The Internal Revenue Service (IRS) recently provided clubs with insight to the IRS's analysis regarding whether an activity is the active conduct of business not traditionally carried by tax-exempt clubs. A club must be vigilant regarding the identification of nontraditional business activities because such activities do not further the exempt purpose of a club—even if conducted solely on a membership basis. Each activity conducted by a club must be evaluated to determine if it furthers pleasure, recreation and other nonprofitable purposes as described in Internal Revenue Code (IRC) § 501(c)(7).

NONTRADITIONAL ACTIVITIES

NEW IRS ANALYSIS

of Problematic Activities

The Code

IRC § 501(c)(7) provides an exemption from federal income tax for clubs organized for pleasure, recreation and other nonprofitable 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 or individual.

Gross receipts are defined in the code as those receipts from normal and usual activities of the club (that is, those activities they have traditionally conducted) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents and similar receipts) and normal recurring capital gains on investments, but excluding initiation fees and capital contributions. A club is permitted to receive up to 35% of its gross receipts from nonmember sources, provided not more than 15% is derived from nonmember use of club services or facilities. Revenue sources should be examined to ensure that such amounts were not derived from the "active conduct of businesses not traditionally carried on" because it is not intended that clubs should be permitted to receive, within the 15% or 35% percent allowances, income from the active conduct of businesses not traditionally carried on.

Determination of Nontraditional Business Activities

In the past, the IRS has advised as to whether certain activities were, or seemed to be, nontraditional. Recently, the IRS set forth an analysis in making such determination. In the example, a club decided to participate

in a carbon offset credit program administered by a state agency; the agency sets the standards that the participants must follow, approves applications and calculates the amount of carbon dioxide their land will sequester. Upon approval, the state agency issues marketable carbon offset credits that reflect the amount of carbon dioxide sequestered. The club will enter into an agreement to manage its forest in accordance with the program's sequestration protocol. The club expects to recognize a large amount of income from the receipt of carbon offset credits.

In this case, the gross income recognized by the club will exceed the 15% and 35% allowances, but the income will be unusual and not expected to recur. Therefore, the income would not be included in the aforementioned allowances, as long as it is not derived from the "active conduct of businesses not traditionally carried on by these organizations."

The IRS stated that *several factors show* that the unusual amount of income that will be recognized upon receipt of the carbon offset credits will *not be derived from active conduct of a nontraditional business:*

- The club did not purchase property in order to engage in this transaction
- The club purchased the property and has used the property for exempt activities
- The transaction will not be a regular recurring event
- The club represents that the carbon offset credit transaction will be a unique event, and although it is not a sale, it is a one-time transaction analogous to the permitted incidental sale.

The club's transaction is related to a crucial aspect of its exempt purpose: to preserve the health of the forest habitat. Although a few of the activities involved in the transaction may not promote exempt purposes, substantially all of the activities the club will undertake over the years in connection with it will support its exempt purpose. The club states that maintaining its exempt property as a preserve will allow club members to continue the exempt activities of recreation. The IRS advised that the maintenance of property that the club uses directly in performing its exempt function is a traditional and normal activity of a club exempt under IRC § 501(c)(7) because it furthers its exempt purpose. CD

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