OPERATING UNDER THE TAX REFORM LAW

By JACK P. JANETATOS and KENNETH EMERSON

This complex law has even the experts baffled. Until new regulations are issued, private clubs will have to file returns without official guidance. The authors give authoritative advice

NEARLY all country clubs in the United States are member-owned non-profit corporations; therefore, they have always been exempt from the Federal income tax. Now, the much publicized Tax Reform Act of 1969 has gone into effect, imposing on these clubs for the first time an income tax. Hereafter, the management of private clubs will have to provide for the payment of an income tax bill.

Complying with this new law, however, will not be easy. The Tax Reform Act is so complex that many tax counselors have called it a monster, because portions of it puzzle even the experts.

In its most pertinent parts, the act amends the Internal Revenue Code to provide for a tax at regular corporate rates on the "unrelated business taxable income" of clubs. The new law defines unrelated business taxable income as "gross income." It then goes on to permit certain deductions.

The first and most important deduction is "exempt function income," defined as: "Gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests, goods, facilities or services in furtherance of the purpose constituting the basis for the exemption of the organization to which such income is paid."

Next, clubs are permitted to take a deduction for all the ordinary and necessary business expenses directly connected with earning the gross income but not the exempt function income. Since all exempt function income is deductable it is not possible to deduct expenses connected with it, because that would amount to taking the same deduction twice.

Clubs may also deduct amounts of income set aside for charitable purposes without limitation.

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Finally, clubs need not include certain capital gains in income. Where property used directly in the performance of a club's exempt purposes is sold at a profit and if the proceeds of the sale are reinvested in property to be used for exempt purposes during a period beginning one year before the sale and ending three years after the sale, then gain on the sale is not recognized and will not be included in gross income.

QUITE clearly, the Tax Reform Act works a revolution. *Clubs which never paid income tax will now have some tax obligation.* It is difficult to imagine a club not having at least some small amount of unrelated business income. At the very least the tax will be applied to non-member income and investment income and nearly all clubs have some of both.

The new law went into effect on January 1, 1970, but the tax is applicable to clubs only for fiscal years commencing after December 31, 1969. A club on a calendar year accounting system became subject to tax on January 1, 1970. A club on a June 30 fiscal year will be taxed on income earned after July 1, 1970.

THE most obvious problems under the new law revolve around the definition of exempt function income. This is a lengthy and complex definition—perhaps too lengthy; certainly too complex. There are four parts to the definition; each raises other questions.

The income, to be excludible, must be paid by a member. *If a member's bill is paid by the member's employer, will the amount be taxable? No such ruling has been made, but the possibility exists.* Certainly, if the charge is paid by a guest the tax would apply, and if in the case of a group party, the group should pay or reimburse the member, the same adverse result could occur. *

The seriousness of this suggestion should not be discounted. One club currently under audit has been required to provide the Internal Revenue Service with a list of the employers of its members. These companies, in turn, are being asked by the IRS to state whether, in fact, they are paying the member's dues and charges.

The amounts paid must be for dues, fees, charges or similar purposes. Congress, it may be assumed, intended to be all-inclusive with this wording, and it is difficult to imagine any amounts paid to clubs which would not be included by this language.

To be excluded from the tax, the charges must be incurred by members, their dependents or their bona fide guests. This part of the definition incorporates the long standing question of who is a bona fide guest. (A rule of thumb definition is someone whom the host pays for.) Since the advent of Revenue Procedure 64-36 promul-

**The NCA in its newsletter has been urging clubs to accept only personal checks in payment of members' accounts. One Eastern club, reportedly, issued a notice to its members which said: "Membership in the club is held only by individuals. Payment of a member's account . . . other than by the member's personal check creates improper inferences as to the status of the membership and also might raise tax problems for the club."*

gating the Five Per Cent Rule, the IRS, however, has never formulated a definition which would serve to identify a guest from a non-member paying customer. Perhaps now this new law will impel the service to formulate some rules so that clubs will be able to compute their taxes properly.

