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

by
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1. Introduction

Social clubs are exempt from federal income tax under IRC 501(a) as organizations described in IRC 501(c)(7) if they are "organized for pleasure, recreation, and other nonprofitable purposes." They were originally granted exemption from federal income tax in the Revenue Act of 1916. Generally, social clubs are membership organizations primarily supported by dues, fees, charges or other funds paid by their members.

The central purpose of social clubs is to provide benefits to members, including access to social and recreational facilities such as club houses, golf courses, and swimming pools. When such benefits are funded by members, exemption has been justified by Congress on the theory that the members will be in the same position as if they had paid for the benefits directly. The practical effect of the exemption is to allow individuals to join together to provide themselves with recreational or social opportunities on a mutual basis without further tax consequences. The individual member is in substantially the same position as if he or she had spent his or her after-tax income on pleasure or recreation without the intervening organization.

Consequently, the exemption for social clubs operates properly only if the club's income is derived exclusively from members. For many years, however, income derived by clubs from outside of their membership (e.g., investment income), operated to subsidize the recreational facilities or activities for the members with revenue that was taxed neither to the members nor to the club. To prevent club members from receiving benefits not contemplated by IRC 501(c)(7), Congress extended the unrelated business income tax to social clubs in the 1969 Tax Reform Act. In doing so, however, Congress decided that, unlike most other types of exempt organizations, which were exempted because they provide some sort of community service or public benefit, clubs should be taxed on all income derived from outside their membership, including investment income. Special rules were provided for nonrecognition of gain from certain sales of club property when the proceeds are reinvested by the club for exempt purposes.

The enactment of IRC 512(a)(3) in 1969 created an almost unique status for

social clubs in that they alone among exempt organizations are taxed on passive income (dividends, rents, and interest). (Although the terms of IRC 512(a)(3) also apply to organizations described in paragraphs (9), (17) and (20) of IRC 501(c), the nature of these organizations, plus special rules in IRC 512(a)(3) relating to set-asides for charitable and similar purposes, virtually negate the tax theoretically imposed on them by IRC 512(a)(3).)

Congress amended IRC 501(c)(7) in 1976 to liberalize prior Service limitations on the portion of income social clubs could receive from nonmember use of their facilities and from investment income without jeopardizing their exempt status. The legislation changed the statutory test for exemption from an exclusivity test ("...operated exclusively for [exempt purposes]...") to a substantiality test ("...substantially all the activities of which are for [exempt purposes]..."). The legislative history of the amendment indicates that Congress did not intend to modify the longstanding Service position that exempt social clubs could not retain exempt status if they received even insubstantial amounts of income from activities not traditionally carried on by clubs in furtherance of their exempt purposes. Regulations to accompany this enactment have never been issued.

The purpose of this article is to supplement and update previous CPE articles (particularly the 1992 text at p. 113, and the 1993 text at page 73) concerning social clubs described in IRC 501(c)(7). Section 2 will re-visit the concepts of "traditional" and "nontraditional" activities with respect to social clubs and the effect the distinction may have on the exempt status of a club. Sections 3 and 4 will examine specific issues regarding timber and advertising sales of social clubs. Section 5 will discuss the nondiscrimination requirement applicable to social clubs under IRC 501(i).

2. Traditional vs. Nontraditional Activities

G.C.M. 39115 (January 12, 1984), as modified by G.C.M. 39412 (September 19, 1985), discusses a social club that conducted some permitted traditional business activities as well as prohibited nontraditional business activities. The principles set forth in G.C.M. 39115 and the current Service position with respect to nontraditional business activities of social clubs may be illustrated by the following hypothetical:

FACTS

Situation 1: Club A was organized 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 typical gas station prices. The lobby of the building contains a number of stores including a barber shop, flower shop, and liquor store. Access to all club facilities is restricted to members and their guests. Income from each of the gas station, liquor store, flower shop, barber shop, long term room rental, and commuter use of the parking facilities constitutes a substantial part of Club A's gross receipts for the taxable year.

Situation 2: Club B was also organized for social and recreational purposes. It operates a restaurant and bar, golf course, swimming pool, and tennis courts. In addition, it provides a take-out service which furnishes food and beverages to members for personal consumption away from the club facility, and a catering service for special events as requested by members. Access to all club facilities is restricted to members and their guests. Income from the takeout and catering services combined constitutes less than five percent of B's gross receipts for the taxable year.

