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“Tax Issues When Social Clubs Liquidate
and Sell Property”
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Faced with general economic hardship and declining membership, some golf clubs and other recreational clubs are being forced to dissolve and sell long-held property. Unlike most exempt entities, such recreational clubs, which are generally exempt as social clubs under §501(c)(7) of the Internal Revenue Code of 1986 (the Code) as amended, are taxable under the unrelated business taxable income (UBTI) regime of §511 et seq. of the Code when they sell their property. However, there is little, if any, guidance as to how the gain that a §501(c)(7) organization realizes upon the disposition of its property should be determined.

Many clubs have held their property for long periods of time during which substantial appreciation is likely to have occurred, even after adding in any capital improvements that may have been made. Over the same period, such clubs may show substantial depreciation on their books, potentially creating the possibility of substantial gain above the actual historical appreciation of the property.

Should such depreciation be taken into account in determining gain from liquidation sales? It appears that it should not, except to the extent such depreciation has been used to calculate income from an unrelated business of the entity, such as catering operations for nonmember functions.

Section 512(a) (3) of the Code states the general rule that social clubs are taxable on all of their gross income other than income from "exempt functions." Although the Internal Revenue Service (IRS) has in the past taken the position in private letter rulings that liquidity sales of property by social clubs are not taxable, it has recently ruled that they are.¹ The ruling appears to be correct, since the definition of "exempt function income" set forth in §512(a)(3)(B) does not include gain from the sale of property and, by implication, in fact excludes it.

In this regard, the nonrecognition rule of Code §512(a)(3)(C), which imports §1031 like kind and §1033 conversion concepts and permits social clubs to avoid recognition of gain when they exchange property for other recreational property or when they purchase property with the proceeds of an involuntary conversion or with the proceeds of insurance after a casualty within a three-year period implies that gain of a social club which is not so protected is taxable.

Code Provisions

The proposition that a club's basis in its property for purposes of determining gain should be the historical cost of its property plus the cost of capital improvements reduced only by depreciation

used to calculate income from an unrelated business is supported by analysis of Code provisions and regulations.

Section 512(a)(3)(A) defines unrelated business taxable income of a §501(c) (7) organization to be its "gross income" less "the deductions allowed by this chapter which are directly connected with the production of the gross income." Code §61(a)(3) includes as gross income "gains derived from dealings in property." Code §1001(a) defines gain as the amount realized less adjusted basis of the property as provided in Code §1011. Section 1011(a) looks to cost of property under Code §1012 as such cost is adjusted under Code §1016. Section 1016(a)(2)(A) requires that the cost of property be reduced by depreciation allowed by the Code, but §1016(a)(2)(B) appears to limit such depreciation to the amount allowed by the Code and which produces a tax benefit.

However, carryover language in §1016 provides that the amount of depreciation "allowable" is the measure for basis adjustment if it is greater than the allowed depreciation restricted to the tax benefit amount. Treas. Reg. §§1.1016-4(a) and (b) require that exempt organizations make an adjustment for depreciation, regardless of any tax benefit from the depreciation, and generally look to the organization's book depreciation as the amount to be used. Since a 501(c) (7) entity receives a tax benefit from depreciation only to the extent a portion is allowed as a deduction in determining its taxable income from an unrelated business, the depreciation "allowable" should generally be the measure for adjusting the basis of its property unless another rule applies. Treas. Reg. §§1.512(a)-1(a) and (b) may supply such other rule.

These regulations provide that an item (including depreciation) is deductible for purposes of the UBTI only if it is both allowed under the Code and is "directly connected with the carrying on of an unrelated trade or business." Depreciation of a building will be entirely "allowable" under that Regulation only if the entire building is used to conduct an unrelated trade or business.

Presumably it is not "allowable" to the extent the building is not so used and should therefore not reduce basis of property of a 501(c) (7) organization for purposes of determining gain from a liquidating sale of that property, although it must be said that these regulations are not on their face concerned with gain determinations but only the periodic taxable income from unrelated trades or businesses.

Legislative Basis

Further support for the proposition may be found in the legislative basis of the much broader UBTI tax regime which the Code imposes on the investment income of social clubs. As the United States Supreme Court explained in *Portland Golf Club v. C.I.R.*, 497 U.S. 154 (1990), "social clubs are exempted from tax, not as means of conferring tax advantages, but as a means of ensuring that the members are not subject to tax *disadvantages* [emphasis in the original] as a consequence of their decision to pool their resources for the purchase of social or recreational services. The Senate Report accompanying the Tax Reform Act of 1969...explained that that purpose does not justify a tax exemption for income derived from investments... Congress intended that the investment income of social clubs should be subject to federal tax...the statutory scheme for the taxation of social clubs was intended to achieve tax *neutrality* [emphasis in the original]... Even the exemption for income from members' payments was designed to

ensure that members are not disadvantaged as compared with persons who pursue recreation through private purchases rather than through the medium of an organization."

Conclusion

Forcing a social club to use depreciated basis (other than any depreciation allowable in the calculation of income from an unrelated trade or business regularly carried on) upon a sale of its facilities would place its members at a disadvantage to unincorporated recreational associations of individuals who simply pool their resources to own club facilities. Such treatment should therefore be contrary to the intent of §512(a)(3) as interpreted by the U.S. Supreme Court.

It should be noted that social club members may still not receive treatment equivalent to members of unincorporated recreational associations because of the potential for a double tax on any gain from a liquidating sale of club property. In Rev. Rul. 55-737, 55-2 C.B. 570, which long predated the enactment of §501(c)(7) and was issued at a time when the IRS apparently took the position that liquidating sales of social club property were not taxable, the IRS ruled that liquidating distributions to members were taxable to the extent they exceeded any initiation fees. The IRS took a similar position in a 1984 private ruling.² However, the double tax approach which results today from that position does not appear to be consistent with Congress's concern that member income from recreation facilities held through a §501(c)(7) social club be taxed in the same way as if such facilities were owned by the members directly.

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Endnotes:

¹ See PLR 201003022 (Oct. 29, 2009), and see GCM 39658 (Aug. 27, 1987), but see PLR 200451031 (Sept. 24, 2004); 200447026 (July 25, 2004).

² See PLR 8409067 (Nov. 30, 1983).

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