The goods, facilities and services for which the charges are made must be within the exempt purposes of the club. *Several months ago a ban on package liquor sales was imposed by the IRS.* The reason for the ban was that off-premises consumption of liquor was not social and did not further a club's exempt purposes. *Any income from this type of activity would be taxable even when paid by a member.*

SIGNIFICANT problems exist also under the deduction for the ordinary and necessary business expenses directly connected with investment and outside income. Determining the amount of allowable deductions will be very difficult. Consider, for example, a typical outside party of 100 non-members at a luncheon. It seems clear that a club would be able to deduct its cost for the food and beverages sold at the lunch and the salaries of the personnel working at that party. But it cannot now be determined whether the club will be permitted to charge off any portion of depreciation on the clubhouse or the capital equipment necessary to conduct such luncheons. There is also a question whether any of the salaries of the supervisory and administrative personnel would be deductible.

The Treasury Department will, perhaps in 1971, issue regulations under the law which may clarify some of the problems. Numerous articles will be appearing in various trade and professional journals in the coming months which will alleviate some confusion, and inquiries can be mailed to the National Club Assn. in Washington, D.C. *Nevertheless, a large number of clubs will be forced to file tax returns and pay taxes before any official guidance is issued.*

Few observers fault Congress for its noble intention of reforming the tax law. Even fewer would grant that Congress did an adequate job of it. The new law, if it has closed some loopholes, has nevertheless created additional complexity which may result in a protracted course of litigation harmful to clubs and costly to the Government. □

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A Brief Tax History

When the income tax came into existence in the early part of this century, private clubs were generally considered not subject to this law because they were non-profit organizations, which the Internal Revenue Service recognized publicly when it issued a ruling advising clubs that no tax returns would be required from them.

But by 1916, it became necessary for the IRS to back up its earlier ruling with statutory authority. So in that year at the Treasury Department's request, Congress added private clubs to the list of tax exempt organizations described in the law. The provision, section 501(c) (7), exempting clubs has changed little over the years.

Subsection (7) exempting clubs is but one of 17 such subsections which provide exemptions for a multitude of different types of organizations. The same law which exempts from the tax hospitals and schools, also exempts country clubs, the operations of which are certainly of a different kind. To many the inclusion of private clubs in this group appears to be an unjustified tax preference.

As the years passed and tax rates climbed, tax exempt organizations began to expand their operations into areas outside the scope of their tax exempt purposes. By the end of the 1940s these business activities began to take on the appearance of tax avoidance. Becoming aware of these profits, Congress enacted in 1950 a tax on the unrelated business income of some types of exempt organizations. These groups were required to set up separate accounts for their unrelated business and pay a tax on the profits. It should be noted that clubs were not included in the list of organizations covered by this tax.

In the early 1960s, the IRS initiated a course of increased audit activity. From these audits came numerous cases in which the agents proposed that the exemptions of clubs be revoked. The contention was invariably based upon the amount of non-member business the clubs were doing. Each case had to be decided finally at the IRS headquarters in Washington.

Clearly the time had come for the IRS to formulate a standard to determine how much outside business was permissable. In 1964 the IRS issued the now famous Revenue Procedure 64-36 setting forth the Five Percent Rule. The rule took the form of an audit guideline instructing revenue agents in the field that they were not to propose revocation where total gross receipts of a club from non-member sources did not exceed 5 per cent of total gross receipts from all sources.

Despite cries of anguish from many club representatives, this restrictive rule seemed to work well in practice. Certainly the rule caused a drastic reduction in the number of proposed revocation cases. First, it prevented the agents from proposing revocation where the amount of outside business was very small. Second, it gave club management a firm guideline to aim for in cutting down on nonmember business.

A few years ago strong taxpayer sentiment began to develop for drastic reform of the tax laws. The 10 per cent surtax pushed tax rates to unbelievable heights and the increasing publicity surrounding tax "loopholes" added impetus to the movement. In response, the Johnson Administration, late in 1968, developed a package of tax reform proposals.

Early in 1969 the House Ways and Means Committee held hearings on the proposals; and the first draft of the Tax Reform Act of 1969 resulted. The bill worked its way through the Congress; last December, the President signed it into law.