TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201235024**
Release Date: 8/31/2012
Date: June 7, 2012
UIL: 512.09-03

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Taxpayer	=
Town	=
City	=
Department	=
Forest	=
x1	=
X2	=
X3	=
Date1	=
Date2	=
Date3	=

Dear

This is in response to your letter dated December 18, 2010, in which you requested certain rulings with respect to section 512(a)(3)(D) of the Internal Revenue Code ("Code").

Background:

According to your ruling request you are an exempt organization under section 501(c)(7) of the Code. You are a social and recreational club located in Town formed for the purpose of outdoor recreation. You have been operated continuously as a social club for several decades, being recognized as exempt for most of that time. You have annually filed your Form 990 with a fiscal year beginning Date1.

You were formed for the primary purpose of providing space and activities for social interaction among families and enjoying outdoor recreation. Throughout hundreds of acres of woodland and waterways your members enjoy hiking, mountain and road biking, trail running, cross-country skiing, snow shoeing, horseback riding, sailing, swimming, canoeing and kayaking, ice skating, tennis, field sports, archery, fishing, and trap shooting. Your facilities currently include two lodges, six tennis courts, playing fields, a stable, a trap range, a boathouse, picnic areas, a skating house, clubhouse, and a waterfront snack bar. There is a well developed system of trails that run throughout your property that were originally developed within your first decade of operations and are continuously maintained by members. These trails, which consist of a primary system and many connector trails, have various uses but many are dedicated to

specific uses such as horseback riding, hiking, or mountain biking. One central feature of your property is a sixty acre lake used for recreation and forbidden to power boats. Your land also holds the head waters to this lake as well as one other smaller pond.

Your land includes an area of approximately x1 acres, which constitutes a little more than a quarter of your land, in the northwest portion of your property known as Forest. Your club has owned this land since its inception. Your members use the land for many activities including hiking, skiing, horseback riding, snow shoeing, camping, picnicking, running, mountain biking, and general enjoyment. Included on this land is the tallest point on your property, which is a popular destination for hiking and picnicking, as well as two prominent trails. Other enjoyable features include an intact root cellar, a cliff for rope climbing, and a cave. Activities occurring on Forest are enjoyed by members throughout the year.

On Date2 you entered into an agreement with Department, a city department of environmental protection, for a conservation easement attaching to Forest. Department is interested in an easement attaching to this property since Forest contains a watershed leading to one of the reservoirs used by the residents of City. After Department has conducted its due diligence and appropriately surveyed the land, you will close on Date3. Department will pay approximately x2 for the easement to prevent pollution of water running through or collecting on Forest. As part of the easement you have agreed that you will not construct new paved roads; create new building envelopes with subsurface sewage treatment systems, paved surfaces, or wells; commercially mine gravel, sand, shale or bluestone of more than x3 square feet; or store, bury, or dispose of hazardous materials designated by local, state, or federal regulations or dispose of cars, trash, sewage, or uncomposted animal waste. Furthermore, the easement restricts your ability to farm, build, and remove timber, though it does not remove those options entirely. Additionally, Department will have the right to enter the land for inspections in order to monitor your use of the land. The easement will run with the land in perpetuity, thus restricting any future sale of the land. Your members can, and will, continue to use the land for all of your traditional recreational activities such as hiking, mountain biking, and horseback riding.

You decided to enter the agreement with Department so that you could raise capital to demolish and rebuild one of your two lodges. The lodge was constructed not long after your inception and has reached the end of its usable life. You represented that you are committed to using all of the funds earned through the sale of the easement in the demolition and construction of the new lodge within the statutory period. This lodge is located at the center of your property near many of your other buildings, tennis courts, the central athletic field, the largest playground, and the dining room. It also contains your administrative offices, meeting and map rooms, tennis office and shop, locker rooms, and mail rooms. Due to its location this lodge serves as a natural meeting point for your members and is the starting point for many of your guided hikes and other tours.

Rulings Requested:

You request a ruling that the gain on the sale of the conservation easement, approximately x2 given your nominal basis in the property, is exempt from tax under Code Section 512(a)(3)(D), provided that the proceeds are reinvested entirely on property to be used in your exempt social and recreational function within the period beginning one year prior to the sale and concluding three years after the sale.

Law:

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in 501(c)(7) 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.

Section 512(a)(3)(D) of the Code provides that if property used directly in the performance of the exempt function of an organization described in 501(c)(7) 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, then gain from such sale shall be recognized only to the extent that the sales price exceeds the cost of purchasing the other property.

In Atlanta Athletic Club v. Commissioner, 980 F.2d 1409 (11th Cir. 1993), the court determined that, "The statute speaks in terms of use rather than intent. Therefore, the Tax Court correctly observed that the Club's various plans for the land were irrelevant. The analysis must concentrate on the ways in which the Westside Property was or was not 'used directly.' This process entails factual findings as to the activities that occurred on tracts A and B of the Westside Property, and legal conclusions as to whether those activities constituted sufficient recreational uses by the Club."

In Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985), the court interpreted "organization's sale price" to mean, "the amount realized, reduced by the aggregate of the expenses for work performed on the old property to assist in its sale." When discussing use of the funds to pay debts of the organization and refund money to members the court stated, "By discharging the indebtedness on its loan and by currently refunding the assessment, which its membership previously had agreed was refundable only upon death or resignation from the club, petitioner did not 'merely reinvest' its funds from the land sale in other types of assets. In the language of the Committee Report, funds were 'withdrawn for gain by the members of the organization,' who benefited through decrease in petitioner's debt and return of the assessment. Petitioner's gain therefore constitutes unrelated business taxable income." Additionally, the court provides an example of an allowable transaction stating, "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." *Id.* at 763-64, *citing* S. Rept. 91-552 (1969), 1969-3 C.B. 423, 470-71.

In Deer Park Country Club v. Commissioner, 70 T.C.M. (CCH) 1445, the court concludes, "that the plain and ordinary meaning of the phrase "used directly in the performance of the exempt function of an organization" as set forth in section 512(a)(3)(D) connotes an exempt organization's use of assets or property that is both actual and direct in relation to the performance of its exempt function. Given petitioner's concession that no part of the 4.8–acre tract on which the 11 homesites are situated was ever physically used by petitioner for recreational activities, it follows that the gain realized on the sale of the 11 homesites does not qualify for nonrecognition under section 512(a)(3)(D), but rather is subject to the unrelated business income tax."

Analysis:

You have requested a ruling that gain from the sale of a conservation easement will not be taxable income if reinvested in a lodge used by your members. Section 512(a)(3) of the Code provides special rules defining taxable income for organizations described in 501(c)(7). Specifically, gains from the sale of property, which has been used for the exempt purpose of certain organizations, will not be recognized, and therefore will not be taxed, to the extent that the sale price is reinvested in property used for the organization's exempt purpose, if that reinvestment occurs within one year prior to and three years following the sale of property. Section 512(a)(3)(D). This statute is further clarified by case law, which stipulates that the property being sold must have been "directly used" for the exempt purposes of the organization, see Atlanta Athletic Club, 980 F.2d 1409, not for some other benefit of the organization, see Deer Park Country Club, 70 T.C.M. (CCH) 1445, and must be reinvested into property up to the "organization's sales price" and not "withdrawn for the gain by the members of the organization." See Tamarisk Country Club, 84 T.C. 756.

The sale of the easement is widely considered by the Service to be a sale of property within the Internal Revenue Code. The easement will be attached to the land in perpetuity affecting all future transactions regarding the land. The easement removes your ability to construct new paved roads; create new building envelopes with subsurface sewage treatment systems, paved surfaces, or wells; commercially mine gravel, sand, shale or bluestone of more than x3 square feet; or store, bury, or dispose of hazardous materials. It additionally hinders your ability to farm, build, and remove timber, though it does not remove those options entirely. The easement also gives access of your land to Department in order to ensure such activities are not taking place. Given the significant restrictions on you, and any purchaser of the land, and the rights provided to Department, you have sold property.

You are selling an easement to land that is substantially used by your members for the social and recreational activities for which you were formed. These activities include hiking, mountain biking, horseback riding, picnicking, skiing, and snow shoeing among others. You also provided several trails through this land and picnic tables to encourage these activities. The land contained other popular features visited by members, specifically, the highest point on the property, a cave, and an active root cellar. Based on the above factors we conclude that the easement property was used heavily for recreational purposes. Your use of the Forest appears to be more frequent than the activities found to constitute exempt purpose use in Atlanta Athletic Club, 980 F.2d at 1412-13, where the organization held foot races, pasture parties, kite flying contests, fishing contests, and allowed jogging by members on the land sold. Furthermore, the court states that an activity need not be organized by the club in order to be sponsored by the club. Id. at 1413. Thus, we conclude that the sale of the easement meets the first criteria because it is attached to land "directly used" for your exempt purposes. The fact that you continue to use the land under the easement for your exempt purposes does not alter the conclusion that you have sold property that you used for an exempt purpose. The restriction of your rights and the rights granted to Department remain, thus you have still sold property used for an exempt purpose.

You have represented that you are committed to using the sales proceeds from the sale of the easement to demolish and reconstruct one of two lodges on your property. The court in Tamarisk Country Club, 84 T.C. at 764, cites S. Rept. 91-552 (1969), 1969-3 C.B. at 470-71,

Providing, by way of example, that, "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." Your lodge has been, and will continue to, serve as the home of your administrative offices, the starting point for many hiking and skiing tours, the mail rooms, and a prominent meeting point for your members. As such, the gains from your sale of the easement will be reinvested in property that will be "directly used" for your exempt purposes within the meaning of section 512(a)(3)(D) of the Code.

Finally, you said that you would fulfill the statutory requirement by making these investments within one year prior and three years following the closing of your sale of the easement. In doing so, you will have met all three requirements under section 512(a)(3)(D) and gain will not be recognized on your sale of the easement to the extent that your sale price is reinvested within the four year window. You also stated that you understand that any money not spent in this time period is subject to tax.

Ruling:

The gain on the sale of the conservation easement, approximately x2 given your nominal basis in the property, is exempt from tax under Code Section 512(a)(3)(D), provided that the proceeds are reinvested entirely on property to be used in your exempt social and recreational function within the period beginning one year prior to the sale and concluding three years after the sale.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose.* A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437