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TAX TREATMENT OF SOCIAL CLUBS AND OTHER MEMBERSHIP ORGANIZATIONS AND CERTAIN OTHER COMMITTEE AMENDMENTS

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Mr. Long, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 1144]

The Committee on Finance, to which was referred the bill (H.R. 1144) to amend the Internal Revenue Code of 1954 with respect to the tax treatment of social clubs and certain other membership organizations, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

The House-passed bill, H.R. 1144, amends the requirements for tax exemption for social clubs and similar organizations (including college fraternities and sororities) in two respects. First, it provides that "substantially all" of such an organization's activities must be for pleasure, recreation, and other nonprofitable purposes. This change (present law requires such an organization to be organized and operated "exclusively" for these purposes) allows the organization to earn income from nonmember sources to a limited extent and to have a limited amount of investment income (both types of income being subject to tax) without losing its general exemption from income tax. The second change provides that such an organization is to lose its tax-exempt status if its charter, by-laws, or other governing instrument or any of its written policy statements contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

In addition, the House-passed bill resolves a question about the corporate dividends-received deduction in the case of organizations which are generally exempt but which nevertheless are taxed on their investment income. It disallows this deduction in computing the

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taxable investment income of social clubs and similar organizations, and of employee beneficiary associations. Similarly, it denies the dividends received deduction for investment income of taxable membership organizations.

The committee agreed to the House-passed bill and in addition added two amendments. The first amendment corrects a technical defect in the Tax Reform Act of 1976 relating to changes in the minimum tax in the case of corporations. Under this amendment any carryover of taxes paid from fiscal years beginning before July 1, 1976, is disallowed as a deduction in the case of the minimum tax on corporations for taxable years beginning after June 30, 1976.

The second committee amendment deals with the treatment of recycling of solid waste materials. It directs the Secretary of the Treasury and the Administrator of the Environmental Protection Agency to conduct a study and investigation of all matters relating to the proper role of the Federal Government in encouraging the recycling of solid waste materials.

II. GENERAL EXPLANATION

A. Social Clubs

1. INCOME FROM NONMEMBERS AND INVESTMENT SOURCES

Present law

Among the present law categories of exempt organizations are social clubs and other somewhat similar nonprofit organizations, such as national organizations of college fraternities and sororities. Present law (sec. 501(c)(7)) provides that these organizations must be organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes with no part of the net earnings inuring to the benefit of any private shareholder. The regulations under this provision (Regs. § 1.501(c)(7)–1(b)) state that a club which engages in business is not organized and operated exclusively for nonprofitable purposes and, therefore, is not exempt.

Generally, the Internal Revenue Service has not challenged the exempt status of these organizations if the income derived from providing goods and services to persons other than members and their guests is small in relation to the total activities of the organization. Thus, as an audit standard (Rev. Proc. 71–17, 1971–1 CB 683), the Service has indicated that it generally will not disturb a social clubs, certain fraternities and sororities, and employees' beneficiary if the club's annual income from outside sources either is not more than $2,500 or is not more than 5 percent of the total gross receipts of the organization. Where gross receipts from nonmembers dealings exceed this 5-percent figure, all facts and circumstances are taken into account in determining whether the organization continues to qualify for exempt status. In the case of investment income, the Service applies no percentage rule, but instead looks to whether a substantial part of the club's income is from investment sources club's exempt status solely on the basis of its nonmember activities (Rev. Rul. 66–149, 1966–1 CB 146).

Reasons for change

In the Revenue Act of 1950, because of the competitive problem with taxable businesses, Congress imposed the regular income tax on the income certain tax-exempt organizations receive from active business enterprises which are unrelated to their exempt purposes. Social clubs, national organizations of college fraternities and sororities, and certain other types of tax-exempt organizations were not subjected to the unrelated business income tax imposed at that time.

In its consideration of the Tax Reform Act of 1969, however, because many of the exempt organizations not subject to the unrelated business income tax were engaging in substantial business activity, Congress extended the unrelated business income tax to virtually all of the exempt organizations not already subject to that tax. As a result, social clubs and national organizations of college fraternities and sororities became taxable on all of their unrelated business income.

In addition, the 1969 Act extended the unrelated business income tax, in the case of these social clubs and national organizations of college fraternities and sororities, to cover investment income as well as unrelated business income. Investment income was made taxable in the case of these membership organizations because not to do so would have permitted them to provide recreational or social facilities and services out of revenues other than membership fees and as a result would have permitted individuals to devote investment income, free of tax, to personal activities.

