Internal Revenue Service

Number: **202019027**
Release Date: 5/8/2020

Index Number: 501.07-00

Department of the Treasury
Washington, DC 20224

[Third Party Communication:
Date of Communication: Month DD, YYYY]

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Refer Reply To:
CC:TEGE:EOEG:EO2
PLR-132622-17
Date:
December 20, 2018

Legend

Taxpayer =
State =
State Agency =

Dear:

This letter responds to a letter from Taxpayer's authorized representative dated September 28, 2017, and subsequent correspondence dated March 22, April 19, October 17, and December 18, 2018 requesting a ruling concerning a transaction involving carbon dioxide offset credits, described below. Taxpayer represents the facts as follows.

FACTS

Taxpayer is a , recognized as exempt under § 501(c)(7) of the Internal Revenue Code (the Code). It owns acres, including several unique ecological environments, such as large patches of old growth forest and undeveloped shoreline in which its members hike, hunt, and fish. A wrote the first conservation plan for Taxpayer eighty years ago. Taxpayer's members have continued to manage this property to preserve its ability to support wildlife, fish, and natural beauty which are essential to the club's social and recreational purposes.

In an effort to reduce greenhouse gas emissions, State enacted a statute that sets limits on such emissions, and allows certain businesses subject to the limits to buy, sell, and trade the rights to produce emissions to help achieve their limits. The statute allows businesses to purchase some emission credits from carbon dioxide offset projects (carbon offset projects) managed by entities not covered by the statute. According to State Agency, regulated companies may use carbon dioxide offset credits (carbon offset credits) to fulfill up to percent of their compliance obligation. The carbon offset projects must affirmatively reduce greenhouse gases through approved methods, including maintaining forestlands. Trees absorb carbon dioxide from the atmosphere, store it, and produce oxygen. Forests can be managed to maximize this absorption

The carbon offset credit program that is administered by State Agency sets standards for the protocol landowners must follow, approves applications to participate, and calculates the amount of carbon dioxide their land will sequester. Upon approval, the State Agency issues marketable carbon offset credits that reflect the amount of carbon dioxide sequestered. Market transactions determine the price paid for the carbon offset credits.

Taxpayer would like to participate in the .

Taxpayer has begun the process of approval as a carbon offset project, but must undergo several rounds of evaluations before it can apply for and receive carbon offset credits.

Taxpayer engaged a contractor to inventory and map trees across the property. Taxpayer also developed a computer model of the carbon uptake of the forest and engaged a third party to verify the results. Taxpayer will enter into an agreement to manage its forest in accordance with the program's sequestration protocol. The plan will require Taxpayer to increase standing live carbon stocks, ensure the presence of a variety of native tree species and their distribution, and support habitats for native plants and wildlife. Taxpayer describes the practices required by the protocol as consistent with Taxpayer's ongoing preservation efforts to maintain the vitality of its forest, which it represents directly promote its exempt purpose of affording opportunities for healthful recreation to its members.

The program requires a year commitment. Taxpayer must conduct complete forest inventories verified by an independent party at year intervals, with independent party verification at year intervals between the complete inventories. A less intensive annual report, including data checks, document reviews, updates in growth and yield models, and timber harvest plans, is also required to ensure that Taxpayer's forest management produces sufficient greenhouse gas reductions. Taxpayer must also remain in compliance with all local, state, and national environmental regulations. If Taxpayer fails to adhere to the agreement, it must surrender carbon offset credits to State Agency or purchase carbon offset credits on the market and retire them.

Taxpayer expects to receive one distribution of carbon offset credits that it would sell for the market price within a year of receipt. Taxpayer will recognize income upon receipt of the credits equal to their fair market value and will subsequently recognize gain or loss based on any difference between the amount realized and the tax basis of the credits sold. Taxpayer will use the amount received from the sale of the credits for its exempt activities; it will not withdraw any amount received for distribution to its members.

REQUESTED RULING:

Income from the described transactions will be an unusual amount that may be excluded from the calculation of gross receipts and participating in the transactions as described will not cause Taxpayer to depart more than insubstantially from its exempt purposes under § 501(c)(7).

LAW

Section 501(c)(7) provides exemption from Federal income tax for clubs 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 or individual.

Section 1.501(c)(7)-1(b) states that a club that engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other non-profitable purposes, and is not exempt under § 501(c)(7). However, an incidental sale of property will not deprive a club of its exemption. (The regulation pre-dates the 1976 amendment to § 501(c)(7)).

