Uniform Issue List
501.07-05
512.05-03
512.01-00

200104038

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

Date: NOV 3 2000

Contact Person:

ID Number:

Telephone Number:

T:EO:B4

Employer Identification Number:

Legend:
M =
N =

Dear Applicant:

This is in response to your letter dated April 12, 2000, wherein you requested a ruling that the sale of approximately 50 acres of land acquired as part of a 391 acre land acquisition qualifies for nonrecognition of gain pursuant to the provisions of section 512(a)(3)(D) of the Internal Revenue Code.

M is exempt from federal income tax as a social club described in section 501(c)(7) of the Code. M acquired the assets and assumed the liabilities of a country club from its developer in August, 1989. M's exempt activity consists of the ownership and operation of facilities for golfing, tennis, and social interaction by and between its members.

Prior to October 18, 1999, M leased 391 acres of land from an unrelated party, a local government agency, N. The 391 acres represents a significant portion of the entire land area used by M for its exempt purposes. The original long-term lease between N and M provided an option to renew the lease on the land. The signed long-term lease was entered into by the developer in 1971 and was assumed at the time M acquired the Club premises in 1989.

Because of an oversight, M failed to properly exercise the option to extend the lease for another 35 years. After lengthy negotiations, N decided to put the land in question up for sale. N asked M to make an offer and also informed M that there was another buyer willing to pay the appraised value of the land. The property consists of 391 acres of contiguous land made up of approximately 300 acres on which 28 holes of the Club's 36 golf holes are situated, approximately 50 acres of raw land, and about 40 acres of flood plain. M was unsuccessful in attempting to get N to agree to sell less than the entire parcel.

In order to retain the golf course land for its exempt purposes and serve its nearly 700 golf members, M agreed to acquire the entire 391 acres. Pursuant to this transaction, M assessed its membership and obtained a bank loan to fund the purchase of the land.

M intends to sell the raw land to a developer inasmuch as this land will not be used for expansion of the golf course. The unrelated developer will build residences thereon. The sale of land should result in a gain to M. We have no evidence that the land in question has ever been used by M's members directly in the performance of M's exempt function. M intends to utilize the proceeds from the sale to replace and improve assets used in the conduct of its exempt activities.

Section 501(c)(7) of the Code provides for the exemption from federal income tax of clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, substantially all 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.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term" unrelated business taxable income to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 512(a)(3)(A) of the Code provides that with respect to organizations described, *inter alia*, in section 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions which are directly connected with the production of the gross income (excluding exempt function income), both computed with certain specified modifications.

Section 512(a)(3)(B) of the Code provides that the term "exempt function income", as used in subparagraph (A), means the gross income from dues, fees, charges, or 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 organization's exemption.

Section 512(a)(3)(D) of the Code, entitled "nonrecognition of gain", provides that if property used directly in the performance of the exempt function of the section 501(c)(7) organization 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, any gain 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.

The Senate Finance Committee set forth the following rationale for enacting section 512(a)(3) in S. Rept. 91-552, 1969-3 C.B. 423, as follows:

> Present Law. — Under the present law the investment income of social clubs, fraternal beneficiary societies, and employees beneficiary associations exempt from income tax. General reasons for change. --- Since the tax exemption for Social clubs and other groups is designed to allow individuals to join together. To provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the Sources of income of the organization are limited to receipts from the from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments..., upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation (or other benefits) to its membership. For example, if a social club were to receive $10,000 of untaxed income from investment in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose. [1969-3 C.B. at 469-70.]

The rationale for the enactment of section 512(a)(3)(D) is also set forth in the Senate Finance Committee Report, as follows (at 1969-3 C.B. 471):

> 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 organization 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 sales 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.

The Committee Report also provides an example where the application of section 512(a)(3)(D) is appropriate, as follows: "... 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."

In Framingham Country Club v. United States, 659 F. Supp. 650 (D. Mass. 1987), the Court stated:

> Although the plaintiff may have purchased the original 120 acres of land with the intention of providing expanded golf facilities, the plaintiff never actually used the 60 acres in question for that purpose. The disposition of Thomas D. Burke, former Treasurer of the Club, indicated that up until January of 1986 the land was "in use for anything" and the Club's greens keeper lived in a house on the property. ... Burke also stated that "large equipment " was stored on the land. ... This Court would hesitate to find on the basis of this rather inclusive deposition testimony, that the use of a home by a greens keeper and the storage of some "large equipment" directly facilitated the performance of the exempt function of the Club. [659 F. Supp. at 653.]

The Court above clearly indicated that the uses described of the land in question was not sufficiently related to the carrying out of the Club's exempt function to come within the exception provided under section 512(a)(3)(D). Further, the intent of the taxpayer in acquiring the property was not relevant.

In Deer Park Country Club v. Commissioner, Tax Court Docket No. 26210-93 (1995), the Court held that the club was liable for unrelated business income tax on the gains it realized from the sale of 11 homesites (to club members) on a 4.8 acre tract of land. This tract was originally part of a 63.8 acre farmland tract, of which 59 acres were used for recreational facilities by the section 501(c)(7) club. The Court agreed with the Service that, "the gain in question does not qualify for nonrecognition treatment under section 512(a)(3)(D) because the tract on which the 11 homesites are situated was never 'used directly' in the performance of (Deer Park's) exempt function". The club's apparent intention, at one time, to use the entire farmland tract for recreational purposes did not suffice to meet the requisite test.

In Tamarisk Country Club v. Commissioner, Tax Court Docket No. 1652-83 (1985), the Court agreed with the Service that the nonrecognition provisions of section 512(a)(3)(D) do not apply to the section 501(c)(7) social club because it had not fully reinvested the proceeds of the sale in question in new land. Tamarisk had purchased land in 1972 to expand its recreational facilities. In 1974, Tamarisk sold the land and realized gain. Within the 4 year period starting one year before the sale and ending 3 years after the sale, Tamarisk purchased other property for an amount less than the consideration it received on the 1974 land sale less selling expenses. It also refunded $318,000 to its members which it had collected in a special assessment to purchase the original land.

M acquired the land which is the subject of your ruling request as part of an entire transaction. N would not sell the property to M without the inclusion of the 50 acres. M acquired the entire tract in order to continue carrying out its exempt purposes. M is not in the real estate business and never treated the 50 acres as investment property. Also, M has not conducted any taxable activity on these 50 acres. Nevertheless, M's intent with regard to this property, and the facts and circumstances relating to its acquisition, are not decisive for purposes of the exception provided by section 512(a)3)(D). The key factor is whether the particular property was used directly for the carrying out of exempt recreational purposes. See the Framingham and Deer Park cases, as well as the legislative history, all cited above. Congress intended a narrow exception to the general rule that the unrelated business income tax applies to all income of a social club other than exempt function income. Because the 50 acres herein was not used directly in furtherance of N's exempt recreational purposes, the proposed transaction does not fit within this exception.

Based on the foregoing, we rule that M's proposed sale of the 50 acre tract of raw land to a developer does not qualify for treatment as nonrecognition of gain under section 512(a)(3)(D) of the Code. Accordingly, the net gain on any such sale would be subject to the unrelated business income tax imposed by section 511.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon your tax status should be reported to the Tax Exempt and Government Entities (TE/GE) Customer Service Office. The mailing address is:

The telephone number there is (a toll free number).

We are sending a copy of this ruling to the TE/GE Customer Service Office. Because this letter could help resolve any questions about your tax status, you should keep it with your permanent records.

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

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

Thank you for your cooperation.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

234