), <u>aff'g.</u> 876 F. 2d 897 (9th Cir. 1989), <u>rev'g. and remanding without opinion</u> T.C. Memo 1988-76.

business (as defined in IRC 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business..."

IRC 511, 512, and 162 are all in Chapter 1 of the Internal Revenue Code. IRC 162 provides for the deduction of all ordinary and necessary expenses paid or incurred in the conduct of a trade or business. Thus, IRC 162, and the regulations thereunder, are determinative as to what expenses are deductible by unrelated businesses of exempt organizations.

However for IRC 501(c)(7) social clubs (and certain other categories of exempt organizations), UBTI is defined somewhat differently in IRC 512(a)(3)(A). IRC 512(a)(3)(A) generally defines UBTI as "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)..."

Exempt function income is explained in IRC 512(a)(3)(B) as "gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services..." It also encompasses income that is "set aide" for IRC 170(c)(4) purposes.

Thus, the Code provides exemption for social clubs differently than for most other categories of exempt organizations in that a social club is taxable on all income except that received from its members pursuant to exempt purposes. Although most other types of exempt organizations are not ordinarily liable for tax on their dividends, interest, and other investment income, IRC 501(c)(7) organizations are (unless such income is set aside for IRC 170(c)(4) purposes).

Because of the modified definition of UBTI for social clubs in the Code, the necessity of a profit motive regarding any trade or business had been debated for many years by the courts, prior to the Supreme Court's decision in Portland Golf. Adding fuel to the substantial litigation was the corresponding controversy regarding multiple UBTI sources and the extent to which aggregation of profits and losses from these sources was appropriate.

2) Lower Court Decisions

Before the renewed focus on social clubs' use of nonmembership losses brought about by the Supreme Court's decision in Portland Golf, several courts and the Service had already addressed the issue, with inconsistent results. It was for this reason that the Supreme Court considered the issue important enough to grant certiorari.

(a) Rev. Rul. 81-69

The Service has consistently relied upon its ruling in Rev. Rul. 81-69, 1981-1 C.B. 351 as a guide in determining proper unrelated business income tax liability for exempt social clubs. Rev. Rul. 81-69 involved a social club that had unrelated business taxable income from investments. It also sold food and beverages to nonmembers at prices insufficient to recover the costs of such sales. Such sales resulted only in losses for several years, and there was every indication that they would continue to result only in losses for the club.

The revenue ruling holds that an exempt social club, in determining its unrelated business income, may not deduct from its net investment income losses incurred on sales of food and beverages to nonmembers under these facts. The ruling's rationale is that the club's policy of continually setting prices on sales to nonmembers at levels insufficient to cover costs demonstrates that its conduct of the bar and restaurant activity with nonmembers is not profit motivated. 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).

(b) Cleveland Athletic Club v. United States

The Service's position in Rev. Rul. 81-69 was rejected by the Sixth Circuit Court of Appeals in Cleveland Athletic Club v. United States, 779 F.2d 1160 (6th Cir. 1985), rev'g. 588 F. Supp. 1305 (N. D. Ohio 1984). Like the club described in Rev. Rul. 81-69, Cleveland Athletic was an exempt social club that received unrelated business income from two sources: investments, and sales of food and drinks to nonmembers. Receipts from nonmember sales exceeded their direct costs, but during all four years in question resulted in a loss once fixed overhead costs were factored in. The club applied this loss as an offset against investment income in calculating its unrelated business taxable income (or loss).

The district court had upheld the Service and disallowed the offset. On appeal, however, the Sixth Circuit reversed this decision, and held that Club may net the excess expenses attributable to sales of food and beverages to nonmembers against its income from investments. The court based its decision on the difference in language between IRC 512(a)(1) and IRC 512(a)(3).

It noted that the definition of "unrelated business taxable income" as applied to social clubs in IRC 512(a)(3)(A) and that used in IRC 512(a)(1) as the general rule for charities and other tax exempt organizations is markedly different. This difference in language, in the court's view, showed that although Congress did not intend for the challenged deductions to come necessarily within the IRC 162 trade or business allowance, they are allowable as ordinary and necessary to the production of income with a basic purpose of "economic gain." The court believed "tax profit" important only as a means of distinguishing between an enterprise carried on in good faith as a "trade or business" and an enterprise carried on merely as a hobby. (IRC 183 permits individuals with hobbies to deduct their expenses only up to the amount of gross income derived from the hobby.)

