

## New IRS Requirement to Track Nonmember Income Generation

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Does your 501(c)(7) private club hold nonmember outside events, and do these events generate a profit for the club? 501(c)(7) private clubs now have additional recordkeeping requirements they must adhere to when hosting these events. This additional recordkeeping is necessary in order to meet IRS reporting requirements when filing the club's tax return.

It is apparent the IRS is putting more emphasis on 501(c)(7) private clubs to ensure they are paying the proper amount of tax on unrelated business income generated. Final regulations were released on December 2, 2020 with guidance that will require 501(c)(7) private clubs to separate their nonmember gross receipts into separate lines of business and separately calculate the unrelated business taxable income (UBTI) on each line of business.

### Lines of Business

Final IRS regulations require 501(c)(7) private clubs to use the two-digit NAICS codes to separate nonmember activities into separate lines of business. Previously, a social club would use NAICS code 71 to report all nonmember gross receipts relating to its golf course or country club. While this code may still be applicable to some activities within the club, the IRS is requiring the club to breakout other activities into various other NAICS codes that more likely describe that line of business.

**Under these regulations, a loss from one line of business cannot offset net income from another line of business.** This will prevent 501(c)(7) private clubs from using losses from an activity that consistently generates losses to offset income from another activity that may have generated profit.

After allocating expenses, each line of business that generates a profit will be subject to the current corporate tax rate of 21%. If a line of business generates a loss, that loss may need to be tracked separately and is unable to be used to offset income from a profitable line of business.

### Identifying Nonmember Income Streams

We anticipate 501(c)(7) private clubs could have up to eight different sectors in which their unrelated gross receipts could generate a line of business. Below are some of the anticipated lines of business that will create a need for separation. Each line will require a separate schedule on the 990-T.

- Retail sales – nonmember pro shop sales, ship stores or grocery sales (including beer, wine and other spirits)
- Real estate rent and lease – nonmember golf carts, beach chairs, cabanas, boat storage, nonmember green fees
- Educational services – nonmember golf lessons, sailing lessons, swimming lessons
- Entertainment and recreation – nonmember day camps, boating, pool, fitness, user fees, guest fees and reciprocal fees
- Accommodation and food service – nonmember food and beverage, non-traditional food and beverage (take out), over-night rentals
- Other services – nonmember personal care, parking lots/garages
- Investment income – interest, dividends, capital gains, passive rentals and cell towers

501(c)(7) private clubs must start tracking the income and expenses associated with these various lines of business now in order to properly comply with these IRS regulations. Compliance will generate

additional time and resources within your accounting department to capture the data necessary to provide to your tax preparer. We anticipate this data will now need to be tracked and documented throughout the year versus year-end when data is compiled to file your tax return.

### **Allocable Expenses**

Final regulations have not been released with guidance on how to allocate expenses to each line of business. As of today, the IRS requires 501(c)(7) private clubs to allocate expenses against nonmember gross receipts on a reasonable basis. Proposed regulations indicate the IRS will allow expenses that are directly related to the separate lines to be directly allocated. It may be simple to track direct expenses for a particular event or golf outing; however, the club will be required to apply a reasonable method in allocating expenses to other day-to-day nonmember usage of their club.

Since each expense category will have a different correlation to income, one method will not work for all expenses. Cost of goods sold, fixed, variable and direct expenses will require their own method of allocation which will be adopted by the club. Some expense categories will require as much detail as tracking the number of nonmember usage in days/hours and rounds of golf.

### **Next Steps**

501(c)(7) private clubs should work with their tax preparer to determine how many lines of business their private club has and incorporate a reasonable method when allocating expenses to those lines of business. Upon implementing these lines of business regulations, 501(c)(7) private clubs could potentially be paying income tax they have never had to pay in prior years. Proper tracking of income and expenses internally within the club and working with your tax preparer to make certain you are capitalizing on the most beneficial expense allocations will be key to validate the club is not over/under paying income taxes on UBTI.

Increase in private club audits suggests that the IRS is focusing on obtaining more tax dollars from private clubs. Closer examinations of these allocations should be expected upon audit. Final regulations noted there is no de minimus exception provided; therefore, even private clubs with minimal unrelated business gross receipts will still need to adhere to the regulations. Penalties for non-compliance are likely to be significant and unlikely to be waived.

We encourage 501(c)(7) private clubs to start determining the separate lines of businesses your club may have right away. We are currently in a year where unrelated business income may be lower than normal, which could make it less burdensome on implementing the proper procedures necessary within the club.

### **Contact Us**

If you would like further information on these new recordkeeping regulations, please contact the partner in charge of your account or:

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