

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

Number: **200532056**
Release Date: 8/12/05

Date: 05/18/05

Contact Person:

Uniform Issue List Numbers: 501.07-00
512.09-03

ID Number:

Employer Identification Number:

Legend:

City A=
State B =
C=
D=

x =
y =
z =

Dear _____ :

This is in response to your representative's June 4, 2004 request for rulings concerning the proposed sale of approximately y acres of your property to finance renovations and improvements to your golf course and other recreational facilities.

You were formed for the purpose of promoting social intercourse among your members and have operated a golf course and other recreational facilities for the benefit of your membership since that time. You have been recognized as an exempt social club under section 501(c)(7) of the Internal Revenue Code of 1986, as amended.

You own x acres of real property located in City A, State B which is bordered by C to the east and B to the south (the "Property"). All of your recreational facilities are located on the Property, and you own no real property

other than the Property. At present, your members and their guests regularly use the Property's facilities for golf, tennis, jogging, swimming, weightlifting, aerobic exercise, basketball, racquetball and squash, fishing, and social activities. Your recreational facilities include an 18-hole golf course, tennis courts, racquetball and squash courts, a swimming pool, a clubhouse, fitness facilities, three manmade lakes, a series of jogging trails and a nature trail.

You acquired the Property several years ago in a partially tax-deferred exchange pursuant to section 512(a)(3)(D) of the Code. Pursuant to this exchange, you exchanged the property on which your recreational facilities previously had been located for the Property and cash. Due to increasing development in the area where your previous facilities had been located and a desire to improve and expand your aging recreational facilities, you decided to relocate to your current location. Prior to this exchange, your recreational facilities had been located at a previous location.

Since acquiring the Property, you have used it exclusively and continuously for the purpose of conducting the exempt recreational activities described above. You have not made substantial renovations or improvements to your recreational facilities since their acquisition, and as a result, these recreational facilities currently are in need of substantial renovations and improvements.

As part of the agreement under which you acquired the Property, you entered into a declaration of restrictive covenants that prohibits the erection of any buildings or other structures on a portion of the Property until September 23, 2007. You now wish to sell approximately *y* acres of the Property and use the proceeds to fund a series of renovations and improvements to your recreational facilities. The *y* acres that you propose to sell are located along the eastern edge of the Property and include a large portion of the tract covered by the restrictive covenant.

The *y* acres of the Property that you propose to sell has been used exclusively for your club's recreational purposes, including a *z* acre lake. The *y* acres border the fifth hole of your club's golf course. The *y* acres are used regularly by your members and their guests for a number of different recreational purposes, including fishing, children's golf practices, jogging and walking on trails, and the retrieving of golf balls hit to the right of the fifth hole.

Because the property that you propose to sell borders a busy commercial thoroughfare, its most valuable use is for commercial development. However, the restrictive covenant to which a portion of the *y* acres is subject effectively prevents any commercial development prior to September 23, 2007. For this reason, you do not expect to be able to sell the *y* acres for its full value prior to mid-2007 but will engage in a sale prior to this time if you are able to obtain fair value for the property. You intend to sell the *y* acres as a single tract if it is economically feasible to do so, and you do not intend to make any improvements

or otherwise prepare the property for sale. You do not intend to engage in any additional sales of your real property other than the sale of the y acres.

You intend to use the proceeds from the sale of the y acres to fund a series of renovations and improvements to your recreational facilities. The renovations and improvements are scheduled to take place in two phases. The first phase began in April of 2004 and is expected to be completed in late December of 2004. This phase includes the restoration of your golf course greens, substantial changes to a number of holes and the practice green, and the replacement of the clubhouse roof. The second phase of the renovations is expected to commence soon after the y acres have been sold and to be completed no later than three years after the sale. The second phase is expected to include renovations to the clubhouse, tennis courts, swimming pool complex, and jogging and nature trails, as well as the purchase of additional personal property such as restaurant equipment for the clubhouse, golf carts, and golf course maintenance equipment.

Because you have not yet been able to sell the y acres, you have borrowed the funds to pay for the first phase of renovations that are now underway. You intend to use part of the proceeds from the proposed property sale to repay this borrowing shortly after the sale. You expect to use most or all of the remaining proceeds of the sale to fund the second phase of renovations, which will be completed no later than three years from the time of the sale.

You have requested the following rulings:

1. The sale of the y acres either as a single tract or in separate parcels if necessary to further its prompt disposition will not jeopardize your club's exempt status under sections 501(a) and 501(c)(7).
2. The renovations and improvements to your club's recreational facilities described above will constitute new recreational use property for purposes of section 512(a)(3)(D).
3. The repayment of indebtedness that was incurred to finance renovations and improvements to your club's recreational facilities will be treated as the purchase of other property for purposes of section 512(a)(3)(D) so long as the repayment occurs within three years of the sale of the y acre tract.

