

## Audit Technique Guide – Social and Recreational Clubs – IRC Section 501(c)(7)

### Introduction

This Audit Technique Guide includes specific information to identify and develop issues commonly encountered during the examination of an IRC Section 501(c)(7) organization.

This guide supplements the procedures in [IRM 4.75, Exempt Organizations Examinations Procedures](#) and isn't intended to restrict you in identifying issues or using examination techniques not included here.

This guide doesn't contain detailed technical information on IRC Section 501(c)(7) organizations. Review the technical information in [IRM 7.25.7, Social and Recreational Clubs](#).

IRC Section 501(c)(7) describes social and recreational clubs exempt from federal income tax under IRC Section 501(a). Generally, social clubs consist of membership organizations supported by dues, fees, charges or other funds paid by their members. Typical organizations that may qualify for exemption under IRC Section 501(c)(7) are:

- College fraternities and sororities
- Country clubs
- Amateur hunting, fishing, tennis, swimming and other sport clubs
- Hobby clubs
- Ethnic clubs
- Yacht clubs
- Community Associations

The objective of an examination of a social or recreational club is to determine whether the organization is organized and operating per the exempt purposes of IRC Section 501(c)(7).

Determine the following:

- The organizational requirements of IRC Section 501(c)(7) have been met.
- The members are bound together by a common objective directed toward pleasure, recreation or similar nonprofit purposes.
- The activities are in furtherance of pleasure, recreation or other similar nonprofit purposes.
- There is no inurement of income.
- All unrelated trade or business income has been properly reported on the Form 990-T, Exempt Organizations Business Income Tax Return.

### Organizational Requirements of a Social or Recreational Club

A social club must be organized for pleasure, recreation and other similar non-profitable purposes.

A social club is described in IRC Section 501(c)(7) if it is organized for pleasure, recreation and other similar non-profitable purposes. However, a club isn't exempt from taxation under IRC

Section 501(a) if the club has any written policy that discriminates based on race, color, or religion. See IRC Section 501(i). The previous statement doesn't apply in the following circumstances:

- Auxiliaries of IRC Section 501(c)(8) fraternal beneficiary societies may limit their membership to the members of a particular religion under IRC Section 501(i)(1).
- A club may in good faith limit its membership to the members of a particular religion in order to further its teachings or principles, and not to exclude individuals of a particular race or color under IRC Section 501(i)(2).
- A club's governing instruments may limit its membership to individuals of a particular national origin without jeopardizing its exemption.
- A club may restrict its membership to a particular political party or to homeowners in a specific housing development.

**Note:** Although membership may be restricted to a particular political party or to homeowners in a specific housing development, these organizations aren't permitted to also limit membership based on race, color, or religion.

### **Auditing Organizational Requirements of a Social or Recreational Club**

- Review the following governing instruments including:
  - Articles of organization
  - Bylaws
  - Any policy statements
- Determine that:
  - The club is organized for pleasure, recreation and other similar nonprofit purposes.
  - There are no activities expressly authorized that are beyond the scope of IRC Section 501(c)(7).
  - There are no written provisions limiting membership on the basis of race, color or religion (except as otherwise noted in IRC Section 501(i)).

**Note:** The IRS doesn't require an organization to have an affirmative statement of nondiscrimination.

### **Membership Requirements of a Social or Recreational Club**

*A social or recreational club must provide the opportunity for personal contact between its members and the members must be bound together by a common objective of pleasure, recreation, and other non-profitable purposes. See Rev. Rul. 74-30, 1974-1 C.B. 137.*

The common objective must be dedicated towards pleasure, recreation and other non-profitable purposes. See *Chattanooga Auto. Club v. Commissioner*, 182 F.2d 551, 554 (6th Cir. 1950) (interpreting section 101(9), the predecessor to section 501(c)(7)); see also *Lake Petersburg Assoc. v. Commissioner*, 33 T.C.M. 259 (1974). **Note:** Members must share common interests or share goals justifying the organization's existence.

## Auditing Membership Requirements of a Social or Recreational Club

When auditing membership requirements, determine any prerequisite conditions or limitations imposed on members, such as an interest in a particular hobby. Examples of social organizations that share a common goal or mutuality of interests could include flying and gardening clubs.

To audit membership requirements:

REVIEW	TO DETERMINE
Bylaws, minutes of meetings, club handbooks, brochures, and newsletters	If members have the opportunity for fellowship, commingling, or other personal contact. Commingling is present if things like meetings, social gatherings, and recreational facilities are available for the membership. Generally, the lack of commingling of members presents a red flag indicating that the basic purpose of the organization serves to provide personal services and goods in a manner similar to commercial enterprises.
Membership applications, club handbooks and any brochures or other information provided to prospective members	Requirements and procedures for obtaining membership. Determine the types of memberships available and whether they include corporations.

An automobile club whose principal activity is rendering automobile services to its members but has no significant social activities doesn't qualify for exemption under IRC Section 501(c)(7). Rev. Rul. 69-635, 1969-2 C.B. 126. **Note:** Rev. Rul. 69-635 hasn't been updated to reflect P.L. 94-568, 1976-2 C.B. 596.

Likewise, a flying club which provides economical flying facilities for its members but has no organized social and recreation program doesn't qualify for exemption under IRC Section 501(c)(7). Rev. Rul. 70-32, 1970-1 C.B. 132. **Note:** Rev. Rul. 70-32 hasn't been updated to reflect P.L. 94-568.

A country club that issues corporate membership is dealing with the general public in the form of the corporations' employees. Accordingly, treat corporate memberships as gross receipts from a nonmember source. However, bona fide individual memberships that a corporation paid for are indistinguishable from other individual memberships. See Rev. Rul. 74-489, 1974-2 C.B. 169. **Note:** Rev. Rul. 74-489 hasn't been updated for P.L. 94-568.

