After a Disaster

A primer on the tax implications of insurance proceeds for private clubs.

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When a natural disaster strikes,

private clubs often face significant property damage and financial loss. Understanding how to treat insurance proceeds for tax purposes is crucial for private clubs to effectively navigate the aftermath of a natural disaster.

A private club that had the foresight and financial ability to insure the club's property may receive insurance proceeds in connection with the destruction of club property. For those clubs, what is the proper tax treatment with respect to the receipt of insurance proceeds? It may be no surprise to some, but the tax treatment of insurance proceeds from a natural disaster differs between tax-exempt and taxable private social clubs.

Tax-exempt Private Social Clubs

Internal Revenue Code ("IRC") §512(a)(3)(D) plays a critical role in the tax treatment of gains realized by tax-exempt private social clubs in the context of insurance proceeds received as a result of natural disasters.

- RC §512(a)(3)(D) states that if property used directly in the performance of the exempt function of a tax-exempt club is sold, 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 club directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such club's sales price of the old property exceeds the club's cost of purchasing the other property. For purposes of this provision, the destruction in whole, or in part, of property shall be treated as the sale of such property.

Tax-exempt private social clubs are, generally, not subject to unrelated business income tax (UBIT) because IRC §501(c)(7) provides for the exemption from UBIT for clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes. The tax exemption for social clubs was designed to allow individuals to join together to provide themselves with social or recreational activities and facilities without tax consequences, and social clubs are exempted from tax not as a means of conferring tax advantages, but as a means of ensuring that the members are not subject to tax disadvantages as a consequence of their decision to pool their resources for the purchase of social or recreational services (Portland Golf Club v. Commissioner, 110 S. Ct. 2780 (1990)).

Consistent therewith, tax-exempt social clubs are not taxed on their member income. Member income, which is also known as exempt function income, includes dues, fees, charges or similar amounts paid by members of the social club as consideration for providing members and their dependents and guests with goods, facilities or services in furtherance of the exempt purpose of the social club.

With limited exceptions, non-member revenues received by tax-exempt clubs are subject to the UBIT. IRC§512(a)(3) indicates, "unrelated business taxable income" means the gross income (excluding any exempt function income), less allowed deductions which are directly connected with the production of the gross income (excluding exempt function income), computed with permitted modifications.

One may suspect that insurance proceeds received from a non-member in connection with a natural disaster would constitute unrelated business income to a tax-exempt social club. However, as indicated earlier, IRC Section 512(a)(3)(D) provides for the deferral of such gain by inclusion of the statement, "[f]or purposes of this provision, the destruction in whole, or in part, of property shall be treated as the sale of such property." Therefore, tax-exempt clubs which receive insurance proceeds as a result of damage sustained to exempt use property of the club, have a basis for deferring gain, provided the insurance proceeds are used to purchase new exempt use property for the club within the specified time period.

A tax-exempt social club has discretion in purchasing and using other exempt purpose assets to avoid recognizing the gain on the sale for tax purposes. Not only may the proceeds be used to acquire,

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construct or reconstruct, exempt purpose assets, the proceeds may also be used to make capital expenditures, including the acquisition of exercise equipment, furniture, kitchen equipment etc. The only requirement is that such expenditures be made for assets used directly in the performance of the exempt function of the club as stipulated by IRC Section 512(a)(3)(D) and within the stated time period. Generally, expenditures for repairs and maintenance are not considered under the definition of the purchase of other property. This interpretation has been supported in case law. One example, in Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985), the Tax Court held that IRC §512(a)(3)(D) does not require the purchase of property that is similar in kind or use to the property sold.

Therefore, a tax-exempt social club fortunate to receive insurance proceeds in connection with a natural disaster may defer the gain realized by the destruction of such property as indicated in IRC §512(a)(3)(D). Therefore, the IRC provides tax-exempt social clubs a means to reinvest the full amount of insurance proceeds received back into the exempt purpose of the club, helping with continuity and stability in the clubs' operations after a natural disaster.

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Taxable Private Social Clubs

Internal Revenue Code §1033 plays a critical role in the tax treatment of gains realized by taxable private social clubs in the context of insurance proceeds received as a result of natural disasters.

