Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: Easement Sale Won't Jeopardize Club's Exemption.

The IRS ruled that a social and recreational club's sale of a conservation easement will not jeopardize its tax-exempt status and that the club's use of the sale proceeds to make capital improvements will constitute other property purchased and used directly in the performance of the club's exempt function if purchased within a specified time.

Citations: LTR 201425016

Contact Person: * * *
Identification Number: * * *
Telephone Number: * * *

Uniform Issue List: 511.00-00, 512.00-00, 512.01-00, 512.09-03
Release Date: 6/20/2014
Date: March 28, 2014

Employer Identification Number: * * *

LEGEND:
Towns = * * *
Amount 1 = * * *
Year 1 = * * *
Amount 2 = * * *
Year 2 = * * *
Year 3 = * * *
Amount 3 = * * *
City = * * *
Date 1 = * * *
Amount 4 = * * *
Amount 5 = * * *

Dear * * *:

This is in response to your letter dated January 11, 2013, in which you requested certain rulings with respect to I.R.C. § 512(a)(3)(D).

BACKGROUND

You are recognized as an organization classified under § 501(c)(7). You are a social and recreational club located in Towns formed for the purpose of golf and other recreation. You have been operated continuously as a social club since you were recognized as exempt well over fifty years ago. 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 one hundred and fifty plus acres ("Property"). All of your recreational facilities are located on the Property and you own no

other real property. Your facilities include an 18-hole golf course, tennis courts and tennis shed, a swimming pool and pool house, staff house, and clubhouse.

You borrowed Amount 1 in debt in Year 1 and Amount 2 in Year 2 to make improvements to your Property. The debt was used exclusively to renovate the golf course, pool house, and clubhouse. You refinanced your debt in Year 3 for Amount 3 to pay off your original debts from Year 1 and Year 2.

On Date 1, you entered into an agreement with City for a conservation easement attaching to Amount 4 acres consisting primarily of your 18-hole golf course, surrounding wetlands, and shrubs. City seeks the easement since your land contains natural resources, such as watercourses, wetlands, and forests, which serve as a source of drinking water for residents of City. The easement is granted for the purpose of limiting development and disturbance of the easement property, preventing pollution, and protecting any portion of the City's water supply system, including its reservoirs and tributaries. City will pay you Amount 5 for the easement.

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, City 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 intend to use the proceeds of the conservation easement agreement to make capital improvements to the Property. These improvements include renovating, expanding, and updating your existing club house; purchasing additional equipment and fixtures for the club house; renovating and expanding your staff house; updating and repairing your golf course; replacing equipment used to maintain golf course; renovating your golf cart barn; repaying and expanding your parking lot; building a new turf management maintenance facility; replacing pool, pool furniture, pump house, heating equipment and engaging in other pool repairs; repairing and updating pool house; refurbishing and expanding tennis courts and tennis house; updating irrigation system; and updating, expanding, and replacing ponds, water resources, and waste systems. All of the updated properties are used by your members in furtherance of your recreational purposes. In addition to expending money to make improvements to your facilities and land, you intend to pay off some of the refinanced debt from Year 3.

RULINGS REQUESTED

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

2. The use of the proceeds of the sale of the easement to improve the golf course, purchase personal property and equipment and add on to, improve, or renovate your facilities, inclusive of those items listed on Exhibit "C," will constitute expenditures for property used directly in the performance of your exempt function for purposes of § 512(a)(3)D) and as such those proceeds will be exempt from tax.

3. The time period for reinvestment of the proceeds of sale of the easement specified in Section 512(a)(3)(D) begins one year before the date of closing of the sale not when the downpayment is deposited with the Escrow Agent or when the contract was signed.

LAW

I.R.C. § 501(c)(7) describes clubs that are 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.

I.R.C. § 512(a)(3)(A) defines unrelated business income, for an organization recognized under § 501(c)(7), as gross income (excluding any exempt function income) less the deductions allowed, both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of § 512(b).