(c) The Brook, Inc. v. Commissioner

A different approach was taken by the Second Circuit in The Brook, Inc. v. Commissioner, 799 F.2d 833 (2d Cir. 1986), aff'g 50 T.C.M. 959 (1985). The Brook is another exempt social club operating in a manner similar to the organization described in Rev. Rul. 81-69 and the Cleveland Athletic Club. It too received unrelated business taxable income from investments and from sales of food and beverages to nonmembers. For the years in question, the Brook avoided unrelated business income tax because losses from nonmember sales exceeded investment income, resulting in an overall net loss when the two were combined.

The Brook conceded that it did not intend to make a profit from selling food and beverages to nonmembers. The Service determined upon audit that the Brook could deduct expenses incurred with respect to sales of food and beverages to nonmembers only up to the amount of income received from that activity, based on the fact that since the Brook had not intended to make a profit from the sales of food and beverages to nonmembers, the excess deductions were not allowable as business expenses under IRC 162.

The Tax Court, upon review, decided in the Government's favor, based on a different theory from that advanced by the Service. The court determined that no nexus existed between the food expenses and the investment income from which it was offset, as required by the Tax Court's interpretation of IRC 512(a)(3)(A) expressed earlier in Ye Mystic Krewe of Gasparilla, 80 T.C. 755 (1983), which Judge Korner held to be controlling.

On appeal, the Second Circuit affirmed the Tax Court's decision, but rejected its reasoning, deeming the Tax Court's interpretation of IRC 512(a)(3)(A) in error and against the plain language and legislative history of the Code section. Instead, the Second Circuit focused on whether The Brook had established that section 162 authorized it to deduct the losses from nonmember food and drink sales from its investment income. The Court of Appeals held that the organization had failed to satisfy the requirements of section 162, and thus, the Code section did not authorize the deduction. The Brook, by its own stipulation, had no profit motive when it engaged in the nonmember sales. As stated by the Court of Appeals, "...since the plain language of IRC 512(a)(3)(A) requires that a social club may only deduct an expense if Chapter 1 authorizes that deduction, The Brook improperly used its losses from serving meals to nonmembers to write-off a portion of its gross income from its investment activity." The Second Circuit expressly rejected the Sixth Circuit's economic gain theory, declaring that it circumvents congressional intent that the tax exemption of social clubs not be used to better or worsen the financial position of their members who conduct social and recreational activities together through the club rather than individually. The Court posited that replacement of the IRC 162 "profit motive" requirement by an "economic gain" test would give social clubs a tax advantage not enjoyed by other taxpayers, which departs from Congress' declared purpose in enacting IRC 512(a)(3)(A).

(d) Sixth Circuit Revisited, and a Loss in Nebraska

Adding to the dissension among the courts and the Service regarding the application to nonmember sales of an "economic gain" test versus a "profit motive" in determining UBTI were two district court decisions that sided with the "economic gain" approach.

Detroit Athletic Club v. United States, 717 F. Supp. 1224 (E.D. Mich. 1989) was a case arising in the Sixth Circuit. As such, it was decided in accordance with Cleveland Athletic Club, supra. The decision was vacated without opinion by the Court of Appeals, 916 F.2d 712 (6th Cir. 1990), following the Supreme Court decision in Portland Golf.

In Inter-Com Club, Inc. v. United States, 721 F. Supp. 1112 (D. Neb. 1989), the District Court for Nebraska (which is in the Eighth Circuit), held that losses from a nonmember activity may be deducted against investment income when the activity is carried on for the production of income even though the activity is not profit motivated. An activity is carried on for the production of income if the nonmember income exceeds variable expenses directly connected with the activity. Having met this test, the Inter-Com Club was allowed by the Nebraska District Court to deduct variable expenses as well as an allocated portion of fixed costs directly connected to nonmember use of the club, even though a net loss resulted when adding in the fixed costs allocation.