Because of the personal nature of these organizations, the Internal Revenue Service in prior years developed the 5-percent test referred to above in determining whether a social club was properly exempt from tax. Not to have significantly limited the income which could be derived from nonmembers, under the conditions prevailing at that time, would have resulted in nontaxed income being devoted to the personal, recreational, or social benefit of the members of these clubs.

However, since the passage of the 1969 Act, this strict line of demarcation between the exempt and nonexempt activities of social culbs appears unnecessary. Since the passage of the 1969 Act all of the income derived from nonmembers as well as investment income is subject to tax, even though the organization itself is still classified as an exempt organization. Thus, while it is necessary to require that social club must still be substantially devoted to the personal, recreational, or social benefit of members, the extent to which such a club can obtain income from nonmember sources can be somewhat liberalized. In view of these considerations the committee's bill clarifies existing law to permit somewhat larger amounts of income to be derived by exempt social clubs from nonmembers and also from investment income sources.

Explanation of provision

The first change made by the bill substitutes for the requirement of existing law that clubs which are exempt from tax under sec. 501(c)(7) must be organized and operated "exclusively" for pleasure, recreation, and other nonprofitable purposes, the new requirement that "substantially all" of such a club's activities must be for these purposes.[1]

[1] The bill continues the present law requirement that no part of the net earnings of the organization may inure to the benefit of any private shareholder.

The effect of this change is twofold. First, it is intended to make it clear that these organizations may receive some outside income, including investment income, without losing their exempt status. Second, it is intended that a social club be permitted to derive a somewhat higher level of income than was previously allowed from the use of its facilities or services by nonmembers without the club losing its exempt status. The decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based on all the facts and circumstances. However, the facts and circumstances approach is to apply only if the club earns more than is permitted under the new guidelines. If the outside income is less than the guidelines permit, then the club's exempt status will not be lost on account of nonmember income.

It is intended that these organizations be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their membership without losing their tax-exempt status. It is also intended that within this 35-percent amount not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. In effect, this latter modification increases from 5 percent (current audit standard: Rev. Proc. 71–17) to 15 percent the proportion of gross receipts a club may receive from making its club facilities available to the general public without losing its exempt status. This also means that a club exempt from taxation described in sec. 501(c)(7) is to be permitted to receive up to 35 percent of its gross receipts from a combination of investment income and receipts from nonmembers so long as the latter do not represent more than 15 percent of total receipts.

Gross receipts are defined for this purpose 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. However, where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in the formula; that is, such unusual income is not to be included in either the gross receipts of the club or in the permitted 35- or 15-percent allowances. On the other hand, where college fraternities or sororities charge membership initiation fees, but no annual dues, such fees will be included in their gross receipts, notwithstanding that initiation fees are ordinarily excluded. It is not intended that these organizations should be permitted to receive, within the 15- or 35-percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations.

It is intended that a social club, national organization of a college fraternity or sorority, and any other organization exempt under section 501(c)(7), may receive the full 35-percent amount of its gross receipts from investment income sources (reduced by any amount of nonmember income, discussed above). This means that a national organization of a college fraternity or sorority that has no outside income from permitting the general public to use its facilities may receive investment income up to the full 35-percent amount of its gross receipts. On the other hand, in the case where a social club

permits nonmembers to use its club facilities and receives 15 percent of its gross receipts from these nonmember sources, it may receive only up to 20 percent of its gross receipts from investment income.

In the case of the application of the unrelated business income tax to investment income of these organizations, present law (sec. 512 (a)(3)) exempts that income which is set aside to be used for religious, charitable, scientific, literary, educational, etc., purposes (the purposes specified in sec. 170(c)(4)) or the reasonable cost of administration of these activities. For purposes of the 35-percent test, this exempt function income should be included in both the numerator and the denominator, and if this exempt function income causes the organization to exceed the 35-percent limit, the organization is to lose its exempt status (unless the facts and circumstances of the case warrant otherwise).

If an organization has outside income in excess of the 35-percent limit (or 15-percent limit in the case of gross receipts derived from nonmember use of a club's facilities), all the facts and circumstances are to be taken into account in determining whether the organization qualifies for exempt status. If it is determined that the organization is to lose its exempt status for that year, all of its income, even that received from its membership, is to be subject to tax in that year. In such a case the income received from the club's members (but only this income) could be offset by the cost of services and goods furnished the members (sec. 277).