I.R.C. § 512(a)(3)(B) defines exempt function income for § 501(c)(7) organizations to mean gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing the goods, facilities, and services in furtherance of the purposes of the organization.

I.R.C. § 512(a)(3)(D) 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 one year before the date of such sale, and ending three 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.

I.R.C. § 1031 provides that no gain or loss shall be recognized on the sale or exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. The date of the exchange is when the taxpayer transfers the property relinquished in the exchange.

Treas. Reg. § 1.501(c)(7)-1(b) provides that a club which engages in business, such as selling real estate, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes. However, an incidental sale of property will not deprive the club of its exemption.

Senate Report No. 91-552, 1st Session, 1969-3 C.B. 423, 470-71 explained the reasons for enacting § 512(a)(3)(D), noting:

"[T]he 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. The committee believes that it is appropriate not to apply the tax on investment income in this case because the organization is merely reinvesting the funds formerly used for the benefit of its members in other types of assets for the same purposes. They are not being withdrawn for gain by the members of the organization. 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."

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

must 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 reason 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), 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 § 512(a)(3)(D). In analyzing whether the club's property was used directly in the performance of its exempt function prior to the sale, the court looked at the club's actual use of the property, regardless of continuity or regularity, rather than the club's intent for use.

In Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985 [CCH Dec. 42, 047]), the Tax Court held that § 512(a)(3)(D) does not require the purchase of property that is of like kind or use to the property sold. Expenditures for golf carts, land improvements, and other items were qualifying purchases of other property for purposes of that section. However, the court found that the club's use of sale proceeds to repay debt owed and refund assessments to its members constituted a withdrawal for gain by the members of the club, who benefited from the decrease in the club's debt and return of the assessments, therefore subjecting the applicable proceeds to unrelated business income tax.

In Deer Park Country Club v. Commissioner, 70 T.C.M. (CCH) 1445, the sale of land that was never actually used for club purposes was not qualified for non-recognition under § 512(a)(3)(D), regardless of the fact that the organization originally purchased the land with the intent of using it for its exempt function.

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. 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) 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 City 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 City, 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 your 18-hole golf course, including hazards and forest, which promotes your recreational and social comingling purposes, and other recreational facilities that are used by members to join together and engage in recreation. 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 criteria because it is attached to land directly used for your exempt purposes. The fact that you continue to use the land under 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 club house and staff house; improvements to your golf course, golf barn, and parking lot; improvements to your pool, pool house, and tennis courts; and updating, expanding, and replacing ponds, water resources, and irrigation and waste systems.

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 capital improvements to land are considered reinvestments in property for your exempt purpose. The gain on the sale (less selling expenses) that is 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 pursuant to § 512(a)(3)(D).

Finally, you requested a ruling that the date of sale of property for purposes of section 512(a)(3)(D) is the closing date of the sale, not when the downpayment is deposited with the escrow agent or when the contract was signed. Section 1031 describes that the date of sale or exchange of like kind property transactions is the date when the taxpayer relinquishes control of the old property. Here, for purposes of determining when the sale occurs in § 512(a)(3)(D), we rule that the date when you relinquish control of the property and title transfers under local law as the date when the sale occurs. Presuming the date of title transfer is the date of closing under local law, then we rule the date of sale under § 512(a)(3)(D) is the date of closing.

RULINGS

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

2. The use of the proceeds of the sale of the easement to improve the golf course, purchase personal property and equipment and add on to, improve, or renovate your facilities, inclusive of those items listed on Exhibit "C," 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 purchase occur within three years after the closing of the sale of the conservation easement. Additionally, capital improvements described above made in the year preceding closing will constitute other property purchased and used directly in the performance of your exempt function for purposes of § 512(a)(3)(D).

3. The date of sale of property for purposes of section 512(a)(3)(D) is the closing date of the sale.

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,

Michael Seto
Manager, EO Technical
Enclosure
Notice 437

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com