1960 TAX DEVELOPMENTS WHICH AFFECT COUNTRY CLUBS

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The Federal tax development affecting country clubs which aroused the greatest interest in 1960 was the release by the Internal Revenue Service of Revenue Ruling 60—324.[1]

The ruling held that a club which made its facilities available to the general public on a regular recurring basis, was not exempt from Federal income tax. The release of the ruling was picked up and given the shock treatment by a great many newspapers. For example, the lead on the Associated Press story carried in the New York Times on November 30, 1960[2] was "TAX EDICT BLOW TO COUNTRY CLUBS . . . CLOSINGS ARE POSSIBLE."

The club which was the subject of Revenue Ruling 60—324 made its facilities, consisting of dining rooms, bar and ballroom, available for civic and public club meetings, business firm employees' parties and school and alumni parties. The arrangements for such parties were negotiated through a member of the club who became responsible for the behavior of these "paying guests." Over a period of seven years, income from these so-called "outside functions" ranged from 12% to more than 17% of the income of the club from all sources. In one of the seven years, 200 outside functions were held and the gross profits realized were equal to 25% of the gross profits from all sources and a substantial net profit was realized. A survey by the club's independent accountants had concluded that if the club discontinued these outside functions, a substantial increase in the members' dues would be necessary.

The rule of law which was stated to be applicable in the ruling was that a club would not lose its exemption merely because it received some income from the general public (that is, persons other than members of their **bona fide** guests) or because the general public occasionally is permitted to participate in its affairs, provided such participation is incidental to and in furtherance of its general club purposes and the income therefrom does not inure to the members. It was held in the ruling that the club's outside activities were of such magnitude and recurrence as to constitute engaging in business, and therefore the outside activities could not be considered incidental to or in furtherance of the general club purposes. Actually, the ruling is consistent with principles previously embodied in rulings of the Internal Revenue Service and to a considerable extent in court decisions.

Prior Law

The applicable statute[3] provides that the organization described in subsection (c) of section 501 shall be exempt from tax. Paragraph (7) of subsection (c) includes, among the exempt organizations, "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 . . ." It should be noted parentheticaly that the Prohibited Transaction provisions[4] and the Unrelated Business Income provisions,[5] which apply to other types of exempt organizations have no application to clubs exempt under subsection (c) (7). There is ample case authority to the effect that occasional use of club facilities by "paying guests" will not affect the exemption where such use does not result in a substantial net profit to the club. In Bar-

1 Internal Revenue Bulletin, 1960—41, p. 11.
2 Page 39.
3. Section 501(a) of the Code.
4 Sections 503 and 504.
5 Sections 511, 512, 513 and 514.

stow Rodeo and Riding Club, Inc.,[6] the club ran an annual rodeo that was open to the public. To meet the cost of the show, admission was charged and drinks and chances were sold. The court upheld the exemption on the ground that the rodeo was held for the pleasure of the members and the public and that by paying the charges the non-members were ". . . in essence, reimbursing the club for the cost of the rodeo held for their benefit . . ."

A slightly more liberal rule was suggested in **Coeur d'Alene Country Club v. Viley.**[7] In that case the Commissioner contested the club's right to an exemption on the ground that there was a relatively large use of the club's golf course by players who were not personal guests of a member and about 26% of its income was derived from green fees of such paying guests. The court upheld the exemption, stating that it was doubtful that the outside activity produced a net profit, but that "if it did, it is immaterial as the amount (of the green fees) so collected was not in excess of what was paid by regular members . . ."

On the other hand, where club facilities are used by a large number of "paying guests" and such use results in net profit to the club, the exemption will be lost. In **Aviation Club of Utah v. Commissioner**[8] the dining room and bar of a previously exempt social club were thrown open in 1942 to all military officers. The total revenues of the club jumped from about $15,000 in 1941 to $112,000 in 1942 and $270,000 in 1943 despite a substantial decrease in the number of members during this period. The court stated that the club's predominant activity during 1942 and 1943 was selling entertainment to non-members for profit and that such activity certainly was not incidential to the social and recreational purposes for which the club was organized.

Another rather well-known case that resulted in a loss of exemption was **West Side Tennis Club.**[9] There, the club built a stadium which it made available for the National Tennis Championships each year under an arrangement whereby it shared with the United States Lawn Tennis Association the proceeds from the sale of tickets to the public. During the two years in question, the club's share of the proceeds produced a net operating income of $32,000 and $22,000, respectively, in each year more than half of the gross income from dues and ordinary club activities. The court held that although the championships interfered with the ordinary club activities during a relatively brief period of several weeks out of the year, the conduct of the tournament constituted such a substantial and profitable business as to preclude the exemption.

Summary

In virtually all of the cases in which the exemption has been lost and in Revenue Ruling 60—324, it seems to me that the profit motive was too apparent. While it is interesting to speculate on how many outside functions can safely be held and what percentage of gross income can safely be realized from these outside functions, I think that these figures are important only as an indication of motive. The statute provides, on its face, that the club must be operated **exclusively** for pleasure, recreation and other **non-profitable** purposes. The cases and rulings have ameliorated the statutory language by permitting incidental profitable activities. However, once it becomes apparent from the figures that the purpose of holding the outside functions is to make the club's financial ends meet, the exemption is lost.

Consequences of Loss of Exemption Federal Tax Aspects

Once it has been determined that a club is not entitled to exemption from income tax, its income must be re-constituted on a taxable basis. In doing this, membership fees and dues (but not the excise tax thereon) must be included as gross income.[10] In addition, most clubs expense their capital expenditures and do not record any depreciation. Adjustments must be made in this regard. In many cubs, of course, the addition of a deduction for depreciation might well cause the club's expenses to exceed its income and make the question of tax-

6 12 TCM 1351 (1953).

7 64 F. Supp. 540 (D.C. Idaho, 1946).

8 162 F .2d 984 (10th Cir., 1947), **cert. den.** 332 U.S. 837 (1947).

9 **West Side Tennis Club v. Commissioner,** 111 F. 2d 6 (2d Cir., 1940). **cert. den.** 311 U.S. 674.

10 **Keystone Automobile Club v. Commissioner,** 181 F. 2d 402 (3d Cir., 1950); **West Side Tennis Club, supra.** The excise tax is levied on the member not the club. I.R.C. section 4241(b).

ability academic. In connection with depreciation, it is provided by the statute and regulations [11] that when an exempt organization becomes taxable, the basis of its property for depreciation purposes is original cost reduced by the straight line depreciation that would have been allowable had the organization been subject to tax. If after appropriate adjustments, the club does have net income and if returns have not been filed, as is likely the case, the club may also be subject to the 25% penalty for failure to file a return.[12]

New York Tax Aspects

While there is no statutory exemption for clubs from the New York Franchise Tax, it has been the practice in New York to consider them exempt. However, if the Federal exemption is lost on the ground that the club is engaged in business, it is likely to be subjected to the New York Franchise Tax. Such was the case following the adverse Federal decision involving the West Side Tennis Club and the Jockey Club.[13]

A.B.C. Laws

Section 3(9) of the New York A.B.C. Law contains a rather elongated definition of a "club" which states in part that it must be operated ". . . solely for a recreational, social, patriotic, political, benevolent or athletic purpose, **but not for pecuniary gain. . . .**" While I have been unable to find any case law in this area, a holding for Federal income tax purposes that a club was engaged in business might well justify a finding by the State Liquor Authority that it was being operated for pecuniary gain. The advantages of operating as a club under the A.B.C. Law are that the license fees are one-half the amount charged commercial operators and that alcoholic beverages can be sold on credit.

Anti-Discrimination Laws

Section 40 of the New York Civil Rights Law, which prohibits discrimination in places of public accommodation, expressly excludes any ". . . institution, club or place of accommodation which is in its nature distinctly private. . . ." Here again, a finding in a tax case that a club was making its facilities available to the public for profit to an extent sufficient to cause the loss of the Federal income tax exemption, might justify a finding that it was a place of public accommodation. In one case, arising under section 40, the court expressed the view that the absence of a ruling exempting a club from Federal income taxes was evidenciary on the question of whether it was open to the public. [14]

New Regulations Relating to Capital Improvements Exemption from Dues Tax

Since 1959 the Code has contained a provision exempting from the 20% excise tax amounts paid as dues, membership fees or initiation fees for the construction or reconstruction (including capital additions and improvements) of any social, athletic or sporting facility, provided that such amounts are expended within three years after the date of payment by the member.[15]

The regulations under this section have just been promulgated and they indicate that any such dues or fees paid are not within the excise tax exemption unless they are ear-marked by the club at the time of receipt for the exempt use.[16] I understand that the Service will take the position that in order to comply with the ear-marking requirement, the members must be informed at the time of collection that the dues or fees will be applied to the exempt use but that it is not necessary that the funds be segregated from the general funds of the club as long as the books of account clearly indicate that an amount equivalent to that collected was actually expended for the exempt use within the required period.

The new regulations also indicate that amounts paid by members of a club as dues, membership fees or initiation fees and used to repay indebtedness incurred for the construction or reconstruction of any social, athletic or sporting facility are exempt. Similarly, any such amounts used to replenish a reserve fund previously expended by the club for the exempt use is also exempt.

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11 Section 1016(2) (3) (B); Regs. 1.1016—4.

12 **West Side Tennis Club, supra.**

13 **West Side Tennis Club v. Browne,** 270 App. Div. 1061, app. dis. Court of Appeals, October 17, 1946; 1952 Ops. N. Y. Atty. Gen. 177 (holding Jockey Club subject to New York Franchise Tax after similar holding for Federal tax purposes in **Jockey Club v. Helvering,** 76 F. 2d 597 (2d Cir., 1935)).

14 **Castle Hill Beach Club, Inc. v. Arbury,** 2 N.Y. 2d 596 (1957).

15 Section 4243(b).

16 Regs. section 49.4243—2.