2. DIVIDENDS RECEIVED DEDUCTION FOR EXEMPT SOCIAL CLUBS, ETC.

Present law

Generally, the tax on unrelated business income does not apply to investment income.[2] However, in the case of social clubs, certain fraternities and sororities, and employees' beneficiary associations, "investment income" is included in the tax base. This result is accomplished in the case of these organizations by defining their unrelated business taxable income (sec. 512(a)(3)) as meaning gross income (other than exempt function income)[3] less allowable deductions directly connected with the production of gross income (again excluding exempt function income).

One of the deductions allowed corporations in the computation of the regular corporate income tax is the dividends received deduction. Generally, this allows corporations a deduction equal to 85 percent of dividends received from taxable domestic corporations. The proposed Treasury regulations on social clubs, certain fraternities and sororities, and employees' beneficiary associations [4] provide that the dividends received deduction is not allowed for purposes of computing unrelated business taxable income for those organizations, because that deduction is not an expense directly connected with the production of income.

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[2] Section 512(b) generally excludes from the term "unrelated business taxable income" passive investment income such as dividends, interest, royalties, and capital gains.

[3] Exempt function income is defined in section 512(a)(3)(B) as gross income from dues, fees, charges, or similar amounts paid by members in connection with the purposes constituting the basis for the exemption of the organization.

[4] Proposed Reg. § 1.512(a)-3(b)(2), published on May 13, 1971 (36 Fed. Reg. 8808-8809).

Reasons for change

Treasury representatives have reported that questions have been raised with respect to these proposed regulations, as to whether Congress intended to disallow the dividends received deduction. To clarify this point the Treasury Department has requested Congress to state specifically that the dividends received deduction is not available in the case of investment income of tax-exempt social clubs, certain fraternities and sororities, and employees' beneficiary associations.

The major reason for the dividends received deduction is to avoid two or more corporate taxes on corporate earnings as the income is passed from one corporation to another, in addition to taxing the same amount to individual shareholders when the earnings are paid out as dividends to them. In the case of social clubs, certain fraternities and sororities, and employees' beneficiary associations, however, the individual income tax on shareholders does not apply, since the dividend income received by these organizations is not distributed to the members. Since the exempt organization is in effect taking the place of the individual member for tax purposes, it seems appropriate that the tax apply to these organizations in much the same manner as in the case of individual shareholders.

For reasons indicated above, the committee believes that the proposed Treasury regulations disallowing the dividends received deduction are consistent with the intent and structure of the provision (sec. 512(a)(3)) enacted in the Tax Reform Act of 1969, which allows deductions in the case of investment income of social clubs, certain fraternities and sororities, and employees' beneficiary associations only in the case of deductions directly connected with the production of income. The bill specifically clarifies this point by providing that in these cases the dividends received deduction is not to be considered as directly connected with the production of gross income.

Explanation of provision

The second change made by this bill denies a corporate dividends received deduction to tax-exempt social clubs, certain fraternities and sororities, and voluntary employees' beneficiary associations (described in secs. 501(c)(7) and (9)) in computing their "unrelated business taxable income." Under present law the unrelated business taxable income of these organizations is defined as their gross income (excluding any exempt function income) less the deductions under this chapter "which are directly connected with the production of the gross income" (again excluding exempt function income). The bill specifically provides that the corporate dividends received deduction is not to be considered as a deduction which is "directly connected with the production of gross income."

3. DIVIDENDS RECEIVED DEDUCTION FOR NONEXEMPT MEMBERSHIP ORGANIZATIONS

Present law

Under present law (sec. 277, enacted as part of the Tax Reform Act of 1969), in the case of taxable membership organizations the deduction for expenses incurred in supplying services, facilities, or goods to the members is to be allowed only to the extent of the income

received from these members. This was provided in order to prevent taxable membership organizations from escaping tax on business or investment income by using this income to provide services, facilities, or goods to its members at less than cost and then deducting the loss from the membership activity against the business or investment income.

Reasons for change

To the extent these organizations receive dividend income which is used to provide services, facilities, or goods to the members the same problem arises in connection with these taxable membership organizations as in the case of the tax-exempt membership organizations described above (sec. 2. Dividends Received Deduction for Exempt Social Clubs, etc.). If the dividends received deduction were available in the case of the tax on the membership organization (in effect, providing a substitute for the dividend tax on shareholders) the second, or individual, tax on this income would be avoided in substantially the same way as in the case of the exempt membership organizations (were the provision described above not to be added). Moreover, if nothing were done in this regard in the case of taxable membership organizations, the nontaxable organizations by revoking their exempt status could avoid the tax on this dividend income in this manner.

