



June 12, 2007

FIN 48: The Death of 501(c)(7) Tax-Exempt Clubs?

In brief: FIN 48 requires a tax-exempt organization to record a liability for income tax when there are uncertainties as to whether its income is exempt from income tax. Fin 48 is effective for fiscal years beginning after December 15, 2006.

Application to 501(c)(7) Tax-Exempt Entities: So what is the big deal? Isn't it true that 501(c)(7) tax-exempt Clubs do not pay income taxes? If this statement has been presented once, it has been offered hundreds of times. 501(c)(7) tax-exempt Clubs can and do have taxable income, if nothing else, in the form of unrelated business income (UBIT). More important, a Section 501(c)(7) tax-exempt Club can lose its' tax-exempt status for a number of reasons including private inurement, private benefit, consistently exceeding the 15 / 35 % nonmember gross receipts limitation, or having more than a de minimis amount of "nontraditional income". These are the reasons why the FASB did not exclude tax-exempt organizations from FIN 48's scope.

***Illustration:** A Club sells a piece of land previously "used directly in the performance of its tax-exempt purpose" to a real estate developer to build condos. The new owners will be required to become Members of the Club. (The golf course is being redesigned since the land being sold was previously the 12th and 13th holes.) An election available to 501(c)(7) Clubs is made to exclude the gain from taxable income under IRC Section 512(a)(3)(D) due to proper reinvestment in Club assets. Federal and state income tax properly avoided in this transaction is \$2,000,000.*

Under FIN 48, the Club must decide whether it can accept the tax position, assessing its level of confidence in its reporting position. Every step of the sale and reinvestment is reviewed and approved by tax consultants. Consequently the sale goes through. The land is sold and the gross proceeds are timely reinvested in Club assets (renovation of the golf course).



After the close of the accounting year end, the auditors arrive to conduct the annual audit and find that there is a significant amount of "nontraditional income" being conducted at the Club. Thanksgiving turkeys and Christmas hams are sold to Members to be consumed at Members residences. The "Wine Club" is purchasing \$200,000 worth of Wine, through the Club, for Members to be consumed off premises, and the Chef has been catering parties at the Members homes to the tune of \$800,000 annually.

Under Step 1 of FIN 48, the Club must decide whether it can take the tax position that it can remain 501(c)(7) tax-exempt. It must then assess its level of confidence in taking this tax reporting position. If the Club concludes more likely than not that it would lose its argument if examined by the IRS, it must accrue a liability for income tax and must record the appropriate tax liability as measured under FIN 48. (For those unacquainted with tax opinion terminology, the more-likely-than-not standard requires more than 50% certainty that the position taken on a tax return will be upheld by a court of final determination. In determining whether to recognize an uncertain tax benefit, the Club must assume that the IRS is aware of the item and that the IRS is aware of all relevant authorities.)

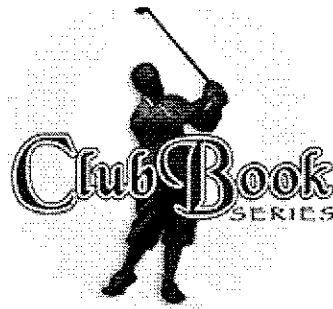
If the Club is unable to satisfy the more-likely-than-not threshold, it must recognize a tax liability in its financial statements, even though the tax return may be filed without paying the tax. That tax liability is calculated under the second part of the two-step process. It requires what will likely be a subjective assessment and possibly complex calculation of the various probabilities associated with the resolution of the uncertain tax issue. This is referred to as the measurement phase. The AICPA has already produced a complex methodology based on a matrix that CPA's can use to measure the liability that must be recognized.

Interest and Penalties: In addition to recognizing the liability, the Club also must accrue a liability for interest on the amount of unpaid tax liability. There is also a requirement that penalties be accrued if the tax position does not meet the minimum statutory requirements for avoiding penalties.