Section 512(a)(3)(A) sets forth special unrelated business income tax rules for organizations described in § 501(c)(7), among others. For those organizations, the term “unrelated business taxable income” means the gross income (excluding any exempt function income), less the deductions allowed which are directly connected with the production of the gross income (excluding exempt function income), both computed only with the modifications provided in §§ 512(b)(6), (10), (11), and (12)).

Section 512(a)(3)(B) defines the term “exempt function income” for purposes of subparagraph (A), as the 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 purposes constituting the basis for the exemption of the organization to which such income is paid.

Before its amendment in 1976 by Pub.L. No. 94-568, § 501(c)(7) required clubs to be organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes. After the amendment, “substantially all” of a club’s activities was required to be for those purposes, allowing § 501(c)(7) clubs to receive some non-exempt income without losing their exempt status. However, the Senate Report (Finance Committee) described Congressional intent to retain the ban on all business income, and it recommended limits on investment and non-member income. The Report states that:

> The first change made by the bill substitutes…the new requirement that 'substantially all' of such a club's activities must be for [exempt] purposes…. it is intended to make it clear that these organizations may receive some outside income, including investment income, without losing their exempt status….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 on all the facts and circumstances. However, the facts and circumstances approach is to apply only if the club earns more than is permitted under the new guidelines. If the outside income is less than the guidelines permit, then the club's exempt status will not be lost on account of non-member income.
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> It is intended that these organizations be permitted to receive up to 35 percent 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-percent amount not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public….
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> Gross receipts are defined for this purpose as those receipts from normal and usual activities of the club (that is, those activities they have traditionally conducted) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents, and similar receipts), and normal recurring capital gains on investments, but excluding initiation fees and capital contributions. 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 the formula; that is, such unusual income is not to be included in either the gross receipts of the club or in the permitted 35- or 15-percent allowances….It is not intended that these organizations should be permitted to receive, within the 15- or 35-percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations….

> If an organization has outside income in excess of the 35-percent limit…all the facts and circumstances are to be taken into account in determining whether the organization qualifies for exempt status.

S. Rep. No. 1318, 94th Cong., 2d Sess. 4 (1976), reprinted as 1976-2 C.B. 597.

Pittsburgh Press Club, 536 F.2d 572 (3d Cir.1976) concerned, in part, whether the amount of income the club earned from use of its facilities by non-members violated the statutory requirements for organizations exempt under § 501(c)(7). The IRS audit had concluded that approximately 800 outside groups paid to use the club facilities over a two year period. The court referred to Treas. Reg. § 1.501(c)(7)-1(b) to note that the amounts earned were not so substantial as to constitute engaging in business as a matter of law, nor so insubstantial as to constitute exclusive operation for exempt purpose as a matter of law. The court remanded the case to the district court for further factual findings. The court directed the district court to make specific findings on the percentage of gross receipts from non-members, net profits derived from non-members, the purpose for which the facilities were made available to non-member groups, and how frequently non-members made use of club facilities.

Rev. Rul. 69-232, 1969-1 C.B.154 provides that even though a profit is realized, a social club will not lose its exemption provided a sale is incidental in that it does not represent a departure from the club's exempt purposes. All of the facts and circumstances must be considered in determining the club's primary purpose for the transaction including: the purpose of the club in originally purchasing the property; the use the club made of the property; the reason for the sale; and the method used in making the sale. The revenue ruling contrasted several sales of club property. One club subdivided excess land, made improvements to the lots, and sold them over a period of years. The revenue ruling held the sales demonstrated a profit-making purpose and were not incidental. Another club sold all of its property as a single unit when it became clear that the club could not afford ownership, and used the proceeds to lease other facilities. The revenue ruling held the sale was incidental to its continuation as a club.

ANALYSIS

In 1976, Congress amended § 501(c)(7) to explicitly allow exempt social clubs to engage in an insubstantial amount of non-exempt activity, rather than none at all. The Senate Report accompanying the legislation described the amount of investment and non-member income allowed under the amended statutory language. The Senate Report discussed guidelines for two categories of non-exempt function income, investment and non-member use income, that together could constitute 35% of a club's gross receipts without indicating a more than insubstantial non-exempt purpose. However, income from the use of club facilities and services by non-members could not exceed 15% of the club's gross receipts.

The Senate Report discussed calculation of these suggested percentages for nonexempt income. Gross receipts, against which the thresholds for investment and non-member income are measured, include receipts from normal and usual activities of the club, such as charges, admissions, membership fees, dues, assessments, investment income and normal recurring capital gains. Excluded from gross receipts are initiation fees, capital contributions, and unusual amounts of income, such as amounts from the sale of a clubhouse or similar facility.

