



Private Club Tax Law Update

Tennessee Volunteer Chapter CMAA

Cherokee Country Club

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Club Tax Book

Club "It's All About Golf" Book 2.0

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An Association of CPA's and Attorneys Serving Private Clubs



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Club Whistleblower Hotline

Expense Allocation; “Reasonable” To Be Modified?

What methods of expense allocation are acceptable according to the IRS?

With the new 2018 changes to the separate trades or businesses UBIT rules, look for the IRS to implement its Priority Guidance Plan regarding what is deemed to be a reasonable allocation of expenses. Below you will find wording from the Notice 2018-67 which discusses Club calculating its income using separate trades or businesses:

The Treasury Department and the IRS currently have an item on the Priority Guidance Plan regarding methods of allocating expenses relating to dual use facilities. The allocation issues under §512(a)(1) also are relevant under §512(a)(6) because an exempt organization with more than one unrelated trade or business must not only allocate indirect expenses among exempt and taxable activities as described in §1.512(a)-1(c) and (d) but also among separate unrelated trades or businesses. The **Treasury Department and the IRS therefore are considering modifying the underlying reasonable allocation method** in §1.512(a)-1(c) and providing specific standards for allocating expenses relating to dual use facilities and the rules under §512(a)(6). The Treasury Department and the IRS are requesting comments regarding possible rules or defined standards for the allocation of indirect expenses between separate unrelated trades or businesses for purposes of calculating UBTI under §512(a)(6)(A), and, in particular, regarding what allocation methods should be considered “reasonable.”

In particular, review the Exhibits below taken from the 2003 Audit Technique Guide. The current guide still has the same examples in it.

Review annually.

References: Notice 2018-67; 2018-36 IRB 1 and IRM 4.76.16.9.4 Expense Allocations (04-01-2003)

Further discussion:

4.76.16.9.4 Expense Allocations (04-01-2003)

(1) A club can use any method to allocate expenses possessing a proximate and primary relationship to the unrelated trade or business income they are allocated against, so long as the allocation method is reasonable. See Treas. Reg. § 1.512(a)-1(c). By definition, the "reasonableness" standard indicates that more than one method of allocation may be reasonable. Thus, a reasonable method of allocating expenses must be allowed even though it may not be the best method.

(2) The Service has generally classified expenses in three categories as follows:

Direct	Expenses which increase in direct proportion to the volume of the activity and would not have been incurred otherwise, e.g., cost of goods sold, or expenses incurred for specific events, e.g., payments for extra labor, perishable decorations and entertainment for a specific event. Direct expenses incurred for specific events are deductible in full from the event receipts and therefore, do not have to be allocated.
Variable	Expenses that vary in proportion to the actual use of the facility but can not be identified with a particular activity, e.g. salaries, utilities, maintenance, cleaning, uniforms, laundry, telephone, postage, printing, and professional fees.
Fixed	Expenses that do not vary in proportion to the actual use of the facility, e.g. depreciation, interest, real estate taxes, property insurance, and permits.

Caution: In some cases, the services and the courts have used different terms to identify the categories of expenses. Therefore, close attention should be paid to how these terms are used in any particular case.

(3) One method of allocation frequently used is the allocation of all three categories of expenses based on gross receipts. This allocation method is commonly referred to as the "Gross Receipts Allocation Method". The "Gross

Receipts Allocation Method" is seldom a "reasonable" method for allocating variable or fixed expenses. Also, the "Gross Receipts Allocation Method" would not be reasonable for the allocation of direct expenses if:

- (a) The fees for the use of the facility is included in the members' dues.

Example: Only nonmembers or guests typically pay green fees. An allocation of expenses based on the ratio that nonmember green fees bears to total green fees would not yield a reasonable approximation of nonmember expenses, since the calculation does not include members' dues which are also used to operate the golf course. A more appropriate allocation method may be to allocate the expenses based on the ratio of the number of rounds of golf played by nonmember to the total number of rounds of golf played.

- (b) Nonmembers are charged more than members.

Example: An equal number of members and nonmembers are served the same meal in a club's dining room. Members pay \$15.00 and nonmembers pay \$20.00.

- (c) Nonmembers are charged additional fees not charged to members.

Example: Nonmember who use the clubs facilities for private parties are charged a rental fee of \$500. Members are not required to pay a rental fee for private parties.

(4) A example of a "reasonable" method of allocation was published by the Service in 1975 in supplemental instructions for completing Form 990, Package 990 Supplement (Section 501(c)(7)). The hypothetical organization in the Package 990 Supplement was named "The Big Divot Country Club, Inc." This allocation method became commonly known as "The Big Divot Allocation Method." An example of the "Big Divot Allocation Method" has been included in the IRM since 1984. Using the "Big Divot Allocation Method," the expenses are allocated as follows:

Direct	Cost of goods sold are allocated based on the ratio of nonmember sales to total sales.
Variable	Variable expenses are allocated based on the ratio of estimated hours of nonmember use during the year to the total hours the facility was used during the year.
Fixed	Fixed expenses are allocated based on the ratio of the estimated hours of nonmember use during the year to the total hours in the year.

(5) The use of the "Big Divot Allocation Method" for fixed expenses was litigated in *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1048 (2nd Circuit 1984). In *Rensselaer* taxpayer argued that fixed expenses should be allocated on the same basis as variable expenses, the ratio of the estimated hours of nonmember use to the total hours the facility was used during the year instead of the ratio of the estimated hours of nonmember use to the total hours in the year as proposed by the Service. The Court held for the taxpayer stating an allocation based on the time of actual use is "reasonable" within the meaning of Treas. Reg. § 1.512(a)-1(c).

Caution: As set forth in the Action on Decision on *Rensselaer*, A.O.D. 1438 (June 18, 1987), the Service continues to take the position that under the circumstances described in *Rensselaer* where the dual use of the facility was near maximum use, fixed expenses should not be allocated on the basis of actual usage. In the Service's view, an allocation based on the total available time is the method of allocating fixed expenses that meets the "reasonableness" standard of Treas. Reg. § 1.512(a)-1(c). The Action on Decision also states that this issue should not be litigated until the "reasonableness" test of Treas. Reg. § 1.512(a)-1(c) is amended.

(6) Exhibits 4.76.16-2 through 4.76.16-4 show the computation of the net profit from nonmember use of a club's restaurant and bar based on the facts stated in Exhibit 4.76.16-1.

Exhibit 4.76.16-2 shows the computation of net profit using the "Gross Receipts Allocation Method."

Exhibit 4.76.16-3; shows the computation of net profit using the allocation method upheld by the Court in *Rensselaer*. This allocation method is referred to in the Exhibits as the "Actual Usage Allocation Method."

Exhibit 4.76.16-4 shows the computation of net profit using the "Big Divot Allocation Method."

Exhibit 4.76.16-1 Computation of Net Profit on Nonmember Income- Facts (04-01-2003)

Exhibits 4.76.16-2, through 4.76.16-4 illustrate three methods of allocating expenses to unrelated business income from nonmember use of a club's restaurant and bar (R&B) base the following facts:

Total Number of Days In the Year	365
Number of Days the R&B Are In Use	300
Average Number of Hours the R&B Are Open Daily	14
Number of Days of Nonmember Use of the R&B	25
R&B Sales to Nonmembers On the 25 Days	\$ 25,000
Total R&B Sales on the 25 Days	\$100,000
Total R&B Sales for the Year	\$250,000
R&B Cost of Goods Sold	\$100,000
R&B Nonmember Direct Expenses	\$1,000
R&B Variable Expenses.....	\$ 95,000
R&B Fixed Expenses.....	\$ 70,000

The expenses shown above have a proximate and primary relationship to the operation of the restaurant and bar. Salaries, depreciation, interest, etc. attributable to the club's recreational facilities are not included.

All receipts from the purchase of food and beverages in the club's restaurant and bar are included in restaurant and bar receipts.

The receipts from the restaurant and bar do not include member assessments for a "minimum amount of purchases in the restaurant and bar unless the member actually used the minimum for restaurant and bar purchases.

Members and nonmembers are charged the same amount for bar and restaurant purchases.

Nonmembers are not charged additional fees for the use of the bar and restaurant.

"R&B Nonmember Direct Expenses" are payments for special entertainment at nonmember parties. These expenses are not related to member receipts.

Exhibit 4.76.16-2 Computation of Net Profit on Nonmember Income Using the "Gross Receipts Allocation Method" (04-01-2003)

Step 1

Determine the ration of nonmember sales to total sales by dividing the nonmember sales by the total sales.

Nonmember Sales	+	Total Sales	=	Gross Receipts Percent
\$25,000	+	\$250,000	=	10%

Step 2

Compute the net profit or (loss) by applying the gross receipts percent to the allocable expenses.

Description	Total	Allocation Percent	Nonmember
R&B Sales to Nonmembers	\$ 25,000	N/A	\$ 25,000
R&B Cost of Goods Sold	\$100,000	10.00%	(\$10,000)
R&B Nonmember Direct Expenses	\$ 1,000	N/A	(\$ 1,000)
R&B Variable Expense	\$ 95,000	10.00%	(\$ 9,500)
R&B Fixed Expenses	\$ 70,000	10.00%	(\$ 7,000)
Net Loss on R&B Sales to Nonmembers			(\$ 2,500)

**Exhibit 4.76.16-3 Computation of Net Profit on Nonmember Income Using the
"Actual Usage Allocation Method." (04-01-2003)**

Step 1

Determine the hours the restaurant and bar are open on the days when nonmember use occurred by multiplying the number of days of nonmember use by the number of hours the restaurant and bar are open daily.

<u>Days of Nonmember Use</u>	x	<u>Hours R&B are Open daily</u>	=	<u>Hours of Use on Days of Nonmember Use</u>
25	x	14	=	350

Step 2

Determine the hours of nonmember use. If the actual hours of nonmember use are not available, an estimate can be used. One method for estimating hours of nonmember use is shown below in Step 3.

Step 3

Usually, both members and nonmembers use the restaurant and bar on days of nonmember use. The time the restaurant and bar is used by members and nonmembers generally will be reflected by the volume of sales during the same time period. Therefore, the hours of nonmember use can be estimated as follows:

Determine the ratio of nonmember use and member use on the days of nonmember use by dividing nonmember sales by the total sales on the days of nonmember use.

<u>Nonmember Receipts</u>	÷	<u>Total Receipts on Days Nonmember Use</u>	=	<u>Percent of Nonmember Use</u>
\$25,000	÷	\$100,000	=	25%

Determine the estimated hours of nonmember use by multiplying the hours the restaurant bar were open on days of nonmember use by percent of nonmember use based on the ratio nonmember receipts to total receipts on days of nonmember use.

<u>Hours R&B Were Open On Nonmember Use Days</u>	x	<u>Percent of Non-member Use</u>	=	<u>Estimated Hours of Nonmember Use</u>
350	x	25%	=	87.5

Step 4

Determine the total hours the restaurant and bar are open during the year by multiplying the number of days the restaurant and bar are open by the number of hours the restaurant and bar are open daily.

<u>Total Days R&B Was Open</u>	x	<u>Hours R&B Was Open Daily</u>	=	<u>Total Hours R&B Was Open During the Year</u>
300	x	14	=	\$4,200

Step 5

Determine the percent of the variable and fixed expenses attributable to nonmember use by dividing the hours of nonmember use by the total hours the restaurant and bar are open during the year.

<u>Hours of Non-member Use</u>	÷	<u>Total Hours R&B Was Open During the Year</u>	=	<u>Percent of Expenses Attributable to Nonmember Use</u>
87.5	÷	4,200	=	2.08%

Step 6

Compute the net profit or (loss) by applying the applicable percents to the allocable expenses.

Description	Total	Allocation Percent	Nonmember
R&B Sales to Nonmembers	\$ 25,000	N/A	\$ 25,000
R&B Cost of Goods Sold	\$100,000	10.00%	(\$10,000)
R&B Nonmember Direct Expenses	\$ 1,000	N/A	(\$ 1,000)
R&B Variable Expense	\$ 95,000	2.08%	(\$ 1,979)
<u>R&B Fixed Expenses</u>	<u>\$ 70,000</u>	<u>2.08%</u>	<u>(\$ 1,456)</u>
Net Profit on R&B Sales to Nonmembers			\$10,565

**Exhibit 4.76.16-4 Computation of Net Profit on Nonmember Income Using the
"Big Divot Allocation Method" (04-01-2003)**

Step 1

Estimated hours of nonmember use.....87.5 hours
(Computed as shown in Exhibit 4.76.16-3 Steps 1 through 3)

Step 2

Percent of variable expenses directly related to nonmember use.....2%

Step 3

Compute the total hours the facility was available for use as follows:

Days in the Year	x	Hours Per Day	=	Total Hours During the Year
365	x	24	=	8,760

Step 4

Determine the percent of fixed expenses attributable to nonmember use by dividing the hours of nonmember use by the total hours in the year.

Hours of Non-member Use	÷	Total Hours During the Year	=	Percent of Fixed Expenses Attributable to Nonmember Use
87.5	÷	8,760	=	1.00%

Step 5

Compute the net profit or (loss) by applying the applicable percents to the allocable expenses.

Description	Total	Allocation Percent	Nonmember
R&B Sales to Nonmembers	\$ 25,000	N/A	\$25,000
R&B Cost of Goods Sold	\$100,000	10.00%	(\$10,000)
R&B Nonmember Direct Expenses	\$ 1,000	N/A	(\$ 1,000)
R&B Variable Expense	\$ 95,000	2.08%	(\$ 1,979)
<u>R&B Fixed Expenses</u>	<u>\$ 70,000</u>	<u>1.00%</u>	<u>(\$ 700)</u>
Net Profit on R&B Sales to Nonmembers			\$11,321

4.76.16.9.4.1 Examination Guidelines (04-01-2003)

(1) Determine whether the expenses allocated to nonmember income have a proximate and primary relationship to the activity that produces the nonmember income.

Example: A club receives nonmember income from the operation of its restaurant and bar. The club manager is paid a salary of \$30,000 per year. The Club manager devotes approximately 35% of his time to the operation of the restaurant and bar. Only \$10,500 (35% of 30,000) of his salary would have a proximate and primary relationship to the restaurant and bar and would be included in the total restaurant and bar expenses to be allocated between member and nonmember expenses.

Example: A club receives nonmember income from the operation of its golf course. The club had a total interest expense of \$40,000. Of the \$40,000 interest expense, \$30,000 was attributable to a loan to build a new swimming pool, \$5,000 for a loan to purchase golf carts and \$5,000 for a loan to repair the tennis courts. Only \$5,000, the interest expense attributable to the purchase of golf carts, would have a proximate and primary relationship to the operation of the golf course and would be included in the golf course expenses to be allocated between member and nonmember income.

(2) Review the method used to allocate expenses to member and nonmember income to determine reasonableness and accuracy.

Note: Be especially alert to expense allocations based in whole or in part, on the "Gross Receipts Allocation Method."

(3) Review allocation of advertising expenses. The Tax Court held that Treas. Reg. § 1.512(a)-1(f) applies to organizations described in IRC § 501(c)(7). See *Chicago Metropolitan Ski Council v. Commissioner*, 104 T.C. 341 (1995). If the organization has deducted editorial expenses, the examiner should determine the Service's current position in this area.

This document is not to be referred to as tax authority. It should be used as a guide in identifying tax issues in the Club Industry. Consult your legal adviser to analyze your specific situation.

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:

___/___/___



A Key Tool of a Whistleblower Policy

Anonymous Hotline

"He who passively accepts evil is as much involved in it as he who helps perpetrate it."

Dr. Martin Luther King, Jr.



Club Whistleblower Hotline

If an employee ever has a concern regarding unethical activity, don't make them keep it to themselves. Insure they discuss their concerns with their appropriate Supervisor or Manager. If they prefer to remain anonymous, we have a toll free Club Whistleblower Hotline:

For questions, call Mitch at: 561-776-0452

or e-mail mitch@clubtax.com

The **Club Whistleblower Hotline** is offered by **Club Tax Network, Inc.** an association of CPA's, Attorneys and Consultants dedicated to serving the Private Club Industry, demonstrating their commitment to protecting Club assets.

Visit www.clubtaxnetwork.com to obtain more information.



CLUB WHISTLEBLOWER HOTLINE

TYPES OF INCIDENTS REPORTED

There are 24 different types of incidents that Club employees and Members can report on the **Club Whistleblower Hotline**. These include:

1. Accounting/Audit Irregularities
2. Conflicts of Interest
3. Customer/Member Relations
4. Discrimination
5. Employee Relations
6. Falsification of The Club Records
7. Fraud
8. Fraudulent Insurance Claims
9. Improper Loans to Executives
10. Insider Trading
11. Kickbacks
12. Policy Issues
13. Product Quality Concern
14. Release of Proprietary Information
15. Retaliation of Whistleblowers
16. Safety Issues and Sanitation
17. Sexual Harassment
18. Substance Abuse
19. Theft of Cash
20. Theft of Goods/Services
21. Theft of Time
22. Unauthorized Discounts
23. Wage/Hour Issues
24. Workplace Violence/Threats

Phone calls are received by a individual trained in gathering the facts and compiling a report.

All reporting, including those listed above, will be forwarded to the Club Manager unless the report is on the Club Manager and then the report will go to the second designee, usually the Club President.

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