A social club doesn't jeopardize its exemption under IRC Section 501(c)(7) by admitting corporation sponsored individuals who have the same rights and privileges as regular individual members and who must seek a membership committee's approval. Rev. Rul. 74-168, 1974-1 C.B. 139. **Note:** Rev. Rul. 74-168 hasn't been updated for P.L. 94-568.

Identify any temporary memberships that allow nonmembers temporary access to member activities and privileges. These may be a guise around the membership rules.

### **Operational Requirements of a Social or Recreational Club**

Substantially all of a club's activities should be devoted to pleasure, recreation and other non-profitable purposes with members and their guests.

Before 1976, IRC Section 501(c)(7) required a tax-exempt club to be organized and operated “exclusively” for pleasure, recreation, and other non-profitable purposes. P.L. 94-568 amended IRC Section 501(c)(7) to require that “substantially all” of a tax-exempt club’s activities are dedicated for pleasure, recreation, and other non-profitable purposes. The amendment was intended to allow IRC Section 501(c)(7) organizations to receive up to 35 percent of their gross receipts, including investment income, from sources outside their membership without losing their exempt status. See S. Rep. No. 94-1318 (1976). Within the 35 percent, no more than 15 percent of gross receipts should come from the general public’s use of the social club's facilities or services. If an organization has outside income over the 35-percent or 15-percent limit, consider all the facts and circumstances to determine whether the organization qualifies for exempt status.

Rev. Proc. 71-17, 1971 C.B. 683, lists guidelines for determining the effect of gross receipts from nonmember use of a social club’s facilities on the club’s exemption. Rev. Proc. 71-17 describes the circumstances under which nonmembers who use a club's facilities are presumed to be guests of members, rather than the general public. The host-guest relationship is presumed as follows, if payment is received directly from the member or the member's employer:

- A group of eight or fewer individuals, and at least one of the group is a member.
- A group, at least 75 percent of which consists of members.

Clubs that rely on either of the host-guest assumptions described above are always required to keep adequate records to substantiate the appropriate facts.

For all other occasions involving use by nonmembers, Rev. Proc. 71-17 section 4.03 requires the club to maintain books and records of each use and the amount of income earned. This requirement applies even if the member pays initially for the use. For each use, the record must contain the following information:

- Date
- Total number in party
- Total number of nonmembers in party
- Total charges
- Charges attributable to nonmembers
- Charges paid by nonmembers
- Member signed statement and information for reimbursement
- Member signed statement and information on employer reimbursements to members for charges attributable to nonmembers

- Member signed statement and information on gratuitous reimbursements (or payments directly to the club) from nonmembers for the benefit of a member

**Caution:** Rev. Proc. 71-17 hasn't been updated for P.L. 94-568.

### **Auditing Operational Requirements of a Social or Recreational Club**

- Tour the facilities noting any signs placed on club property inviting the general public to patronize its facilities or functions. Also, note the presence or absence of signs restricting admittance to "members only."
- Review admittance procedures to determine if facilities are open to the general public. A club should have some system in place, such as key-cards or a membership log that restricts facilities' use to members and their guests.
- Review brochures, applications, policy statements and governing instruments to determine if membership requirements are broad or vaguely stated. Members must have a common objective. A club should have established membership criteria, which effectively precludes the general public at large from becoming a member in the organization. The criteria may include, for example, requiring an interest in a particular hobby or other recreational activity, or requiring the club's membership to select and approve new members.
- Review the minutes for discussions of proposed activities or restricted membership that may violate exempt purposes.
- Review the club's liquor license. Some states issue limited liquor licenses to social clubs, restricting liquor sales to club members and their guests.
- Review gaming license(s) noting any information that might indicate the games are open to the public. Generally, gambling engaged in by members and guests of a social club is considered a recreational activity for purposes of IRC Section 501(c)(7) regardless of the legality of the gaming activity. See Rev. Rul. 69-68, 1969-1 C.B. 153. **Note:** Rev. Rul. 69-68 hasn't been updated for P.L. 94-568.
- Review contracts with any taxable corporations. Review management contracts to identify any relationships the club may have with the manager or management company. Closely scrutinize agreements that state more than general administrative responsibilities. The club may be operated as a commercial venture if the management company establishes the dues or fees and is responsible for members' selection and expulsion.
- Analyze the initiation charges or dues to ensure the amount charged is not so low that it encourages the general public to use the facilities one time or transiently.
- Analyze disbursements for advertising to determine if the club solicits public patronage.
- Review advertisements in newspapers, business phone directories, and vacation guides and other publications printed by the chamber of commerce or visitors' bureau.

## Auditing Nonmember Income of a Social or Recreational Club

Determine the potential for nonmember income and set the audit scope in this area accordingly. (Nonmember income is taxable as unrelated business income. See “Unrelated Business Taxable Income (UBI) for Social and Recreational Clubs” below.)

**Example:** If the club uses key-cards to restrict entry to members only and all other facts indicate only members use the club, consider limiting the work in this area. Document your workpapers to adequately support your conclusion that the club doesn’t have nonmember income.

- Interview the club manager about the following:
  - Cash sales
  - Credit card sales
  - Availability of reservation book, banquet book, party function sheets, and other Rev. Proc. 71-17 records
  - Member sponsorship of parties
  - Dates and seasons when club is closed
  - Reciprocal use of the club
  - Sales of food and liquor for off-premise consumption
- Review income accounts that might include potential nonmember income. Common sources include:
  - Cash sales. Assume that cash sales come from nonmembers if they cannot be traced to members.
  - Credit card sales
  - Reciprocal use of club
  - Parties over eight individuals
  - Club functions
- Review club records to substantiate parties in which a host guest relationship is assumed. Determine whether it has met the Rev. Proc. 71-17 requirements for a presumed host-guest relationship.

