PART I

EXEMPT ORGANIZATIONS TECHNICAL TOPICS

A. HEALTH CLUBS

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1. Introduction

A health club or fitness center is a facility containing exercise equipment and/or facilities for activities such as jogging, squash, racquetball and swimming. Hotels and motels often include a fitness center as one of the amenities offered to their guests or to the community on a membership fee basis. Freestanding commercial fitness centers are also commonplace. Exempt organizations such as Young Women's Christian Associations (YWCAs), Young Men's Christian Associations (YMCAs), Jewish Community Centers (JCCs) and colleges and universities have traditionally offered sports or fitness programs.

Other exempt organizations, notably hospitals, also operate fitness centers. Given the increasing commercial character of fitness centers operated by exempt organizations, it is important for exempt organizations and exempt organizations specialists to be aware of the standards that distinguish an exempt fitness center from its commercial counterparts.

The need for clarity in these standards was recently underscored by the publication of a technical advice memorandum, LTR 9803001. This TAM involved the operation of a fitness center by an exempt hospital. The TAM was criticized by commentators because it was not clear just what standards the Service had applied in reaching its conclusion that the activities of the fitness center did not produce unrelated business taxable income.

Congressional concern about the standards applicable to such cases was also reflected in the Senate Committee report accompanying the Treasury and General Government Appropriations Bill for Fiscal Year 1999. The Senate Committee requested that the IRS review the legal standards and precedential decisions the IRS utilizes in determining when fitness services and activities of tax-exempt organizations should be subject to unrelated business income tax. However, the House Conference Report narrowed the scope of the IRS review as follows:

> The conferees understand that the IRS has developed appropriate standards based on broad community accessibility for determining whether fitness activities are substantially related to the charitable mission of community organizations, such as YMCAs, YWCAs, and JCCs... Accordingly, changes in the standards that apply to such organizations are not the conferees' concern. Rather, the conferees direct that the IRS review the standards it applies to fitness activities operated by educational and health-care organizations.

2. Issues

Issues regarding health clubs in the exempt organization context arise in two ways. First, a health club can be a part of a larger system such as a hospital system or a university. Second, operating a health club can be an organization's primary activity. In the first instance, the question is whether the health club activity is substantially related to an exempt purpose or whether the activity is an unrelated trade or business. In the second instance, the question is whether the health club activity furthers an exempt or non-exempt purpose. In either case, the analysis is similar.

3. Public Recreational Facilities

The landmark case relating to health clubs and how they fit into the realm of IRC 501(c)(3) is Isabel Peters v. Commissioner, 21 T.C. 55 (1953), nonacq., 1955-1 C.B. 8, withdrawn and acq. substituted therefor, 1959-2 C.B. 6. The Isabel Peters case stands for the proposition that providing recreational facilities can be a charitable activity, provided the facilities are available to the general community.

In Isabel Peters, the Eagle Dock Foundation was exempt as a civic league, originally under the predecessor to IRC 501(c)(4). The Foundation's activity was the operation of a public beach, playground and bathing facilities. Access was confined to residents of a bloc of neighboring communities in the Cold Spring Harbor area of Long Island. The IRC 501(c)(3) issue arose as a result of an individual pass-holder who wanted to deduct a contribution to the Foundation under IRC 170(c)(2). The Foundation mailed passes to persons in the above communities with a request for voluntary contributions; about one-third of all those receiving passes made the donation. The Tax Court concluded that even though the organization was classified as a civic league, the benefits flowed to the community at large and the organization therefore warranted IRC 501(c)(3) exemption with the attendant IRC 170(c)(2) deductibility.

The Isabel Peters decision was incorporated into Rev. Rul. 59-310, 1959-2 C.B. 146, as follows:

> In the instant case, the organization was formed to establish, maintain and operate a public swimming pool, playground and other recreation facilities for the children and other residents of the community. Its funds are principally raised by public subscription. It appears that the income derived from charges for admission to the swimming pool is minor in amount and that such charges are purely incidental to the orderly operation of the pool. No part of the net income inures to the benefit of any private individual. Its assets upon dissolution will be turned over to recognized charitable organizations. Accordingly, since the property and its uses are dedicated to members of the general public of the community and are charitable in that they serve a generally recognized public purpose which tends to lessen the burdens of government, it is concluded that the instant organization is exclusively charitable within the meaning of section 501(c)(3) of the Code and is entitled to exemption from Federal income tax under section 501(a) of the Code.

Thus, the facts in the ruling were virtually identical to the Isabel Peters case except that a minor amount of the income was derived from charges for admission to the swimming pool.