(e) North Ridge Country Club v. Commissioner

An analysis of the background leading to Portland Golf would not be complete without a discussion of North Ridge Country Club v. Commissioner, 877 F.2d 750 (9th Cir. 1989), rev'g. 89 T.C. 563 (1987).

North Ridge Country Club basically conducted four categories of activities: (1) exempt activities; (2) nonmember golf tournaments; (3) nonmember food and beverage sales (separate from the tournaments); and (4) investments resulting in interest income. The last three categories represent the extensive unrelated business activities.

The Tax Court examined each nonmember activity for profit motivation, as the Service had urged. However, the court relied on a unique interpretation of what constitutes a "profit motive." The government had argued that a determination of profit motive results from analyzing the taxable income, taking into account both direct costs and an allocable portion of fixed costs. The court rejected this approach, and rather, looked to "profit" motive from the standpoint of "an incremental increase in available funds" to the Club (thus emphasizing economic, not taxable, profit). Finding that the Club had "profited" (under this unusual definition) by each dollar earned over and above the direct costs of such activity, the court found that North Ridge was engaged in all of its nonmember activities with the intention of making a profit.

The Ninth Circuit Court of Appeals reversed, rejecting the Tax Court's analysis of profit motivation and essentially adopting the Second Circuit's analysis in The Brook, supra. The Ninth Circuit held that a social club may deduct losses from nonmember activities only if it undertakes those activities with an intent to profit, where profit means the production of gains in excess of all direct and indirect costs. It ruled that North Ridge did not have an intent to profit.

B. Portland Golf Club

1) The Facts

Portland Golf Club is a social club recognized as exempt under IRC 501(c)(7). The Club owns and operates a golf course and country club, a restaurant and bar, and tennis courts. A major portion of Portland Golf Club's income comes from "exempt function" sources - membership dues and fees, and sales of food and drink to members. Portland Golf Club has two sources of "nonexempt function" income - sale of food and drink to nonmembers, and income from investments.

For each year in question before the Court, the Club sustained a net loss on the food and drink sales to nonmembers. In determining this loss, the Club included both the variable expenses incurred in nonmember sales (direct costs immediately associated with those sales, varying according to the volume of sales) and an allocable portion of its fixed overhead expenses (indirect costs that would have been incurred regardless of whether sales had been made to nonmembers).

The Club determined the portion of fixed costs allocable to nonmember sales by using a formula known as the "gross-to-gross" method. This method allocates the percentage of fixed costs to nonmember sales on the same basis as the ratio that nonmember sales bears to total sales. The parties stipulated that this was a reasonable method of making the allocation and that an allocable portion of fixed costs was properly attributable to and directly connected with the generation of nonmember income.

The Club used the loss from nonmember sales to offset its investment income. The loss from nonmember sales was in excess of its net investment income. Consequently, the Club reported no unrelated business taxable income for those years.

On audit, the Service concluded no deductions could be taken by the Club for expenses associated with nonmember sales in excess of the amount of receipts from those sales, because the sales to nonmembers lacked a profit motive. As a result, the Club could not offset its investment income (the other nonexempt function source of income) with the remaining losses from the sales activities.

The Club petitioned the Tax Court, which ruled in favor of the Club. As in North Ridge, the Tax Court's underlying basis for the ruling came from an assumption that losses associated with sales to nonmembers could be used to offset investment income only if the sales were undertaken with a profit motive, again relying on an economic basis rather than the taxable income basis. The Tax Court held that the Club had adequately manifested a profit motive, since its gross receipts from nonmember sales consistently exceeded its direct costs associated with those sales, without regard to its fixed, indirect costs.

On appeal the Ninth Circuit reversed the decision of the Tax Court, citing its holding in North Ridge Country Club. It held that the Tax Court had applied an incorrect legal standard in determining that the Club had shown an intent to profit. It remanded the case back to the Tax Court for a determination of whether the Club undertook the nonmember sales with the intent required under North Ridge to deduct losses from those activities.

In view of the active conflicting analyses and holdings in the Circuits, the Supreme Court granted certiorari.

