non-profit status: WHEN IS IT A DRAWBACK?

This third article in a series, which explores the impact that a change in the tax-exempt status would have on a club, studies the financial point at which a club may consider dropping its exempt status

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Private clubs pay out a large amount of money to meet various kinds of taxes. Real estate taxes levied by state and local governments probably are the biggest; payroll taxes and retail sales taxes continually drain money away from clubs and their members and impose administrative burdens on clubs. The Federal income tax is the smallest paid by a club (for most, no substantial amount of tax is ever paid), yet the complexity imposed upon the management of clubs by this tax exceeds all the others put together.

The member-owned club usually is organized as a non-profit corporation and is governed by a board and a set of officers chosen by and from among the members. This type of club is the most numerous in the industry, comprising roughly 95 per cent of the membership of the National Club Assn. The majority of these clubs are exempted from Federal income taxes by law.

EARLY INFORMALITY

From the beginning of the passage of the Federal income tax in the early part of this century, golf clubs have enjoyed this exemption, first founded in an informal policy set by the Internal Revenue Service, which permitted clubs simply to ignore the new law. It grew quickly in importance, however, and by 1916, it became necessary for Congress to formalize the exemption. They did this by including golf clubs in the list of types of exempt organizations. That list now contains 18 separate categories describing about 35 types of exempt organizations.

The statutory exemption for clubs is simply phrased to include "clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder." This seeming simplicity was expanded over the years by the IRS, which has issued about 45 published rulings for the guidance of clubs. The ensuing complexity of the law has come about because the IRS has single-mindedly tried to hold to an absolute minimum the amount of non-member participation in a club's activities. Its concern is that clubs will sell goods and services to non-members at a profit and that tax-free profit will fall naturally into the hands of the members in one form or another. Usually, this profit takes the form of lower member dues. This, says the IRS, is "inurement" of net earnings and is specifically prohibited by the statute.

About 10 years ago, the IRS promulgated the now-famous 5 per cent rule to control non-member business. The thrust of the rule is to provide a "safe harbor" for clubs that earn 5 per cent or less of their total gross receipts from non-members. Those clubs that do not hold down their outside business to this safe level risk losing exempt status, if they are found to be "doing business with the general public." Because no one has been able to figure out the meaning of that phrase, a rule of thumb developed: If a club is between 5 and 10 per cent, it keeps its exemption if it can demonstrate that it had some good, non-profit motive for exceeding the guideline; if it goes over 10 per cent, it loses its exemption.

Perhaps, all this doesn't sound too complicated, but every year the IRS national office in Washington decides about two dozen cases. The clubs involved spend a lot of time and money on the procedures, and the IRS has had to make decisions using vague standards. Club officials are faced with an unhappy situation: they must determine daily what is or isn't outside business and refuse non-member business, an unpleasant duty; and members must fill out irritating forms whenever they entertain a party of more than eight people.

For the same reason that non-member business is restricted, loss of exemption can result from earning too much investment income. Idle cash in a savings account and a "rainy day fund" kept in bank certificates of deposit produce investment income. So does a building fund invested in corpo-

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rate or Government securities. This passive income came tax free to an exempt club, and the IRS had to impose a prohibition to prevent "inurement." How much is too much investment income and what effect differing circumstances may have on the result is even vaguer than the rules on outside business.

UNRELATED BUSINESS INCOME TAXED

More than 20 years ago, Congress imposed a tax on the unrelated business income of some exempt organizations. The classic example of the type of abuse needing correction was the tax exempt university that owned a macaroni company. Clubs were not subject to this tax for reasons more historical than logical. Then Congress passed the massive Tax Reform Act of 1969, curing this historical accident by extending the unrelated business tax to include clubs as well as all other exempt organizations. Under this new law, all profits on non-member business and investment income are taxed.

Before the passage of the Tax Reform Act, profits from member income, non-member income and investment were not taxed. Now that the act is in effect, profits from member income remain tax free, but profits from non-member income and investment income are taxed. It would seem logical that the imposition of the tax would remove the requirement for limiting non-member business and investment income. But this didn't happen when the act was passed. As an incidental matter, though, Congress now is considering increasing the 5 per cent rule to 15 per cent and imposing a 10 per cent guideline limit on investment income.

