TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Number: **201302043**
Release Date: 1/11/2013

Date: October 19, 2012

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL: 501.07-03; 512.09-03

Legend:

Taxpayer	=
Town	=
City	=
Department	=
x1	=
X2	=
X3	=
X4	=
Year1	=
Year2	=
Date1	=
Date2	=

Dear

This is in response to your letter dated December 18, 2010, as amended on September 6, 2012, in which you requested certain rulings with respect to section 512(a)(3)(D) of the Internal Revenue Code ("Code").

Background:

According to your ruling request you are an exempt organization under section 501(c)(7) of the Code. You are a social and recreational club located in Town formed for the purpose of golf and other recreation. You have been operated continuously as a social club for over a decade, being recognized as exempt for that time.

You were formed for the primary purpose of owning and operating a private club for golf and other leisure activities for the recreation of your members. You own approximately x1 acres. Of those acres, a little less than half are devoted to a 9-hole golf course, an equipment barn, tennis courts, and a club house. The other, larger portion of the land consists of two lakes and its surrounding land, which contains a cottage for employee use and a boathouse for member use. Members use the lakes and boathouse for swimming, boating, and other scheduled events.

On Date1 you entered into an agreement with Department, a city department of environmental protection, for a conservation easement attaching to x3 acres consisting primarily of six holes of

golf and wetlands. Department is interested in an easement attaching to this property since your land contains a watershed leading to one of the reservoirs used by the residents of City. After Department conducted its due diligence and appropriately surveyed the land, you expect to close on Date2. Department will pay approximately $x4 for the easement to prevent pollution of water running through or collecting on this portion of your land. As part of the easement you have agreed that you will not construct new paved roads; create new building envelopes with subsurface sewage treatment systems, paved surfaces, or wells; or store, bury, or dispose of hazardous materials designated by local, state, or federal regulations or dispose of cars, trash, sewage, or uncomposted animal waste. Furthermore, the easement restricts your ability to disturb the surface, subsurface, or trees on the easement land, though it does not remove those options entirely. The easement also provides for a building envelope for you where your current impervious surfaces are permitted along with certain expansions limited by the easement and subject to prior approval. Additionally, Department will have the right to enter the land for inspections in order to monitor your use of the land. The easement will run with the land in perpetuity, thus restricting any future sale of the land. Finally, you have also agreed to terms for a Water Resource Protection Plan that dictates the manner you are permitted to care for your grounds to include the amount and type of fertilizer, herbicide, and pesticide as well as how often such efforts can occur. Your members, however, can, and will, continue to use the land for all of your traditional recreational activities such as golfing.

You want to use the proceeds from the sale of the easement to make capital improvements throughout your land. These improvements include improvements to your boathouse and waterfront; improvements to the decks on your waterfront; purchasing items for entertaining such as a commercial ice maker, dishes, stemware, silverware, and a new bar; updating your clubhouse; updating your golf barn; updating your golf course; and updating the tennis courts. These purchases constitute your Proposed Capital Projects. In addition to the purchases described above you also made purchases for the upkeep of your golf course in year2, the year preceding the closing of the sale, using money from a line of credit provided in year1 totaling $x2. All of the updated properties are used by your members in furtherance of your recreational purposes.

Rulings Requested:

You requested the following rulings:

1. The sale of the Conservation Easement will not jeopardize your tax-exempt status under 501(c)(7).

2. The proceeds from the sale of the Conservation Easement will not jeopardize your tax exemption under 501(c)(7) of the Internal Revenue Code provided that you receive no more than thirty-five percent of your gross receipts, from sources outside your membership and not more than fifteen percent of such gross receipts are from the use of your facilities by the general public.

3. The Conservation Easement constitutes property used directly in the performance of your exempt function for purposes of § 512(a)(3)(D) of the Code.

4. Gain from the sale of the Conservation Easement will be recognized only to the extent the sales price of the Conservation Easement (less any selling expenses) exceeds the purchase price of other property purchased within the time period specified in §512(a)(3)(D) and used by you directly in furtherance of your exempt function.

5. The Proposed Capital Projects will constitute other property purchased and used directly in the performance of your exempt function for purposes of § 512(a)(3)(D) so long as the purchases occur within three years after the receipt of proceeds from the sale of the Conservation Easement.

Law:

Section 501(c)(7) of the Internal Revenue Code ("Code") describes a club that is organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in 501(c)(7) the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income.

Section 512(a)(3)(D) of the Code provides that if property used directly in the performance of the exempt function of an organization described in 501(c)(7) is sold by such organization, and within a period beginning 1 year before the date of such sale, and ending 3 years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, then gain from such sale shall be recognized only to the extent that the sales price exceeds the cost of purchasing the other property.

