

A social club which entered into a management and lease agreement for the management and operation of its facilities by the lessor may qualify for exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954 where the club retains control over the selection of its membership and the amount of initiation fees and dues, and has an option to purchase the property leased by the club and terminate the agreement.

Revenue Ruling 65-219, C.B. 1965-2, 168, distinguished.

Advice has been requested whether a social club which entered into the management and lease agreement described below qualifies for exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954.

The club is a nonprofit membership corporation which was formed for the pleasure and recreation of its members. The club entered into a management and lease agreement designed to provide for financing the acquisition and maintenance of club facilities and for professional management of the club. The agreement is for a period of 12 years with an option to purchase the leased property after 6 years. The manner of determining the selling price is set forth in the agreement. The agreement also provides that all improvements placed on the property during the term of the lease belong to the club and the lessor shall manage the club during the term of the lease, or until the earlier exercise of the purchase option.

The club has the right to set membership initiation fees and dues above a specified minimum, and to select and expel members in accordance with rules and regulations which it promulgates. Under the agreement, all membership dues and all amounts collected in connection with the operations of the facilities, such as providing food and beverages for the members, are paid to the lessor. The agreement further provides that initiation fees are to be deposited in an account which may be used solely for improvements or additions to club facilities. Prices for food and beverages sold to members and any improvements or additions to club facilities are subject to the club's approval. The lessor bears all risk of loss in connection with the club operation. The terms of the management and lease agreement were arrived at by arm's length negotiations between club representatives and the owner of the land.

Section 501(c)(7) of the Code provides that clubs organized and operated exclusively for pleasure, recreation, and other non-profitable purposes are exempt from Federal income tax, provided no part of the net earnings inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1 of the Income Tax Regulations provides

that exemption under section 501(c)(7) of the Code extends only to other non-profitable purposes, but does not apply to a club if any part of its net earnings inures to the benefit of a private shareholder.

The facts indicate that the club, desiring to be relieved of the responsibilities of day-to-day and overall administrative operations, entered into negotiations based on what both parties agreed would result in reasonable compensation for services to be rendered. While the lessor receives any profits arising from club operations prior to the exercise of the option to purchase the property and terminate the agreement, he bears the risk of any losses. Furthermore, the club may eliminate his opportunity to derive profits from operation of the club by exercising the purchase option after 6 years and terminating the agreement. The value of the improvements on the leased land are not included in the purchase price under the option. If the option is not exercised, the club may remove or dispose of the improvements at the expiration of the 12-year agreement.

In view of the foregoing, the organization qualifies for exemption from Federal income tax under section 501(c)(7) of the Code.

This organization is distinguishable from the club which was held not to be exempt under section 501(c)(7) in Revenue Ruling 65-219, C.B. 1965-2, 168. In that case the operator had the power to control the amount of the club's income by virtue of his control of the solicitation, number, and transfers of membership, as well as the sole right to determine initiation fees, transfer fees, and annual club dues. Also, the benefit of any improvements paid for by the club accrued to the benefit of the operator at the end of the 20-year lease agreement, and the club had no right to acquire the assets from the operator. The facts in that Revenue Ruling show that the club was operated primarily for the benefit of the licensor rather than for the pleasure and recreation of the members.

An organization which considers itself within the scope of this Revenue Ruling must, in order to establish exemption under section 501(c)(7) of the Code, file an application on Form 1025, Exemption Application, with the District Director of Internal Revenue for the internal revenue district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.