Even before the first draft of the 1969 act was published as a proposal, Congress foresaw the obvious loophole. An exempt club would set its prices to produce a profit on non-member business and anticipate being taxed. Looking at the financial statement, though, the club could see that over-all it was operating at a loss or at best it was breaking even. If the club gave up its exemption, it could take its loss on membership operations from its profits on non-member operations, show no taxable income and pay no tax. Congress never allowed that loophole to come into existence.

As part of the Tax Reform Act, a provision was included to disallow deductions related to membership activity in excess of income from membership activity. Thus, no matter how much loss a club incurs in membership activity, the loss cannot be written off against non-member activity and a non-exempt club remains taxable on its non-member profits and its investment income. The result of all of this? Parity—the exempt club is treated the same as the non-exempt club, with some differences. These differences are worth examining in deciding how much a club's exempt status is worth.

The first difference is that the exempt club has a $1,000 specific exclusion from income. That comes off the top and represents a tax savings of probably only $220, but depending upon the bracket, $480 as a maximum. As a matter of judgement, one may conclude that this difference is insubstantial and will not have any significant importance in any decision making process.

A more significant difference is the ability of an exempt club to sell property without paying capital gains tax. A taxable club is an ordinary corporate taxpayer (except for the limitation on deductions discussed previously) and pays a tax on capital gains at a 30 per cent rate. The difference, then, can be substantial.

The relief from the capital gains tax for an exempt club is somewhat narrow. First, it applies only to the sale of property used in the exempt function, such as land and buildings. It does not apply to investment assets, such as securities or rental property. Second, the proceeds of the sale must be reinvested in property used in the exempt function within three years. When these restrictions are met, and it is usually not difficult to comply, the capital gain on the sale need not be recognized.

For example, suppose a club, which has 100 acres of land surrounding its golf course, determines that holding the land is an intolerable burden. The land is sold then in one parcel to a housing developer with architectural restrictions ensuring appropriate development. Assume a cost of $100 an acre when purchased 20 years ago. The sale price is $5,000 per acre to the developer. Below is a comparative calculation of the Federal tax impact:

	Taxable club	**Tax-exempt club**
Proceeds of sale	$500,000	$500,000
Expenses of sale	35,000	35,000
Amount realized	465,000	465,000
Basis in land	10,000	10,000
Gain realized	455,000	455,000
Gain recognized	455,000	-0-
Tax rate	.30	.30
Federal income tax on sale	136,500	-0-
After tax profit on sale	318,500	455,000

The difference is simple and apparent. The taxable club paid $136,500 in taxes; the tax exempt club paid nothing. The exempt club now has nearly one-half million dollars available, but it is restricted. The money must be put to use within three years. The taxable club can use its money, nearly one-third million dollars, for anything it wishes, including reducing dues or absorbing a loss from operations. If the exempt club had plans to spend $155,000 per year on capital improvements whether the land was sold or not, it has no difficult judgment to make. The problem arises only if the exemption forces reinvestment in a manner and at a time contrary to the club's desires.

Despite this judgement factor, it seems clear that tax exemption has some value from the potentiality of the tax-free sale. The quantification of that value is difficult. It will depend primarily upon the probability of any sale of assets. If it seems unlikely that any sale could ever occur, then the value would be

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vania or in Kansas or in California. It is very nearly universal. Details are not a part of this editorial. They will be documented in a later article for GOLFDOM. In the meantime, it is my hope that club officials will have read this piece and will make a meaningful start toward establishing an adequate pension-retirement program for the golf course superintendent. It is later than you think!

WHAT? NO PENSION?

A good friend of long standing, a retired golf course superintendent now living in Florida, wrote to me recently. After 26 years of devoted service to his club (and he had many good years of service left) he was "retired," actually dismissed, without a pension of any kind. I know the man and I know the club. He introduced innovations in equipment, fertilizers, ground covers and many other things. What I don't understand is how the businessmen for whom he worked could so callously turn him out to pasture without the thank you and the courtesy of some sort of pension or endowment. it is a bit like unharnessing the horse, opening the pasture gate and giving him a slap on the rump.