LAW AND ANALYSIS

IRC 501(c)(7) (prior to its amendment in 1976 by P. L. 94-568, 1976-2 C.B. 596) provided for exemption from federal income tax of social clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder.

P. L. 91-172, 1969-3 C.B. 10, amended IRC 511 in 1969 to extend the unrelated business income tax provisions to all exempt organizations, including social clubs described in section 501(c)(7). It also added IRC 512(a)(3). IRC 512(a)(3)(A), in relevant part, provides that for certain organizations, including those described in IRC 501(c)(7), the term "unrelated business taxable income" means, in part, the gross income (excluding any exempt function income), less the allowable deductions directly connected with the production of the gross income (excluding exempt function income). IRC 512(a)(3)(B) provides that, for purposes of IRC 512(a)(3)(A), the term "exempt function income" means the gross income from dues, fees, charges, or other similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

P. L. 94-568 amended IRC 501(c)(7) to provide for exemption from federal income tax of clubs 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.

Reg. 1.501(c)(7)-1(b) (which interprets the pre-1976 statute) provides, in part, that a club which engages in business, such as by making its social and recreational facilities available to the general public or by selling real estate, timber, or other products is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under IRC 501(a).

Rev. Rul. 58-589, 1958-2 C.B. 266 (which interprets the pre-1976 statute and accompanying regulations), sets forth criteria for qualification under IRC 501(c)(7) of the Code. It provides, in part, that a social club will not qualify for exemption if it engages in business activity for profit. However, where a club engages in income producing transactions which are not part of the club purposes, exemption will not be denied because of incidental, trivial, or nonrecurrent activities, such as sales of property no longer adapted to club purposes.

Rev. Rul. 66-149, 1966-1 C.B. 146, holds a social club not exempt as an organization described in IRC 501(c)(7) where it regularly derives a substantial part of its income from nonmember sources such as, for example, dividends and interest on investments it owns.

Rev. Proc. 71-17, 1971-1 C.B. 683 (which has not been updated to reflect the 1976 enactment), sets forth guidelines for determining the effect of gross

receipts derived from nonmember use of a social club's facilities on exemption under IRC 501(c)(7). Section 3.01 of the guidelines provides that if annual gross receipts from the use of club facilities by the general public are $2,500 or less or, if more than $2,500, gross receipts from the general public for such use is five percent or less of total gross receipts, then, as an audit standard, the Service will not rely upon this as a factor reflecting the existence of a nonexempt purpose. Where nonmember income from the use of the club facilities exceeds this standard, a conclusion that there is a nonexempt purpose will be based upon all the facts and circumstances, including but not limited to the gross receipts factor. Section 3.02 of the guidelines defines "total gross receipts" as receipts from "normal and usual activities of the club including charges, admissions, membership fees, dues, and assessments." Excluded are initiation fees and capital contributions; interest, dividends, rents, and similar receipts; and unusual amounts of income such as amounts derived from nonrecurring sales of club assets.

The legislative history of the 1976 amendment indicates that Congress intended to clarify then-existing limitations on the amount of income a social club could receive from investment income and from nonmember use of its facilities. Congressional intent 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. 94-1318, 94th Cong., 2nd Sess. 4 (1976), 1976-2 C.B. 597, 599 (Emphasis added.) See also H.R. Rep. No. 94-1353, 94th Cong., 2d Sess. 4 (1976).

However, the legislative history also indicates Congress did not intend to change other, then-existing legal requirements for exemption. Both Senate and

House Committee reports explained the effect of the statutory amendment as follows:

> First, it is intended to make it clear that these organizations may receive some outside income, including investment income, without losing their exempt status. Second, it is intended that a social club be permitted to derive a somewhat higher level of income than was previously allowed from the use of its facilities or services by nonmembers without the club losing its exempt status. The decision in each case as to whether ***substantially all*** of the organization's activities are related to its exempt purposes ***is to continue to be based on all the facts and circumstances.*** (Emphasis added.)