Section 1.501(c)(7)-1(b) of the Income Tax regulations ("regulations") states that a club which engages in business, such as making its recreational facilities available to the general public or selling real estate is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a). However, an incidental sale of property will not deprive a club of its exemption.

Senate Report No. 94-1318, 2d. Session, 1976-2 C.B. 597, provides that the decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based upon all of the facts and circumstances. It is intended that these organizations be permitted to receive up to 35% of their gross receipts, including investment income, from sources outside their membership, without losing their tax-exempt status. It is also intended that within this 35% amount not more than 15% of the gross receipts should be derived from the use of a club's facilities or services by the general public. However, where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in this formula.

In discussing this Tax Reform Act of 1969 provision, the committee on Finance of the United States Senate noted that:

> "The tax on investment income is not to apply to the gain on the sale of assets used by the organizations in the performance of their exempt functions to the extent the proceeds are reinvested in assets used for such purposes within the period beginning 1 year before the date of sale and ending three years after that date ... For example, where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years." (emphasis added) S.Rep. No. 91-552, 91st Cong., 1st Sess. 72 (1969), 1969-3 C.B. 423, 470.

Revenue Ruling 69-232, 1969-1 C.B. 154, provides that even though a profit is realized, the sale of property will not cause a social club to lose its exemption provided the sale is incidental in that it does not represent a departure from the club's exempt purposes. All of the facts and circumstances of a sale will be considered in determining the club's primary purposes in making the sale, including: (1) the purpose of the club in purchasing the property; (2) the use the club makes of the property; (3) the reasons for the sale; and (4) the method used in making the sale.

In Atlanta Athletic Club v. Commissioner, 980 F.2d 1409 (11th Cir. 1993), the court determined that, "The statute speaks in terms of use rather than intent. Therefore, the Tax Court correctly observed that the Club's various plans for the land were irrelevant. The analysis must concentrate on the ways in which the Westside Property was or was not 'used directly.' This process entails factual findings as to the activities that occurred on tracts A and B of the Westside Property, and legal conclusions as to whether those activities constituted sufficient recreational uses by the Club."

In Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985), the court interpreted "organization's sale price" to mean, "the amount realized, reduced by the aggregate of the expenses for work performed on the old property to assist in its sale." When discussing the use of the funds to pay debts of the organization and refund money to members the court stated, "By discharging the indebtedness on its loan and by currently refunding the assessment, which its membership previously had agreed was refundable only upon death or resignation from the club, petitioner did not 'merely reinvest its funds from the land sale in other types of assets.' In the language of the Committee Report, funds were 'withdrawn for gain by the members of the organization,' who benefited through decrease in petitioner's debt and return of the assessment. Petitioner's gain therefore constitutes unrelated business taxable income." Additionally, the court provides an example of an allowable transaction stating, "where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years."

In Deer Park Country Club v. Commissioner, 70 T.C.M. (CCH) 1445, the court concludes, "that the plain and ordinary meaning of the phrase "used directly in the performance of the exempt function of an organization" as set forth in section 512(a)(3)(D) connotes an exempt organization's use of assets or property that is both actual and direct in relation to the performance of its exempt function. Given petitioner's concession that no part of the 4.8–acre tract on which the 11 home-sites are situated was ever physically used by petitioner for recreational activities, it follows that the gain realized on the sale of the 11 home-sites does not qualify for nonrecognition under section 512(a)(3)(D), but rather is subject to the unrelated business income tax."

Analysis:

Clubs that engage in the selling of real estate will not be considered to be operated for exempt purposes under § 501(c)(7). Section 1.501(c)(7)-1(b). However, if the selling of real estate is incidental to the club's exempt purpose it will not jeopardize the club's exemption. Id. Rev. Rul. 69-232, supra, provides that even if a sale results in a profit it will not result in a loss of exemption as long as it does not represent a departure from the club's exempt purpose. All the facts and circumstances are to be taken into account when determining whether a departure from the exempt purposes has occurred. Id. Items to consider include (1) the purpose of the club in purchasing the property; (2) the use the club makes of the property; (3) the reasons for the sale; and (4) the method used in making the sale. Id.

In this case, you have purchased the property with which the easement will run for the purpose of playing golf and other recreation, which are your exempt purposes. You have used this property since buying it and will continue to do so after the sale of the easement, for playing golf and other recreational activities. You are selling the easement in order to raise capital to invest in improvements to the grounds and equipment of your club. You are not selling the property as part of an ongoing plan to sell or develop real estate, and this sale is a one-time occurrence. Furthermore, because the sale of the easement is similar to the sale of your clubhouse, infra, any income derived from this sale will not be a part of a thirty-five percent test of your income from outside your membership. See Senate Report No. 94-1318, supra. The sale of this easement will not jeopardize your exemption under § 501(c)(7) of the Code.