The receipt of insurance proceeds by a taxable club is a taxable event. In the case of insurance proceeds received in connection with the destruction of property, the taxable income is not the amount of the insurance proceeds, but the taxable amount is the excess of the insurance proceeds over the tax basis of the property destroyed.

- IRC §1033 provides an exception to the recognition of gain if the taxpayer satisfies the rules for acquiring replacement property. If the taxpayer receives money or other consideration for the involuntarily converted property and, within the replacement period, uses the proceeds to acquire similar replacement property, the taxpayer can elect deferral under IRC §1033. In that case, the taxpayer recognizes gain only to the extent that the amount realized on conversion exceeds the cost of the replacement property acquired by the taxpayer.

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With respect to insurance proceeds, the goal of club management, as a general matter, is to avoid having the club taxed on insurance proceeds used to restore the club's property to pre-natural-disaster condition. Yet, in attempting to accomplish such goal, club management has to wrestle with the inherent limitations contained in IRC §1033 with respect to replacement property and reinvestment period. If certain criteria is met, the club may be relieved from recognition of taxation with respect to such gain.

- IRC §1033(a)(2)(A) provides that if the taxpayer, during the period specified, for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer, the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property. Such election shall be made at such time and in such manner as the Secretary may by regulations prescribe.

The club may defer realized gain only to the extent that the club actually reinvests the proceeds in replacement property. A club that uses only a portion of the proceeds to acquire replacement property may recognize gain on the balance of the proceeds.

Replacement Period

Adhering to the replacement period is essential for deferring gain recognition. Failure to reinvest within the specified period may result in the immediate recognition of the gain, leading to potential tax liability. IRC §1033(a)(2)(B) specifies the replacement period as the time frame within which the taxpayer must acquire replacement property to defer the gain from an involuntary conversion. The period begins on the date of the disposition of the converted property and ends:

- **Two Years After the Close of the First Taxable Year.** This is the standard period, which ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized.
- **Extension by the Secretary.** The secretary of the treasury has the authority to extend this period under certain terms and conditions.

Similar or Related Use

When a private social club's property is involuntarily converted into money, such as through insurance proceeds following a natural disaster, the club can elect to defer recognizing the gain by reinvesting in similar or related property. However, the requirement for the replacement property to be "similar or related in service or use" can be challenging to interpret.

Generally speaking, similar or related in service or use requires:

- **Substantially Similar Business Property.** The reinvestment must be in property that is substantially similar to the property that was converted. The new property should serve a similar function and be used in a similar manner as the original property.
- **Continuation of Prior Commitment.** The reinvestment should represent a continuation of the club's prior commitment of capital. The club should not significantly change the nature of its investment or operations.
- **Character of Investment.** While the replacement property does not need to be an exact duplicate of the converted property, the overall character should remain consistent. The club should aim to return to its original position as closely as possible.

Federally Declared Disasters of Property

As a general matter, if a club replaced property that was involuntarily converted with property that was not similar or related in service, the club would recognized gain. If a natural disaster overwhelmed a community and the U.S. President declared such community a disaster area, the tangible replacement property acquired and held for productive use in a business by the club would be treated as similar or related in service or use.

- IRC §1033(h)(2) provides that if property held for productive use in a trade or business located in a disaster area and is compulsorily or involuntarily converted as a result of a federally declared disaster, then any tangible property of a type held for productive use in a trade or business is treated as similar property for the purposes of replacement.

The legislative history of IRC §1033(h)(2) advises that this provision provides relief to businesses by allowing them to reinvest their funds in any tangible business property without being forced to recognized gain. This provision offers significant flexibility to taxable clubs affected by federally declared disasters, allowing them to replace their converted property with a broader range of business assets than would typically be permitted under the general "similar or related in service or use" standard of IRC §1033. If a club receives insurance proceeds because of the destruction caused by a natural disaster, club management should investigate, along with the club's tax adviser, to determine if the club is in an area covered by a presidential declaration of federal disaster.

Conclusion

While the IRC provides for circumstances in which both tax-exempt and taxable private social clubs may defer gain associated with the receipt of insurance proceeds from a natural disaster, clubs navigating these complex rules should consult with a qualified tax professional to ensure compliance and to maximize the benefits available under the Internal Revenue Code. CD

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