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

Based on the foregoing, the Congressional intent in amending IRC 501(c)(7) seems clear: the percentage of outside income a social club may receive was to be liberalized according to a fixed percentage; in all other respects social clubs would continue to be treated as they were in the past, that is, traditional business activities should continue to be distinguished from nontraditional business activities. Traditional business activities are now subject to a 15 percent rather than 5 percent limitation for businesses conducted with nonmembers. Nontraditional business activities continue to prohibited (subject to an insubstantial, trivial, and nonrecurrent test) for businesses conducted with both members and nonmembers.

In extending the unrelated business income tax to social clubs in 1969, the Senate Finance Committee Report declared:

> In recent years, many of the exempt organizations not now subject to the unrelated business income tax -- such as churches, ***social clubs***, fraternal beneficiary societies, etc. -- have begun to engage in ***substantial commercial activity*** * * * it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity. (Emphasis added.)

S. Rep. No. 91-552, 91st Cong., 1st Sess. 67 (1969), 1969-3 C.B. 423, 467. See also H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 47, 1969-3 C.B. 200, 230.

By such a statement, Congress indicated its sense that social clubs were engaging in business activity exceeding the "incidental, trivial, or nonrecurrent" standard of Rev. Rul. 58-589, supra. Nevertheless, Congress, in the 1969 legislation, did not propose to withdraw exemption from social clubs because of such business activity.

In defining "gross receipts" for purposes of applying the percentage tests created by the 1976 amendment, the committee reports borrowed virtually the same language used in Rev. Proc. 71-17 (which, in turn, borrowed it from Rev. Proc. 64-36, 1964-2 C.B. 962; thus, the term has been in use in this context for at least 30 years). Both definitions include receipts "from normal and usual activities," with the committee reports adding the parenthetical phrase "(that is, those activities they have traditionally conducted)." (Emphasis added.) What, then, are these "traditionally conducted" activities?

It is reasonably clear that the meaning given to the phrase "normal and usual activities" in Rev. Proc. 71-17 is the meaning intended to be given the same term in the committee reports. In that revenue procedure, the term "normal and usual activities" of a social club appears to encompass those social and recreational activities upon which the club's exemption is based. According to the revenue procedure, extension of these traditionally exempt social club activities to the general public gives rise to unrelated business income.

A traditional business activity, then, 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. Congress also intended that traditional activities include income from investments since investing its capital 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. Therefore, exemption will be denied if the income from such nontraditional business activity is substantial. 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).

In Situation 1, the gas station, flower shop, liquor store, and barber shop are nontraditional business activities that do not further the pleasure and recreational needs of Club A's 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 recreation 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 nontraditional business activities.

By providing athletic facilities, dining rooms, meeting rooms, and libraries, Club A is conducting activities that further the pleasure and recreational needs of club members. Therefore, they are permitted traditional activities.

(However, income, if there were any, generated from their use by nonmembers other than guests would be subject to tax on unrelated business income and the 15 percent limitation.)

The rental of rooms to members for occasional use when club activities end late in the evening furthers purposes described in IRC 501(c)(7) by allowing members to fully participate in club events. But the long-term rental of rooms to members primarily serves to provide housing and does not further purposes described in IRC 501(c)(7). 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 purposes described in IRC 501(c)(7).

Because the gas station, liquor store, flower shop, barber shop, long-term room rental, and commuter use of the parking facilities are all nontraditional business activities that separately generate income which constitutes a substantial part of the club's gross receipts, the club is not exempt under IRC 501(c)(7). Each activity, standing alone, prevents the club from qualifying for exemption from federal income tax as an organization described in IRC 501(c)(7).

For the same reasons as in Situation 1, the take-out and catering services provided by Club B in Situation 2 are nontraditional business activities that do not further the pleasure and recreational needs of club members. However, income from the take-out and catering services, which combined is less than five percent of gross receipts for the year in question, does not constitute a substantial part of the club's gross receipts. Thus, neither service, nor the two combined, prevents Club B from qualifying for exemption from federal income tax as an organization described in IRC 501(c)(7).

In Situation 2, the income from nontraditional activities must be included in the club's 15% limit on income from the general public's use of club facilities and 35% limit on non-member income overall. Although Congress described those limits in terms of member and non-member income, all nontraditional income must be included in the numerator and denominator even if it is member income. To establish a separate 5% limit on nontraditional activities in addition to these limits would allow organizations with income from nontraditional activities to have a greater percentage of their total income from unrelated activities than organizations with all traditional activities. That result would be contrary to Congressional intent, as expressed in the Committee Reports to the 1976 legislation, cited supra, not to loosen restrictions on nontraditional activities.

