IRS guidelines: A little less confusion

The release of the Internal Revenue Service Guidelines to the Tax Reform Act of 1969 on May 12th, 1971—13 months late—provided few surprises.

Covering 40 typewritten pages, they provide expanded definitions of "unrelated business taxable income," "exempt function income" and "directly connected expenses." These terms are of great importance to nonprofit clubs calculating their unrelated business tax.

In general the new law is designed to impose a tax on all income from nonmember sources. The guidelines define "exempt function income"—that income not subject to tax—as "gross income from dues, fees, charges, or similar amounts paid by members in connection with the purposes constituting the basis for the exemption of the organization." To this category the guidelines add "passive income"—interest income—that is set aside for charitable purposes.

The guidelines further define "directly connected expenses" as those expenses directly connected with the production of the unrelated business taxable income and which are incurred in the production of that income. The guidelines specifically exclude from this category all dividends received deductions. However, it appears that such expenses as depreciation, maintenance, overhead and such administrative expenses as can be documented will be allowable deductions.

"Unrelated business taxable income" is defined in the guidelines as "gross income (excluding exempt function income) less those deductions directly connected with the production of the unrelated business taxable income."

Probably no single issue in the law has stirred as much concern as the limiting of exempt income to that income "paid by a member" and its possible application to corporate checks. After a lengthy meeting early this year with the National Club Assn., IRS now has added the following clarification to the guidelines.

"The fact that a member is reimbursed by his employer or a gratuitous donor for amounts paid to a social club . . . will not prevent the amounts so paid from being considered to have been paid by the member . . ."

The guidelines then go on to make clear that when a company pays a member employee's account for the benefit of the member employee, the payment will be considered to have been paid by the member. When the beneficiary is the company, *i.e.*, the company Christmas party, the payment will be considered to be taxable income.

Much of the remainder of the guidelines are given over to specific examples which will certainly help many clubs with specific problems. However to further resolve these problems IRS has also issued Revenue Procedure 71-17.

Rev. Proc. 71-17 is particularly significant because, as of July 1st, it replaces the old Rev. Proc. 64-38, the so-called "5% guideline." The new procedure deals almost exclusively with the use of a club's facilities by nonmembers.

Of great importance to clubs in determining whether or not they are within the "5% guideline" is 71-17's definition of gross receipts. Among the source of income excluded under the new definition are: 1) Initiation fees and capital contributions and 2) Interest, dividends, rents and similar receipts.

Of even greater importance to clubs, both profit and nonprofit, is the new procedure's requirement on determining the status of nonmembers. The procedure reads:

1) "Where a group of eight or fewer individuals, at least one of whom is a member, uses club facilities, it will be assumed for audit purposes that the nonmembers are the guests of the member, provided payment for such use is received by the club directly from the member or the member's employer.

2) "Where 75% or more of a group using club facilities are members, it will likewise be assumed . . . that the nonmembers in the group are guests of members . . .

"In all other situations, a host-guest relationship will not be assumed *but must be substantiated*" (italics are the author's).

With respect to the preceding paragraph the IRS will require the keeping of specific records for each use of the club by nonmembers *even though the member pays initially for such use.*

Included as part of these records will be a signed statement by the member who is hosting a party of more than eight persons saying whether he has been or will be reimbursed for such nonmembers as are present and if so, the amount of the reimbursement, who made it and for what purpose.

Rev. Proc. 71-17 goes on to say that where such records are not maintained or are not made available to the IRS for examination, the use of the minimum gross receipts standard will be precluded.

Copies of both the regulations and Revenue Procedure 71-17 are available from the NCA which will be filing its comments on both with the IRS within the next 30 days and which is presently developing the forms which will supply the information required of clubs by IRS. □