

501(c)(7); Times To Be Tax-Exempt Checklist

There are at least 6 times in the life of a Private Club when being 501(c)(7) tax-exempt can be extremely important. History has shown that for each of these times, there can be a substantial income tax savings of \$1,000,000 or more. Conversely, Section 277 taxable Clubs place themselves at risk of a substantial tax liability unless they are attentive to these 6 times. 501(c)(7) tax-exempt Clubs should be aware of these times so as not to be placing themselves at risk of losing the tax-exempt status at a critical time. A 501(c)(7) tax-exempt Club engaging in activities that could be detrimental to retaining its tax-exempt status is placing itself at a risk of one or all of these items coming into play. Section 277 taxable Clubs must work to avoid an income tax liability with proper timing of the receipt of income and incurring expenses.

Checklist

_____ **Membership Transfer Gains.** Clubs are often the benefactors when one Member resigns from the Club and replaced by a new Member. If the new Member pays more for the membership than is repaid to the departing Member, there is a membership transfer gain. The IRS has deemed that membership transfer gains are taxable income in a number of Clubs that are not 501(c)(7) tax-exempt. If a Club were to lose 501(c)(7) tax-exempt status and become, by default, a Section 277 taxable Club, this income may become subject to tax. Although the replacement Member is acquiring an equity position in the Club, the IRS is regularly taking the position that the membership transfer gains are taxable income. This is a primary reason Clubs are considering applying for 501(c)(7) tax-exempt status.

_____ **Member Assessments.** Membership assessments could be deemed by the IRS to be taxable income if a Club were to lose its 501(c)(7) tax-exempt status. A taxable Club, subject to Section 277 of the Internal Revenue Code, must review the Member assessment to determine its nature which can dictate whether it is taxable or not. Member operating assessments are included in taxable income of a Section 277 taxable Club. Member capital assessments, where the Member does not have an "investment motive", could find the assessment included in taxable income of a Section 277 taxable Club. The IRS is asking about the "investment motive" when reviewing Member assessments. Failure to establish an acceptable "investment motive" would probably cause the Member assessment to be taxable for a Section 277 taxable Club. ("Investment motive" can be an illusive term not well developed in Club tax law, especially when most Clubs documents note a Club Membership is not to be acquired as an investment.)

_____ **Sale of Club Assets.** When an asset is sold by a 501(c)(7) tax-exempt Club that was "properly used directly in the performance of the Club's exempt function" and the proceeds are timely reinvested, there will not be a taxable transaction. However, the sale of the same assets by a Section 277 taxable Club will be deemed to be taxable income. Clubs wanting to dispose of Club assets "properly used directly in the performance of the Club's exempt function" will not want to be deemed a taxable Club in the year of sale. Below is a list of some assets that have been deemed not taxable for a 501(c)(7) tax-exempt Club:

- Sale of old Club ball fields
- Sale of Club artwork taken from a clubhouse wall
- Sale of excess real estate when "properly used directly..."
- Sale of total Club property in a move from one location to another
- Sale of part of the Club golf course for real-estate development
- Granting of easements
- Sale of water basin
- Granting of options to sell assets, such as an option to sell land

_____ **Capital Asset Replacement Reserves.** 501(c)(7) tax-exempt Clubs establishing capital asset replacement reserves record the receipt of these funds as Member related and will not incur a tax even if the current Member receipts exceeds current Member expenses. Section 277 taxable Clubs must concern themselves with this excess receipts over expenses as it may cause the Club to have a tax liability. If the establishment of reserves does not match the receipt of income with a corresponding expense, there could be potential taxable income to a Section 277 taxable Club.

_____ **Final Liquidation of Club Assets.** The final sale of Club assets in complete termination and liquidation of the Club will not incur a tax liability for the Club if it is 501(c)(7) tax-exempt. A Section 277 taxable Club could incur a tax at the corporate level in this type of final sale. Many Clubs that are struggling to make ends meet often pursue nonmember income to the level that it exceeds the 15% limits of a 501(c)(7) Club and they lose their tax-exemption. The rationale is that as long as the Club is not making any money, there cannot be a tax due. Subsequently, if the Club is liquidated, a tax that could have been avoided on liquidation could be incurred. (At the time of writing this information, the IRS is revisiting this issue and may conclude that the sale of assets by a 501(c)(7) tax-exempt Club in final liquidation may actually be taxable.)

_____ **Taxable Income.** Most Clubs, whether they are 501(c)(7) tax-exempt or Section 277 taxable, operate on a break even budget and with an additional tax deduction for depreciation, do not owe an income tax on Member related activities. However, occasionally there is a Club that does generate a significant amount of net profit from Member activities and are wise to consider 501(c)(7) tax-exempt status.

Clubs that are 501(c)(7) tax-exempt may want to remain as such if they have any of the above transactions. Clubs that fail to be tax-exempt and are by default Section 277 taxable Clubs, must work around these items or just pay any income tax when due. Clubs that are at risk of losing their 501(c)(7) tax-exempt status due to exceeding their nonmember gross receipts limitations or that are pursuing nontraditional activities do not want to lose the tax exemption for a year they were relying on 501(c)(7) to avoid the tax on the above items.

This document is not to be referred to as tax authority. It should be used as a guide in identifying tax issues in the Club industry. Consult your tax adviser to analyze your specific tax situation.