Rev. Rul. 67-325, 1967-2 C.B. 113, reiterated the basic, if indirectly stated, position of Rev. Rul. 59-310, albeit now for the first time as a positive principle, rather than the negative inference gleaned from the cautious assent to Isabel Peters. The ruling focused on recreational facilities in the context of IRC 501(c)(3), and the problem of restrictions on use. In this case, the restriction was on the basis of race, though the racial discrimination did not quite reach the "public policy" implications that racial discrimination did later with respect to exempt private schools. The ruling indicated that community recreational facilities may be classified as charitable if they are provided for the use of the general public. Citing trust law, the ruling stated,

> In this body of general law pertaining to purposes considered charitable only where all the members of the community are eligible to receive a direct benefit, no sound basis has been found for concluding that there would be an adequate purpose if some part of the whole community is excluded from benefiting except where the exclusion is required by the nature or size of the facility.

In this case the organization did not qualify for exemption under IRC 501(c)(3) because admission to its facilities was restricted on the basis of race.

A number of other revenue rulings dealing with community parks and recreation facilities are discussed in Rev. Rul. 78-85, 1978-1 C.B. 150. In that case, a nonprofit

organization with membership open to the general public derived its support from membership dues and contributions from the general public. It cooperated with municipal authorities in preserving, beautifying, and maintaining a public park in the center of the city. In reviewing the applicable authorities, the revenue ruling stated--

> Prior revenue rulings have recognized as charities organizations that devote their assets to the maintenance and improvement of community recreational facilities and parklands. For example, Rev.Rul. 70-186, 1970-1 C.B. 128, holds that an organization formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features is exempt under section 501(c)(3) of the Code. Similarly, Rev. Rul. 68-14, 1968-1 C.B. 243, holds that an organization formed to promote and assist in city beautification projects and to educate the public in the advantages of street planting is exempt under section 501(c)(3).

Based on these authorities, the revenue ruling concluded that the organization's activities served public purposes even though property owners whose property was located near the park received an incidental benefit as a result of the organization's activities.

Rev. Rul. 78-85 also notes and distinguishes Rev. Rul. 75-286, 1975-2 C.B. 210, which holds that an organization formed to beautify a city block and whose members were limited to the property owners and business operators on that block did not qualify for exemption. The distinction is that the benefits to the members of the organization described in Rev. Rul. 78-85 were direct and substantial rather than being merely incidental to the accomplishment of a larger public purpose.

Several federal court cases have dealt with the issue of recreational activities and exemption:

Estate of Philip Thayer v. Commissioner, 24 T.C. 384 (1955), held that a California Alumni Association Camp was exempt under IRC 501(c)(3). The issue was whether the social and recreational activities were substantial or merely incidental to the objective of advancing the interest of the university. The court found that the recreational activities were incidental in size and purpose.

In People's Educational Camp Society, Inc. v. Commissioner, 331 F.2d. 923 (2nd Cir. 1963), a non-profit resort camp was denied IRC 501(c)(4) status based on the fact that it competed actively for public business with other resorts in the area.

Eden Hall Farm v. United States, 389 F. Supp. 858 (W.D. Pa. 1975), held that a non-profit vacation home for working women so that they could receive rest and recreation was not exempt under IRC 501(c)(3) but was exempt under IRC 501(c)(4). The primary issue was whether the organization sufficiently benefited the community to warrant IRC

501(c)(4) exemption. The facilities were open to employees of selected corporations and guests of the selected corporations' employees. The court held that the organization was benefiting the community as a whole, within the limits of its facility, by providing wholesome rest and recreation for a large number of working women. However, the IRS does not follow the decision in this case. Rev. Rul. 80-205, 1980-2 C.B. 184.

Schoger Foundation v. Commissioner, 76 T.C. 380 (1981), held that religious camps that offered recreation were not entitled to exemption under IRC 501(c)(3) because they were operated primarily to provide members of the public with social and recreational activities in a commercial manner rather than for charitable purposes within the meaning of IRC 501(c)(3).

Columbia Park and Recreation Association v. Commissioner, 88 T.C. 1 (1987), aff'd without pub. op., 838 F.2d 465 (4th Cir. 1988), held that a nonprofit recreational entity which served Columbia, a large, unincorporated planned community that was not a political subdivision, was not qualified as an IRC 501(c)(3) charitable organization. The community included a number of residential villages designed to serve various income levels. The residential villages were clustered around a central retail and commercial core.

Although the Service had recognized the Association as exempt under IRC 501(c)(4), it subsequently applied for recognition of exemption under section 501(c)(3). As described in the court opinion, the Association provided over 100,000 residents with facilities such as public parks, neighborhood pools, tennis courts, softball fields, a horse center, athletic clubs, golf courses, boat docks, an indoor swimming complex, a children's zoo, and an ice rink. The organization made subsidized memberships available for needy persons and was controlled by a volunteer board of directors. The organization argued that it was entitled to 501(c)(3) exemption on the theory that it was providing public recreational facilities and lessening the burdens of government.