This friend is understandably bitter, soft-spoken as he is. It is too late to turn back the clock for him, but his experience, which is shared by many, should guide present and future negotiations between club and superintendent. Surely there must be some guidelines that can help the new or old superintendent achieve a just and honorable contract, which will help to sustain him when he retires. Club officials should bow their heads in shame if they do not insist upon some such stipulation in the contract. One may safely assume that nine out of 10 businessmen in the club have made sure that they will have a retirement income. Shouldn't they also do the same for one of their most devoted employees?

I have just talked with another good friend who has been at his club since it was built about 1952. He has tried to negotiate a retirement benefit for several years, but each time he is told that he is being selfish in wanting something just for himself. These short-sighted officials one day will wonder, "Why can't we attract good men?" The horse is not likely to be drawn to an empty feedbag. □

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low. If a sale is imminent, the value would be high. Most decisions would be made upon facts falling somewhere in between these two extremes, and so the judgement of necessity would be imprecise.

Going beyond the two enumerated statutory differences, let us examine the differences in treatment on ordinary club operations. To begin, one must acknowledge that the necessary generalization of this discussion makes it inapplicable to any specific case. The practical performance of the comparison should be accomplished on a case basis. The method would be to construct tax returns on both Form 990T (applicable to the tax exempt situation) and Form 1120 (applicable to the taxable situation). The difference in the bottom line figure showing tax due the Government would be indicative of the value of exemption.

A generalized treatment of the problem is not instructive. Industry statistics generally show that the operating departments of clubs produce a loss and that when overhead (but not depreciation) is included that loss increases substantially. The Harris, Kerr, Forster 1971 aggregate for 75 country clubs shows about $40 million of operating income and a resulting loss of well over $20 million. The difference is made up from members' dues, which also produces enough revenue to leave about $1 million as excess of income over expense. Depreciation would take care of most or all of this so that no tax would be payable. Even the limitation on deductions applicable to member activities would not produce a change, because from a tax standpoint, even the non-member activities are operated at a loss. So the "aggregate" clubs would not be paying any tax even if they were taxable.

As is well known, however, the "aggregate" clubs are, in the main, tax exempt. Experience has shown, and the aggregate figures confirm, that these clubs are not paying any significant amounts of unrelated business tax.

But suppose that a particular club trying to make an informed judgment on the worth of its exemption isn't anything like the aggregate. Suppose instead that by conscious decision and skillful management it is making a profit on operations and has a lot of income in excess of expense—so much that it wouldn't be eaten away by depreciation. The result would be different.

Insofar as this club would be paying a tax on non-member income (and it would) no difference would exist between taxable and tax exempt status. The big difference for such a club is that without exemption, it would be paying taxes on the profits from member income.

PROCEED WITH CAUTION

If the foregoing has any value, it is that it brings out the desirability of a comparative computation. Beware, though, that the computation is not made poorly. An unskilled computation would be worse than misleading, it could produce a misjudgment costing the club a lot of money.

This discussion, and the two earlier articles on the subject of giving up tax exemption have undoubtedly demonstrated the complexity of the issue. It seems clear that a decision cannot be based upon a snap judgment, neither can it be based solely upon debate in the board room. The decision must result from informed calculations and conscious judgment. □

CASPER DIRECTS ON THE COSTA BLANCA

NEW YORK—One of the world's top-ranking golfers, Billy Casper, has been named director of Golf at the new Almaina Park G & CC in Alicante, Spain.

The announcement was made by Casper and the developers of the plush resort on Spain's Costa Blanca, a Riviera-type strip on the country's south-central Mediterranean coast. Almaina Park will be designed for residential, vacation or retirement living, it was announced, and will include two 18-hole courses.

Casper, who will retain his affiliation with Boise Cascade/Ocean Pines, won more PGA tournaments in 1966-70 than the three other top players combined.