Section 501(a) of the Code provides that an organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503. Section 501(c)(7) of the Code provides that the organizations referred to in section 501(a) include clubs organized for pleasure, recreation, and other nonprofit 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 1.501(c)(7)-1(b) of the Income Tax Regulations provides that a club which 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 nonprofit purposes, and is not exempt under section 501(a), but that an incidental sale of property will not deprive a club of its exemption.

Section 501(c)(7) of the Code was amended by Public Law 94-568 to provide that section 501(c)(7) organizations could receive some outside income without jeopardizing their exempt status. Senate Report No. 94-1318, 2d Session, 1976-2 C.B. 597, 599 provides that the decision in each case as to whether substantially all of an organization's activities are related to its exempt purposes is to continue to be based upon all of the facts and circumstances. The Senate Report explains that a social club is permitted to receive up to 35 percent of its gross receipts, including investment income, from sources outside of its membership without losing its exempt status. However, where a club receives an unusual amount of income, such as from the sale of its clubhouse, or similar facility, that income is not to be included in the formula.

Rev. Rul. 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 purpose 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. Situation 2 of Rev. Rul. 69-232 provides that where a social club subdivides land into building lots, makes improvements to the lots, and sells the lots for a substantial profit over a period of years when it could have sold the property in a single unit, the sale of the property is not an incidental sale. Situation 3 of Rev. Rul. 69-232 provides that where a social club sells all of its recreational use property to developers at a profit and uses the proceeds to purchase more modern facilities in a location that is more desirable to its members, the sale is incidental within the meaning of the Income Tax Regulations.

Your club's proposed property sale is similar to the sale of a social club's clubhouse or similar facility. The acreage that you intend to sell is part of property acquired in order to provide recreational facilities for your club's members, and your purpose in selling it is to pay for renovations and improvements to your recreational facilities. You do not intend to subdivide the property, make improvements to it, or otherwise prepare it for sale. However, you may sell the acreage at issue in two or more transactions if you cannot obtain full value in a single sale within a reasonable amount of time after the expiration of the

restrictive covenants. Therefore, your proposed sale of this acreage will be an incidental sale of property that will not be a departure from the club's exempt purposes and will not jeopardize the club's exempt status under sections 501(a) and 501(c)(7).

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from tax under section 501(c)(7).

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in section 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 (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b).

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 section 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, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property.

In Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985), the Tax Court held that section 512(a)(3)(D) of the Code does not require the purchase of property that is of like kind or use to the property sold and that expenditures for golf carts, land improvements and other items were qualifying purchases of other property for purposes of that section.

In Atlanta Athletic Club v. Commissioner, 980 F.2d 1409 (11th Cir. 1993), expenditures made for the construction of a tennis center and the renovation of a clubhouse were deemed to be purchases of other property for purposes of section 512(a)(3)(D) of the Code.

Your club has incurred debt in order to make a number of renovations and improvements to its golf course and clubhouse. These renovations and improvements constitute property used directly in your exempt function. Likewise, the property that you propose to sell has been used directly in your exempt function since its acquisition. You intend to use a portion of the proceeds from the sale of the property to repay indebtedness incurred to finance the first phase of your renovations. You intend to use the remaining proceeds to pay for additional renovations and improvements to your recreational facilities and to purchase additional personal property that will be used in your recreational activities. You intend to repay the existing indebtedness, make the additional renovations and improvements and purchase the additional personal property all

within three years after the sale of the property. You do not intend to use the proceeds of the sale to reduce the club's dues or to defray the club's other operating costs. Therefore, the proceeds from the sale of the property will be deemed to be used for the purchase of other property used directly in the performance of your 501(c)(7) exempt function for purposes of section 512(a)(3)(D) of the Code.

Based on the application of the above principles to the facts presented in your ruling request, we rule as follows:

1. The sale of the y acres either as a single tract or in separate parcels if necessary to further its prompt disposition will not jeopardize your club's exempt status under sections 501(a) and 501(c)(7).
2. The renovations and improvements to your club's recreational facilities described above will constitute new recreational use property for purposes of section 512(a)(3)(D).
3. The repayment of indebtedness that was incurred to finance renovations and improvements to your club's recreational facilities will be treated as the purchase of other property for purposes of section 512(a)(3)(D) so long as the repayment occurs within three years after the sale of the y acre tract.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Except as we have ruled therein, we express no opinion as to the tax consequences of the transactions under other sections of the Code and Income Tax Regulations.

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.

Any changes that may have bearing on your tax status should be reported to the Service.

We are informing your Key District Director of this ruling. Because this ruling could help resolve future tax questions about your federal income tax status, you should keep it in your permanent records.

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

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

Sincerely yours,

Jane Baniewicz
Manager, Exempt Organizations
Technical Group 2