Baker Tilly Tax Alert
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Section 501(c)(7) organizations: Don't lose your tax-exempt status

Section 501(c)(7) organizations (tax-exempt social clubs) have acutely felt the financial stress of the recession. While many have eliminated initiation fees and reduced membership fees in an effort to combat declining numbers, they continue to struggle to attract new members. As a result, these clubs are looking to alternative revenue sources. Social clubs, however, must be careful when attempting to boost revenues. Advertising by social clubs is closely scrutinized by the Internal Revenue Service (IRS) since income generated from certain activities may be considered unrelated business taxable income (UBTI). The IRS will impose penalties on organizations that do not report UBTI, but more importantly, **social clubs that receive too much unrelated business income risk losing their tax-exempt status altogether**. The following discussion addresses what types of income will place a social club's tax-exempt status at risk.

Nonmember and nontraditional income

A social club's activities can be categorized as either traditional or nontraditional. Traditional activities are activities that further a social club's tax-exempt purpose. Income generated by traditional activities involving that social club's members is exempt from tax. Income generated by traditional activities involving nonmembers, however, is subject to tax. Moreover, the IRS may revoke the tax-exempt status of a social club that receives too much nonmember income. While 35 percent of a social club's gross receipts can be derived from nonmember sources, no more than 15 percent of gross receipts can be derived from use of the club's facilities by the general public.[1] For example, in PLR 200623072, the IRS revoked a skydiving club's tax-exempt status because the club received more than 15 percent of its gross income from the general public in the form of fees collected from nonmember students enrolled in skydiving classes.

Nontraditional activities are activities, which – even if conducted with members – would not further a social club's tax-exempt purpose. A social club must pay taxes on income generated by nontraditional activities, and **the IRS may revoke the tax-exempt status of a social club that receives income from nontraditional activities, unless those activities are deemed "insubstantial, trivial, and nonrecurrent."** There is no fixed standard to determine when activities are insubstantial, trivial, and nonrecurrent. The IRS, however, has stated that a de minimis amount of income from nontraditional activities may not jeopardize a social club's tax-exempt status. The IRS can revoke a social club's tax-exempt status for receiving income from any nontraditional activities, but social clubs have historically not lost their tax-exempt status as long as income from nontraditional activities is less than 5 percent of gross receipts. For instance, in PLR 9212002, the IRS revoked a social club's tax-exempt status because its nontraditional income had steadily increased over a five-year period from 4.28 to 6.07 percent of gross revenue.

The IRS determines whether a social club's activity is traditional or nontraditional on a case-by-case basis. While there is no comprehensive list of what activities are considered traditional for a section 501(c)(7) organization, there are a number of authorities that shed some light on what kinds of activities the IRS will deem traditional, i.e., "for pleasure, recreation, and other nonprofitable purposes." The IRS has consistently stated that the commingling of members should play a material part in traditional activities.

In PLR 8424001, an alumni association, in conjunction with travel agencies, operated a travel tour program whereby members would submit reservations and payments through the alumni association. The IRS determined that the alumni association's travel tour program was a nontraditional activity and reasoned: "Commingling of members for social or recreational purposes does not appear to be the goal of the travel tour program based upon the facts available." The IRS did not give specific facts to establish why the alumni association's travel tours did not promote commingling of members; however, PLR 8424001 suggests that travel tour programs can be traditional activities if measures are taken to segregate social club members from the general public.

[1] Typically, the term "general public" does not include a member's guests.

In PLR 9212002, the IRS determined that food sales by a social club to members for consumption off premises were nontraditional activities. It also established that the short-term rental of sleeping rooms and "mini-offices" are both traditional activities, while the sale of petroleum services, rental of sleeping rooms on a permanent basis,[2] and operation of a commuter parking garage, as opposed to a garage providing access to the club itself, are likely nontraditional activities.

Advertising

In addition to monitoring types of activities and who participates in those activities, social clubs should also exercise caution when advertising. A social club is not prohibited from advertising to promote or increase membership, but advertisements that solicit public patronage of a social club's facilities create the presumption that a social club is engaged in business and not operated for simply pleasure, recreation, or social purposes.

In Rev. Rul. 65-63, 1965 C.B. 240, a club organized for various sport car events was denied tax-exempt status because the club solicited public patronage of its auto races. In PLR 201025078, a wine-tasting club advertised its membership policy, which established that any person who purchased services or products from the club was automatically a club member. In denying the wine-tasting club's application for an exemption from income tax, the IRS reasoned: "the persons whom you call members are essentially the customers of your commercial business operation. Thus your commercial advertising for public patronage of your facilities, standing alone, provides sufficient justification for the proposed denial of exempt status."

Consistent with the concept that a social club can receive up to 15 percent of its gross income from the general public's use of its facilities, the IRS has issued an information letter that states that a social club is not necessarily engaged in the operation of a business when the social club solicits public patronage of its facilities. In other words, a social club may not necessarily lose its tax-exempt status for soliciting public patronage of facilities. The IRS will evaluate "the form and nature of the advertising and the nature of the social club" to determine whether the advertising is permissible. While this information letter suggests an expansion of what types of advertising are permissible for social clubs, the IRS is likely to closely scrutinize a social club's advertisements.

For more information or any questions you might have on this topic, we encourage you to contact your Baker Tilly tax advisor or send an e-mail to tax@bakertilly.com.

[2] The IRS did not establish a fixed time period to distinguish between "short-term" and "permanent." Short-term sleeping rooms were rented to members in connection with special club events or for out-of-town guests. Permanent sleeping rooms, in contrast, were rented to members as a principal residence during divorce proceedings.

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