DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

200427031

TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

Uniform Issue List
512.01-00
512.08-03
512.10-00

Date:

APR - 8 2004

Contact Person:

Identification Number:

Contact Number:

T:EO:B4

Employer Identification Number:

Legend:

M =
N =
O =
P =
Q =
R =
x =

Dear Sir or Madam:

We have considered the ruling request dated November 13, 2003, submitted on behalf of M, a nonprofit organization which is exempt from federal income tax as an organization described in section 501(c)(7) of the Internal Revenue Code. M seeks a ruling on the proper treatment of capital gain deferral under section 512(a)(3)(D) of the Code.

FACTS:

M was incorporated on a nonprofit basis in the State of N. As stated in its certificate of incorporation, M's purposes are to perpetuate the friendships started in the Fraternity of O and to acquire land and funds for the erection, furnishing, and maintenance in a city, P, of a suitable fraternity house as the home and principal office of M. Since its inception, M has been associated with the Q University chapter of the Fraternity of R, an international fraternity organization. In furtherance of its purposes, M purchased real property (the "Fraternity House") at an identified street address in P and has maintained the Fraternity House for use by the members of the O chapter who were undergraduate students at Q University. Thus, M was organized and operated as a social club described in section 501(c)(7) of the Code.

On account of the need to renovate the Fraternity House, M borrowed money, first from Q University and later from R. The loan from R was used to repay the earlier loan from Q University. In connection with the loan from Q University, M also gave the university a right of first refusal to purchase the Fraternity House at ninety percent of its fair market value. In Q University demanded that the local O chapter cease its operations on the Q campus. In

accordance therewith, R withdrew its certification of its Q University chapter. Further, R notified M that it would foreclose on the Fraternity House if M did not repay the loan. These events led M to conclude that it could no longer accomplish its purposes by continued ownership of the Fraternity House and that it must either sell the Fraternity House or lose it in foreclosure proceedings.

M sold the Fraternity House to Q University at a price that resulted in a gain of $x. With the filing of its tax return, M will elect, pursuant to section 512(a)(3)(D) of the Code, to defer the recognition of this gain. M has provided a copy of its timely filed Form 990 return, which includes the section 512(a)(3)(D) election.

As a result of the sale of the Fraternity House and the decertification of the local O chapter of R, M's members decided to consider changing its exempt function. As graduates of Q University, many of M's members have supported the University financially and by actively participating in various alumni organizations. Accordingly, the members determined that M should change its purposes to educational and charitable purposes in support of Q University and its students who need financial assistance.

M proposes to convert from an organization described in section 501(c)(7) of the Code to one described in section 501(c)(3). As a section 501(c)(3) organization, M would continue its association with Q University by providing financial assistance to the University and making scholarships available to students of Q University. A proposed Restated Certificate of Incorporation of M, which will be filed in the event that the Internal Revenue Service approves this request, is attached as an exhibit. A completed Form 1023 exemption application, which will also be filed if this request is approved, is another exhibit. Further, if this request is approved, M will then use the proceeds of the sale to purchase securities within three years of the date of sale of the Fraternity House, and the income derived will be used to fund educational scholarships. No members of M have received or are intended to receive any of the net proceeds of the sale of the Fraternity House. Also, the officers and directors of M serve strictly as volunteers and receive no salaries or other remuneration for acting in such capacities.

Ruling Requested:

M requests that the Service rule that the proposed change of M's exempt purposes from those of a social club described in section 501(c)(7) of the Code to those of an organization described in section 501(c)(3) would allow M to recognize capital gain only to the extent the net sales proceeds from the Fraternity House exceed the cost of purchasing the new property, pursuant to section 512(a)(3)(D).

Law:

Section 501(c)(7) of the Code provides for the exemption of clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, substantially all the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1(a) of the Income Tax Regulations states that the exemption provided to organizations described in section 501(c)(7) of the Code applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. The regulation also states that, in general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

Section 1.501(c)(7)-1(b) of the regulations provides that a club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not tax exempt. Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c), including those described in section 501(c)(7).

