

SILOS AND THE SOCIAL CLUB

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Your tax questions answered: The "Silo Rule"

Albert Einstein is quoted as saying that "[t]he hardest thing in the world to understand is the income tax." Well, the computation of taxable income is getting harder, especially for tax-exempt social clubs. An omen of the complexity on the horizon was contained in the innocent-sounding Tax Cuts and Jobs Act (Public Law 115-97) (the TCJA). This provided, among other things, that losses from one unrelated trade or business of a tax-exempt club may not be used to offset income derived from another unrelated trade or business.

Tax Cuts and Jobs Act

Under the TCJA, social clubs with more than one unrelated trade or business are prevented from offsetting unrelated business taxable income (UBTI) generated by a profitable unrelated trade or business with a loss from an unprofitable one. This prohibition is generally known as the UBTI Silo Rule (the "Silo Rule"). Simply stated, a social club that receives non-member income from multiple sources, such as from a dining facility and from a retail store, may have more than one unrelated trade or business and be subject to the TCJA requirement to calculate gains and losses separately.

Proposed Regulations

The Internal Revenue Service (IRS) issued proposed regulations that provide guidance for social clubs with more than one unrelated trade or business in connection with the calculation of UBTI. The proposed regulations provide guidance with respect to identifying separate trades or businesses, including investment activities, included in UBTI.

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NAICS Codes

The proposed regulations, as a general matter, provide that 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) that most accurately describes a trade or business.

- NAICS Sector Code 71 includes, among others, establishments that operate facilities or provide services that enable patrons to participate in recreational activities or pursue amusement, hobby and leisure-time interests. A social club would not be able to use NAICS Code 71 for entertainment and recreation, which includes golf courses and country clubs, to identify all of its unrelated trades or businesses. NAICS Code 71 should only be used if it describes an unrelated trade or business, such as rounds of golf played by non-members for which the greens fees 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.
- NAICS Sector Code 72 includes clubs that provide customers with lodging and/or meals and beverages for consumption because the two activities

are often combined at the same establishment.

- NAICS Sector Code 45 includes clubs engaged in retailing merchandise, generally without transformation, and rendering services incidental to the sale of merchandise made through point-of-sale locations or non-store sales locations, including websites.

A club will report each NAICS code only once; this should allow social clubs to offset income from one activity with losses from another activity, provided 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.

Gross-to-Gross Method Is Reasonable

The 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. The percentage resulting from this ratio is used to determine the percentage of the shared costs attributable to the unrelated trade or business activities. The IRS has stipulated that the gross-to-gross method is reasonable.

Unadjusted Gross-to-Gross Method is Unreasonable

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 non-exempt. If the 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. 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) appears to overstate the percentage of the indirect expenses that should be allocated to the unrelated activities and is unreasonable according to the IRS.

Proposed Applicability Dates

The proposed regulations will apply to taxable years beginning on the date they are published in the Federal Register as final regulations; prior thereto, a club may rely on a reasonable method when identifying separate unrelated trades or businesses. •



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