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The Unrelated Business Taxable Income of Social Clubs: An Analysis of Section 512(a)(3)(A), Cleveland Athletic Club, Inc. v. United States, and Brook, Inc. v. C.I.R.

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THE UNRELATED BUSINESS TAXABLE INCOME OF SOCIAL CLUBS: AN ANALYSIS OF SECTION 512(a)(3)(A), *CLEVELAND ATHLETIC CLUB, INC. V. UNITED STATES*, AND *BROOK, INC. V. C.I.R.*

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I. INTRODUCTION

Currently, the United States Courts of Appeals for the Sixth Circuit, in *Cleveland Athletic Club, Inc. v. United States*,[1] and the Second Circuit, in *Brook, Inc. v. C.I.R.*,[2] are in conflict about whether a tax-exempt social club can deduct its net expenses attributable to sales of meals to nonmembers from its net investment

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1. 779 F.2d 1160 (6th Cir. 1985).

2. 799 F.2d 833 (2d Cir. 1986).

income in determining the club's unrelated business taxable income under section 512(a)(3) of the Internal Revenue Code ("Code").[3] The conflict at issue affects the amount of unrelated business income tax that a social club may incur. In addition, the resolution of the issue may affect the amount of expenses that can be attributed to a social club's sales of meals to nonmembers. This article examines the unrelated business income taxation of social clubs, the *Brook* and the *Cleveland Athletic Club* cases, which opinion is correct and why, and the ramifications of these decisions.

II. THE *BROOK* AND THE *CLEVELAND ATHLETIC CLUB* CASES

A. The District Court's Decision in the Cleveland Athletic Club Case

On July 19, 1984, in *Cleveland Athletic Club, Inc. v. United States*,[4] the United States District Court for the Northern District of Ohio held that a tax-exempt social club could not net its excess expenses attributable to the sales of meals to nonmembers against its net income from investments. This case concerned the Cleveland Athletic Club, which is a tax-exempt social club as described in section 501(c)(7) of the Code.[5] Organized to provide entertainment, amusement, and athletic recreation to its members, the Cleveland Athletic Club supplemented the income it received from membership dues with unrelated business income derived from investments and sales of food and beverages to nonmembers.[6] In conducting the sales operation, the club incurred a net loss.[7] On its income tax returns for the fiscal years ending in 1975, 1976, 1977, and 1978, the Cleveland Athletic Club offset its excess expenses from the food and beverage sales against its net investment income.[8] The Internal Revenue Service ("IRS") determined that the

3. *Compare* 779 F.2d 1160 *with* 799 F.2d 833. All references to Code are to sections of the Code of 1954, as amended.

4. 588 F. Supp. 1305 (N.D. Ohio 1984), *rev'd*, 779 F.2d 1160 (6th Cir. 1985).

5. *Id.* at 1306. I.R.C. section 501(a) in pertinent part provides a tax exemption for organizations described in section 501(c). Organizations that fall within section 501(c)(7) are "Clubs organized 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."

6. 588 F. Supp. at 1306.

7. *Id.*

8. *Id.*

Code did not allow the Cleveland Athletic Club to offset its investment income with those expenses.[9]

Section 511 of the Code imposes a tax on the "unrelated business taxable income" of social clubs that are exempt under section 501(c)(7).[10] The definition of "unrelated business taxable income" as it applies to section 501(c)(7) organizations is found in section 512(a)(3)(A) of the Code.[11] Under section 512(a)(3)(A), the term "unrelated business taxable income" is defined in pertinent part as "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) . . . ."[12] The court decided that expenses deductible under section 512(a)(3)(A) must be directly connected with the production of gross income and be a deduction "allowed by this chapter."[13] The parties had already stipulated that the claimed deductions were directly connected with the production of gross income, so the district court focused on the meaning of the phrase "allowed by this chapter."[14] The court averred that the phrase could be read only to refer to Chapter One of the Code.[15] The *Cleveland Athletic Club* court supported this interpretation by citing to *Deputy v. du Pont*,[16] which held that courts must interpret and read the Code according to its plain meaning. The court reasoned that, in view of the plain meaning of section 512(a)(3)(A), section 162(a) of the Code applied because it provided Chapter One's general rule for the deduction of trade or business expenses.[17] Thus, the district court would allow the deduction of the expenses claimed by the club only if the expenses met the requirements of section 162(a).[18]

Section 162(a) states that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."[19]

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9. *Id.*
10. I.R.C. § 511.
11. I.R.C. § 512(a)(3)(A).
12. *Id.*
13. 588 F. Supp. at 1307.
14. *Id.* at 1307-08.
15. 26 U.S.C. §§ 1-1379, *cited in id.* at 1308.
16. 308 U.S. 488 (1940), *cited in* 588 F. Supp. at 1307-08.
17. 588 F. Supp. at 1308.
18. *See id.*
19. I.R.C. § 162(a).