The court noted that only a small number of persons qualified for reduced fees and they had to be residents of the planned community. Moreover, access to facilities was available only to residents who had a membership right based on property ownership rights as homeowners or tenants. Thus, the court agreed with the Service that the organization was merely a neighborhood association, albeit one with a large number of members, and that it was simply providing home ownership services and facilities to its members and not to the public in general. The court specifically noted that the Association's facilities were not available to all residents of the political subdivision in which it was located. The lessening the burdens of government argument was dismissed as merely an incidental correspondence of several functions (public parks, etc.) with similar government-sponsored activities.

4. Exclusive Facilities

Rev. Rul. 79-360, 1979-2 C.B. 236, is the lone ruling on health clubs and unrelated business income. The ruling holds that income from the operation of health club facilities in a commercial manner by an IRC 501(c)(3) organization, whose purpose was to provide for the welfare of young people, constituted unrelated business taxable income. The organization has a two-tiered fee structure. A higher fee was charged for an "executive" fitness program that provided more luxurious facilities and services than those available to the general membership at rates comparable to those charged by commercial health clubs in the area. The fees were sufficiently high to restrict participation to a limited number of the members of the community.

The ruling cites Rev. Rul. 76-33, 1976-1 C.B. 169, which holds that the rental of residential accommodations to certain charitable classes of people is related to its exempt purposes and is not unrelated trade or business. Thus, the ruling is based on the underlying proposition that an organization must benefit either the community in general or a charitable class within the community to be recognized as charitable. The ruling sets forth the general rule regarding health clubs and unrelated business income: that is, in order to be exempt from unrelated business income tax, a health club must benefit a significant segment of the local population.

Although GCMs are not precedential, the position taken in the revenue ruling is compatible with GCM 35601 (Dec. 14, 1973), which, among other things, addressed the question of whether an organization's health club's earnings were subject to UBIT. Although some of the organization's health club activities appeared to be exempt, the GCM indicated that the organization had not shown a broad community benefit resulting from its operation of programs known as the Executive Health Club and the Businessmen's Health Club. Unfavorable facts included that the dues structure seemed to be sufficiently high to restrict accessibility to a limited number of the members of the community and that it did not differ from commercial health clubs.

Despite the GCM's noting the similarity of the fees charged to those of a commercial counterpart, the general rule is that, in determining whether an activity constitutes unrelated trade or business, the fees charged by an exempt organization in connection with the activity are relevant only after it is first resolved that such activity accomplishes the exempt purposes of the organization. If the activity achieves the organization's exempt purposes, the fact that fees are charged does not detract from the "relatedness" of the activity unless the existence and magnitude of the fees charged preclude the general community from benefiting from the activity.

High fees might inhibit participation in the organization's activity to an extent that only a relatively small class of people in the community benefits (e.g., relatively affluent group residing in a predominantly middle-income community). Where fees prevent the general community from obtaining the benefits of the activity, the activity cannot be deemed charitable and related to the exempt purposes of the organization. The community benefit test must be applied on a case by case, community by community basis; charges that preclude sufficient availability in one community may not do so in another.

5. Benefiting the Community in General

The issue of what constitutes a "significant segment of the local population" remains murky. There is no precedential guidance that addresses this particular issue in detail. Each case is resolved on the basis of facts and circumstances, and on a community by community basis.

Although private letter rulings and GCMs are not precedential, some go into great detail with respect to the above issue. For example, TAM 8505002 and GCM 39327 (Jan. 18, 1985) involve an organization that used three methods to establish that its health club fees were set at a level within the reach of the community as a whole. First, it compared occupational data with respect to members of the community with the same data provided with respect to health club members. Although the community data was for 1981 and the health club membership information was from 1978, a statement from a long-time board member asserted that there was no significant change in the extent to which the various income groups were represented in the health club. Second, the organization submitted the results of a survey of the incomes of 51% of its members of the men's club and 63% of its members of the women's club and compared these with a U.S. Census Bureau analysis of annual family incomes in the community for that year. Third, the organization included data to show that the average American family spent $3,068 per year on discretionary recreational activities. Therefore, the average family in the community served by the health club could afford to pay the fees.

The comparison of occupational data showed that the occupational makeup of the members of the community and health club membership were very similar. However, when

annual family income figures were juxtaposed, it was clear that families making under $15,000 comprised 23.8% of the community, while members in the same income earning range comprised only 14% of the club's membership. Also, almost 26% of the club's members had an annual family income in excess of $50,000, but only 12.5% of the community members were in that class.

The bottom line was that a significant percentage of families making under $15,000 were members of the health club and the average family in the community could afford to belong. Thus, PLR 8505002 concluded that the health club's services "contributed importantly" to the organization's exempt program. Two factors which critics of this ruling have found troublesome are that the fees approximated those charged by commercial facilities in the area and that there was no special provision for low-income or financially needy persons.

