

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 164

November 21, 1957

EXEMPTION: LOSS OF EXEMPT STATUS BY SOCIAL CLUBS

Syllabus:

When income from profit-making activities is received by a tax exempt social club over a substantial period of time so as to justify the conclusion that it is deliberate such net earnings inure to the benefit of its members and the social club is no longer entitled to its tax exempt status. However, when a gain is realized from the sale of club assets upon dissolution it does not cause the loss of the exempt status when it is not merely a profit taking device.

X is an incorporated social club exempt from taxation. It derived income from dues, initiation fees and an annual show, conducted by X for several years, which had always shown a profit. The tickets for the show were sold to the general public; however, a substantial part of the income was derived from sponsors and entry fees. X in the process of dissolution sold its real property which, due to normal growth of the area and appreciation in value, resulted in a substantial gain. The gain from the sale and prior accumulations were then distributed to the members. The annual show was not given in the year of dissolution. Advice is requested whether X was entitled to the exemption in the years it conducted the shows and if the sale and distribution of assets to its members resulted in a loss of the exemption for the final year.

Section 23701(g) and Regulation 23701(g) provide the exemption for clubs organized and operated for pleasure and recreation. However, case law has allowed social clubs to derive passive or incidental income from sources other than membership dues and assessments without losing their exemption. Koon Kreek Club v Comm., 108 F2d 616 (Passive income, i.e., rent); Santee Club v White, 87 F2d 5 (Incidental sale of real property); Cour d'Alene Country Club v Viley, 64 F Supp 544 (Incidental income from nonmembers). In Jockey Club v Helvering, 76 F2d 597, the court in determining whether income derived from nonmembers inured to the benefit of members, held that a club may make a profit on occasion but, taken by and large, the returns from outsiders should do no more than reimburse the club for its costs. However, if upon computation they are such a source of income over a substantial period of time so as to justify the conclusion that it is deliberate, such net earning inure to the benefit of the members. This principle was applied in West Side Tennis Club v Comm., 111 F2d 6, Cert. den. 61 S. Ct. 40, where the club conducted only an annual event as did X in this case. During the years X conducted annual shows, the profit in any one

year was insufficient to cause X to lose its exempt status. However, when over a period of years profits were consistently made, it must be concluded that they were consciously conducted for a profit. Consequently, the income from the shows inured to the benefit of the members and X is not entitled to exempt status during the years the shows were conducted.

X was entitled to an exemption the last year of operation unless the status was lost as a result of the sale of the property and the distribution of the proceeds to the members. In Mill Lane Club, Inc. v Comm., 23 TC 433, the court held that when such a sale and dissolution was not to facilitate profit taking but was prompted by circumstances incidental to club purposes which require a sale, it does not result in a loss of the exemption. As to the question of such profits inuring to the benefit of the members the court said, "It is well settled that the fact that the assets of a club will, upon dissolution, be paid to members is not alone sufficient to make the organization liable to render income tax returns (S.M.2710, 111-2 C.B. 230)." Consequently, the distribution of the gain from the sale upon dissolution did not result in a loss of the exempt status of X in the year of dissolution.