2) The Supreme Court Decision

In Portland Golf Club v. Commissioner, supra.[2], the Supreme Court held that the IRC 501(c)(7) exempt social club is allowed to offset investment income by losses incurred in sales to nonmembers only if those sales were motivated by an intent to profit. The Supreme Court further held that an intent to profit is determined by using the same method to allocate fixed costs to nonmember sales as that used to compute the club's actual profit or loss. Applying this standard, the Court determined that Portland failed to show that it had intended to earn gross income from nonmember sales in excess of its total cost. Therefore, the club lacked the requisite profit motive with regard to this activity.

Profit Motive Required. The Court initially considered the issue of whether Portland Golf Club must show that nonmember sales were motivated by an intent to profit in order to offset investment income with losses from such sales. It held that profit motive is essential.

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[2] Justice Blackmun wrote the majority opinion. A separate concurrence was written by Justice Kennedy, joined by Justices O'Connor and Scalia.

To come to this conclusion, the Court analyzed the language of IRC 512(a)(3)(A). IRC 512(a)(3)(A) defines the term "unrelated business taxable income" as it relates to social clubs as meaning "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)." The Court viewed the inclusion of the phrase "allowed by this chapter" as limiting deductions to Chapter 1. Thus, only deductions that meet the criteria of IRC 162(a) are permitted.

Under IRC 162(a), expenses must be incurred in connection with a "trade or business." The Court cited a previous ruling[3] in stating that trade or business activities fall within the scope of IRC 162(a) only if an intent to profit has been shown.

Although conceding that generally a profit motive is vital in determining whether an activity is a trade or business, the Club argued that by including receipts from nonmember sales within the definition of "unrelated business taxable income" as that term is used in IRC 512(a)(3)(A), the Code has implicitly designated such sales as a trade or business. Consequently, there is no reason to question an intent to profit from this source; the activity is already within the definition.

The Court dismissed that argument. In its opinion, the use by Congress of the word "business" within the phrase "unrelated business taxable income" in IRC 512(a)(3)(A) to refer to all receipts other than payments from members "hardly manifests an intent to define as a 'trade or business' activities otherwise outside the scope of IRC 162." The opinion noted further that the club's reading would "render superfluous the words 'allowed by this chapter' in IRC 512(a)(3)(A): if each taxable activity ... is 'deemed' to be a trade or business, then <u>all</u> of the expenses 'directly connected'... would presumably be deductible."

<u>Demonstrating Requisite Profit Motive</u>. The Court concluded that a social club is required to demonstrate an intent to earn gross receipts in excess of both variable and fixed costs to show an intent to profit. In so doing, the Court also determined the proper method of allocating a share of the fixed costs to nonmember sales.

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[3] <u>Id</u>. at 2787, citing <u>Commissioner v. Groetzinger</u>, 480 U.S. 23, 35 (1987).

The Ninth Circuit, in remanding the case back to the Tax Court, had ruled that some allocation of the fixed costs was necessary but had left open the possibility that the social club could apply an allocation method different from that used in calculating its actual losses. This rationale was perceived by the Supreme Court as an "inherent contradiction." It ruled that a club must allocate fixed expenses between member and nonmember sales according to the same method used in computing actual profit or loss. According to the Court, since Portland Golf Club's calculation of actual losses rests on its position that a portion of its fixed expenses is properly deemed as attributable to the production of income from nonmember sales, these expenses cannot be ignored or attributed to the Club's exempt activities in determining whether the Club had acted with the required profit motive. Having relied on the gross-to-gross allocation method in figuring actual losses, Portland Golf, according to the Court, is then foreclosed from arguing that some other allocation method more accurately reflects the economic reality of intent to profit.

The Court noted that it is not advocating that any particular method of allocating fixed expenses must be used by social clubs. Rather, it was holding only that the allocation method used in determining actual profit or loss must also be used in determining whether a social club acted with a profit motive.

Concurring Opinion. Three of the Justices concurred with the judgment but disagreed with the opinion's ruling regarding how to determine profit motive. Justice Kennedy, joined by Justices O'Connor and Scalia, agreed that in order for a social club to offset investment income with losses from nonmember sales, it must demonstrate an intent to profit, allocating both variable and fixed expenses to the nonmember sales. However, he asserted that the Court went too far when it ruled that social clubs must use the same allocation method as that used in reporting taxes in showing the profit motive - a ruling he felt unnecessary to the disposition of the case and, in his view, decided the wrong way.