The TAM's associated GCM agreed that the organization's health club operations generally achieved the organization's exempt purpose. In addition, the GCM stated that the part of the organization's operations that provided exclusive health club benefits benefiting only a limited number of the members of the general community constituted unrelated trade or business. However, the TAM that was issued only dealt with the question of the medically-supervised health club activities and did not appear to address the exclusive health club benefits.

6. The Promotion of Health as an Exempt Purpose

Some exempt organizations may claim that their health club operations are charitable on the grounds that they promote health. In the general law of charity, the promotion of health is considered to be a charitable purpose. Restatement (Second) of Trusts, section 368 and section 372 (1959); IV A. Scott, The Law of Trusts, section 368 and section 372 (3d ed. 1967); W. Bogert, Trusts and Trustees, section 372 (2d ed. 1964). While many health-related organizations may further other charitable causes, such as the relief of poverty, the sole charitable purpose of promoting the health of the general community constitutes a sufficient basis for tax-exempt status under IRC 501(c)(3). See Rev. Rul. 69-545, 1969-2 C.B. 117.

Activities promoting health are considered beneficial to the general community even though the class of beneficiaries eligible to receive a direct benefit from such activities does not include all members of the community, provided that the class is not so small that its relief is not of benefit to the community. See Rev. Rul. 83-157, 1983-2 C.B. 94.

There is a profusion of recreational activities that may be classified as promotion of health in that any physical or mental exertion may assist in the prevention of illness and be consistent with generally recognized medical principles and conducive to mental and

physical well-being. Additionally, some have argued that a health club parallels the preventive care aspects of qualifying HMOs and should be accommodated under the health promotion classification of IRC 501(c)(3). However, the activities of IRC 501(c)(3) health care organizations (such as the hospital described in 69-545, supra) serve to alleviate the distress of the sick and incapacitated and may be distinguished from health club activities which promote health generally by providing for the maintenance of physical fitness through recreational exercise and the promotion of healthful living. Health club operations promote health in a manner which is collateral to the providing of recreational facilities for purposes of fostering well-being of the community in general. Clearly, while innumerable activities may relate to preventive health in the broad sense of being consistent with medical principles and conducive or beneficial to the soundness of the body and mind, not all such activities are recognized as charitable under IRC 501(c)(3).

The Service and the courts have, therefore, concluded that not every activity that promotes a healthy lifestyle qualifies as the charitable promotion of health. In Federation Pharmacy Services v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F. 2d 804 (8th Cir. 1980), a nonprofit organization that sold pharmaceutical products did not qualify for exemption because the benefit to the community was too limited. Similarly, in Living Faith, Inc. v. Commissioner, 60 T.C.M. 710, 713 (1990), an organization that claimed to be religious and charitable by advancing the doctrine of the Seventh-day Adventist Church by operating vegetarian restaurants and health food stores was denied exemption because it operated in a commercial manner in direct competition with other restaurants and health food stores. In Geisinger Health Plan v. Commissioner, 985 F.2d 1210, (3rd Cir. 1993), rev'g 62 T.C.M. 165 (1991), the court found that a health maintenance organization (HMO) did not qualify where it arranged for health care coverage, including preventive programs, solely for its members in the absence of significant levels of charity care, research or education under a "flexible community benefit standard" approach that would demonstrate based on a totality of the circumstances that charitable purposes were served. Merely discounting some membership dues was not sufficient. Conversely, in Sound Health Association v. Commissioner, 71 T.C 158 (1978), acq. 1981-2 C.B. 2, the Service's acquiescence related to an HMO that provided direct health care services to its membership which was "truly open to a sufficiently broad segment of the community served" and in a manner consistent with the community benefit standard satisfied by the tax-exempt hospital described in Rev. Rul. 69-545, supra.

Although health club operations are characterized essentially as recreational and not health-promoting, there is a very limited circumstance in which the activities of a health club may be deemed to promote health. This situation arises in the case of a hospital patient undergoing rehabilitation. PLR 9110042 is illustrative. The subject of that ruling was a health and fitness center operated as an activity of and adjacent to an IRC 501(c)(3) hospital. The center was to be used by three disparate groups: the hospital's patients, its employees, and the general public. With respect to each group, the operation of the center

did not result in UBIT. By rehabilitating patients in accordance with treatment plans prescribed by appropriate hospital personnel, the hospital's exempt purpose of providing for the health care needs to the community was served. In other words, in the case of the hospital patients using the health and fitness center, the center was promoting health. Use by employees was justified under the convenience exception of IRC 513(a)(2). As for use by the general public, the ruling stated that a fitness facility can be a charitable activity if it provides recreation that is available to a significant segment of the community, as, for example in Rev. Rul. 67-325, supra. The letter ruling then found that the rates that the fitness center charged to the general public (substantially lower than commercial rates in the area and low enough that a significant segment of the local population could afford to participate) made the provision of fitness services a charitable activity on the basis of providing recreational facilities to the general public.