You also requested a ruling that gain from the sale of a conservation easement will not be taxable income if reinvested in property furthering your exempt purpose. Section 512(a)(3) of the Code provides special rules defining taxable income for organizations described in § 501(c)(7). Specifically, gains from the sale of property, which has been used for the exempt purpose of certain organizations, will not be recognized, and therefore will not be taxed, to the extent that the sale price is reinvested in property used for the organization's exempt purpose, if that reinvestment occurs within one year prior to and three years following the sale of property. Section 512(a)(3)(D). This statute is further clarified by case law, which requires that the property being sold must have been "directly used" for the exempt purposes of the organization, see Atlanta Athletic Club, 980 F.2d 1409, not for some other benefit of the organization, see Deer Park Country Club, 70 T.C.M. (CCH) 1445, and must be reinvested into property up to the "organization's sales price" and not "withdrawn for the gain by the members of the organization." See Tamarisk Country Club, 84 T.C. 756.

The sale of the easement is considered by the Service to be a sale of property within the Internal Revenue Code. The easement will be attached to the land in perpetuity affecting all future transactions regarding the land. The easement removes your ability to construct new paved roads; create new building envelopes with subsurface sewage treatment systems, paved surfaces, or wells; or store, bury, or dispose of hazardous materials. It additionally hinders your ability to disturb or remove surface and subsurface areas as well as trees, though it does not remove those options entirely. The easement also gives access of your land to Department in order to ensure such activities are not taking place. Given the significant restrictions on you, and any purchaser of the land, and the rights provided to Department, you have sold property.

The property you have sold must have been used directly for your exempt purpose. Section

512(a)(3)(D). You use the land over which the easement runs primarily for golf as the land contains six of your nine holes of golf as well as your clubhouse, which is used as a meeting place for your members, and tennis courts. All of these activities are in direct furtherance of your exempt purpose. See e.g., Atlanta Athletic Club, 980 F.2d 1409. Thus, we conclude that the sale of the easement meets the first criterion because it is attached to land "directly used" for your exempt purposes. The fact that you continue to use the land burdened by the easement for your exempt purposes does not alter the conclusion that you have sold property that you used for an exempt purpose.

You have stated that you intend to use a portion of the funds generated from the sale of the easement for capital investments in your facilities and equipment. These investments include improvements to your boathouse and waterfront; improvements to the decks on your waterfront; purchasing items for entertaining such as a commercial ice maker, dishes, stemware, silverware, and a new bar; updating your clubhouse; updating your golf barn; updating your golf course; and updating the tennis courts.

Purchasing personal property and updating real property constitutes the purchase of property for purposes of § 512(a)(3)(D). Congressional commentary on § 512(a)(3)(D) in the senate report uses the term assets where the statute uses the term property. S. Rep. No. 91-552, supra. Furthermore, the intent of the social club exemption is to allow individuals to pool their money for pleasure and not be taxed since they would not have been taxed had they spent that money on pleasure individually. Id. Given Congress' intent in providing special rules for unrelated business income for organizations exempt under § 501(c)(7), the purchase of equipment and the making of capital improvements to land are considered reinvestments in property for your exempt purpose. Any of the sales price (less any selling expenses) used on capital projects similar to those described herein that are used exclusively in furtherance of your exempt purpose within three years from the closing of the sale of the easement will not be recognized for tax purposes. Additionally, $x2 was spent on capital improvements for your exempt purpose within the one year prior to the sale of the easement. Since these purchases fall within the time period specified by Congress, these purchases will also constitute a reinvestment of funds, the extent of which will remove recognition of that portion of the sales price of the easement.

Conclusion:

Accordingly, based on the forgoing, we rule as follows:

1. The sale of the conservation easement will not jeopardize your tax-exempt status under § 501(c)(7).

2. The proceeds from the sale of the conservation easement will not jeopardize your tax-exemption under § 501(c)(7) provided you receive no more than thirty-five percent of your gross receipts, not including the proceeds from the sale of the conservation easement, from sources outside your membership and not more than fifteen percent of such gross receipts from the use of your facilities or services by the general public.

3. The conservation easement constitutes property used directly in the performance of your exempt function for purposes of § 512(a)(3)(D).

4. Gain from the sale of the conservation easement will be recognized only to the extent the sales price of the conservation easement (less any selling expenses) exceeds the purchase price of other property purchased within the time period specified in §512(a)(3)(D) and used directly in furtherance of your exempt purpose.

5. The Proposed Capital Projects will constitute other property purchased and used directly in the performance of your exempt function for purposes of §512(a)(3)(D) so long as the purchases occur within three years after the closing of the sale of the conservation easement. Additionally, the capital improvements described above made in the year preceding closing will constitute other property purchases and used directly in the performance of your exempt function for purposes of § 512(a)(3)(D).

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose.* A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Ronald Shoemaker
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437