In Justice Kennedy's opinion, the Court should have followed the Ninth Circuit's remand to the Tax Court for a determination of profit motive so that the Tax Court and the Court of Appeals could have the opportunity to consider the issue in the first instance. He further posited that the Code allows clubs the option of demonstrating profit motive by a method different from that used to calculate expenses under IRC 162(a). Justice Kennedy believed that determination of a taxpayer's profit motive should not turn upon the particular accounting method by which it reports its ordinary and necessary expenses to the Service.

4. Ramifications of Portland Golf

A. Case aftermath to Portland Golf Club

Atlanta Athletic Club v. Commissioner, T.C. Memo 1991-83 (1991), recently decided by the Tax Court, cites Portland Golf Club as authority. In Atlanta, we get some insight as to the direction the Tax Court will follow in light of Portland.

Atlanta Athletic Club is an exempt social club that had unrelated business taxable income from the following sources: (1) investment income; (2) food and beverage sales to nonmembers; (3) use of facilities, such as the golf greens and tennis, athletic, and aquatic centers, and amateur tournaments for nonmembers; and (4) two professional golf tournaments. The Club aggregated the income and expenses from the nonmember "undertakings" (the term used by the court to characterize all nonexempt, non-member functions), offsetting the losses from the sales of food and beverages to nonmembers and the nonmember golf days against the income received from the tournaments. The Club further offset the excess losses from the nonmember undertakings taken as a whole against its investment income.

Among the issues facing the court, pertinent ones for this discussion include: (1) whether the nonmember undertakings listed above constitute one activity or three separate activities; (2) if all nonmember activities are considered one activity, then whether Atlanta Athletic Club is entitled to offset its losses from all such undertakings against its gross receipts from all such undertakings; and finally, (3) whether the Club can offset losses from nonmember undertakings against its investment income.

The Tax Court held that the Club is not entitled to offset the losses from its nonmember undertakings against its investment income for the taxable years in question because it did not enter into such undertakings with an intent to profit. It further held that the Club's undertakings, excluding investment income, constitute one activity; and, therefore, the Club is entitled to offset its losses from all such undertakings against its gross receipts from all such undertakings, excluding investment income.

Upon audit of the Atlanta Athletic Club, the Service had divided into three separate activities the sales of food and beverages to nonmembers; the use of the facilities and amateur tournaments by and for nonmembers; and the professional tournaments. It determined that each particular activity should be examined for profit and loss to determine a profit motive. The Tax Court agreed with the assertion by the Club that the undertakings have a common business purpose - i.e., to promote nonmember interest in the Club - and that the undertakings are economically interrelated. Contrary to the Service's argument, the court found that the Atlanta Athletic Club's separate bookkeeping of these undertakings is not sufficient alone to justify treating each undertaking as a separate activity. Judge Whitaker was unimpressed by the government's citation of the Tax Court's earlier decision in Ye Mystic Krewe, supra., in this regard; he found it to be inapposite.

The court then examined whether the nonmember undertakings, seen as one activity, were entered with an intent to make a profit. Utilizing the test enunciated by the Supreme Court in Portland Golf Club, the Tax Court determined that the Club did not enter into the activity with an intent to profit in any of the years in issue despite the unrefuted fact that it realized a gross profit (receipts over direct expenses) from the activity. The Tax Court saw no need to discuss this contention, but merely cited the Supreme Court's ruling in Portland.

B. Release of Suspended Cases in the Field

In Announcement 90-138, 1990-51 I.R.B. 38, the Service disclosed that cases involving unrelated business income tax of IRC 501(c)(7) social clubs that had been held in suspense pending the decision of the Supreme Court in Portland Golf Club have been released. Field offices have been advised to complete these cases employing the rationale from the Portland Golf Club decision. The field offices have also been notified to assess all applicable penalties, where appropriate.

In essence, the Supreme Court's decision in Portland Golf Club affirms with finality the Service position first announced in Rev. Rul. 81-69. It should lay to rest all challenges to its basic principle that exempt social clubs can only offset their investment income with losses from sales to nonmembers if a profit motive is manifested in the latter activity. When a profit motive is not shown, no offset is allowable.