This dichotomy--health promotion for hospital patients and community recreational facilities for the rest of the public--runs through other private letter rulings to hospitals. For similar fact patterns and results, see PLRs 9736047, 9329041, 9226055, and 8934061.

7. Education as a Charitable Purpose

Another possible basis for exemption of sports and recreational facilities, particularly for youth, is that they are incidental to the attainment of educational objectives. This began with Rev. Rul. 55-587, 1955-2 C.B. 261 (an interscholastic athletic association formed for the purposes of promoting and protecting the health of high school athletes through uniform interscholastic competition under the direction and control of school officials, and of cultivating the ideals of good sportsmanship, loyalty and fair play); continued in Rev. Rul. 65-2, 1965-1 C.B. 227 (an organization providing free instruction, facilities, and equipment to children in connection with teaching them a particular sport) and Rev. Rul. 77-365, 1977-2 C.B. 192 (organization conducting clinics, workshops, lessons, and seminars at municipal parks and recreation areas to instruct individuals in a particular sport); and carried through to Rev. Rul. 80-215, 1980-2 C.B. 174 (an organization that developed, promoted, and governed a sport for individuals under 18 years of age in a particular state). The idea in all cases is that activities with significant instructional content are educational. The organization's activities may also serve to help prevent delinquency when children or youth are involved by helping them become wholesome members of the community. Contrast this to Rev. Rul. 70-4, 1970-1 C.B. 126, where promotion of an amateur sport was not educational since there was no instructional component, but the activity could nonetheless qualify as promotion of social welfare under IRC 501(c)(4). Generally, competitive sports activity that was IRC 501(c)(3)-educational when directed at youth, was, at best, IRC 501(c)(4) when conducted for adults. This area was somewhat streamlined by the enactment of the Tax Reform Act of 1976 (further amended by TEFRA 1982) in which the promotion of national or international sports competition was added to the Code as an

independent basis for exempt status.

Rev. Rul. 78-98, 1978-1 C.B. 167, discusses the role of a ski facility utilized by an exempt school as part of its physical education program. While not exactly parallelling the health club/recreational center cases, there is a distinct analogy. The students used the facility for recreational purposes, as did members of the general public. The latter were required to pay slope and ski lift fees comparable to nearby commercial facilities. The ruling held that the student recreational use was related to the exempt educational function, even though the activity did not consist of actual instructional sessions. However, the income from the public's use of the facility was subject to UBIT. The significance of this position is that the student use of the ski facility per se furthered the school's educational mission in that it supplemented the students' physical educational instruction whereas public use at commercial rates had no nexus to an exempt educational purpose.

PLR 8020010 involved, among other things, the question of whether use of a university's recreational facility generated UBI. The facility was used mainly by students, staff and faculty. However, a limited number of memberships were available to the general public and to alumni. The ruling concluded that the student and faculty use were substantially related to the university's exempt educational purpose. However, the use by the general public and alumni was not related to the university's exempt purpose of education; rather, this type of use only provided the public and alumni the opportunity to engage in personal recreational activities. Therefore, use by the public and alumni generated UBI.

8. Health Clubs and UBI

In determining whether a health club activity is an unrelated trade or business, the analysis focuses on whether the activity is substantially related to an organization's exempt purpose. In order to be reported as an unrelated business activity, an activity must meet three criteria: (1) it must be a trade or business, (2) it must be regularly carried on, and (3) it must not be substantially related to the accomplishment of the organization's exempt purposes. In the case of health clubs, the substantially related test is the key.

Providing recreational facilities to the general public can be an exempt purpose under IRC 501(c)(3) as long as the facilities are available to a wide segment of the community. Similarly, in order to be exempt from unrelated business income tax, a health club conducted as an activity of an exempt organization must benefit a significant segment of the local population. The community benefit test is applied on a case by case, community by community basis; in making this determination, the analysis consists of weighing the facts and circumstances of each case. The same type of analysis also applies when a health club offers various levels of memberships for different charges.

In cases involving some mixture of exempt and unrelated activities, the proper analysis is based on IRC 513(c) and Treas. Reg. 1.513-1(d)(3), which indicate that income from a particular activity may be deemed unrelated even where the activity is an integral part of a larger complex of activities that may be in furtherance of an exempt purpose. This is commonly known as the fragmentation rule. The fragmentation rule provides that, with respect to health clubs that operate as part of a larger exempt organization, the health club is analyzed separately to determine whether the health club generates UBI; additionally, each health club activity can be further fragmented so that one health club activity may be deemed to be related to exempt purposes while another health club activity may result in imposition of UBIT.

9. Examples

The situations described below are illustrative of the types of issues we are currently seeing in this area. These issues can arise in the context of liability for unrelated business income tax or qualification for exemption.