CONCLUSIONS

Under the circumstances described above, Club A in Situation 1 is not entitled to exemption from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(7) because it conducts nontraditional businesses, the income from each of which constitutes a substantial part of the club's gross receipts for the taxable year.

In Situation 2, Club B also conducts nontraditional businesses. However, it is not barred from exemption from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(7) because the income from such businesses does not constitute a substantial part of its gross receipts for the taxable year. For this purpose, the Service will construe "substantial" as meaning five percent or more.

However, the income from nontraditional businesses of the organizations described in both situations must be taken into account in computing the organization's unrelated business taxable income under IRC 512 because it is not exempt function income within the meaning of IRC 512(a)(3). Furthermore, it must be included in the calculation of whether the organization has exceeded the 15 and 35 percent limits on non-member income.

3. Timber Sales

A. Traditional or Nontraditional?

By their nature, hunting and fishing clubs usually find themselves in

possession of wooded lands. Not uncommonly, these organizations engage in the sale of timber to the general public. Their reasons for these dispositions vary, and may be determinative of the issue of whether income from this activity constitutes income from a traditional or nontraditional source. G.C.M. 39688 (September 23, 1987) examined one fact pattern. The club in that case operated a private hunting and fishing preserve and assisted in the protection and preservation of fish, birds, game, and natural resources. It was recognized as exempt from federal income tax as an organization described in IRC 501(c)(7).

Forestry experts and wildlife agencies had advised the club that pine timber on the club's property should be selectively harvested in order to maintain the quality of the forest as a wildlife habitat. According to the club's representations, unless the timber was harvested, much of the club's property would no longer be useful for hunting and fishing because as pine timber matures, it causes the forest to produce less food for wildlife. Additionally, once the forest reaches maturity it would cease to allow new growth and would become more susceptible to diseases. The administrative file presented no evidence to contradict these contentions.

The club proposed to selectively harvest the pine timber from its land. The timber would be cut to maintain the forest as a wildlife habitat and to provide for the construction of water facilities. The club planned to sell the timber designated for harvest to a commercial timber company which would cut the timber and remove it from the property. The sale of the timber would allow the club to cut and remove the timber without cost to the club or waste of the club's resources. The revenues generated from the sale of timber would be used to complete the environmental projects necessary to protect the club's property as a wilderness area and wildlife habitat.

The G.C.M. concluded that the sale of timber furthered the club's exempt purposes and, therefore, was not a nontraditional business:

> The information in the administrative file indicates that the harvesting of pine timber is necessary to preserve the usefulness of the Club's property as a wilderness and wildlife habitat. Because a wildlife habitat is necessary for the hunting, fishing and wildlife preservation activities conducted by the Club, we agree with your conclusion that the proposed harvesting of timber, in this case, furthers the Club's exempt purposes and will not constitute a nontraditional business.

This conclusion may appear to conflict with Reg. 1.501(c)(7)-1(b) which

states that the selling of timber is an activity evidencing that an organization is not organized and operated exclusively for exempt purposes. It should be noted, however, that this example (along with the others provided in the Reg.) was intended merely to emphasize the then existing prohibition on IRC organizations engaging in business with the general public. As the G.C.M. points out, the Reg. predates the 1976 amendments to IRC 501(c)(7) that allow such activities within prescribed limits if the activities have been traditionally carried on by those clubs. Thus, the reference to "selling timber" is not a per se prohibition. Each case requires an analysis of the facts presented.

B. TIM-BERRRRRRRR! Will Exempt Status Fall?

If a club's timber sales are determined to be a traditional activity, its exempt status will be preserved as long as the income generated by the activity does not exceed 35% of the organization's gross receipts. In addition, the legislative history of the 1976 amendment to IRC 501(c)(7) notes two exceptions to the prescribed limits on nonmember income. The first exception concerns "unusual" income and the Senate Report states that unusual income is to be excluded from the formula:

> However, where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not be included in the formula; that is, such unusual income is not to be included in either the gross receipts of the Club or in the permitted 35 or 15 percent allowances.

