

# TaxViews

A tax periodical for the private club community

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May 2020

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## Silos and the Social Club

We have previously written about the Tax Cuts and Jobs Act ("TCJA") requirement that tax-exempt organizations, subject to tax on unrelated business taxable income ("UBTI"), must compute UBTI separately for each trade or business (referred to as a "Silo" or the "Silo Rule"). The Department of the Treasury ("Treasury Department") and Internal Revenue Service ("IRS") have recently issued proposed regulations under the TCJA that provide guidance for tax-exempt organizations, including social clubs, with more than one unrelated trade or business with respect to the calculation of UBTI.

- "The organization's [UBTI] for the taxable year is the sum of the amounts (not less than zero) computed for each separate trade or business, less the specific deduction allowed under section 512(b)(12)." H.R. Rep. No. 115-466 (2017), at 548. "Thus, the legislative history states that "a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year." Id. at 548

The proposed regulations provide guidance on identifying separate trades or businesses, including investment activities, as well as certain other amounts included in UBTI. Under prior law, as a general matter, UBTI was the gross income of all unrelated trades or businesses less the allowed deductions from all unrelated trades or businesses. The loss from one trade or business may no longer offset the income from another separate trade or business. These are our preliminary thoughts on the proposed regulations.

## NAICS Codes

The proposed regulations generally provide that exempt organizations, including social clubs, will identify each of their separate unrelated trades or businesses using the first two digits of the North American Industry Classification System ("NAICS") ("NAICS 2-digit codes") that most accurately describes a trade or business. NAICS 2-digit codes identify trades or businesses in 20 sectors.

*NAICS Sector Code 71:* The Arts, Entertainment, and Recreation sector includes a wide range of establishments that operate facilities or provide services to meet varied cultural, entertainment and recreational interests of their patrons. This sector comprises the following:

- Establishments that are involved in producing, promoting, or participating in live performances, events, or exhibits intended for public viewing;
- Establishments that preserve and exhibit objects and sites of historical, cultural, or educational interest; and
- *Establishments that operate facilities or provide services that enable patrons to participate in recreational activities or pursue amusement, hobby, and leisure-time interests.*

A tax-exempt social club would not be able to use NAICS Code 71 for arts, entertainment, and recreation, which includes golf courses and country clubs, to identify all of its unrelated trades or businesses. A social club must use the NAICS code that most accurately describes its unrelated trade or business activities. The social club may use the NAICS Code 71 only to the extent such code describes its unrelated trades or businesses, such as rounds of golf played by non-members for which the greens fees would result in UBTI.

While NAICS Code 71 may describe some of a social club's non-member income, such as greens fees, the IRS advises that other NAICS codes are more appropriate to describe other non-member income, such as merchandise sales (NAICS Code 45) and food and beverage services (NAICS Code 72).

*NAICS Sector Code 72:* The Accommodation and Food Services sector comprises establishments providing customers with lodging and/or preparing meals, snacks, and beverages for immediate consumption.

- The sector includes both accommodation and food services establishments because the two activities are often combined at the same establishment.

*NAICS Sector Code 45:* The Retail Trade sector comprises establishments engaged in retailing merchandise, generally without transformation, and rendering services incidental to the sale of merchandise. The retailing process is the final step in the distribution of merchandise; retailers are, therefore, organized to sell merchandise in small quantities to the general public. This sector comprises two main types of retailers: store and non-store retailers.

- Store retailers operate fixed point-of-sale locations. They typically sell merchandise to the general public for personal or household consumption, but some also serve business and institutional clients.
- Non-store retailers, like store retailers, but their retailing methods differ. These establishments reach customers and market merchandise through various methods, including websites.

A tax-exempt club will report each NAICS code only once which presumably permits the aggregation of broadly similar activities when computing UBTI, and thus would allow social clubs to offset income from one activity with losses from another activity, as long as the two activities are classified within the same NAICS code.

### **Allocation of Expenses to Silos**

Once the businesses are separated into Silos, a club must determine how to allocate expenses that may apply to more than one activity to each Silo. Until the IRS issues further guidance on the issue, it seems reasonable to conclude that the expenses may be allocated using any reasonable method.

#### *Gross-to-Gross Method is Reasonable*

In general, a gross-to-gross method of allocation uses a ratio of gross income from an unrelated trade or business activity over the total gross income from both unrelated and related activities generating the same indirect expenditures. The percentage resulting from this ratio is used to determine the percentage of the shared costs attributable to the unrelated trade or business activity (or activities). In *Portland Golf Club v. Comm.*, 65 AFTR 2d 90-1162 (497 US 154, 110 S Ct 2780), 06/21/1990, the IRS stipulated that the gross-to-gross method provides a reasonable formula for allocating fixed costs.