A. Situation 1

Facts

A operates a fitness center located in a particular county. A has facilities for racquetball and squash and a variety of multistation fitness machines, treadmills, stationary bicycles, and free weights.

In order to use A's facilities, individuals must purchase a membership. The membership requires the payment of monthly fees for a period of at least one year. The membership contract is enforceable in court. Members are legally required to pay the monthly fee for the contract period regardless of whether or not they use the facilities. Members may freely sell or transfer their membership contract to other persons.

A advertises its fitness center by frequently distributing flyers in residential neighborhoods where property values are generally at or above the 70th percentile for all residential properties in the county where the fitness center is located. A attempts to set its rates at affordable levels for people who live in these neighborhoods. Census data indicates that approximately 25% of the county's population resides in these neighborhoods. Virtually all of A's members are residents of the neighborhoods where the flyers are distributed.

Discussion

The pursuit of physical fitness through sports and exercise is primarily a recreational activity. Therefore, the principles applicable to community recreational facilities are the appropriate standard to use in determining whether A's activities further an exempt purpose.

Community recreational facilities that levy admission charges must set their charges at a level affordable to the community they serve. See Rev. Rul. 79-360, supra. In one case, a political subdivision consisting of a county was an appropriate community for determining public benefit. See Columbia Park and Recreation Association, supra. Since A's charges are designed to be affordable to only the upper 30 per cent of the persons in its county, A does not satisfy this standard. Therefore, operation of A's fitness center does not further exempt purposes within the meaning of IRC 501(c)(3).

B. Situation 2

Facts

B is a fitness center established by and located on the campus of a community hospital exempt from federal income tax under IRC 501(a) as an organization described in 501(c)(3). The fitness center consists of a large room. The room contains stationary bicycles, treadmills, and free weights. The fitness center offers classes in aerobics appropriate to various fitness levels.

B provides individualized programs for persons who have been referred to the fitness center by their physicians for physical therapy and cardiac rehabilitation as part of a prescribed treatment regiment for ameliorating the effects of injury or disease. These programs are conducted under the supervision of appropriate hospital personnel. B's employees may use the fitness center upon payment of nominal monthly fees.

Members of the community may use the facilities in exchange for the payment of monthly fees. There are two classes of membership available, a regular membership and an executive membership. Regular members pay a monthly fee, which entitles them to utilize the facilities on an as available basis. Executive members pay a significantly higher fee that

entitles them to priority in using certain facilities and equipment. Executive members are also entitled to exclusive use of the equipment during certain hours Monday through Friday and on Saturday mornings.

After initially establishing its two-tiered fee structure, B surveyed its members to determine their gross income levels and compared the results of the survey to income data for the community served by the hospital. B periodically repeats the process and uses the information to adjust its fees. The most recent survey of B's community members indicates that 30% of the regular memberships are held by persons below the 25th income percentile; 30% are held by persons between the 25th and 50th income percentiles; 25% are held by persons between the 51st and 75th percentile; and 15% of the memberships are held by persons above the 75th income percentile. In the case of executive memberships, all memberships are held by persons above the 75th income percentile.

Discussion

Since B offers a variety of different fitness and health services, the proper analysis is to segregate each type of activity and determine whether it furthers an exempt purpose. If any activity furthers a nonexempt purpose, the income generated by the activity will be subject to the unrelated business income tax.

While sports and fitness programs are generally recreational in nature, exercise or fitness therapy which is part of a medically supervised regimen designed to rehabilitate cardiac or other patients serves to promote health. Since the promotion of health is the hospital's exempt purpose, fitness programs directed to rehabilitation further the hospital's exempt purpose. See Rev. Rul. 69-545, 1969-2 C.B. 117.

The provision of health club facilities on its campus for use by its own employees is excepted from unrelated business income tax under the IRC 513(a)(2) convenience of employees exception.

The income derived from members of the general community is related to the attainment of the charitable purpose of providing community recreational facilities only if the charges are affordable to the community served. See Rev. Rul. 79-360, supra. In this case, a charitable purpose is demonstrated by the fact that the fees charged for regular memberships are affordable to most of the members of the community. However, executive memberships are affordable only to higher income persons as demonstrated by the fact that all memberships are held by such persons. Executive memberships are not

affordable to the community as a whole. Therefore, income derived from executive memberships is subject to the tax on unrelated business income.

C. Situation 3

Facts

C operates a fitness center that consists of a building containing a heated, olympic-sized swimming pool and a smaller pool called a lap pool. C also has a small gymnasium devoted primarily to free weights and basic facilities for use in gymnastics as an adjunct to its swimming program. C's primary activity is the conduct of ability-graded classes in swimming. C charges fees for the classes, but its policy is to waive or reduce the fees for those who cannot afford them. This policy is advertised in community newspapers during May and December of each year when C conducts fund raising appeals. The fees are waived for children enrolled in Headstart programs. The unreduced fees are estimated to be affordable for persons with incomes at or above the 50th percentile for the area.

