

August 21, 2013



501(c)(7) SOCIAL CLUBS

What social clubs need to know to qualify for and maintain tax-exempt status



What are social clubs?

- Clubs organized for pleasure, recreation, or other similar nonprofit purposes
- Typical examples are country clubs; college fraternities; dinner clubs; hobby clubs; and, amateur hunting, fishing, swimming and other sport clubs



Benefits of tax-exempt status

- The organization is not taxed on the income from its exempt function of providing recreational and social facilities and services to its members (e.g., member dues, fees, charges)



Limits of tax-exempt benefits

- Investment and other non-exempt function income is taxed
- Members' dues payments are not deductible as business expenses



Rationale for granting social clubs tax exemption

- Prevent “double taxation”
- Members who pool their funds for recreational and social purposes should not be worse off than those who obtain recreational and social benefits on an individual basis



Requirements for a social club to obtain and maintain exemption

- Club
- Organized for recreational, pleasure, or similar purposes
- “Substantially all” of its activities further its exempt purposes
- No inurement
- No written policy which discriminates against individuals seeking membership on the basis of race, color, or religion



What is a club?

- Members (generally, individuals)
- Shared interests
- Commingling (face-to-face meetings, gatherings, etc.)
- Not a business open to public



What are recreational, pleasure, or similar purposes?

- Must not be organized for business purposes or for providing commercial services to members (e.g., an automobile club; provision of death benefits)
- Organization's governing instrument must be amended if it provides power to provide prohibited services/benefits



When do substantially all our activities further exempt purposes?

- Substantially all of income must be from members for traditional recreational/social services or facilities
 - Allows for some nonmember income
 - 35/15 Test: May receive as much as 35% of its gross receipts from nonmember sources (including investment income) and, within that 35%, up to 15% of gross receipts can be from nonmember use of club's facilities or services
 - Facts and circumstances test if not within the 35/15 Test
- Club may have no more than a de minimis amount of income from nontraditional activities
- GCM 39115 provides a good discussion and examples of traditional vs. nontraditional activities



The 35/15 Test: Example 1

- Country club with \$100,000 in gross receipts, including \$14,000 from nonmember use of dining room and \$21,000 from investment income. Remaining gross receipts are from members for recreational activities.
- Satisfies the test: no more than 35% of income from nonmember sources (\$14k + \$21k); no more than 15% from nonmember use of facilities (\$14k)



The 35/15 Test: Example 2

- Country club with \$100,000 in gross receipts, including \$16,000 from nonmember use of dining room and \$19,000 from investment income. Remaining gross receipts are from members for recreational activities.
- Does not satisfy the test b/c it fails the 15% prong: no more than 35% of income from nonmember sources (\$16k + \$19k); BUT, MORE THAN 15% from nonmember use of facilities (\$16k).



When do substantially all our activities further exempt purposes? (cont.) – Family & Guests

- A member's spouse and dependents are treated as members
- Charges paid by a member (or member's employer) to entertain guests are treated as membership income
- IRS assumptions and recordkeeping requirements apply in determining when income is from a guest (Rev. Proc. 71-17, 1971-1 C.B. 683)
- Visiting members of another social club are not guests (i.e., reciprocity agreements create nonmember income)



Rev. Proc. 71-17

IF:	THEN:
Group of 8 or less with at least 1 member	The nonmembers are guests provided the member or member's employer pays.
Group of any size, 75% of whom are members	The nonmembers are guests provided the member or member's employer pays.
Other cases	The club must maintain books and records of each use and amount of income even if member pays.



What is inurement?

- Net earnings cannot inure to the benefit of any private shareholder
- Prohibition applicable to ‘insiders’, including members
- Inurement includes: overt distributions like dividends; unreasonable salaries to officers; differing member dues rates not supported by reasonable basis
- Inurement does not include: reasonable compensation; liquidating distributions to members on sale of club assets; prizes for winning club recreational events



Avoiding discriminatory written policies

- No written policy which discriminates against individuals seeking membership on the basis of race, color, or religion
- No requirement for an affirmative statement of non-discrimination and no requirement to have a specific, or any, percentage of members from a particular group
- Two exceptions: A social club can limit its membership to a particular religion if (1) it is an auxiliary of a 501(c)(8) fraternal beneficiary society; or (2) the limitation is a good faith attempt to further the teachings or principles of that religion and isn't intended to exclude individuals of a particular race or color



Taxation of 501(c)(7) social clubs

- (c)(7)'s are not taxed on their exempt function income, but in general, all other income is taxed (UBTI)
- Different approach than for most EO's, which are not taxed on any income except (1) income from unrelated trades or businesses regularly carried on and (2) debt-financed investment and capital gain income
- So, unlike other EO's, (c)(7)'s are taxed on most of their investment (passive) income



Exempt function income

- Gross income from dues, fees, charges, or similar amounts paid by members for the traditional social goods, facilities, or services the club provides to the members and their family and guests



Unrelated business taxable income

- Gross income (excluding exempt function income), less the deductions directly connected with the production of the gross income
- This includes: ‘nontraditional’ activities income; ‘traditional’ activities income from nonmembers; passive/investment income



UBTI exceptions

- Investment income set asides
- If a club sells property used directly in the performance of its exempt function and with the proceeds purchases, within a period of one year before the sale and three years after the sale, other property that is used by the club directly in the performance of its exempt function, the gain (if any) is recognized and taxable as UBTI only to the extent the sales price of the old property exceeds the cost of the new property



UBTI exception: Example 1

- Club sells its clubhouse in 2012 for \$1 million, realizing a \$500,000 gain.
- Club purchase a new clubhouse in 2013 for \$1.2 million.
- Entire gain falls within the UBTI exception.



UBTI exception: Example 2

- Club sells its clubhouse in 2012 for \$1 million, realizing a gain of \$500,000.
- Club purchase a new clubhouse in 2013 for \$800,000.
- Gain is recognized to the extent the sales price exceeds the purchase price (\$200,000 UBTI; \$300,000 exclusion)



Obtaining recognition of exempt status

- A club files a Form 1024, including Schedule D, to obtain recognition from the IRS of its tax-exempt status
- A club that meets the requirements of exempt status can operate without recognition of its exempt status, but has no assurance the IRS agrees that the club is exempt



Filing requirements

- A social club files the appropriate Form 990 series return (990, 990-EZ, 990-N) each year
- A social club's exemption will be automatically revoked if it fails to file its required Form 990 for three consecutive years
- A social club must file Form 990-T (including Schedule G for investment income) for years in which it has \$1,000 or more in gross unrelated taxable income



Questions?

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Additional information

- <http://www.irs.gov/Charities-&-Non-Profits>
- <http://www.irs.gov/Charities-&-Non-Profits/Other-Non-Profits/Social-Clubs>
- 1-877-829-5500
- Rev. Proc. 71-17 (guests and recordkeeping)
- General Counsel Memo (GCM) 39115 (traditional vs. nontraditional activities)
- Notice 2011-44 (automatic revocation and reinstatement)



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