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

Date: SEP 22 2000

Contact Person:

ID Number:

Telephone Number:

SIN # 512.09-03

T:EO:B4

Employer Identification Number:

Dear Applicant:

This is in response to your representative's letter of April 28, 2000, requesting two rulings with respect to the sale of a painting by the Club.

The Club is a social and recreational club exempt from federal income tax pursuant to section 501(c)(7) of the Internal Revenue Code. Its facilities consist of a furnished brick building with dining facilities and sleeping quarters situated on a lot with a small lawn, and an adjacent building housing squash courts and exercise equipment. Among the assets of the Club is a painting, received as a bequest in 1933. Since that date, the painting has been prominently displayed in the Club's small dining room . The Club contends that the painting is an important part of its exempt function because it enhances a room where exempt activities take place. The Club is not in the business of selling art nor is it an investor in art. The Club has never sold any other artwork.

In 1998, the Club received an offer from an unrelated third party to purchase the painting, which had substantially appreciated in value. At that time, the Club

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was advised by its insurance carrier to increase the coverage of the painting to the appraised value of the painting. Due to concerns about the adequacy of the security protection at the Club, the insurance carrier also recommended that the painting be removed to a more secure location. The Club's board of directors and membership determined that the Club could not afford the expense of adequate security, and removing the painting to a safer location would mean removing it from the Club premises and putting it in storage. In light of these factors, the Club determined to sell the painting and use the proceeds in furtherance of the Club's exempt purpose. The painting was sold to an unrelated third party

The Club has requested the following rulings:

1. The painting is property used directly in the performance of the Club's exempt function, such that the gain on the sale is excluded from tax by section 512(a)(3)(D) of the Code, provided that the sales proceeds are spent entirely on property to be used in the performance of the Club's exempt function within the period beginning one year before the date of the sale and ending three years after such date.

2. The sale of the painting will not adversely affect the Club's exemption from tax as an organization described in section 501(c)(7) of the Code.

Section 511(a) of the Code imposes a tax on the unrelated business income of an organization described in section 501(c)(7) of the Code.

Section 512(a)(3)(A) of the Code provides that, in the case of 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 the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b).

Section 512(a)(3)(D) of the Code provides that if property used directly in the performance of the exempt function of an organization described in section 501(c)(7) is sold by such an 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.

The painting in question hung for many years in the Club's main dining room, which was named for it. Its use in this way constitutes use directly in the performance of the Club's exempt function. The Club received the painting as a

bequest, for the use and enjoyment of its members and not as an investment. There is no evidence that the Club is in the business of buying or selling works of art. The gain on the sale of the painting therefore qualifies for exclusion under section 512(a)(3)(D) of the Code, assuming that the proceeds are used to purchaseother property used by the Club directly in the performance of its exempt function within the specified time period.

Section 501(c)(7) of the Code provides for the exemption from federal income tax of clubs organized and operated for pleasure, recreation, and other nonprofitable purposes substantially all of 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 501(c)(7) was amended by Public Law 94-568 to provide that section 501(c)(7) organizations could receive some outside income without losing their exempt status. Senate Report No. 94-1318 (1976), 2d Session, 1976-2 C.B. 597, at page 599 explains that a social club is permitted to receive up to 35 percent of its gross receipts, including investment income, from sources outside its membership without losing its tax-exempt status. However, where a club receives unusual amount of income, such as from the sale of its clubhouse, or similar facility, that income is not to be included in the formula. That is, such unusual income is not to be included in the gross receipts of the club for purposes of the permitted 35 percent allowance.

The Senate Report quoted above states that unusual amounts of income are to be excluded from both the numerator and the denominator for purposes of determining whether the 35% limit has been exceeded. The only example given is income from the sale of a clubhouse or similar facility. As noted before, the Club is not in the business of buying and selling art. It has never sold another painting and does not expect to sell any in the future. Furthermore, since, as discussed before, the painting was used directly in the performance of the Club's exempt function, its sale is similar to the sale of the clubhouse or similar facility referred to in the legislative history. The proceeds of the sale are therefore excluded from both the numerator and denominator for purposes of determining whether the 35% limit has been exceeded. The sale will therefore not adversely affect the Club's exemption from tax.

Based on the application of the above principles to the facts presented in your ruling request, we rule as follows:

1. The painting is property used directly in the performance of the Club's exempt function. Therefore, the gain on the sale is excluded from tax by section 512(a)(3)(D) of the Code, provided that the sales proceeds are spent entirely on property to be used in the Club's exempt function within the period beginning one year before the date of the sale and ending three years after such date.

2. The sale of the painting will not adversely affect the Club's exemption from tax as an organization described in section 501(c)(7) of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any changes that may have bearing on your tax status should be reported to the Service.

We are sending a copy of this ruling to the TE/EG key district office. Because this letter could help resolve any questions about your exempt status, you should keep it with your permanent records.

If you have any questions, 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(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Sincerely yours,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

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