Section 512(a)(3)(A) of the Code provides, in part, that with respect to an organization described in section 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with certain modifications provided in section 512(b).

Section 512(a)(3)(B) of the Code defines "exempt function income" to mean the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which income is paid.

Section 512(a)(3)(D) of the Code provides, in part, that if property used directly in the performance of an exempt function of an organization described in section 501(c)(7) is sold by such organization, 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 organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property.

Rev. Rul. 58-501, 1958-2 C.B. 262, holds that where a social club described in section 501(c)(7) of the Code finds it impracticable to continue to conduct its exempt activities and, as such, sells its property and liquidates, such sale is incidental to its exempt purposes. The Rev. Rul. states that the club is still to be considered as operated exclusively for pleasure, recreation, and similar purposes up through the date of the sale and distribution of the liquidated assets to

its active members. The Rev. Rul. concludes that profit from the sale by the club of all its property in conjunction with the termination of its activities and liquidation does not deprive the club of the exemption provided by section 501(c)(7).

Analysis:

The facts surrounding M's sale of the Fraternity House to Q University at a price that resulted in a gain of $x show that the Fraternity House was used to carry out M's exempt activities under section 501(c)(7) the Code. However, circumstances changed, particularly in view of Q University's demand that the local O fraternity chapter cease its operations on the Q campus, R's withdrawal of its certification of its Q University chapter, and the threat of foreclosure proceedings. As in the case of the organization described in Rev. Rul. 58-501, supra, which found it impractical to continue with its exempt social activities, M's circumstances have changed and its members decided that it was in M's best interest to sell the Fraternity House and discontinue its operation as a tax exempt social club described in section 501(c)(7).

However, unlike the organization described in Rev. Rul. 58-501, M will not be dissolved, and its assets will not be distributed to its members. The purpose of the sale was not to make a profit for M's members, and no net proceeds have ever been distributed to M's members, nor is this planned for the future. Instead, M states that it will use the proceeds from the sale of the Fraternity House to buy securities, which, in turn, will be used to fund educational scholarships for Q University students. This is an exempt educational purpose under section 501(c)(3), and is in accord with M's intention to restate its Certificate of Incorporation to reflect section 501(c)(3) exempt purposes and to apply for recognition of exemption under this section.

Concerning the unrelated business income tax issue, as indicated above, the Fraternity House was used directly to carry out M's exempt function under section 501(c)(7) of the Code, and the proceeds from the sale will be used to buy securities to fund scholarships in furtherance of exempt educational purposes under section 501(c)(3). Although no "other property" will be purchased by M and used directly in the performance of its exempt function, such proceeds will be permanently dedicated to exempt purposes under section 501(c)(3) and used to fund scholarships. Under these circumstances, gain in the amount of $x from the sale of the Fraternity House need not be recognized in accordance with section 512(a)(3)(D), and income from the sale of the Fraternity House is not considered unrelated business taxable income pursuant to section 512(a)(3)(A).

Ruling:

Based on the foregoing, we rule that the proposed change of M's exempt purposes from those of a social club described in section 501(c)(7) of the Code to those of an organization described in section 501(c)(3) will allow M to recognize capital gain only to the extent the net sales proceeds from the Fraternity House exceed the cost of purchasing the new property, based on the provisions of section 512(a)(3)(D).

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon M's exempt status

should be reported to the Tax Exempt and Government Entities (TE/GE) Customer Service Office. The mailing address is: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, e telephone number there is toll free number).

Pursuant to a Power of Attorney on file in this office, we are sending a copy of this letter to your authorized representative.

We are also sending a copy of this ruling to the TE/GE Customer Service Office. Because this letter could help resolve any questions about M's tax status, it should be kept with M's permanent records.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Thank you for your cooperation.

Sincerely,

(signed) Marvin Friedlander

Marvin Friedlander
Acting Manager, Exempt
Organizations Technical Group 4