The following examples shows two situations that presume the host-guest relationship.

**Example:** Mr. Y is a member of the X Country Club. Mr. Y hosts a small party at the club for himself and seven friends. They play a round of golf and then eat lunch in the main dining room. After lunch, Mr. Y signs his name and member number on a food/drink voucher (sometimes referred to as a chit). To document that the income from Mr. Y's party qualified as member income, the club must keep records showing that there were eight persons in the party, Mr. Y was a member in attendance, and Mr. Y paid the club for the total amount due. Most clubs simply keep the voucher, which shows the first two requirements. The member's monthly statement shows the billing and the cash receipts will show that Mr. Y paid the bill. As

long as Mr. Y pays the club directly, the club doesn't have to ask Mr. Y if his friends will reimburse him because we can assume a host-guest relationship. However, if there's evidence showing that Mr. Y's friends paid the club directly, then you'd consider the income nonmember income.

**Example:** The M Club holds a Memorial Day Party for its members. Members must make advance reservations and are billed for the number of persons in their party. Some members bring a guest to the party. The club should retain the vouchers for the day, which show all of the individuals attending. Or, the club can keep the reservation sheet, which shows the number of members and guests attending the party. As long as 75 percent or more of the persons attending the party are members and the club receives payment directly from the members, we assume a host-guest relationship. Again, as long as the members pay the club directly, the club doesn't need to ask if the guests reimbursed the member.

- Review the organization's records for groups where the host-guest relationship isn't assumed.

The following two examples show situations where a host-guest relationship is not assumed and the club must maintain adequate records to support the club's classification of a nonmember as a guest.

**Example:** Mr. Z, Vice President of Marketing, holds a business luncheon meeting at the X Club for the marketing department of his company. Mr. Z is a member of the X Club, but the other 25 persons in the group are not. At the end of the luncheon, Mr. Z signs his name and member number on the vouchers. The club manager also hands him an additional form to complete, which asks for all of the information in Rev. Proc. 71-17 section 4.03. Mr. Z completes the form and the club keeps the form with the other forms from the period. Upon audit, the EO Specialist verifies that the form is properly completed and that the meeting served a business, personal, or social purpose of the member.

**Example:** Mr. A and Ms. B decide to get married at the X Club. Mr. A is a member, but Ms. B is not. They invite 200 guests and plan to pay for the wedding themselves. After the wedding, Ms. B's parents present their gift to the newlyweds; they propose to pay for the wedding at that time. Mr. A signs the voucher and completes the form stating that his new in-laws paid the bill. This is an example of a gratuitous payment by a nonmember. As long as the club keeps a properly completed form, this event is considered member income because the Rev. Proc. 71-17 requirement under section 4.03-9 was met to establish a host-guest relationship.

- Reconstruct nonmember income for cases in which the club's classification is not correct. Inspect and analyze the reservation book(s), membership rosters, party function sheets, monthly member billings, and other club records to determine nonmember income.
- Consider whether a club is precluded from using the minimum gross receipts standard. Audit assumptions apply to cases under Rev. Proc. 71-17 section 4.04 when records are inadequate or unavailable.

- Calculate the percentage of gross receipts derived from the general public's use of social club facilities or services (total nonmember gross receipts divided by total gross receipts). Total gross receipts include charges, admissions, membership fees, membership dues, member assessments and investment income. It doesn't include unusual amounts of income, such as the sale of a clubhouse. See S. Rep. No. 94-1318 (1976).
- Calculate the percentage of gross receipts from investment income. Include set-aside income (see "Set Aside Income of a Social or Recreational Club," below) in this computation. See S. Rep. No. 94-1318 (1976).
- Apply a facts and circumstances test when a club exceeds the 15 or 35 percent limitations. Consider these factors in applying this test:
  - The actual percentage of nonmember receipts and/or investment income.
  - The frequency of nonmember use of club facilities.
  - The number of years exceeding the percentage.

**Note:** Generally, view a high percentage of nonmember income in one year more favorably than a pattern of consistently exceeding the limits. For example, a club's high percentage of nonmember receipts in three consecutive years is more likely to indicate that a nonexempt purpose exists than its receiving it in one out of three years.

### **Nontraditional Business Activities of a Social or Recreational Club**

Activities that do not further a social club's exempt purpose, even if conducted based on a membership, are referred to as nontraditional business activities. A social club is prohibited from conducting more than an insubstantial amount of nontraditional business activities. The prohibition applies equally to business with members and nonmembers.

To compute the gross receipts test, the Committee Reports that accompanied P.L. 94-568, 1976-2 C.B. 596, state that social clubs shouldn't receive, within the 15 or 35 percent allowances, any income from nontraditional business activities. S. Rep. No. 94-1318 (1976). When an organization's nontraditional income causes the organization to exceed the 15 or 35 percent allowances, consider whether the organization continues to substantially operate for IRC Section 501(c)(7) purposes.

An article on social clubs in the 1996 EO Continuing Professional Education (CPE) indicates that the IRS would consider nontraditional income to determine whether an organization has exceeded the overall limits on outside income. The article states that not considering it would allow organizations with nontraditional income to have a greater percentage of their total income from unrelated activities, contrary to Congress' intent.

Income from nontraditional business activities can be a source of unrelated business income (UBI). See "Unrelated Business Taxable Income for Social and Recreational Clubs" below.



## Auditing Nontraditional Business Activities of a Social or Recreational Club

- Tour the club's facilities noting any activities which might generate nontraditional income.
- Analyze the club's income to identify any revenue not generated from recreational, social or similar services.