S. Rep. No. 94-1318, at 4.

The second exception provides that all the facts and circumstances will be taken into account if the percentages are exceeded. Ibid. at 5:

> If an organization has outside income in excess of the 35 percent limit (or 15 percent limit in the case of gross receipts derived from nonmember use of a club's facilities), all the facts and circumstances are to be taken into account in determining whether the organization qualifies for exempt status.

A recent PLR request involved an exempt hunting and fishing club that had instituted a timber and game management program, which was developed and managed by professional foresters, to provide planned harvesting of timber resources, improvement of habitat for wild game, and control of gypsy moths.

The timbering income received by the club increased threefold from one year to the next. This increase was due to unusual timbering activity to minimize the damage caused by gypsy moth infestation. The club's lands provide a wildlife habitat for game and other species. In light of the club's purposes, it was essential that this habitat be preserved. The forestry professionals retained by the club recommended that the Club remove an unusually large amount of timber because of damage caused by gypsy moths.

The PLR concluded that due to the unusual nature of the income received and facts and circumstances indicating that the activity was necessary to preserve exempt assets, the exempt status of the Club would not be jeopardized even though timber sales accounted for more than 35% of the club's gross receipts in that particular year. Periodically repeated instances of similar activity may be cause for questions, however.

C. Reinvestment Option

Income derived by social clubs from nonmembers is taxable as unrelated business income under IRC 512(a)(3)(A) if it is not exempt function income. However, IRC 512(a)(3)(D) provides for nonrecognition of gain in certain cases where property was used directly in the performance of an organization's exempt function and the proceeds from the sale are expended to purchase new property used for the organization's exempt function:

> If property used directly in the performance of the exempt function of an organization described in paragraph (7), (9), (17), or (20) of section 501(c) is sold by such organization, and within a period beginning 1 year before the date of such sale, and ending 3 years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property.

Section 512(a)(3)(D) was added by section 121 of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 502. The Senate Finance Committee Report explained:

> In addition, the Committee's bill provides that the tax on investment

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

S. Rept. 91-552 (1969), 1969-3 C.B. 423, 470-471.

A recent TAM involved a hunting and fishing club that cleared 60 to 70 acres of timber as part of a forestry management plan instituted to maintain the club's hunting range. The income from the timber was to be used within three years to reconstruct four dams used to create an environment conducive to fishing. The TAM concluded that the club was entitled to exclude the gain from the sale of the timber from unrelated trade or business income under IRC 512(a)(3)(D).

4. Advertising Income

A. Background

Many social clubs distribute newsletters and other publications to their members. Within these publications, clubs sometimes sell advertising space to help defray publishing costs. Advertising income derived from members or non-members is unrelated business income under IRC 512(a)(3)(A) because it is not exempt function income. The sale of advertising is also a nontraditional business activity because it does not further the pleasure and recreational needs of the club's members or facilitate the use of the club for recreational or social activity.

B. Allocation of Advertising Expenses

Recently, a TAM considered whether a social club may offset its advertising income with excess readership costs (expenses related to the editorial content of the publication) as provided in Reg. 1.512(a)-(1)(f), which provides specific rules pertaining to the deductibility of expenses attributable to unrelated business taxable income related to advertising.

The TAM concluded that the advertising regulations were intended to apply only to computations of unrelated trade or business income under IRC 512(a)(1) and not to those made under IRC 512(a)(3). Allowing deductions for readership costs would, according to the TAM, create a tax advantage for the club by enabling it to subsidize the tax-exempt activities of the club with untaxed advertising income. This result would defeat the Congressional tax policy underlying the IRC 501(c)(7) exemption which is to provide neither advantage nor disadvantage to the pooling of funds for recreational purposes.

In Chicago Metropolitan Ski Council v. Commissioner, 104 T.C. 15 (1995), the Tax Court disagreed with the TAM and held that Reg. 1.512(a)-1(f) is applicable to social clubs. The court noted that the language used in sections 512(a)(1) and 512(a)(3)(A) is similar. Each of those sections refers to gross income "less the deductions allowed by this chapter which are directly connected with" such income. Further, nothing in the regulations specifically indicates that they are not equally applicable to all exempt organizations whether their unrelated business taxable income is determined under IRC 512(a)(1) or IRC 512(a)(3)(A). Moreover, the court noted, Reg. 1.512(a)-i(f) provides for the deduction of those expenses "directly connected with unrelated advertising activity," language that closely resembles the language in both statutes.