The court noted that, whether activities rise to the level of carrying on a "trade or business" within the meaning of the statute is to a great extent a matter of degree, and the determination of this issue depends on the facts in each case.[20] In addition, the district court stated that prominent among the factors for deciding whether a taxpayer carries on a "trade or business" is the existence or absence of a profit motive.[21] Moreover, the *Cleveland Athletic Club* court ruled that the existence of a profit motive must be established before the club can deduct from its investment income its net losses from its sales of food and beverages to nonmembers.[22]

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20. 588 F. Supp. at 1308. *See generally* Higgins v. Commissioner, 312 U.S. 212 (1941) ("to determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case"); *see also* C.I.R. v. Groetzinger, 107 S. Ct. 980, 988 (1987) ("We therefore adhere to the general position of the *Higgins* Court, taken 45 years ago, that resolution of this issue requires an examination of the facts in each case."). Generally, the Code and the Treasury regulations provide scant assistance as to what facts are considered and the conclusions that can be drawn with regard to the existence of a "trade or business" for purposes of section 162. Boyle, *What is a Trade or Business?*, 39 TAX LAWYER 737 (1986). However, it is possible to summarize the pertinent facts generally reviewed by the courts. *Id.* These facts are as follows:

(1) good faith intention of making a profit or producing income;
(2) extensive activities over a substantial period of time;
(3) whether the activity has actually begun; and
(4) whether the taxpayer holds himself out to others as engaged in the selling of goods and services.

Id. at 742-43.

21. 588 F. Supp. at 1308. *See generally* McDowell v. Ribicoff, 292 F.2d 174, 178 (3d Cir. 1961) ("It is well established that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business."); Boyle, *supra* note 20, at 758-59 ("Of the four factors used to determine whether an activity constitutes a trade or business [*see id.* at 759], the one most accepted by the courts is the profit motive. This is an absolute necessity."). It is interesting to note that neither the Code or the Treasury regulations define the term "trade or business."

22. 588 F. Supp. at 1308. Rev. Rul. 81-69, 1981-1 C.B. 351, also concerned the issue of whether a social club could offset against its net investment income its net excess expenses that the club consistently experienced over a number of years from sales of food and beverages to nonmembers. The ruling supports the court's position by holding that under section 512(a)(3)(A) "deductions allowed by Chapter One" means that the proposed deductions must meet section 162. *Id.* The costs of expenses for nonmembers were held not to be deductible under section 162 of the Code because they were not related to a profit-seeking activity. *Id.* Therefore, such expenses were not allowed to be offset against the club's net investment income. *Id.*

In Priv. Ltr. Rul. 85-51-003 (Sept. 13, 1985), an examining agent concluded

The court held that the primary motive for the club's nonmember food and beverage sales was not to earn a profit but, rather, to defer part of the fixed or overhead expenses that otherwise would be paid by its members.[23] Therefore, the club could not take the deductions at issue.[24]

The court's holding flows from two premises: first, the term "allowed by this chapter" in section 512(a)(3)(A) refers to Chapter One of the Code; and, second, the only section in which the taxpayer's proposed deductions could fall is section 162. These assumptions are reasonable since both sections 512(a)(3)(A) and 162 are included in Chapter One and section 512(a)(3)(A) unequivocally states that the only deductions permitted thereunder are those "allowed by this chapter."[25] In addition, even though the

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that, because a social club's sales of food, beverages, and other products and services to nonmembers had consistently resulted in net losses for a number of years, no deduction should be allowed for such losses. The IRS stated that the taxpayer contended Rev. Rul. 81-69 should not apply unless there were continual losses generated from sales to nonmembers where the cost of goods sold and directly connected expenses do not exceed the amount charged. *Id.* The government added that the taxpayer thus believed that indirect overhead costs should not be considered in deciding whether sales to nonmembers were profit motivated. *Id.* The IRS held that the term "costs" as used in Rev. Rul. 81-69 means "all costs," including allocable indirect costs such as overhead and depreciation, and not merely the direct costs of nonmember sales. *Id.* Accordingly, the IRS disallowed the taxpayer's proposed deductions. *Id.*