Examples of nontraditional income may include:

- Sale of package liquor for consumption off social club premises
  - Long-term rental of rooms
  - Take out and catering activities for consumption off social club premises
  - Commuter use of parking facilities
  - Advertising income
  - Provision of personal services, such as the operation of a service station, or barber shop
- Determine the percentage of income the club received from nontraditional activities.
  - Determine the effect of nontraditional activities on the club's exempt status by considering the percentage of nontraditional income compared to its total activities, whether the percentage is rising and any other relevant factors. Court cases and IRS rulings haven't set a fixed standard to determine whether a club's nontraditional business activities are deemed insubstantial.

**Note:** The 1994 EO CPE textbook indicates that if the gross receipts from nontraditional activities is less than 5% of gross receipts from total activities, the club's nontraditional activities would normally be insubstantial and not affect exemption. If the gross receipts from nontraditional activities are increasing and more than 5% of gross receipts from all activities, then the organization's exemption may be affected. This suggestion derived from analyzing the following:

- *Santa Barbara Club v. Commissioner*, 68 T.C. 200 (1977) –social club that received more than 25% of gross receipts from selling liquor to members for consumption off premises, which amounted to 7% of all gross receipts, was not exempt.
- G.C.M. 39115 (July 21, 1983) as modified by G.C.M. 39412 – opined that, technically, any gross receipts from a nontraditional business would require revocation, but as a practical matter it may be administratively appropriate in some cases to allow insubstantial amounts of this type of income.
- TAM 9212002(Dec. 4, 1991) – social club that received 6.07% of its gross revenue (which had increased steadily from 4.28% over five years) from selling food to members for consumption off premises was not exempt.

## Inurement for Social and Recreational Clubs

A social club can't have any part of its net earnings inure to a shareholder or member.

During the initial interview, ask whether the club manager, a director, or an officer receives a percentage of gross or net profit.

Analyze distributions to identify any dividends or bonuses. IRS found that distributions of condemnation proceeds and fees paid to bring in new members didn't constitute inurement to members. See Rev. Rul. 65-64, 1965-1 C.B. 241 and Rev. Rul. 80-130, 1980-1 C.B. 117.

**Note:** Rev. Rul. 65-64 hasn't been updated for P.L. 94-568.

Review classes of membership to determine if nonvoting members pay disproportionately more for services or benefits. Pay particular attention to memberships with varied dues structures or clubs with voting and nonvoting classes having different fee schedules. Determine if there's a reasonable basis for the difference in dues and/or fees. See Rev. Rul. 70-48, 1970-1 C.B. 133.

Review fee schedules to determine whether any class of member is possibly favored.

## Revocation Considerations

If a membership organization's exempt status is revoked, IRC Section 277 states that nonexempt membership organizations can't offset losses from membership activities against income derived from investments or other nonmember sources. This ensures that nonexempt clubs don't receive more favorable tax treatment than those recognized as exempt.

Precedents describing organizations that failed to qualify for exemption under IRC Section 501(c)(7) include the following (**Note:** these rulings were not updated for P.L. 94-568):

CITATION	HOLDING
Rev. Rul. 70-48, 1970-1 C.B.133	A social club charging active members much lower dues and fees than associate members with identical rights and privileges in the club facilities isn't exempt under IRC Section 501(c)(7).
Rev. Rul. 70-32, 1970-1 C.B. 132	Flying club offering services to members but no organized social or recreational programs isn't exempt under IRC Section 501(c)(7).
Rev. Rul. 69-527, 1969-2 C.B.125	A social club formed to help members in business endeavors at weekly meetings

	isn't exempt under IRC Section 501(c)(7).
Rev. Rul. 69-220, 1969-1 C.B. 154	A social club that receives substantial rental income and uses that income to defray operating expenses and to improve and expand its facilities isn't exempt under IRC Section 501(c)(7).
<a href="#">Rev. Rul. 68-535, 1968-2 C.B. 219</a>	A social club with regular sales of liquor to members for consumption off-site isn't exempt under IRC Section 501(c)(7).
<a href="#">Rev. Rul. 66-149, 1966-1 C.B. 146</a>	A social club with substantial income from nonmember sources such as dividends and interest isn't exempt under IRC Section 501(c)(7).

Consider the impact of IRC Section 277 when you review converted Forms 1120 or calculate a revoked club's taxable income. Discuss the impact of IRC Section 277 with the club before securing an agreement for revocation. The club may incorrectly think being nonexempt would yield less tax liability when in fact, they will due to IRC Section 277.

### **Unrelated Business Taxable Income (UBI) for Social and Recreational Clubs**

IRC Section 512(a)(3)(A) defines unrelated business taxable income (UBI) for social clubs as gross income (excluding exempt function income), less certain deductions and computed with certain modifications described in that section.

IRC Section 512(a)(3)(A) generally defines exempt function income as gross income from dues, fees, charges, or similar amounts members of the organization pay. Exempt function income also includes income set aside for certain charitable purposes. See IRC Section 512(a)(3)(B) for more information.

A social club is generally taxed on income derived from the following sources:

- Nonmember use of facilities, including income from reciprocal use of the club
- Investment income, including royalty income
- Nontraditional business activities, including those with members
- Sales of property, other than sales described in IRC Section 512(a)(3)(D)
- Activities not in furtherance of its exempt purpose, including those with members

**Caution:** Investment income a club receives from a member for an exempt purpose, such as, interest on a delinquent accounts from charges for the member's use of the club's facilities or initiation fees paid in installments, is not UBI.

## Auditing Unrelated Business Income (UBI) of a Social or Recreational Club

- Audit the cash receipts journal and related supporting documents to determine the club income's size, extent, and nature and whether it's related to the organization's exempt purpose.
- Review the balance sheet assets to identify any that might produce investment income. Investment income not set aside is generally taxable.