Discussion

The operation of sports or fitness programs may be educational if the programs involve a significant amount of instruction. See Rev. Ruls. 65-2 and 77-365, supra. C's instructional programs in swimming are conducted to teach people how to swim rather than to provide them with an opportunity for recreational swimming. Therefore, C's programs further exempt purposes within the meaning of IRC 501(c)(3).

C does not have to be charitable in addition to being educational to qualify for exemption under IRC 501(c)(3). However, waiving its fees for Headstart children and reducing its fees for other persons who cannot afford them is evidence that the advancement of educational purposes, as distinguished from maximizing profits, is the objective of C's activities. The fee structure thus provides evidence of a noncommercial purpose.

D. Situation 4

Facts

D is a hospital that is exempt from federal income tax under IRC 501(a) as an organization described in 501(c)(3).

D operates a fitness center at its hospital facility, which is comparable in size and facilities to the better commercial fitness centers in the area. D offers monthly memberships to the fitness center at rates based on a sliding scale keyed to income and family size. The highest fees on the scale are slightly less than those charged by other comparable fitness centers in the area.

Apart from the hospital's patients and employees, D's fitness center is used almost exclusively by persons whose incomes are above the 95th percentile of annual gross income of both the town and county in which the hospital is located. The fitness center is also used by D's employees and by the rehabilitation department of the hospital to provide therapy for cardiac and other patients. D's employees pay for use of the facilities. Patients pay higher fees than regular users, the exact fee being dependent on the nature of the services provided and facilities used.

A large commercial fitness center has recently been established in a shopping mall that is frequented by persons who live in the residential subdivisions surrounding the hospital. Its charges are slightly higher for regular memberships than those charged by the hospital's fitness center. The commercial fitness center argues that the difference in fees can be accounted for by the fact that the hospital pays no unrelated business income tax on its income derived from the fitness center.

Discussion

As in Situation 2, the initial step in the analysis is to isolate the various activities of the fitness center and determine whether or not each activity serves an exempt purpose.

The first activity is the provision of fitness programs to the public. See Rev. Rul. 79-360, supra. This activity is recreational in nature and therefore furthers an exempt purpose only if it is affordable to the community. While the fees are affordable to the high income residents in the town and county, they are beyond the reach of most people in the community as a whole. Therefore, the income derived from providing programs to those persons is subject to unrelated business income tax. The analysis applicable to D's own employees and to persons in need of rehabilitative therapy is discussed in Situation 2.

The fact that D's fitness center may be in competition with a commercial counterpart is immaterial in determining whether or not D's fitness center income is subject to unrelated business income tax. Similarly, if there were no other health club facilities in the area, filling that void would not, by itself, establish an exempt purpose. The purpose served by the center's activities, not the possible impact of those activities on commercial competitors or providing an otherwise unavailable service, determines whether income from the activities is subject to unrelated business income tax. Thus, the result in this case would be the same if there were no commercial fitness centers located in D's service area.

D would still be subject to tax on its income derived from serving the recreational needs of the wealthy residents of the community. Also, the presence at a sliding scale membership fee keyed to income levels and family size is a favorable factor; however, in practice the facility does not afford community access.

E. Situation 5

Facts

E is a hospital that is exempt from federal income tax under IRC 501(a) as an organization described in 501(c)(3). E operates a fitness center at its hospital facility that is equipped similarly to better commercial fitness centers. E offers fitness programs to the general public, hospital patients in need of rehabilitation, and its own employees.

E determined that, absent extraordinary efforts on its part, the primary users of its fitness center were likely to be persons whose incomes place them above the 95th percentile of the annual gross income of both the town and county in which the hospital is located. In order to assure that other persons living in the community are apprised of the availability of the facilities, E frequently advertises its fitness center in direct mail publications that are distributed throughout the community, which includes a mixture of neighborhoods reflecting a diverse economic composition. The advertisements call attention to E's policy of making its fitness facilities available on a sliding scale fee structure based on income and family size. E monitors its membership to determine whether users of the fitness facilities reflect a representative cross section of the town and county in which it is located and adjusts its advertising and promotional efforts as necessary to maintain a membership reflective of the community as a whole.

E makes its facilities available to community organizations that conduct sports and other programs for at risk youth for two hours each weekday afternoon. No charge is made for use of E's facilities by the community organizations. E also waives its fees for children enrolled in Headstart programs.