#### *Unadjusted Gross-to-Gross Method is Unreasonable*

With respect to facilities or personnel that are used both to carry on exempt activities and to conduct unrelated trade or business activities or more than one separate unrelated trade or business, the Treasury Department and the IRS have concluded that allocation of expenses, depreciation, and similar items using an *unadjusted* gross-to-gross method is not reasonable.

In some circumstances, the provision of a good or service can be both related and unrelated depending on to whom the good or service is offered. For example, with respect to social clubs, the provision of goods and services to members is an exempt function whereas the provision of the same goods and services to non-members is a non-exempt function. If the social club charges non-members a higher price than it charges members for the same good or service, the gross-to-gross ratio will increase, resulting in more indirect expenses being allocated to the unrelated activity. However, no difference likely exists in the cost of providing the good or service to members versus non-members. Accordingly, the failure to adjust the price of the good or service offered to non-members or the general public for purposes of determining the allocation of indirect expenses (that is, using an unadjusted gross-to-gross method) overstates the percentage of the indirect expenses that should be allocated to the unrelated activities.

When a tax-exempt club charges different prices for the same good or service depending on whether the offering of the good or service is a related or unrelated activity, then the club should adjust the per "unit" price of the good or service of the related activity to that of the unrelated activity (or activities) for the ratio created by the gross-to-gross method to appropriately account for the percentage of indirect expenses attributable to the unrelated activity. Failing to make this

adjustment does not appropriately account for the portion of indirect expenses attributable to an unrelated activity and is therefore an unreasonable method for allocating expenditures. Accordingly, the proposed regulations provide that the *unadjusted* gross-to-gross method is not reasonable.

### **UBTI – Investment Income and Set-Aside**

There is a special definition of UBTI for social clubs. UBTI is generally defined as “gross income (excluding exempt function income).” For a club, the gross income subject to the unrelated business income tax generally includes interest, annuities, dividends, royalties, rents, and capital gains. Accordingly, social clubs generally must include such amounts in UBTI, unless such amounts are set aside for charitable purposes, and therefore would be exempt function income excluded from UBTI.

- Section 512(a)(3)(B) defines “exempt function income” as (1) “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;” and (2) “all income...which is set aside.”
- Section 512(a)(3)(B)(i) includes in exempt function income amounts set aside for a purpose, that is, exclusively for religious, charitable, scientific, literary, or educational purposes.

#### *Example*

A social club has interest and dividends and does not set aside any amount of such interest or dividends for a charitable purpose, then the full amount of the interest and dividends would constitute UBTI.

However, if the social club sets aside any amount of the interest or dividends for a charitable purpose, the amount of the interest and dividends set-aside would be excluded from the calculation of UBTI as exempt function income (provided that such amount set aside actually is used for a charitable purpose).

A social club would identify its unrelated trades or businesses using NAICS codes and treat the income derived from investment activities, not set-aside, as a separate unrelated trade or business.

### **Hosting of a Professional Golf Tournament**

May the income from a social club event, such as a major golf tournament that is infrequently held be classified as a single trade or business?

The IRS advised that the proposed regulations generally require an exempt organization to identify its separate unrelated trades or businesses using the NAICS 2-digit code that most accurately describes each trade or business. Whether an infrequent or possibly nonrecurring event constitutes a separate unrelated trade or business or whether such event is part of another trade or business

(including, in some cases, part of the social club's investment activities) depends on the facts and circumstances of each social club and the event at issue, including the scope of activities as part of the event. While such determination is not necessary for including such income in UBTI, identification of separate unrelated trades or businesses is necessary for applying the Silo Rule.

The Treasury Department and the IRS request comments regarding the particular facts and circumstances that should be considered by a social club when determining whether a non-recurring event should be treated as a separate unrelated trade or business, part of a larger trade or business, or as part of a social club's investment activities for purposes of the Silo Rule.

## **Comments**

Written or electronic comments and request for a public hearing with respect to these proposed regulations must be sent to the IRS by June 23, 2020.

- Final regulations will apply to tax years beginning on or after the date they are published as final.
- For tax years beginning before such date, an exempt organization may rely on a reasonable, good-faith interpretation, considering all the facts and circumstances, when identifying separate unrelated trades or businesses for purposes of the Silo Rule. In addition, for these same tax years, an exempt organization may rely on these proposed regulations.

Submit electronic comment submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-106864-18) by following the online instructions for submitting comments. Send hard copy submissions to: CC:PA:LPD:PR (REG-106864-18), Room 5203, IRS, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. The Treasury Department and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy.

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