Announcement 90-138 advised clubs to follow Rev. Rul. 81-69 in figuring their proper unrelated business income tax liability and in filing amended returns where they have inappropriately used losses from nonmember sales in a return previously filed. Announcement 90-138 further warned clubs that the Service will closely monitor the return filing patterns of IRC 501(c)(7) organizations. The

Service will watch to ensure that social clubs are filing amended Form 990-T returns and to identify those clubs for examination that should be filing Form 990-T returns and that are not presently doing so.

C. Estimated Tax, Amended Returns, & Application of Penalties

The Service is aware that prior to the Supreme Court decision in Portland Golf Club many exempt social clubs did rely on the Sixth Circuit decision in Cleveland Athletic Club v U.S. and inappropriately offset investment income from losses from nonmember sales. Due to the timing of the Portland Golf Club decision coming in June, 1990, these clubs may have then either missed or made underpayments for the first or second quarterly installments of estimated tax for their fiscal year 1990.

Tax-exempt organizations are required to make estimated tax payments on their unrelated business income tax. IRC 6655(a) levies an added tax for any underpayment of estimated corporate tax. No statutory authority exists that allows the Service to waive the corporate estimated tax addition. The damages are avoided only if the exempt organization fits one of the safe harbors in IRC 6655(d)(1) or 6655(e), or if the tax due for the fiscal year is less than $500.

IRC 6655(d)(1)(B)(ii) allows organizations to avoid incurring a penalty for underestimating the income tax for the current year if estimates are based on the amount of tax shown on the return of the corporation for the preceding taxable year. This safe harbor is not available, however, to large exempt organizations, defined as having taxable income of $1,000,000 or more, or if the preceding taxable year was not a taxable year of 12 months or the organization did not file a return for the preceding year showing a tax liability. The Service has deemed, with the Fifth Circuit Court of Appeals agreeing, that the phrase, "the tax shown on the return for the preceding taxable year," as used in IRC 6655, refers to the original filed return, and not to any later amended return or redetermination that shows taxes actually due for the preceding year to be greater or less. See, e.g., Evans Cooperage Co., Inc. v. United States, 712 F.2d 199 (5th Cir. 1983).

As a general rule, tax-exempt organizations that are subject to the unrelated business income tax and have unrelated taxable business income are required to file Form 990-T, Exempt Organization Business Income Tax Return. However, in response to a written request from a taxpayer to consider waiver of the penalties for underpayment of estimated tax by social clubs, the Service wrote that where an exempt organization has concluded in good faith that it had no unrelated business income and, therefore, it was not required to file any return other than Form 990, Form 990 will be deemed to qualify as the original return filed for the preceding taxable year for purposes of IRC 6655(d)(1)(B)(ii). In the letter, the Service warned that the Form 990 must state the nature of the income-producing activity in sufficient detail to alert the Service of the potential existence of unrelated business activity, and the return must disclose the gross receipts for this activity.

As an aid to exempt social clubs that had made underpayments of the estimated tax for fiscal year 1990, the letter paraphrased Reg. 1.6655-1(b), which provides that if there has been an underpayment of estimated tax as of the installment date prescribed for an exempt club's payment and the club believes that one or more of the exceptions described in the applicable Code and regulation sections precludes the assertion of the addition to the tax, the exempt organization should attach to its Form 990-T for the taxable year a Form 2220, Underpayment of Estimated Tax by Corporations, showing the applicability of any exception upon which the organization relied.

In view of the fact that Portland, supra., was decided in June 1990, an exempt social club will be deemed to have received ample notice as to proper computation of the unrelated business income tax due, and corresponding proper payment of estimated tax for fiscal year 1991 and beyond.

D. Proper Allocation Methods and Allowable Deductions under IRC 512(a)(3)(A) for Social Clubs

In Portland Golf Club as well as in the case of Atlanta Athletic Club, discussed earlier, the Service had determined upon audit that the allocation method used by each of the clubs, the gross-to-gross method (allocating indirect expenses based on the ratio that sales from all nonmember activities bore to total sales of the Club) was inappropriate. In briefs before the courts, however, the Service stipulated to the reasonableness of the results of the gross-to-gross method of allocation in each case in order to get past factual issues and focus on the lack of intent to profit, regardless of allocation method used.

