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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **201002043**
Release Date: 1/15/2010

Date: October 21, 2009

Contact Person:

Identification Number:

Telephone Number:

Employer Identification No.:

501.07-00 Social Clubs (Exempt v. Not Exempt)

501.07-03 Sale or Lease of Club Property

Legend:

Titleholding=
Club =
State A =
a =

Dear :

This is in reply to Club's letter dated January 16, 2004, concerning the proper treatment of a proposed exchange of certain real property currently owned by Titleholding, for other real property, pursuant to section 512(a)(3)(D) of the Internal Revenue Code ("Code.")

The Internal Revenue Service (the Service) has recognized Titleholding as a title holding corporation exempt from federal income tax under section 501(c)(2) of the Code. Titleholding owns property that it leases to Club, which the Service has recognized as a social club exempt from federal income tax under section 501(c)(7) .

Club is organized and operated to maintain hunting and fishing camp for its members. Shortly after its incorporation, Titleholding purchased *a* acres of land, and later acquired additional forest land in the same county. After its purchase of the land, Titleholding leased the exclusive hunting and fishing rights on the forest land (Forest) to Club for nominal rent.

All profits derived from rent of property, from sale of timber, and from other sources of operation, after payment of all ordinary and necessary expenses which may be due by Titleholding, have been turned over to Club, for its use and benefit in the operation of a social club.

At all relevant times, Titleholding and Club represent that they have filed, and will continue to file, consolidated Forms 990.

Titleholding has a contract with State A, under the terms of which Titleholding Forest is designated as an auxiliary state forest. In return for an agreement by the State not to assess or collect tax on the timber, Titleholding agreed to various restrictions on its use, management, and sale of the timber.

Consistent with its goal of maintaining the open park-like character of its land, Titleholding has not regularly removed timber from Titleholding Forest. When timber has been removed from Titleholding Forest in the past, it was in connection with the remediation and restoration of a portion of Titleholding Forest that had been subject to wind or storm damage.

State A, through its forest management agency, has urged Titleholding to develop a forest and wildlife resources plan for Titleholding Forest. The past management practices of maintaining an open, park-like character have resulted in an overall decline in the health and vitality of the standing timber and the wildlife population.

In order to comply with the directives of State A, selected types of timber must be removed from Titleholding Forest over a period of several years. Titleholding proposes to grant a timber deed that will convey to an unrelated third party the rights to specifically described or marked timber located in Titleholding Forest. There will be only one cutting per management tract, and once a tract is cut pursuant to the State directive, the timber on that tract will not be cut again for another 40 to 50 years. Due to the size of the Forest, it will take several (perhaps six to eight) years to comply with the State directive.

Titleholding desires to exchange such timber for real or personal property to be used by Club directly in the performance of its exempt function (the "Exchange.") Pursuant to the agreement governing the terms of the Exchange, the proceeds from the transfer of the timber property will be held by a qualified intermediary to be used for the acquisition of the Club related property. It is contemplated by Titleholding and Club that the acquired Club related property will be purchased within three years of the transfer of the timber property.

Rulings Requested:

1. Titleholding's exchange of timber removed from Titleholding Forest for real or personal property to be used by Club directly in the performance of Club's exempt

function will not adversely affect or jeopardize the Section 501(c)(7) exempt status of Club.

2. Titleholding's exchange of timber removed from Titleholding Forest for real or personal property to be used by Club directly in the performance of Club's exempt function, within the time period specified by Section 512(a)(3)(D), will not result in unrelated business taxable income to Club.

Law:

Section 501(c)(2) of the Code provides for the exemption of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under section 501(a) of the Code.

Section 501(c)(7) of the Code provides for the 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.

Section 511(a)(1) of the Code imposes a tax for each taxable year on the unrelated business taxable income of those organizations described in Section 501(a), which includes those organizations described in sections 501(c)(2) and 501c)(7).

Section 511(c) of the Code provides that if a corporation described in section 501(c)(2) --

(1) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or which would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and

(2) such corporation and such organization file a consolidated return for the taxable year, such corporation shall be treated, for purposes of the tax imposed by subsection (a), as being organized and operated for the same purposes as such organization, in addition to the purposes described in section 501(c)(2).

Section 501(c)(7) of the Code was amended in 1976 by Pub.L. 94-568 to provide that section 501(c)(7) organizations could receive some outside income without losing their exempt status. The legislative history provides that the decision as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based upon all of the facts and circumstances. It is intended that these organizations are permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside 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. However, the Senate Finance Committee Report states that it is not "intended that these organizations should be permitted to receive within the 15-or 35-percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations." S. Rep. No. 1318, 94th Cong., 2d Sess. 4 (1976).

The Senate Report further notes two exceptions to the 35 percent/15 percent allowances. The first exception concerns unusual income and the Senate Report, at 4 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.

The second exception provides that all the facts and circumstances will be taken into account if the percentages are exceeded, S.Rep. No. 94-1318 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.

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in Section 501(c)(7) of the Code, the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income).

Section 512(a)(3)(B) defines exempt function income for organizations described in section 501(c)(7) of the Code as 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.

Section 512(a)(3)(C) of the Code provides that in the case of a corporation described in section 501(c)(2), the income of which is payable to an organization described in [Section 501(c)(7)] . . .[Section 512(a)(3)(A)] . . . shall apply as if such corporation were the organization to which the income is payable if it filed a consolidated return with such organization for such year.

Section 512(a)(3)(D) of the Code shields from capital gains tax property used directly in the performance of the exempt function of an organization described in Section 501(c)(7). If such exempt function property 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 1.501(c)(2)-1 of the Income Tax Regulations ("the regulations") provides, inter alia, that an organization exempt under Section 501(c)(2) of the Code cannot have unrelated business taxable income as defined in section 512 other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C).

Section 1.501(c)(7)-1(b) of the regulations provides that a club which engages in business, such as 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 section 501(a). However, the section distinguishes a business of selling products from an incidental sale of property that will not deprive a club of its exemption.

Section 1.511-2(c) of the regulations provides that if an item of income of the section 501(c)(2) corporation is derived from a source which is related to the exempt function of the exempt organization to which such income is payable and with which such corporation files a consolidated return, such item is, together with all deductions directly connected therewith, excluded from the determination of unrelated business taxable income under section 512 and shall not be subject to the tax imposed by section 511(a).

Analysis:

Titleholding has a ruling recognizing its exemption under 501(c)(2) of the Code. It holds title to forest lands, and remits all of its income yearly to Club, which has a ruling recognizing its exemption under Section 501(c)(7). Titleholding represents that it has filed a consolidated return with Club for all the relevant years.

Titleholding proposes to cut and sell certain timber, pursuant to recommendations from a State agency in order to restore the wildlife habitat on lands it owns. It will sell the timber to an unrelated third party, and remit the income to Club, to be used to acquire other Section 501(c)(7) exempt function property. Club seeks a ruling that such sales will not prejudice its Section 501(c)(7) ruling or cause it to incur unrelated business income tax on the sale.

Ordinarily, a 501(c)(2) organization cannot have unrelated business taxable income as defined in section 512 of the Code other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C). Section 1.501(c)(2)-1 of the regulations. Certain other exceptions in the regulation are not applicable here. The purpose and effect of Section 512(a)(3)(C) and regulations are to treat Titleholding and Club as one for the purpose of computing unrelated business income tax. Therefore, the first question is whether the proposed sale of timber by Titleholding would jeopardize Club's exemption under 501(c)(7).

The Senate quantified the amount of non-member income that a social club could receive in the Senate Report accompanying the 1976 revision of the law regarding social clubs.

The limits were not codified in the statute, or in the implementing regulations. Nevertheless, the Service and the courts have relied on the 15 percent limit on non-investment, non-member income, and the 35 percent limit on all non-member income. See, e.g., Santa Barbara Club v. Commissioner, 68 T.C. 200, 211 (1977); Zeta Beta Tau Fraternity v. Commissioner, 87 T.C. 421, 432 (1986).

The proposed sale of timber need not be counted in the 35 percent limit because under section 1.501(c)(7)-1(b), it would be revenue from an incidental sale, not the proceeds of a business in which the club is engaging. It is an incidental sale of property in two senses of the term. First, the timber on each parcel will be harvested and sold just once, thus limited in time.

Second, the sale will enhance the club's exempt purpose, and thus be incidental in the sense of closely related to that purpose, because the harvesting that results in the sale will be done to improve the health of the forest habitat—a necessary action to further the exempt functions of the club. The information in the administrative file indicates that the harvesting of 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, the harvesting of timber, in this case, furthers the Club's exempt purposes and will not constitute a nontraditional business.

The Senate Report contrasts the active conduct of a nontraditional business—such as timbering—with the receipt of an unusual amount of income from sale of a club asset. As discussed above, the timbering in issue here is not the conduct of a business, but rather the maintenance of the club's forest land asset.

Accordingly, the sales transactions will not affect Club's 501(c)(7) status.

Club also seeks a ruling that the income from the timber sales will not be unrelated business income. Since Titleholding and Club are treated as one social club, the sale of the timber to a third party—not a member—normally would give rise to unrelated business income under Section 512(a)(3)(A) of the Code.

However, Congress has excluded from unrelated business treatment the gain from the sale of exempt function property if it is reinvested in other exempt function property. Section 512(a)(3)(D) of the Code provides that if property used directly in the performance of the exempt function of an organization described in Section 501(c)(7) 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.

The social club holding company—the combined 501(c)(2) and 501(c)(7)--plans to sell the timber, and then use the proceeds to purchase exempt function property within the

three year period required by Section 512(a)(3)(D) of the Code. As a result, the timber sales proceeds will not be subject to the unrelated business tax if property related to the purpose of Club is purchased with the timber sales proceeds within the three year period.

Rulings:

1. Titleholding's exchange of timber removed from Titleholding Forest for real or personal property to be used by Club directly in the performance of Club's exempt function will not adversely affect or jeopardize the Section 501(c)(7) exempt status of Club.

2. Titleholding's exchange of timber removed from Titleholding Forest for real or personal property to be used by Club directly in the performance of Club's exempt function, within the time period specified by Section 512(a)(3)(D) of the Code, will not result in unrelated business taxable income to Club.

This ruling is based on the facts presented and on the understanding that there will be no material changes in the facts upon which it is based.

This ruling is limited to the issue discussed above. It does not cover the exchange of property or any other issue or statute, whether or not discussed in the instant ruling request.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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 by others as precedent.

Because this letter could help resolve any future questions about tax consequences of your activities, you should keep a copy of this ruling in 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.

In accordance with the Power of Attorney and Declaration of Representative currently on file with the Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald J. Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure:

Notice 437