**Caution:** Interest a social club receives on state issued obligations is not taxable. See Rev. Rul. 76-337, 1976-2 C.B. 177.

- Identify any income from nonmembers or the general public. Amounts a member or spouse paid for dependents are considered exempt function income. Also, amounts the member's employer or gratuitous donor paid for the member's benefit, typically would constitute exempt function income. See Rev. Proc. 71-17.
- Identify green fees paid for any golf rounds played by bona fide guests possibly included in the total green fees. Even though green fees are usually only paid by or for nonmembers, the entire amount is not necessarily nonmember income as the member may have paid some of the green fees for bona fide guests.
- Analyze how the club treats nonmembers as guests. Ensure they've properly treated them as guests and complied with the recordkeeping requirements of Rev. Proc. 71-17.
- Identify any income from nontraditional business activities. Usually, don't consider income from these activities exempt function income. This holds true even if the activity is conducted with members, for example, selling package liquor to members for off-premise use and selling advertising space in the organization's newsletter to members and nonmembers.
- Review comparative balance sheets and notes to financial statement to identify any sales of assets. IRC Section 512(a)(3)(D) permits non-recognition of gains from certain sales when proceeds are reinvested in property used exclusively for exempt IRC Section 501(c)(7) purposes. See [IRM 7.27.7.4, Gain on Sale of Assets](#). When they must recognize gain, however, it's treated as UBI. See *Tamarisk Country Club v. Commissioner*, 84 T.C. 756 (1985).
- Determine whether the taxpayer and another social club merged and whether any excess assets have been sold or whether the social club has sold its assets and ceased operations. In the latter case, in addition to determining whether the club has UBI from the sale of its assets and real property, review whether the club has made distributions to members. If so, determine whether the organization issued Forms 1099 to the members because these distributions may create taxable income under IRC Section 301.

- Ensure all UBI is properly reported on Form 990-T and on Form 990. If there are indications that the organization sold property, check the returns to make sure the organization has notified the IRS of the sale. Review Schedule D and Form 4797 and any other attachments that show the amount of gain they should recognize. Verify that the organization has properly determined the property's adjusted basis, including adjusting the basis by depreciation for all earlier tax years, in computing its gain.

### Set-aside Income of a Social or Recreational Club

A social club can set aside its investment income to be used for religious, charitable, scientific, literary, educational and other purposes specified in IRC Section 170(c)(4). IRC Section 512(a)(3)(B). If the investment income is properly set aside, it's not subject to the tax on UBI but would appear on [Form 990](#) and Form 990-T. See IRM 7.27.7.2.2.2., Set-Asides.

**Example:** Refer to *Phi Delta Theta Fraternity v. Commissioner*, 90 T.C. 1033 (1988).

### Auditing Set-aside Income of a Social or Recreational Club

- Review the club's board of directors resolution, describing the income set aside. Make sure the funds are used for an IRC Section 170(c)(4) purpose.
- Ensure income is set aside timely. To be excluded, income must be set aside during the year deemed taxable or if the organization elects, set aside on or before the Form 990-T filing due date including extensions.
- Identify any amounts set aside that are later used for a non- IRC Section 170(c)(4) purpose. The amount diverted is includible in UBI for the year of diversion.
- Analyze the sources of income set aside and ensure the income is eligible to be set aside. Examples of eligible income include dividends, interest, capital gains, royalties, rents from real property, and income from a volunteer or irregular activity.

**Note:** Social clubs may set aside income that would otherwise be taxable under section 512(a)(3). Income from an unrelated trade or business regularly carried on is computed under IRC Section 512(a)(1) and can't be set aside. IRC Section 512(a)(3)(B).

### Computation of Unrelated Taxable Business Income

Unrelated business taxable income (UBI) consists of gross UBI less those deductions allowed by IRC Chapter 1 that are directly connected with the carrying on of that trade or business, subject to certain modifications described in IRC Section 512(b). IRC Section 512(a)(1). To be "directly connected with" the conduct of an unrelated business for IRC Section 512, an item of deduction must have a proximate and primary relationship to the carrying on of that business. See Treas. Reg. 1.512(a)-1(a).

Expenses deductible from gross UBI fall into two general categories:

- Direct expenses are expenses attributable solely to the unrelated business activities. See Treas. Reg. 1.512(a)-1(b).
- Allocable expenses are expenses attributable to both exempt function and unrelated business activities, expenses used for both exempt function and unrelated business activities. See Treas. Reg. 1.512(a)-1(c).

Deductions commonly used by social clubs include:

Code Section	Title	Expense Description
162	Trade or Business Expenses	1) Food & beverage department salaries expense. Golf department salaries expense, administrative expenses. 2) Social club expenses incurred to earn investment income. 3) Utilities expense
162 & 471	General Rule for Inventories	The cost of food and beverages sold.
167	Depreciation	The wear and tear on the facility space and equipment used in the food and beverage activities for nonmembers
168	Accelerated Cost Recovery System	The wear and tear on the facility space and equipment used in the food and beverage activities for nonmembers.
164	Taxes	Any state or local income taxes paid or accrued.

An organization can't use losses on unrelated business activities lacking a profit motive to reduce taxable unrelated business income from investments. See *Portland Golf Club v. Commissioner*, 497 U.S. 154, 171 (1990); see also Rev. Rul. 81-69, 1981-1 C.B. 351.

In order to prove intent to profit in the activity, the taxpayer must establish that in each year in issue it intended to earn net income from its activity. *Atlanta Athletic Club v. Commissioner*, 61 T.C.M. (CCH) 2011 (1991), rev'd on other grounds, 980 F.2d 1409 (11th Cir. 1993); see *Portland Golf Club*, 497 U.S. at 166.

