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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201003022**
Release Date: 1/22/10
Date: 10/29/2009

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL Number: 501.07-03-Sale of Club Assets

Legend:

You or the Association =

Dear

We have considered your letter dated December 6, 2007, in which you requested rulings that the sale of your assets would not cause you to lose your tax exempt status under section 501(c)(7) of the Internal Revenue Code (Code), and that any gain realized upon the sale of assets as part of your liquidation would not be subject to unrelated business income tax. For the reasons explained below, your organization will not lose its tax exempt status, however, the gain you realized upon the sale of assets will be subject to unrelated business income tax. We cannot grant your request because such a distribution is subject to tax.

You were incorporated under the non-profit statutes of your State and were recognized as exempt from federal income taxation under section 501(c)(7) of the Code shortly thereafter. Your purpose is to provide for the recreational and social enjoyment of members and to purchase, construct or otherwise acquire, own, operate, and maintain athletic facilities and other recreational facilities for the recreational and social use of its members, their families and their guests.

You operated the facilities for many years. Your income consisted of dues and assessments paid by your members. Recently, your City decided to build a new recreation center with similar athletic facilities in close proximity to the club's property.

You explained that a period of declining membership, the need for significant maintenance and repairs to your facilities, and interest in the property from commercial buyers, led your members to vote to terminate the club and sell the property.

The Club is in the process of a dissolution. The members will receive shares of the assets (cash) after all debts and other obligations are paid.

Rulings Requested

- Will the sale of the club's assets cause the association to lose its tax exempt status under section 501(c)(7) of the Code?

- Whether this social club, recognized as exempt under section 501(c)(7) of the Code, must pay unrelated business income tax on the proceeds of the property that it sells as part of the termination of the club?

Law

Section 501(c)(7) of the Code exempts from federal income tax clubs organized for pleasure or recreation, 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 512(a)(3)(A) of the Code defines unrelated business income, for an organization recognized under section 501(c)(7), as gross income (excluding any exempt function income) less the deductions allowed, both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of section 512(b).

Section 512(a)(3)(B) of the Code defines exempt function income for 501(c)(7) organizations to mean gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing the goods, facilities, and services in furtherance of the purposes of the organization.

Section 512(a)(3)(D) of the Code states that if property used directly in the performance of the exempt function of an organization described in section 501(c)(7) is sold by the organization, and within a period beginning one year before the date of the sale, and ending three years after the date, other property is purchased and used by the organization directly in the performance of its exempt function, gain from the sale shall be recognized only to the extent that the sales price of the old property exceeds the organization's cost of purchasing the new property.

Section 512(b)(5) of the Code excludes from UBIT all gains or losses from the sale, exchange or other disposition of property, excluding property held primarily for sale to

customers in the ordinary course of trade or business.

Section 1.501(c)(7)-1(b) of the Treasury Regulations (the regulations) states that a club that 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 operated exclusively for pleasure, recreation, or other nonprofit purpose and therefore is not exempt. However, an incidental sale of property will not deprive a club of its exemption.

Revenue Ruling 58-59, 1958-2 C.B. 262 states that where a social club under section 501(c)(7) of the Code finds it impractical to continue its exempt activities and, as a result, sells its property, such sale is incidental to its exempt purposes, and the sale does not deprive the club of the exemption provided by section 501(c)(7).

Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985) was the first judicial consideration of the 1969 Tax Reform Act provision (section 512(a)(3)(D) of the Code), which sheltered gain on sale of property by a social club. The court held in this case that the amount of gain reinvested by a club in new property for its exempt purpose was sheltered from tax, but the amount of gain distributed to the members was subject to tax.

In Atlanta Athletic Club v. Commissioner, 980 F.2d 1409 11th Cir. (1993), a gain on the sale of land that was fully reinvested in other exempt property qualified for non-recognition under section 512(a)(3)(D) of the Code, even though it had not been in continuous or direct use before the sale.

In Deer Park Country Club v. Commissioner, T.C. Memo 1995-567, the sale of land that was never actually used for club purposes was not qualified for non-recognition under section 512(a)(3)(D) regardless of the fact that the organization originally purchased the land with the intent of using it for its exempt function.

Rationale

The service has a long standing position spelled out in Revenue Ruling 58-501 that the sale of property does not deprive a social club of its exempt status. While the point made in the revenue ruling is still the policy of the Service, the ruling does not address whether the revenue from the sale of property is taxable to the social club as unrelated business taxable income.

Congress defined "related business" more narrowly for social clubs recognized under section 501(c)(7) of the Code than for other categories of exempt organizations in determining unrelated business taxable income. When Congress applied the unrelated business income tax to social clubs, it excluded only income earned through their exempt function. Exempt function income of a social club is limited to that received

from members for goods, facilities, and services that further the club's exempt function. Thus, revenue from the sale of property, even if the sale is not in the course of a regular trade or business, is taxable for a social club.

Congress clearly expressed its intent to tax revenue from passive investments by social clubs in the reports accompanying the legislation for Section 512(a)(3) explaining that:

> 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...the extension of the exemption to such investment income is, therefore, a distortion of its purpose. S. Rept. 91-552 (1969), 1969-3 C.B. 423, at 469.

However, Congress afforded social clubs a special exception for revenue earned by the sale of exempt function property that is reinvested into other exempt function property. When a club sells property that had been used directly in the performance of its exempt function, and the proceeds are used within a specified period to purchase other property used in the performance of its exempt function, no tax is assessed. Congress would not have needed to provide for this exception unless it had already determined that revenue from the sale of property is taxable for a social club. The legislative history discusses the reason to protect proceeds that are reinvested in the exempt purpose. Proceeds that are reinvested in the exempt function of the club are:

> Not being withdrawn for gain by 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, at 470-471.

Several courts have ruled on the application of the unrelated business income tax to sale of property by a social club. The court in Tamarisk Country Club, *supra*, ruled that the club did owe tax on the portion of the proceeds from sale of its property that exceeded the amount used to purchase new exempt property because it was not reinvested, but withdrawn for gain by the members of the organization. The court applied the principle that revenue from the sale of property will be taxed, except if it is reinvested in exempt function property.

Other courts also have applied the unrelated business income tax to sale of assets by social clubs. In Deer Park, the property had never been used for exempt functions, and so was not eligible for the non-recognition. In Atlanta Athletic, *supra*, the property did qualify because it was used in exempt functions even though it was not the main

exempt function, and was reinvested in other property used in exempt functions within three years.

In your case, the property being sold has been used in your exempt function. However, you will not reinvest the proceeds in new exempt function property because your organization is disbanding. Your members intend to withdraw the proceeds for private gain. Thus, the proceeds will not be eligible for the special non-recognition of gain provision in section 512(a)(3)(D) of the Code, and you therefore owe unrelated business income tax on the gain.

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

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

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

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 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.

In accordance with the Powers of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437