

## THE GRASS IS NOT ALWAYS GREENER

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As Published in *The Boardroom*

The recession has impacted clubs dramatically this year. Members are leaving and clubs are looking for new and more innovative ways to bring in revenue. Unemployment is an issue and many clubs are just looking to survive. Costs, particularly employee benefits, continue to rise and we have not even gotten to the issues involving any new health care plans being forced on business by the government. Although economist say we are coming out of the recession, consumer confidence still is at the lowest level in decades. The entertainment dollar is lower than it has been in years but opportunities to spend it proliferate.

Clubs are forced to compete in a marketplace that continues to change and not always to the benefit of clubs. Clubs are looking to cut expenses and defer capital expenditures but you can only take this so far. In reality, they need more members. With members playing less golf it makes it harder to justify belonging to a club. High-end daily fee courses (although not without their own problems) challenge the exclusivity of country clubs, and managers are asked to do more with less. The board wants to fund operations without raising dues and see the increased use of the club by nonmembers or by providing nontraditional activities. As a result, nonmember income approaches or exceeds the limits established by the Internal Revenue Service for tax-exempt clubs, and the club expands the amount of nontraditional activity in which it engages.

At this point, a club may consider giving up its tax-exempt status. Adding to the debate right now are a number of consultants that encourage the giving up of tax exempt status because clubs do not make any money anyway or privacy and exclusivity is not as important as it was in the past. In my last column, I mentioned the importance of not making decisions that have a long term impact, based on a short term crisis. Before proceeding, consider alternatives! Do not change status on what you think might be the advantages. Investigate thoroughly. Taxable status is not a panacea. It has its own set of problems and limitations. Among the benefits of tax exemption:

- No tax on net member income – Dues, initiation fees, and special assessments all fall within this category.
- It is possible to defer the tax on the capital gains from the sale of some club property provided certain conditions are met.
- While investment income generally is taxable, net income from the sale of goods to nonmembers may be reduced through the allocation of certain overhead costs.

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For a taxable club, initiation fees and special assessments are almost always taxable. Dues and payments for services are always subject to tax. While a club may not have a profit from operations, most will have a profit when dues, initiation fees, and special assessments are added. If not, the club is headed into financial difficulty and potential bankruptcy.

There may be a tax cost on conversion and it is unclear whether a club can make this change unilaterally since it had to apply to get the status in the first place.

### Recordkeeping Requirements

A chronic complaint of many tax-exempt clubs is the IRS recordkeeping requirements to distinguish between member and nonmember income. Records must be kept on nonmember use of a club to ensure that permissible levels of use are not exceeded. Two safe harbors are provided. In all other situations, the club must substantiate a host-guest relationship. Failure to keep adequate records could result in the income being treated as nonmember. A tax-exempt club is limited to the amount of income it may generate from nonmembers.

The paperwork burden does not disappear for clubs switching to taxable status. For a member-owned taxable club, records must substantiate which expenses relate to member and which to nonmember functions. The deductibility of certain expenses arising from furnishing services to members is limited to member income. Deductions that exceed member income may be carried forward to subsequent years. These limitations can result in higher income than expected. For example, if a club has net income for the year of \$100,000, which is composed of nonmember income of \$300,000 and a member loss of \$200,000, the club is subject to tax on \$300,000, not the net income of \$100,000. One advantage that a taxable club has is that no limitation exists on the amount of nonmember income it may generate.

### Traditional Activity

Another distinction between a taxable and nontaxable club is the issue of nontraditional activities. The Service defines a nontraditional business as any business which, if conducted on a membership basis, would not further the club's exempt purpose. The official position is that any gross receipts from a nontraditional activity could cost a club its tax exemption. However, informally, the Service indicated that it would allow up to five percent of gross receipts to be generated from nontraditional activities. Unfortunately, the Service also has said that this income is nonmember regardless of whether the activity is member related. A fine line exists between acceptable and unacceptable activities. The Service has never come out with a definitive position on what is a nontraditional activity but as clubs delve into providing different types of services to its members, it may run into problems if examined.



## State Laws and Privacy

Carefully review all state laws before changing taxable status. States reserve the right to tax entities engaged in business in the state in a variety of ways. Many states provide exemptions from taxes to organizations that qualify as federally exempt organizations. Exemptions often cover more than just state and local income taxes. Property and franchise tax breaks may be given to social clubs that meet certain requirements, and sales tax may not be charged on some member sales or club functions. In some states, changing to taxable status may result in loss of, or more difficulty in obtaining, a liquor license.

Privacy is very important and goes much further than just who you let into the club. It may impact operations, the application of certain federal laws and how the club is viewed in the community. States or municipalities with public accommodation laws, as well as the federal government, may be more willing to treat your organization as a “private” club if it is tax-exempt and limits the usage of its facilities by the general public. A private clubs should be operated for the benefit of its members. Public usage must be limited to be considered infrequent and irregular. If the club is hovering around the fifteen percent mark, what is the maximum business it could generate from the community and the members will tolerate. Remember, many members prefer to maintain exclusivity, and by attracting too much nonmember business or by conducting too many nontraditional activities, the club may lose what makes it unique. The demand for usage must also be considered.

While there may be reasons for a club to change to taxable status (and survival may be one of them), you must have member support. In addition, **check with tax and legal advisors** prior to a final decision. Limitations and aggravations are present whether you operate as a taxable or tax-exempt organization.

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