**Note:** Net income is determined by subtracting that activity's direct and indirect costs from the that activity's gross receipts, allocating indirect expenses using the gross-to-gross method. *Atlanta Athletic Club*, 61 T.C.M.

In *Atlanta Athletic Club v. Commissioner*, a taxpayer lacking a profit motive for six tax years (taxpayer incurred losses for five out of the 6 years) wasn't permitted to offset its sales to non-members net losses against its investment income. See 61 T.C.M.

Note: When organizations have sold assets/real property and reported net capital gain, review the Form 990-T returns to determine whether it has attempted to offset that net capital gain with net operating loss carry forwards or carrybacks from nonmember sales activities which incurred pre- or post sale losses. These NOLs aren't allowed to offset net capital gain or other investment income in the absence of a profit motive.

A club can use any method to allocate expenses possessing a proximate and primary relationship to the UBI they are allocated against, if the allocation method is reasonable. See Treas. Reg. 1.512(a)-1(c). By definition, the "reasonableness standard" indicates that more than one method of allocation was deemed reasonable. So, a reasonable method of allocating expenses must be allowed even though it's not necessarily the best method.

The IRS has generally classified expenses in three categories as follows:

Direct	Expenses which increase in direct proportion to the volume of the activity and not incurred otherwise, such as, cost of goods sold, or expenses incurred for specific events, for example, payments for extra labor, perishable decorations and entertainment for a specific event. Direct expenses incurred for specific events are deductible in full from the event receipts and therefore, no need for allocation.
Variable	Expenses that vary in proportion to the actual use of the facility but can't be identified with a particular activity, such as, salaries, utilities, maintenance, cleaning, uniforms, laundry, telephone, postage, printing, and professional fees.
Fixed	Expenses that don't vary in proportion to the actual use of the facility, such as, depreciation, interest, real estate taxes, property insurance, and permits.

**Caution:** In some cases, the IRS and the courts have used different terms to identify the categories of expenses. Therefore, pay close attention to how your particular case uses these terms. For example, sometimes overhead expenses (sometimes referred to as variable expenses) and fixed expenses are simply lumped together as "fixed expenses"; other times, they've been referred to as indirect expenses. Sometimes, the term "variable" is used to refer to expenses, which are actually direct expenses.

One method of allocation frequently used is allocating all three expense categories based on gross receipts, commonly referred to as the "Gross Receipts Allocation Method." This method is generally not considered reasonable to allocate variable or fixed expenses when members and nonmembers pay different amounts. For example, the "Gross Receipts Allocation Method" isn't reasonable for the allocation of expenses if:

- The fees for using the facility are included in the members' dues.

**Example:** Only nonmembers or guests typically pay green fees. An allocation of expenses based on the ratio that nonmember green fees bears to total green fees wouldn't yield a reasonable approximation of nonmember expenses, since the calculation does not include members' dues, also used to operate the golf course. A more appropriate allocation method may be to allocate the expenses based on the ratio of the number of nonmember rounds of golf played to the total number of rounds of golf played.

- Nonmembers are charged more than members.

**Example:** An equal number of members and nonmembers are served the same meal in a club's dining room. Members pay \$15 and nonmembers pay \$20.

- Nonmembers are charged additional fees not charged to members.

IRS published a "reasonable" method of allocation in 1975 in [Form 990](#), Package 990 Supplement supplemental instructions (IRC Section 501(c)(7)). The hypothetical organization in the Package 990 Supplement had the title "The Big Divot Country Club, Inc." This allocation method became commonly known as "The Big Divot Allocation Method."

To use the "Big Divot Allocation Method," allocate the expenses as follows:

- **Direct:** Allocate cost of goods sold based on the ratio of nonmember sales to total sales.
- **Variable:** Allocate variable expenses based on the ratio of estimated hours of nonmember use during the year to total facility use hours for the year.
- **Fixed:** Allocate fixed expenses based on the ratio of the estimated hours of nonmember use during the year to total hours in the year.

To summarize this "reasonable" method of allocation:

Type of Expense	Big Divot Allocation Method	Description
Direct	$CGS = \frac{\text{Nonmember Sales}}{\text{Total Sales}}$	
Variable	$\frac{\text{Estimated Hours of Nonmember Usage}}{\text{Total Hours Facility Actually Used}}$	Allocate salaries based on the time devoted to each activity. Allocate occupancy costs based on the portion of space devoted to each activity. Cf. Treas. Reg. 1.512(a)-1(f)(6)(i) (addresses deductions attributable to exempt organization periodicals).
Fixed	$\frac{\text{Estimated Hours of Nonmember Usage}}{\text{Total Hours in the Year}}$	Allocate depreciation based on space occupied and the portion of the particular



		asset used in each activity. Cf. Treas. Reg. 1.512(a)-1(f)(6)(i) (addresses deductions attributable to exempt organization periodicals).
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In *Rensselaer Polytechnic Institute v. Commissioner*, the court held for the taxpayer stating that an allocation of fixed expenses based on the time of actual use is “reasonable” per Treas. Reg. 1.512(a)-1(c). 732 F.2d 1058 (2d Cir. 1984).

In *Portland Golf Club V. Commissioner*, the court held that losses incurred as a result of taxpayer’s sales to nonmembers could be offset against investment income only if nonmember sales were undertaken with intent to profit, and that taxpayer was required to use same method of allocating fixed expenses, in determining whether nonmember sales activity was undertaken with intent to earn profit, that it used to calculate its actual loss from these sales. 497 U.S. at 171.