For the reasons indicated above, the committee believes it is appropriate to disallow the dividends received deductions in the case of these taxable membership organizations in the same manner as in the case of the tax-exempt membership organizations referred to above.

Explanation of provision

The third change made by this bill denies a corporate dividends received deduction to taxable social clubs and other membership organizations operated primarily to furnish services or goods to members (referred to in sec. 277). These organizations, with certain exceptions set forth in present law, are permitted deductions attributable to furnishing services, insurance, goods, or other items of value to their members only to the extent of the income derived from members or transactions with members. The bill specifically provides that the corporate dividends received deduction (secs. 243, 244, and 245) is not to be allowed to these organizations.

4. PROHIBITION OF DISCRIMINATION BY SOCIAL CLUBS, ETC.

Present law

The Internal Revenue Code does not deal explicitly with the question of whether an income tax exemption for social clubs, etc. (i.e., organizations described in sec. 501(c)(7) which are exempt under sec. 501(a)), is incompatible with discrimination on account of race, color, or religion.

It has been held (*McGlotten* v. *Connally*, 338 F. Supp. 448 (D.C., D.C. 1972)) that, in light of the present statutory scheme of income tax treatment of social clubs, etc. (including their treatment under the unrelated business income tax provisions described above), discrimination on account of race is not prohibited under the Constitution in

the case of an exempt organization merely because it is described in section 501(e)(7).[5]

Reasons for change

In view of national policy, it is believed that it is inappropriate for a social club or similar organization described in section 501(c)(7) to be exempt from income taxation if its written policy is to discriminate on account of race, color, or religion.

Explanation of provision

Under the bill, an organization otherwise exempt from income tax as an organization described in section 501(c)(7) is to lose its exempt status for any taxable year if, at any time during that year, the organization's charter, by-laws, or other governing instrument, or any written policy statement contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

5. EFFECTIVE DATES

The amendments made by the bill relating to social clubs generally apply to taxable years beginning after the date of enactment of this Act.

The amendment as to income from nonmembers and investment sources, and the amendments as to the corporate dividends received deductions are intended as clarifications of existing law under the Tax Reform Act of 1969.

B. Effective Date for Repeal of Tax Carryovers in the Case Of the Minimum Tax on Corporations

The committee added an amendment to the bill which corrects a technical defect in the Tax Reform Act of 1976. The provision of that Act relating to changes in the minimum tax on individuals and corporations (sec. 301) provided that no amount of any carryover of regular taxes paid (which, under prior law, was allowed as a deduction in determining the amount subject to the minimum tax in subsequent years) would be allowed from a taxable year beginning before January 1, 1976, to any taxable year beginning after December 31, 1975. This same provision was in the bill as passed by the Senate, except that for corporations (other than subchapter S corporations and personal holding companies) the Senate bill applied to carryovers from taxable years beginning before July 1, 1976, to taxable years beginning after June 30, 1976. Since the House-passed bill had no provision limiting tax carryovers for coprorations, the change in the Senate date to January 1, 1976, for corporations was a technical error. The amendment of the committee to this bill merely conforms the effective date of this provision of the Tax Reform Act back to the same provision that was in the Senate bill, as agreed to by the

[5] In that same decision, the court held that, in the case of fraternal beneficiary societies operating under the lodge system, discrimination on account of race is inconsistent both with such an organization's tax-exempt status (sec. 501(c)(8): this may also apply as to sec. 501(c)(10)) and also with its status as a limited charitable contribution donee (sec. 170(c)(4)).

Also, the Supreme Court has affirmed (*Coit v. Green*, 404 U.S. 997 (1971)) a decision (*Green v. Connally*, 330 F. Supp. 1150 (D.C., D.C. 1971)) that discrimination on account of race is inconsistent with an educational institution's tax-exempt status (sec. 501(c)(3)) and also with its status as a charitable contribution donee (sec. 170(c)(2)).

conferees. Thus, for corporations (other than subchapter S corporations and personal holding companies) any carryover of regular taxes paid from a taxable year beginning before July 1, 1976, is not to be allowed as a carryover for any taxable year beginning after June 30, 1976. For individuals the provision remains the same as provided in the Tax Reform Act that carryovers from taxable years beginning before January 1, 1976, are not to be allowed in taxable years beginning after December 31, 1975.