Financial Statement Footnote Disclosures: FIN 48 requires extensive footnote disclosures. Not only must the gross amounts (liabilities associated with all positions taken together) be reported, but it requires that specific positions be disclosed if the unrecognized tax benefits might significantly increase or

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decrease within 12 months of the reporting date. The IRS has had a longstanding policy that has largely precluded its agents from reviewing audit and tax accrual workpapers pertaining to the accrual for income tax liability, but this disclosure requires taxpayers to put red flags in their financial statements under certain circumstances, thereby providing easily accessible roadmap.

Not A Big Deal?

You may conclude it is still not a big deal since FIN 48 applies only to income tax liability. Most Club tax controversies involve property tax and sales tax issues as well as employment taxes. FIN 48 does not apply to those, however, it should be noted that FASB No. 5 Accounting for Contingencies, is still out there to address any other potential tax issues. Unrelated business income issues (including allocations between unrelated and related activities) will also be frequent issues that come up under FIN 48.

Ignorance is Bliss

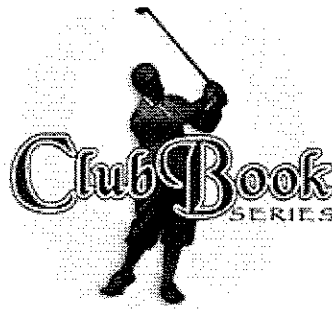
Should a Club take FIN 48 lightly, or even just ignore it? This author's conclusion is "Absolutely Not!" Smaller Clubs will in large, probably ignore FIN 48. That may not be wise, but many of the auditors who audit smaller Clubs simply are not equipped to deal with the intricacies of the tax issues specific to 501(c)(7) tax-exempt Clubs. Larger Clubs will, however, probably find themselves spending a lot of time and effort to remain in compliance with the laws to remain 501(c)(7) tax-exempt. This is particularly true because FIN 48 contemplates an annual review of each tax position that is required to be analyzed under FIN 48. Tax lawyers and accountants must take into account precedents and other changes in the law that has occurred since the last review. It has been suggested by one author that tax lawyers, rather than auditors make the determination on tax issues and to then write the footnote disclosures. Well-counseled clients may not want assessments of litigation risk floating around in audit workpapers, where they may be inadvertently discovered by an IRS agent.

Final Observations

This will come across as self serving, but 501(c)(7) tax-exempt Club Boards must ask their Controller or Director of Finance about resources available to explain all of the Club specific tax risks they face. I am not aware of an updated publication other than **Club Tax Book** that brings every federal tax issue into one, easy to read format. Updated quarterly, many of the leading CPA firms and Law firms serving the Club Industry are already current subscribers. (Visit the web site of www.clubtax.com for a list of these firms by states that have given Club Book Series, Inc. approval to disclose their names.)

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Additionally, in its 11th year in publication, each "Club Tax Issue" has an area at the bottom of the document that was designed for a situation such as FIN 48 documentation.

"For Club Internal Use:

The Above Noted Tax Issue Is Applicable To This Club: Yes ___ No ___ Initial _____

The Last Known Date This Tax Issue Was Addressed By The Club: ___/___/___

Person Or Persons Given Responsibility For Insuring Club Is In Full Compliance: _____

Date This Tax Issue Was Resolved And The Club Is In Full Compliance With The Law: ___/___/___"

Is it time to take Private Club Governance seriously and provide your employees the tools necessary to keep the Club out of potential tax problems? Ask your CPA firm about FIN 48. See if FIN 48 is just blowing smoke? Ask your CPA firm if there is any regularly updated publication on the market any better at providing answers to the important Club tax issues than **Club Tax Book** and then place your order.

References:

- www.charitygovernance.com/charity_governance/2007/04/fin_48_big_deal.html
- **A Desktop Guide for Nonprofit Directors, Officers, and Advisors: Avoiding Trouble While Doing Good** by Jack Siegel

Mitchell L. Stump, CPA, is the author of **Club Tax Book** and a consultant and regular contributor to the education of the Club Industry.