Safeguarding a Club's Tax Exemption and Privacy

They are not the same

By Kevin F. Reilly

You already have zero privacy. Get over it.
—Scott McNealy, CEO of Sun Microsystems Inc.

It is amazing this quote was said in 1999, 20 years ago and before social media impacted every aspect of our life. Today, Sun Microsystem no longer exists except as a part of Oracle. But what does it have to do with clubs? Clubs are tax exempt and, therefore we must be private. Why is it still important to remain private in today's society?

Privacy is important and a club going too far afield runs the risk of losing its ability to select its membership and may be treated as a public accommodation. What is a private club? The Internal Revenue Code defines a private club as a place where people with a common bond congregate for social and recreational purposes. By its very nature, it is not a place open to the general public. The purpose is to serve members for social reasons and not business purposes. Activities and access are limited to members, their immediate family and accompanied guests and membership policies are selective.

Privacy at the Club

Let's consider your club. Does it have an admission policy, or does it accept anyone who applies? As long as the check does not bounce, are they voted in as members? Does the club allow nonmembers to use the facilities even if not accompanied by a member? Are weekends booked with weddings and Mondays full of golf outings? Does the club have reciprocal arrangements with other clubs leaving the feeling that the club is just running a hotel?

The answer to these questions may be "my club does these activities to some extent but not to worry, we are below the 15% threshold for nonmember use of the club that the IRS says we can have without potentially losing our tax-exempt status." Unfortunately, that may not protect a club if it's treated as a public accommodation. Some of the tax issues will be covered later in the article, but let's look first at the importance of privacy.

Why Privacy is Important

A private club is protected by the First Amendment of the Constitution. This provides a right to freedom of association and perhaps even more important, a right to not associate. Giving up private status destroys the essence of what it means to be a private club. Likely, the club will lose its right to determine who are its members as well as limiting access to its facilities. Private clubs can treat people differently than public businesses. They are exempt from certain provisions of the Civil Rights Act of 1964 as well as the American with Disabilities Act (ADA).

Courts Define What Makes a Club Private

The courts have weighed in on some of these protections. Federal and state courts are very protective of civil rights and while a club's rights under the First Amendment generally are protected, the court will scrutinize the activity of the club to ensure the club deserves this special dispensation. The Supreme Court has ruled on the matter and helped define what is considered a private club. The court addressed the issue of private status in two cases dealing with the Rotary and the Jaycees. While these types of organizations may be different than a private club, several points were made that may apply to clubs:

- They have no genuine selectivity in membership.
- The size of the clubs was not limited.
- Nonmembers could participate in events.
- They advertised for membership openings and for club events.
- Finally, members used the club for business purposes.

Since then, a number of states and municipalities have enacted public accommodation legislation. Courts have

looked at the activities of the club and determined based on the activities of the club, it is not truly private and should be subject to the federal and state law. The courts are reluctant to grant absolute immunity from federal and state civil rights laws. This is now being extended to the requirements under the ADA.

A recent court case in Massachusetts went through all the factors that makes a club truly private and concluded in that case that the club was private so not subject to the ADA. However, around the same time, several clubs in California were not found to be private and were held to be subject to the ADA. Based on the opinions, the rationale could easily be applied to the Civil Rights Act. A number of other cases have also found that clubs could be subject to public accommodation legislation because they were not private enough.

The Privacy and Tax-Exempt Status Connection

The relationship between privacy and tax-exempt status is close but not identical. A club can be private and not tax exempt or tax exempt and not treated as private. A tax-exempt club must be organized for pleasure, recreation or other nonprofitable purpose. Substantially all of the club's activities must be in furtherance of the above. No part of the club's net earnings can benefit members—either individuals or a specific group. It may not have a written policy that discriminates on the basis of race, color or religion. Finally, it is established to provide personal contact, commingling and fellowship among members.

The Internal Revenue Service (IRS) does allow some revenue from nonmember use of club facilities, but it is strictly limited. Unlike other tax-exempt organizations, unrelated business income is determined in a different manner. For most, all income is good unless a specific code section states that it is unrelated. Clubs are just the opposite. All income is treated as unrelated unless it meets a specifically designed provision. Generally, this is income from members and there are a few other exceptions. That is why recordkeeping is so important to

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a club. If a club cannot prove that it is member income, the IRS can take the position that it is subject to taxation.

If the IRS decides that the income is nonmember, a club may be able to argue against its position, but it is much better off having the records from the beginning. During the recession, clubs expanded the amount of nonmember business they were willing to accept. More and more clubs crept towards the limit of 15%. This percentage is based on total gross receipts of the club except for initiation fees and capital assessments. There is another 35% limitation which is the total of nonmember usage as well as investment income.

Clubs are being challenged by the IRS as to what goes into these limits. As members demand more from the club, do they run afoul of these rules? Remember, one of the requirements of a club is to bring members together for the personal contact and fellowship among members. This is why the IRS frowns about off-premises catering and food to go. A club is not established for service outside the facility. One of the more popular additions to the club culture is the idea of bringing in national and local winemakers to make a presentation to the members. A direct result is members requesting the club to purchase wine and spirits from the vendor for purchase by the members to take home. In addition to a potential loss of a liquor license if a club is not licensed for off-premises sales, it could also lose its tax status as well as insurance protection.

When the IRS extended the percentage of nonmember income allowed to 15%, it did not change the rules on nontraditional activities. Unless the activity is truly deminimis, the club should not be involved in a nontraditional activity. One problem is the definition of traditional in the club world has evolved while for the IRS it has not. Also, the IRS really has no guidance on what should be included in this category or how much of it can be had by a club. Most clubs use a five percent guideline, but this is only found in unofficial guidance provided by the IRS to its agents in training. It would be difficult to argue that $500,000 is deminimis for a $10,000,000 club.

The National Club Association has a privacy checklist which all clubs should review on a regular basis (nationalclub.org/privacychecklist). However, the items on the list on which courts seem to focus include:

1. The bylaws state that the club is private and organized exclusively for social and recreational purposes.
2. The members ultimately control the club (whether through a board or professional management).
3. The club selectively chooses its members based on criteria established, including referrals from other members.
4. Final approval of new members rest with the board of directors, membership committee or membership at large.
5. Guest rules are restrictive and enforced.
6. Unaccompanied guest use of facilities is prohibited.
7. Members are the primary source of capital and operating funds.
8. Outside business activities (including usage by charities) is strictly limited.
9. The club does not advertise for members.
10. The club does not advertise to the public for the use of its facilities or of events occurring at the club.

While the club world may be changing and a club must learn to adapt, it cannot give up what makes it truly unique or it risks losing the benefits of being a private organization. Remember, the evaluation of whether a club is private is a separate and distinct calculation than whether it meets all the rules to maintain its tax exempt status. CD

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