Discussion

The facts in Situation 5 establish that E has a fee structure and advertising program designed to assure that all income levels within its community are aware of and may make use of the programs offered at its fitness center. This example illustrates that advertising, which is often taken to be indicative of commercial activity, can also be used to promote an exempt purpose, in this case making the general public aware of a program they might not readily discover by any other means. It is also significant that E monitors its membership to assure that these programs are achieving the desired objective and adjusts its advertising and promotional efforts as needed to accomplish its goal of serving the community as a

whole rather than merely wealthy individuals. The fact that E cooperates with other organizations and with the Headstart programs in offering after school programs for youth is further evidence of E's commitment to serving all segments of the community. In these circumstances, the fact that some members of the community may pay rates comparable to those charged by similar commercial fitness centers does not detract from the conclusion that E's fitness center is available to and used by the community as a whole. Accordingly, E's fitness center is described in IRC 501(c)(3).

10. Other Code Provisions

A. IRC 501(c)(4)

Restriction of community-wide participation could result in loss or denial of IRC 501(c)(4) status, per Rev. Rul. 80-205, 1980-2 C.B. 184. This ruling addressed the case of Eden Hall Farm v. United States, supra. The ruling examines the court's rationale:

> The district court found that the organization's provision of recreational facilities served a recognized community need and that the organization qualified as a social welfare organization under section 501(c)(4) of the Code. With respect to the organization's restrictions on the use of its facility, the court found that the restrictions were consistent with the capacity of the facilities and provided a means of limiting use of the facilities to those who met the organization's requirements. Thus, the court concluded that the organization was not operated for the benefit of X corporation or its employees.

However, the ruling held that organizations that restrict participation to employees of selected corporations and their guests do not qualify for exemption under IRC 501(c)(4). These organizations primarily benefit the individuals that are allowed to use the facility and any benefit to the community is purely incidental. Thus, the IRS does not follow the decision in Eden Hall.

The regulations clearly require, and prior revenue rulings have recognized, that an organization claiming exemption under IRC 501(c)(4) must operate for the benefit of the community as a whole rather than for the benefit of a limited group. Compare Rev. Rul. 78-69, 1978-1 C.B. 156, which holds that an organization providing rush hour commuter bus service to all residents of a community qualifies for exemption under IRC 501(c)(4), with Rev. Rul. 55-311, 1955-1 C.B. 72, which holds that a local association of employees operating a bus primarily for the convenience of its members does not so qualify. Also compare Rev. Rul. 62-167, 1962-2 C.B. 142, which holds that an organization retransmitting television signals for the benefit of an entire community qualifies for exemption under IRC 501(c)(4), with Rev. Rul. 54-394, 1954-2 C.B. 131, which holds that an organization providing television on a cooperative basis does not qualify. See also GCM

39357 (May 3, 1985) which concluded that an employee health club in which membership is available only to salaried employees can qualify under section 501(c)(4), but as a local association of employees.

Thus, a health club that benefits only a limited group as opposed to the community in general (apart from a local association of employees) would not qualify for exemption under IRC 501(c)(4) under the precedent cited above, let alone IRC 501(c)(3) with its additional benefit of deductibility of contributions.

B. Social Clubs under IRC 501(c)(7)

Social clubs are typically formed to provide members with recreational facilities. See Rev. Rul. 69-281, 1969-1 C.B. 155; 70-32, 1970-1 C.B. 132; and 74-30, 1974-1 C.B. 137. However, expansion of the club's facilities and services to the general public can adversely affect the club's status. See Rev. Rul. 69-219, 1969-1 C.B. 153; and P.L. 94-568, 94th Cong., 2nd Sess. (176), 1976-2 C.B. 596. In addition, operation of a business in the guise of a social club is problematic. In Rev. Rul. 58-588, 1958-2 C.B. 265, the Service addressed the question of whether a health club could qualify as a social club under IRC 501(c)(7). Several individuals formed a health, recreational, and social club. The primary activity was selling approximately 25,000 associate memberships which essentially consisted of rights to the use of the club's facilities, but no rights in the management of the club. Twenty-five "active" members managed and controlled the organization; five of these members were full-time employees, and two of the members operated a restaurant and barbershop on the club premises. The ruling held that the club was operated for the personal interest of a few individuals and that the social features were not a material purpose. Rather, the predominant purpose was the business of selling of memberships for profit to individuals for the right to utilize the club's facilities. Thus, the organization did not qualify under IRC 501(c)(7).

11. Summary and Conclusion

In most cases, community benefit provides the basis for distinguishing exempt fitness centers from their commercial counterparts. Where special considerations apply, education, prevention of juvenile delinquency or promotion of health may serve as a basis for finding that an exempt purpose is furthered. As in all cases, the burden is upon the organization seeking the exemption to establish that it is, in light of all the facts surrounding its operations, engaged in an activity that furthers an exempt rather than a commercial purpose. This burden is not met by a showing that the organization is otherwise exempt, for example as a hospital or an educational institution. In appropriate circumstances, the activities of a fitness center may be fragmented so as to subject those activities, which are indistinguishable from their commercial counterparts to unrelated business income tax.