The reasonableness of the allocations method is still a main consideration when reviewing nonmember activities of exempt social clubs and determining profit motive. The Service does not have any one approved method of allocating expenses. We only require that the method be reasonable. A method is reasonable if it results in the deduction of only those expenses that hold a proximate and primary relationship to the unrelated trade or business income against which they are applied.

The Unrelated Business Income Allocations Article of this CPE text presents a detailed discussion of the proper allocation methodologies. It also focuses on the application of IRC 512(a)(3)(A) in determining the proper method of identifying expenses allowable as deductions from nonmember gross receipts of social clubs.

5. Sales of Assets, and Other Issues Involving Social Clubs

Atlanta Athletic Club v. Commissioner, supra., is a significant case for more reasons than simply being indicative of the direction courts will take following the Portland holding. In this case, the Tax Court further held that the Atlanta Athletic Club is not entitled to deduct certain expenditures made to comply with P.G.A requirements to host its championship tournament because they are capital expenditures. The expenditures were for redesigning certain golf course greens, for constructing a new practice green, and for reworking the drainage system on the golf course. The court found that these were permanent improvements rather than merely restorations to pre-tournament condition, and that they had a useful life beyond the year of the tournament. The decision appears to be essentially one of fact, rather than law, and similar fact patterns should be resolved in the same way.

Even more notable is the holding of the Tax Court regarding the sale of surplus land by the club. The club owned a parcel of land across the street from its main facilities. It sold the land and reinvested the proceeds in exempt function property. It declined to report unrelated business income tax from this activity, asserting instead the applicability of the nonrecognition of gain rule of IRC 512(a)(3)(D). IRC 512(a)(3)(D) provides that if property used directly in the performance of the exempt function of the social club is sold, 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 the social club directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that the social club's sales price of the old property exceeds the club's cost of purchasing other property.

The most recent court case regarding this issue prior to Atlanta Athletic Club was Framingham Country Club v. United States, 659 F.Supp. 650 (D. Mass. 1987). See both the 1989 and 1988 CPE Texts for detailed discussions regarding the decision and Service thinking in light of it. In the 1989 text, we made it clear that the Service interprets IRC 512(a)(3)(D) to mean that gain will be excluded only on property that was in actual, direct recreational use, a position we believe to be more in tune with the rationale of Framingham Country Club.

The Service applied this standard in the case of Atlanta Athletic Club and declared that the Club did not clearly present that the property was in actual, direct, continuous, and regular use in furtherance of exempt purposes for the nonrecognition of gain rule of IRC 512(a)(3)(D) to apply. The court agreed with the standard and with the Service determination that the Club had not adequately proved that the property was used for exempt purposes. Having decided the appropriate legal standard, Judge Whitaker was left with a simple question of fact, and once again he clearly found that the IRS agent had done his job well and presented a more credible version of the facts. The result was that the entire gain was taxable.

6. Conclusion

If in doubt as to whether a particular activity is considered traditional, look to whether the activity furthers the social club's exempt purposes. Determination as to whether an activity is nontraditional vs. traditional is essentially factual. If the activity does not further exempt purposes it is nontraditional, and if it is conducted on more than an incidental, trivial, or nonrecurrent basis the club should not be exempt.

In Portland Golf Club, the Supreme Court has settled the longstanding issue as to whether profit motive is required in order to deduct losses arising from nonmember business under IRC 512(a)(3)(A) in figuring unrelated business income tax of an exempt club. Also settled by the Court is the question whether fixed (indirect) costs must be taken into account in proving profit motive, along with variable (direct) costs. Rev. Rul. 81-69 has been vindicated and confirmed to be a valid interpretation of the law.

Not so clear cut, however, are the methods the courts will allow to be used in allocating fixed costs between nonmember sales activities and member activities. Neither is the extent to which courts will allow the various non-member activities to be aggregated in determining profit motive. No doubt, case law will continue to evolve.