**Caution:** As noted in the Action on Decision on Rensselaer, AOD 1987-014 (June 18, 1987), the IRS continues to take the position that under the circumstances described in Rensselaer where the dual use of the facility was near maximum use, we won’t allocate fixed expenses based on actual usage. In IRS’s view, an allocation based on the total available time is the method of allocating fixed expenses that meets the “reasonableness” standard of Treas. Reg. 1.512(a)-1(c). The AOD also states that we shouldn’t litigate this issue until the “reasonableness” test of Treas. Reg. 1.512(a)-1(c) is amended.

### **Auditing expenses allocated to nonmember income**

- Determine whether the expenses allocated to nonmember income have a proximate and primary relationship to the activity that produces the nonmember income.

**Example:** A club receives nonmember income from its restaurant and bar. The club manager’s salary is \$30,000 per year. The club manager devotes approximately 35 percent of his time to the restaurant and bar’s operation. Only \$10,500 (35 percent of 30,000) of his salary has a proximate and primary relationship to the restaurant and bar and is included in the total restaurant and bar expenses allocated between member and nonmember expenses.

**Example:** A club receives nonmember income from its golf course. The club’s total interest expense is \$40,000. Of the \$40,000 interest expense, \$30,000 is attributable to a loan to build a new swimming pool, \$5,000 for a loan to purchase golf carts and \$5,000 for a loan to repair the tennis courts. Only \$5,000, the interest expense attributable to the purchase of golf carts has a proximate and primary relationship to the operation of the golf course and normally includable in the golf course expenses, allocated between member and nonmember income.

- Review the method used to allocate expenses to member and nonmember income to determine reasonableness and accuracy.

**Note:** Be especially alert to expense allocations based in whole or in part, on the “Gross Receipts Allocation Method.”

- Review allocation of advertising expenses. The Tax Court held that Treas. Reg. 1.512(a)-1(f) applies to organizations described in IRC Section 501(c)(7). See *Chicago Metropolitan Ski Council v. Commissioner*, 104 T.C. 341 (1995). If the organization has deducted editorial expenses, determine the IRS's current position in this area.

### **Employment Tax Issues of a Social or Recreational Club**

See [IRM 4.23.3, Classification, Selection, and Assignment of Employment Tax Cases](#) for guidance on employment tax issues.

Use command code IRPTRR with destination code R, retrieve, Forms W-2, Wage and Tax Statement, 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons and Form 1099 electronically. Send a request to the designated Exam Program and Planning Specialist to receive the files.

Use the Information Report Analysis System (IRAS) to analyze the data. Generate report, noting issues that you need to further develop during the field phase of the audit.

Plan the employment tax audit with the social club audit. Generally, request Forms 940, 941, and W-2 at the same time. During your pre-audit analysis, look at the organization’s web sites and links to determine awards and prizes awarded, and to identify key staff members needed to run the club.

Refer to IRM 4.23 for employment tax procedures and the list below for items specific to a social club employment tax audit:

- Commissions or bonuses disbursed - Example: The check register records payments in December for holiday bonuses.
- Employee benefits handbook
- Prizes and awards
- Advances or loans
- Use of organization owned vehicles
- Expenses of family members attending company sponsored meetings and events
- Tips and gratuities
- Assets sold to employees at a discount; If so, request details
- Employment status of staff professionals including the golf and tennis pro(s), the restaurant manager(s), the harbor master, etc., received treatment as employees or independent contractors
- Copies of all 1099's issued to individuals. Ask the organization to write on each form a description of the service provided.

## Exceptions to Employment Tax Encountered in Social or Recreational Clubs

IRC Sections 3121(b)(2), 3306(c)(2), 3306(a)(3), and 3401(a)(3) provide an exception from the definition of employment or employer for FICA, FUTA and income tax withholding purposes for certain domestic service in local college clubs or local chapters of a college fraternity or sorority.

The FICA exception extends to students enrolled and regularly attending classes at a school, college or university. The FUTA exception covers excepted service, but only if the club pays cash to all individuals employed in that service less than \$1,000 in any calendar quarter during the current or preceding calendar year.

The regulations state that excepted services are those “of a household nature in or about the club rooms or house” and include services rendered by “cooks, waiters, butlers, maids, janitors, laundresses, furnace men, handymen, gardeners, housekeepers, and housemothers.” Treas. Reg. 31.3121(b)(2)-1(b) (FICA); Treas. Reg. 31.3306(c)(2)-1(b)(2) (FUTA); and Treas. Reg. 31.3401(a)(3)-1(b)(2) (Income Tax Withholding).

See also Rev. Rul. 72-174, 1972-1 C.B. 315 where the IRS held that services performed by students in a women's club, weren't excepted because the women's club didn't constitute a “local college club” under the Code because too many members weren't associated with the college. Also, see Rev. Rul. 68-448, 1968-2 C.B. 481, which held that payments to a sorority "housemother" for services performed during a university's summer term when the house was primarily used to accommodate nonmembers weren't excepted.

### Tip income treatment

Social clubs that employ waiters, waitresses, or any other employees receiving tips as part of their compensation are generally subject to certain withholding and reporting requirements.

See IRM 4.23.7, Employment Tax on Tip Income for additional information on the proper reporting and withholding of tip income.

Interview the club manager and determine if they pay any compensation, particularly casual labor, in cash, and whether any workers receive tips.

Review service contracts to identify any potential misclassifications of workers as independent contractors. Identify any workers meeting the service-based exceptions described above.

### Exhibit 1 – Computation of Net Profit on Nonmember Income

#### Facts

Total Number of Days in the Year .....	365
Number of Days the Restaurant & Bar (R&B) Are In Use.....	300
Average Number of Hours the R&B Are Open Daily .....	14
Number of Days of Nonmember Use of the R&B .....	25
R&B Sales to Nonmembers on the 25 Days .....	\$25,000

Total R&B Sales on the 25 Days .....	\$100,000
Total R&B Sales for the Year.....	\$250,000
R&B Cost of Goods Sold .....	\$100,000
R&B Nonmember Direct Expenses.....	\$1,000
R&B Variable Expenses .....	\$95,000
R&B Fixed Expenses .....	\$70,000

The expenses shown above have a proximate and primary relationship to the operation of the restaurant and bar. Salaries, depreciation, interest, etc. attributable to the club's recreational facilities aren't included.