With respect to the policy argument raised in the TAM, the court suggested that if the regulations "do not adequately safeguard the legislative policy, then perhaps the regulations should be revised."

At this writing, the Service had not yet determined whether it would acquiesce or recommend appeal of the Tax Court decision.

5. Discriminatory Social Clubs - IRC 501(i)

The Fifth and Fourteenth Amendments to the U.S. Constitution prohibit racial discrimination by government or private organizations that are supported by the government. However, private organizations may lawfully discriminate unless the "state action" doctrine applies under which government is deemed to have

supported or encouraged the discrimination.

Numerous cases involving the "state action" doctrine have been decided in recent years, including some in the private club context. For example, in Pitts v. Department of Revenue, 333 F. Supp. 662 (E.D. Wis. 1971), the court held that the grant of a state property tax exemption to organizations that discriminate in their membership on the basis of race was significant state action encouraging discrimination in violation of the Fourteenth Amendment.

In McGlotten v. Connally, 338 F. Supp. 448 (D.D.C. 1972), an African-American individual, allegedly denied membership in a lodge of a fraternal organization solely because of his race, brought a class action suit to enjoin the granting of tax exemption to fraternal organizations described in IRC 501(c)(8) that exclude individuals from membership on the basis of race.

In this case, the Court concluded that an IRC 501(c)(7) social club's policy of racial discrimination would not preclude tax exemption, although the exemption given to fraternal organizations under IRC 501(c)(8) required a nondiscriminatory policy. The court based its decision on the fact that all of the income of social clubs excepting "exempt function income" is taxed at regular corporate rates. Therefore, exemption under IRC 501(c)(7) did not amount to a grant of federal funds to them. Fraternal organizations, on the other hand, receive a benefit in that they are taxed only on unrelated business taxable income and not on investment income. The Court held that this government-conferred benefit constitutes prohibited state action.

In response to the McGlotten case, Congress in 1976 enacted IRC 501(i). Congress stated in the legislative history of the enactment that, in view of national policy, it is inappropriate for a social club described in IRC 501(c)(7) to be exempt from federal income tax if its "written policy" is to discriminate on account of race, color, or religion.

IRC 501(i) provides that an organization which is described in IRC 501(c)(7) shall not be exempt from taxation under IRC 501(a) for any taxable year if, at any time during a taxable year, the charter, by-laws, or other governing instrument of the organization or any written policy statement of the organization contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

In 1980, Congress amended IRC 501(i) to exclude from this provision, to

the extent it relates to discrimination on the basis of religion, tax-exempt social clubs that are affiliated with fraternal beneficiary societies. The amendment also allows a club to limit its membership "in good faith" to the members of a particular religion in order to further the teachings of that religion. Among the intended beneficiaries of the amendment were social clubs operated by the Knights of Columbus.

It should be noted that IRC 501(i) does not preclude social clubs from limiting their membership based on ethnic origin or gender.

In recent years, several exempt social clubs have come to the attention of the Service through highly publicized incidents of apparent discrimination based on race or religion. In these cases, substantial evidence of actual discrimination, either in the selection of members or in the use of club facilities, was uncovered by the examining agents. However, there was no evidence that the clubs had written policies governing their discriminatory actions. Technical advice was requested concerning the clubs' continuing qualification for exempt status.

The TAM's issued in response recognized that an organization's operations are more indicative of discrimination than the mere absence of a written discriminatory provision in corporate documents, but concluded that under the current state of the law there was no basis for revoking the exempt status of the clubs. Under IRC 501(i), the standard for determining whether a social club is discriminatory is based on the existence of a discriminatory policy in writing. Where there is no ambiguity in the language, either in the statute or the legislative history, finding an operational component within this standard is problematical, at best. Regarding the rules of statutory interpretation or construction, the Supreme Court has stated, "Where the language is plain, there is no room for construction." United States v. American Trucking Associations, 310 U.S. 534 (1940). The unavoidable consequence of the law as currently drafted is that a club may operate in a discriminatory manner and retain its tax exemption, so long as its discriminatory policy is not reduced to writing. Ironically, a club that does not in fact discriminate, but has an ancient charter with a discriminatory provision must be revoked (unless, under a closing agreement, they agree to modify the charter), while one that does in fact discriminate, but has no such provision, must not be.