However, the Senate Report indicated that excluded unusual amounts should be examined to assure they were not derived from the "active conduct of businesses not traditionally carried on by these organizations." Further, if a club has outside income in excess of the thresholds, it should be analyzed in light of all facts and circumstances to be certain that it does not indicate a substantial non-exempt purpose. The legislative history included in the Senate Report, while not binding, is useful for interpreting the changes to the Code and courts have applied the approach discussed in the Senate Report in determining whether a substantial non-exempt purpose existed. See, e.g., Santa Barbara Club v. Commissioner, 68 T.C. 200, 211 (1977); Zeta Beta Tau Fraternity v. Commissioner, 87 T.C. 421, 432 (1986).

Taxpayer expects to recognize a large amount of income from the receipt of the carbon offset credits. Taxpayer's submission shows that the income recognized will exceed the guideline percentages. However, it will be unusual in that it is a new source of income for Taxpayer, and a one-time event that is not expected to recur. Therefore, the income would not be included in measuring gross receipts and percentages of investment and non-member income, as long as it is not derived from the "active conduct of businesses not traditionally carried on by these organizations."

Several factors show that the unusual amount of income that will be recognized upon receipt of the carbon offset credits will not be derived from active conduct of a non-traditional business. Taxpayer did not purchase property in order to engage in this transaction; it purchased the property and has used the property for exempt activities for . The transaction will not be a regular recurring event. Taxpayer represents that the carbon offset credit transaction will be a unique event. Although it is not a sale, it is a one-time transaction analogous to the incidental sale permitted by the regulation. The regulation distinguishes a club that sells timber or real estate to the general public as a business, which is not recognized as exempt, from a club that makes an incidental sale of property, which may continue to be recognized as exempt. Treas. Reg. 1.501(c)(7)-1(b); Rev. Rul. 69-232.

Furthermore, Taxpayer's transaction is related to a crucial aspect of the club's purpose: to preserve the health of the forest habitat. Although a few of the activities involved in the transaction may not promote exempt purposes, substantially all of the activities Taxpayer will undertake over years in connection with this transaction will support its exempt purpose. Taxpayer submitted documentation setting forth the technical requirements of the protocol for sequestering carbon dioxide and its plans for compliance. Taxpayer states that maintaining its exempt property as a healthy forest will allow club members to continue the exempt activities of hiking, fishing, hunting and other outdoor social recreation. The maintenance of property that an organization uses directly in performing its exempt function is a traditional and normal activity of an organization exempt under § 501(c)(7) because it furthers the organization's exempt purpose. The transaction will not require Taxpayer to substantially depart from its long-standing exempt purpose and activities. Its members will continue to use its property in the same manner as they always have done. Rev. Rul. 69-232.

In remanding Pittsburgh Press Club, the Circuit Court directed the District Court to analyze factors that are also relevant in analyzing Taxpayer's transaction--the purpose for which the facilities were made available to non-members and how frequently non-member groups used the club facilities. Pittsburgh Press Club, 536 F.2d 572, 575-6. In this case, Taxpayer will agree to maintain the facilities as a healthy ecosystem for use of its members as it has since its inception. The members will not be displaced by non-members, but will continue to use the property for exempt purposes.

Based solely on the facts and representations submitted by Taxpayer, we rule as follows:

RULING:

Income from the described transactions will be an unusual amount that may be excluded from the calculation of gross receipts and participating in the transactions as described will not cause Taxpayer to depart more than insubstantially from its exempt purposes under § 501(c)(7).

The rulings contained in this letter are based upon information and representations submitted by or on behalf of Taxpayer (accompanied by a penalty of perjury statement executed by an individual with authority to bind Taxpayer) and upon the understanding that there will be no material changes in the facts. This office has not verified any of the material submitted in support of the request for rulings, and such material is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2018-1, § 11.05.

No opinion is expressed or implied concerning the federal income tax consequences of any other aspects of any transaction or item of income described in this letter ruling. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because it could help resolve questions concerning federal income tax status, this letter should be kept in Taxpayer's permanent records.

A copy of this letter must be attached to any tax return to which it is relevant. Alternatively, if Taxpayer files a return electronically, this requirement may be satisfied by attaching a statement to the return that provides the date and control number of this letter.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Taina Edlund
Senior Technician Reviewer, EO Branch 2
(Tax Exempt and Government Entities)

cc: