



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

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Number: **200625034**

Release Date: 6/23/06

Date: March 31, 2006

Contact Person:

Identification Number:

Telephone Number:

Employer Identification No.:

512.00-00

Legend:

X =

Y =

Z =

a =

b =

c =

x =

y =

Dear :

We have considered your ruling request dated June 15, 2005, on your status as a tax-exempt social club, and the proper tax treatment of certain set aside gain from the sale of exempt function property.

FACTS:

Taxpayer, X , is the alumni club of the Y Fraternity, an undergraduate fraternity located on the campus of Z University in a. X has filed Form 990 returns claiming exemption under section 501(c)(7), and has a ruling recognizing such exemption. X is not currently included in the group exemption of National b.

The mission of X is to furnish facilities for bringing together its members for educational purposes, through the medium of discussion of all general educational and scientific subjects, and the reading of papers, magazines, periodical and books of scientific and literary character. X's mission also includes the establishment and maintenance of a fund to be used for the erection, equipment, and maintenance of a permanent home in the a area, for the exclusive use of X's members and the Y Fraternity.

X has the following four activities:

1. X provides guidance and leadership to the Y Fraternity and its members to aid them in their educational pursuits and development. X supports these activities by defraying the costs to the undergraduates for these activities.
2. X supports the members of the Y Fraternity in their participation in the annual founders' day dinner.
3. X sponsors a scholarship program for the undergraduate members of the Y Fraternity.
4. X supports the charitable fund raising efforts of the Y Fraternity.

X owned the residential and educational facility located on the campus of Z University on land owned by and leased from the University. The facility was leased by X to undergraduate members of the Y Fraternity. X collected rent from the members that resided in the facility and paid the expenses of maintaining the facility. The facility provided sleeping quarters, dining and study and meeting areas, a library and computer facilities to the undergraduate members.

Under a change in operating philosophy, Z University forced all organizations that owned facilities of this nature to sell the facilities to the University under provisions of their land leases. X was forced to sell its facility to Z University in c, realizing approximately \$ x gain on the sale.

The property sold was used directly in the performance of X's exempt function, and X intended to reinvest the full proceeds in another fraternity house, so as not to recognize gain under section 512(a)(3)(D). However, various factors have made such reinvestment impossible. Instead, X intends to lease back the property from the University and thereby continue its exempt activities.

X now intends to set aside the \$ x as provided for in Section 512(a)(3)(B). The projected set asides are as follows:

Educational and housing scholarships to X's members	\$ <u>x</u>
Educational loans to X's members	<u>x</u>

Educational and housing loans to other alumni clubs and chapter housing organizations and to <u>b</u> (National)	<u>x</u>
Rent subsidy on educational segments of X's facility	<u>x</u>
Leadership and citizenship schools and services	<u>x</u>
Sponsorship of national fraternity events	<u>x</u>
Donations to the <u>b</u> section 501(c)(3) Foundation	<u>x</u>
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	\$ <u>x</u>

The amounts set aside will be so designated by X's Board, segregated on X's financial statement, placed in a separate account and tracked. These funds, including both the original set aside amount and the earnings thereon, will not be commingled with other funds of X.

X projects that, leaving aside the proposed set asides described above, its revenues will be as follows:

Rental income from Y members	\$ <u>x</u>	63.2%
Founders' Day dinner	—	.6%
Interest income from educational loans to Y members	<u>x</u>	1.5%
Interest income from educational and housing loans to other alumni clubs, chapter housing organizations of National <u>b</u> , and to National <u>b</u>	<u>x</u>	11.8%
Total member gross receipts	\$ <u>x</u>	77.1%
Total gross receipts	\$ <u>x</u>	100.0%

#### RULINGS REQUESTED:

1. Whether X will have excess income from nonmembers so as to lose its tax exempt status under section 501(c)(7) in the projected year.
2. Whether X's set aside of all or part of the approximately \$ x for the specific purposes outlined above is a qualified set aside as defined section 512(a)(3)(B).

#### LAW (Issue 1):

Section 501(c)(7) provides exemption from federal income tax for clubs organized for pleasure, recreation and other similar purposes, substantially all of the activities of

which are for such purposes and no part of the net earning of which inures to the benefit of any private shareholder.

Section 511(a) imposes a tax for each taxable year on the unrelated business taxable income of organization described in Section 501(c)(7).

Section 512(a)(3)(A) defines the unrelated business taxable income of a social club as being the gross income (excluding exempt function income), less the allowable deductions which are directly connection with the production of gross income.

It is the position of the Service that, in the case of a social club, the term "gross income from members" includes the interest income derived from members.

#### ANALYSIS (Issue 1):

X is the alumni club of a local university fraternity that is affiliated with the b national fraternity. X is not included in the section 501(c)(7) group ruling of b. The first issue is whether X qualifies for tax exemption under section 501(c)(7) assuming it has revenues as detailed below.

It is apparent that, leaving aside charitable set-asides, approximately 77.1 percent of X's projected gross income, describe in the "Facts" above, will be derived from member sources.

Public Law 94-568 provides that tax exempt social clubs may receive up to 35 percent of their gross receipts, including investment income, from non-member sources. Since X is projected to receive over 65 percent of gross receipts from member sources, income from non-member sources must necessarily be below the 35 percent limit. X will therefore qualify for section 501(c)(7) exemption in a year when revenues are as projected above. Obviously, if member income falls below 65 percent in any year, X would not be exempt under section 501(c)(7) in that year.

The second issue involves whether all or part of the approximately \$ x proposed to be set aside qualifies under sections 512(a)(3)(B) and 170(c)(4).

#### LAW (Issue 2):

Section 511 of the Code imposes a tax on the unrelated business taxable income (as defined in section 512) of certain organizations exempt from federal income tax under section 501(a) of the Code.

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as gross income derived by an organization from an unrelated trade or business regularly carried on by it, less the deductions directly attributable to such business activity.

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in paragraph (7), (9), (17) or (20) of section 501(c) of the Code, the term "unrelated business taxable income" means the gross income (excluding an exempt function income), less the deductions allowed by Chapter 1 which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of section 512(b) of the Code.

Section 512(a)(3)(B) of the Code provides that the term "exempt function income" means 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 exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside for a purpose specified in section 170(c)(4) of the Code. If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than those described in section 170(c)(4) of the Code, such amount shall be included in unrelated business taxable income for the taxable year.

Section 170(c)(4) of the Code describes among others, certain charitable and educational purposes.

Senate Report 91-552, 1969-3 C.B. 433, states that in reference to section 512(a)(3)(B) of the Code, "the committee intends in the case of national organizations of college fraternities and sororities that the amount set aside for scholarships, student loans, loans on local chapter housing, leadership and citizenship schools and services, and similar activities, be classified as amounts used for educational or charitable purposes under this provision. This exception would also extend to any other educational or charitable activities of these or other exempt organizations."

#### ANALYSIS (Issue 2):

As discussed above, section 512(a)(3)(B) of the Code defines exempt function income as all income (other than amounts equal to the gross income derived from any unrelated trade or business regularly carried on by such organization) set aside for purposes specified in section 170(c)(4) of the Code. Moreover, the legislative history behind section 512(a)(3)(B) of the Code, indicates that amounts set aside for activities which are educational or charitable in nature should be covered by the exclusion provided in section 512(a)(3)(A) of the Code for the computation of unrelated business taxable income.

It is apparent that Congress intended that loans by national fraternities to subsidize education and housing for members of local fraternities should qualify for the section 512(a)(3)(B) set aside. It follows that amounts that X, a local unit of a national

fraternity, sets aside for educational and housing scholarships for members of X, also qualify for the section 512(a)(3)(B) set aside.

The same rationale applies to amounts set-aside for loans to members of X. Such amounts qualify for the section 512(a)(3)(B) set aside.

Congress intended a national fraternity to qualify for the section 512(a)(3)(B) set aside with respect to educational and housing loans to local fraternities. We think that loans by X, a local unit of a national fraternity, to other units of the national fraternity, and to the national fraternity itself, for educational and housing purposes, also qualify for the section 512(a)(3)(B) set aside.

X plans to set aside funds to provide rent subsidies to its members living in the fraternity house. Congress intended that national fraternity loans to local fraternities for housing would qualify for the set aside. Such loans would have the effect of lowering the rents paid by fraternity members to the local fraternity.

Here, X does not own the local fraternity house, so housing loans are not practicable. However, subsidies of student member rents achieve the same result, and accordingly we think that the amounts set aside for this purpose qualify under section 512(a)(3)(B).

X seeks to set aside amounts to support leadership and citizenship schools and services. Our analysis of the descriptions of these schools and services indicates that those described primarily promote the education and training of the student participants. These activities qualify as educational under section 170(c)(4), and thus can be part of the section 512(a)(3)(B) set asides.

The proposed amounts to be set-aside for “Amounts designated for Sponsorship of National Fraternity Events” refers to the same educational programs and services described in the preceding paragraph, and thus qualify for the section 512(a)(3)(B) set aside. These amounts are not for support of general local or national fraternity meetings, events, or administration, which would not qualify for the section 512(a)(3)(B) set aside.

Amounts set aside for donations to section 501(c)(3) organizations qualify for the section 512(a)(3)(B) set aside. Accordingly, the projected set aside for donations to the b 501(c)(3) Foundation qualifies under section 512(a)(3)(B).

#### RULINGS:

1. Assuming X has the projected revenues set forth above, in any such year it will be tax exempt under section 501(c)(7) of the Code.
2. The amounts projected to be set aside, as described above, qualify for set aside treatment under section 512(a)(3)(B) of the Code.

This ruling is limited to the two rulings set forth above. Among other issues, it does not cover the issue whether X's gain on the sale of the facility to Z University qualifies for nonrecognition of gain under section 512(a)(3)(D).

This ruling is based on the understanding there will be no material changes in the facts upon which it is based. Any changes that may have a bearing on your tax status should be reported to the Service. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described.

Please keep a copy of this ruling in your organization's permanent records.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

Sincerely,

Debra J. Kaweck  
Manager, Exempt Organizations  
Technical Group 2

Enclosure: Notice 437