All receipts from the purchase of food and beverages in the club's restaurant and bar are included in restaurant and bar receipts.

The receipts from the restaurant and bar don't include member assessments for a "minimum" amount of purchases in the restaurant and bar unless the member actually used the minimum for restaurant and bar purchases.

Members and nonmembers are charged the same amount for bar and restaurant purchases. Nonmembers aren't charged additional fees for using the bar and restaurant.

"R&B Nonmember Direct Expenses" are payments for special entertainment at nonmember parties. These expenses aren't related to member receipts.

*Method 1: Compute Net Profit on Nonmember Income Using the Gross Receipts Allocation Method*

*Step 1*

Determine the ratio of nonmember sales to total sales by dividing the nonmember sales by the total sales (Nonmember Sales / Total Sales = Gross Receipts Percent)

Nonmember sales	Total Sales	Gross Receipts Percent
\$25,000	\$250,000	10%

Step 2

Compute the net profit or (loss) by applying the gross receipts percentage to the allocable expenses.

Description	Total	Allocation Percent	Nonmember
R&B Sales to Nonmembers	\$25,000	N/A	\$25,000
R&B Cost of Goods Sold	\$100,000	10.00%	(\$10,000)
R&B Nonmember Direct Expenses	\$1,000	N/A	(\$1,000)
R&B Variable Expense	\$95,000	10.00%	(\$9,500)
R&B Fixed Expenses	\$70,000	10.00%	(\$7,000)
Net Loss on R&B Sales to Nonmembers			(\$2,500)

*Method 2: Compute Net Profit on Nonmember Income Using the Actual Usage Allocation*

Step 1

Determine the hours the restaurant and bar are open on the days when nonmember use occurred by multiplying the number of days of nonmember use by the number of hours the restaurant and bar are open daily.

Days of Nonmember Use	X	Hours R & B are Open Daily	=	Hours of Use on Days of Nonmember Use
25		14		350

Step 2

Determine the hours of nonmember use. If the actual hours of nonmember use are not available, use an estimate. One estimating method is shown below in Step 3.

Step 3

Usually, both members and nonmembers use the restaurant and bar on days of nonmember use. The time that members and nonmembers use the restaurant and bar is generally reflected by the volume of sales during the same time period. Therefore, you can estimate the hours of nonmember as follows:

Nonmember Receipts	÷	Total Receipts on Days of Nonmember Use	=	Percent of Nonmember Use
\$25,000		\$100,000		25%

Determine the estimated hours of nonmember use by multiplying the hours the restaurant and bar were open on days of nonmember use by percent of nonmember use based on the ratio of nonmember receipts to total receipts on days of nonmember use.

Hours R & B Were Open On Nonmember Use Days	X	Percentage of Non-member Use	=	Estimated Hours of Nonmember Use
350		25%		87.5

Step 4

Determine the total hours the restaurant and bar are open during the year by multiplying the number of days the restaurant and bar are open by the number of hours the restaurant and bar are open daily.

Total Days R&B Was Open	X	Hours R&B Was Open Daily	=	Total Hours Open During the Year
300		14		4,200

Step 5

Determine the percent of the variable and fixed expenses attributable to nonmember use by dividing the hours of nonmember use by the total hours the restaurant and bar are open during the year.

Hours of Non-member Use	X	Hours R&B Was Open During the Year	=	% of Expenses Attributable to Nonmember Use
87.5		4,200		2.08%

Step 6

Compute the net profit or (loss) by applying the applicable percent to the allocable expenses.

Description	Total	Allocation Percent	Nonmember
R&B Sales to Nonmembers	\$25,000	N/A	\$25,000
R&B Cost of Goods Sold	\$100,000	10.00%	(\$10,000)
R&B Nonmember Direct Expenses	\$1,000	N/A	(\$1,000)
R&B Variable Expense	\$95,000	2.08%	(\$1,976)
R&B Fixed Expenses	\$70,000	2.08%	(\$1,456)
Net Profit on R&B Sales to Nonmembers			\$10,565

*Method 3: Compute Net Profit on Nonmember Income Using "Big Divot" Allocation*

Step 1

Estimated hours of nonmember use: 87.5 hours  
(Computed as shown in Method 2 Steps 1 through 3)

Step 2

Percent of variable expenses directly related to nonmember use: 2.08%  
(Computed as shown in Method 2 Steps 1 through 5)

Step 3

Compute the total hours the facility was available for use as follows:

Days in the Year	X	Hours Per Day	=	Total Hours During the Year
365		24		8,760

Step 4

Determine the percent of fixed expenses attributable to nonmember use by dividing the hours of nonmember use by the total hours in the year.

Hours of Non-member Use	÷	Total Hours During the Year	=	% of Fixed Expenses Attributable to Nonmember Use
87.5		8,760		~1.00%

Step 5

Compute the net profit or (loss) by applying the applicable percent to the allocable expenses.

Description	Total	Allocation Percent	Nonmember
R & B Sales to Nonmembers	\$25,000	N/A	\$25,000
R&B Cost of Goods Sold	\$100,000	10%	(10,000)
R&B Nonmember Direct Expenses	\$1,000	N/A	(\$1,000)
R&B Variable Expense	\$95,000	2.08%	\$(1,979)
R&B Fixed Expenses	\$70,000	1.00%	(\$700)
Net Profit on R&B Sales to Nonmembers			\$11,321