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## Accent on management

by Ken Emerson

### Tax reform and Private clubs

Events occasionally occur which are of sufficient importance to the industry to require immediate explanation. Such an occasion was the appearance of the National Club Assn. representatives before the House Ways and Means Committee last January 24. As executive director of the NCA, I would like to offer the following report of our testimony, stating the association's position on tax reforms.

Historically, the U.S. Treasury Department has found that securing tax returns from social clubs was "a source of expense and annoyance and has resulted in the collection of either no tax or an amount which is . . . negligible."

It is clear that the inclusion of social clubs in the list of exempt organizations in the 1916 tax law the first time they were included, was not a matter of Congress conferring a benefit to aid clubs, but was rather a recognition of the economic reality that bona fide member-owned, social clubs have no taxable income in an economic sense.

Indeed, two years before Congress enacted the exemption into law, the Commissioner of Internal Revenue recognized the exempt status of social clubs in an interpretive letter sent to a taxpayer, recognizing the economic reality.

The Treasury Department has now made certain recommendations on tax reform and proposes

the extension of the unrelated business income tax to social clubs exempt from income tax under section 501 (c) (7) of the Internal Revenue Code. While the National Club Assn. does not oppose this principle and, in fact, agrees with the Treasury that new legislation is needed in this area, the association does feel that this new concept should be closely examined for the sake of order and reason in the law and, also, to be certain that any new legislation has a desirable appropriate effect upon both the IRS and a worthwhile industry.

There are four problem areas which have developed in the more than 50 years that clubs have operated in this manner. It is to these problem areas that the Treasury proposals are directed. And it was to these problem areas that the NCA directed its testimony when it appeared before the House Ways and Means Committee last January. These areas are: 1) Doing business with non-members; 2) Non-social business transactions with members; 3) Investment income; and 4) Capital Gains.

In its testimony before Ways and Means the industry had this to say about these four areas.

#### NON-MEMBER BUSINESS

In order to fulfill its function, the club must permit its members to bring guests to the club in the same manner that members bring guests into their own homes. In this situation the club treats the members' guests in the same manner that it treats its members. But

Continued on page 30



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**Emerson**

*Continued from page 28*

beyond this, there is other non-member participation in club activity which is nearly impossible to avoid. One example occurs in small communities where the club is the only facility available for large social gatherings. In this case a club performs a community service by making its facilities available to the general public upon appropriate occasions.

The IRS and the courts over the years have established limitations on this non-member usage. Perhaps the most important of these limitations is the 5 per cent rule promulgated in Revenue Procedure 64-36 which was issued more than four years ago. It stated: "Where the activities of a social club in making its facilities available to the general public are of such magnitude and recurrence as to constitute engaging in business, the club will be deemed not to be operated exclusively for pleasure, recreation, or other non-profitable purposes."

It then went on to say that where the percentage of gross receipts from the general public is 5 per cent or less of the total gross receipts, the IRS will consider that receipts from non-members will not conclusively demonstrate a deliberate purpose to engage in business. Thus, the social club industry has been permitted to fulfill its obligations to its members and to the community within the framework of the statute as it exists at the present time. It should be made clear that this small amount of permissible activity is not generally used by the industry with a profit-making intent.

We do not object, in a theoretical sense, to the imposition of the unrelated business income tax upon profits which may accrue to the club from this type of activity. We do feel, however, that the position advanced by the Treasury Department 50 years ago remains valid today. Any amount of tax which might be collected from this miniscule tax base would have to be borne both by the IRS and by the industry. Detailed commentary from the industry on this

*Continued on page 32*

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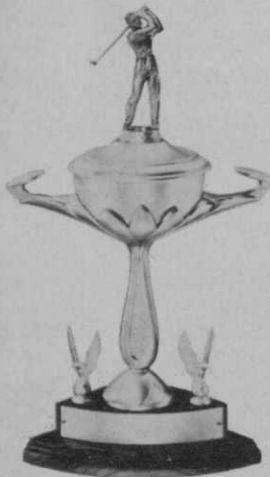
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## Emerson

Continued from page 30

point must await the drafting of specific legislation on the subject.

If, however, new legislation should be drafted to extend the unrelated business income tax to cover these transactions, it would appear that the necessity for a restriction on the amount of that activity would disappear and, if speculation serves any purpose, the removal of the restriction coupled with the imposition of the tax may provide some benefit to the IRS.

Most of our clubs, we expect, would continue to operate in the same manner as today and restrict usage of club facilities by non-members to the present level well under 5 per cent.

### NON-SOCIAL TRANSACTIONS

In recent months the Internal Revenue Service has promulgated Revenue Ruling 68-535 which prohibits the sale of alcoholic beverages to members for consumption off the club's premises. The theory is that such sales are unrelated to the exempt purposes of the club. This ruling has had a significant impact upon the operations of many clubs, and a few weeks ago the IRS announced that the ruling would be given prospective application only.

It would appear that liquor sales to members are not inconsistent with the theory of exemption, which is mutuality. As in other areas of activity the income of the liquor sales department would approximate its expenses and no taxable income would be generated.

We see no difficulty in administration of the tax laws should this type of activity be permitted. The only problem would come from a continuation of the present status with respect to the unrelated business income tax should sales be made to non-members. But here again the Treasury proposal would solve this.

It should be noted in this context that in view of the 5 per cent rule previously described, the statute is partially interpreted that way in any event.

Continued on page 44

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## INVESTMENT INCOME

Investment income appears now to be a minor problem. The IRS has ruled on many occasions that an exempt club may not receive investment income with a few minor exemptions. When these exceptions do apply we feel that a tax on the income would be appropriate. However, here as with non-member income, the imposition of the tax would obviate the need for the prohibition.

## CAPITAL GAINS

We must voice our opposition to the proposal to tax the capital gains of social clubs. We are not aware that this proposal would raise substantial revenues from the Treasury's standpoint, but the amounts from the standpoint of an affected club would be large and in some cases catastrophic.

Capital gains arise infrequently in the industry as a whole. They almost invariably occur when a club sells land as a result of condemnation or economic necessity.

The economic necessity usually

arises when the property tax burden on the club's land becomes too heavy for continued use. Typically our country clubs are subject to the increase in land values which has been a characteristic of our economy for many years. As urban usage spreads to the borders of a country club, its land value will increase dramatically. In most states land is taxed at a value based upon the highest and best use to which the land can be put. If high-rise apartments appear in a club's neighborhood, taxing authorities will value the club's land at the same figure as the apartment developer's land. This causes great increases in taxes—in one example a club which paid \$30,000 for property taxes last year received a bill for \$180,000 for 1969 property taxes.

These drastic tax increases require that the club move to less valuable land. This requires the construction of entirely new facilities and usually requires the club to borrow heavily to augment the land sale proceeds in financing the acquisition of new facilities.

When land is condemned the problem is similar. The club must move and acquire new facilities.

In both these cases the capital gains tax would take away a significant portion of the proceeds and, in some cases, prevent the club from reinstating operations.

A sale of club property is usually a wholly fortuitous event. But, it is an event which is contrary to the preference of the members. They do not move voluntarily; they do not sell their facilities voluntarily. When this event does occur—and it's happening more often—it is always damaging to a club and frequently the damage is irreparable.

## SUMMARY

Our position then, is that we do not oppose the principle of the extension of the unrelated business income tax to clubs. We oppose vigorously the imposition of a capital gains tax on the sale of club facilities.

For a comprehensive look at the rising property costs that are plaguing today's country clubs, turn to page 54

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