C. Study of Recycling Incentives

Present law

There is no provision in present law providing for any tax incentives to encourage salvage and reclaiming of materials as a means to conserve natural resources, reduce energy consumption, and reduce environmental litter. In sections 611 and 613 of the code, a schedule of percentage depletion rates is provided for various metals and minerals to encourage their discovery, development and mining so that the metals and minerals may be made available for industrial use. Percentage depletion also is provided to the owners of these materials because they are irreplaceable assets. Capital gains treatment is available on timber income and on royalties from coal and iron ore.

Reasons for change

For the past two Congresses, many members of both bodies have introduced or supported legislation that would provide tax incentives for recycling solid waste materials. The motivation for the interest in tax incentives has been the proliferation of unsightly and unhealthy environmental litter, the need to conserve on the consumption of energy and prolong the availability of our existing fuel sources, and recognition of the need to reduce the rate of consumption of the limited supplies of various metallic and mineral resources.

The proposed tax incentives generally have taken the form of a tax credit that would be earned by those who perform the actual recycling. The amount of the credit generally has taken the form of a percentage of the price paid for recyclable materials multiplied by the volume of material purchased. Others have emphasized the necessity to increase the productive capacity of the industry and to achieve technology breakthroughs which would make economical the recycling of solid waste with relatively small amounts of recyclable matter.

Two versions of the recycling tax credit on purchases have been reported by the two tax-writing committees. The Committee on Ways and Means included a recycling tax credit in H.R. 6860, as reported by the committee, but the provision was deleted on the floor of the House. The Committee on Finance included a recycling tax credit in H.R. 10612, the Tax Reform Act of 1976, but it was replaced in the bill on the floor of the Senate by a substitute provision which requested that a study of the need for tax and other incentives be made by the Treasury Department and the Environmental Protection Agency. This provision was also eliminated in the conference report on H.R. 10612 since the conferees decided not to consider any of the energy provisions on the Tax Reform Act but to defer consideration until the energy bill (H.R. 6860) is sent to conference.

In view of the interest in recycling incentives but in recognition of some of the concerns which have also been expressed, especially the related costs, the committee believes it is appropriate to provide a study of the recycling incentives. It is expected that this study, which is to be completed within six months, will provide the information necessary to assist the Congress in determining to what extent tax incentives would be appropriate in the case of recycling.

Explanation of provision

The Secretary of the Treasury, in cooperation with the Administrator of the Environmental Protection Agency, is directed to conduct a study and investigation of all matters relating to the proper role of the Federal Government in encouraging the recycling of solid waste materials. The study should include an examination of the feasibility and revenue effects of providing incentives and disincentives for recycling through the Internal Revenue Code. The study should also include an examination of the various types of solid wastes produced in the domestic economy, those materials which are now or could be recycled, the available technology and capacity for recycling those materials, the cost-competitiveness (with virgin production) of recycling for various materials, and potential governmental actions (both economic and noneconomic) which might increase the amount of recycling in the U.S. The Secretary is to report his findings, together with his recommendations for legislation, to the President and the Congress as soon as this study is completed, but no later than 6 months after the enactment of this bill.[6]

Effective date

The requirement for the study is effective as of the date of enactment of this bill.

III. EFFECT OF THE BILL ON THE REVENUES AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect of this bill on the revenues. The committee estimates that the provisions dealing with social clubs will result in a small revenue gain, probably less than $100,000 per year. The Treasury Department agrees with this statement. The change in the effective date for the repeal of tax carryovers in the case of the minimum tax on corporations will have no revenue effect because the revenue estimates for this provision in the Tax Reform Act of 1976 were based on the June 30, 1976, effective date which was intended for that Act, but which was changed by technical error. The study of recycling incentives will have no revenue impact.

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote of the committee on reporting the bill. The bill, as amended, was ordered favorably reported by the Committee by voice vote.

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[6] This provision is virtually identical to the amendment to the Tax Reform Act (H.R. 10612) which was offered by Senators Hart and Durkin. That amendment was a substitute for the Committee on Finance provision to provide a recycling tax credit. The only change from the Hart-Durkin amendment is to require that the report on the recycling study be submitted to Congress 6 months after the date of enactment.

IV. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).