The *Cleveland Athletic Club* court, citing Five Lakes Outing Club v. United States, 468 F.2d 443 (8th Cir. 1972), and Adirondack League Club v. Commissioner, 55 T.C. 796 (1971), *aff'd per curiam*, 458 F.2d 506 (2d Cir. 1972), also noted that the profit motive requirement has been used to deny deductions to other tax-exempt organizations. 588 F. Supp. at 1308. Although *Adirondack League* and *Five Lakes Outing* did not involve tax-exempt organizations as the *Cleveland Athletic Club* court claimed, the facts and the holdings of these cases are worth noting. In *Adirondack League*, a nonexempt social club maintained a hunting and fishing preserve for the benefit of its members. 55 T.C. at 797. It also recorded a substantial amount of income from profitable timber operations on its property. *Id.* at 805. The issue in the case was whether the club's losses from providing facilities and services to its members could be applied against the timber income. *Id.* at 807. In holding against the club, the Tax Court stated that a profit motive is a prerequisite to deductibility under section 162(a) for a nonprofit social club. *Id.* at 809. In *Five Lakes Outing*, a nonexempt social club wanted to deduct losses arising from its recreational operations against income it received from an outside source. 468 F.2d at 443. In holding against the taxpayer, the Eighth Circuit provided the rule set forth in *Adirondack League*. *Id.* at 445.

23. 588 F. Supp. at 1309.

24. *Id.*

25. Under the Code in effect at the time the decision was rendered (the Code

sales of meals to nonmembers were not made for profit, the sales did resemble business-like activities.[26] Section 162 is the only section that allows a deduction for ordinary and necessary business expenses.[27] Therefore, section 162 was the appropriate deduction section with regard to the sales expenses.

B. The Tax Court's Decision in the Brook Case

In *The Brook, Inc.*,[28] decided on September 4, 1985, the Tax Court also grappled with the issue of whether a tax-exempt social club could net its excess expenses attributable to the sales of meals to nonmembers against its net income from investments. The facts of this case were almost identical to those in *Cleveland Athletic Club*.[29] The petitioner in the case, The Brook, was a private social club that qualified for tax exemption under section 501(c)(7).[30] During its 1979 and 1980 fiscal years, The Brook had unrelated business taxable income from two sources: investments and food and beverages sold to nonmembers at private dinner parties hosted by club members.[31] In this period the club had investment income of $31,951 but avoided paying tax on this income by deducting from it net losses incurred in the sales of meals to nonmembers.[32] The IRS held that The Brook could deduct only expenses incurred in supplying food and beverages to nonmembers up to the amount of income the club received from such activities.[33] However, unlike the Cleveland Athletic Club, when The Brook's case came to trial, the club stipulated that it did not have any section 162 profit mo-

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of 1984 which amended the Code of 1954), Chapter One covered sections 1 through 1379.

26. Sales of goods are often regarded as "business-like" activities. *See, e.g., Groetzinger*, 107 S. Ct. at 987 ("[T]he offering of goods . . . usually would qualify the activity as a . . . business . . . .").

27. *See* the I.R.C. The rule in most federal circuit courts is that "deductibility of 'business-like' expenses or losses is denied unless the taxpayer can show an intention to seek profit." Bessenyey v. Commissioner, 379 F.2d 252, 256 (2d Cir. 1967); *accord, e.g.*, Brannen v. Commissioner, 722 F.2d 695, 704 (11th Cir. 1984); International Trading Co. v. Commissioner, 275 F.2d 578, 584 (7th Cir. 1960).

28. 50 T.C.M. (CCH) 959 (1985), *aff'd*, 51 T.C.M. (CCH) 133 (1985), *aff'd*, 799 F.2d 833 (2d Cir. 1986).

29. *Id.* at 960-61.

30. *Id.* at 960.

31. *Id.*

32. *Id.* at 961.

33. *Id.* at 962.

tive when it engaged in the sales at issue.[34]

The *Brook* court held for the Commissioner on two grounds.[35] The Tax Court's major basis for ruling against the taxpayer rested on a finding that section 512(a)(3)(A) requires a nexus between an expense and the income against which it is to be offset.[36] The court cited *Ye Mystic Krewe of Gasparilla v. Commissioner*,[37] a Tax Court case, as authority.[38]

In *Krewe*, the taxpayer, an entity that qualified for tax exemption under the predecessor of section 501(c)(7),[39] was organized to hold certain annual social events.[40] One of these events included a reenactment of an invasion of the City of Tampa, Florida, by a replica of an 18th century pirate ship, followed by a parade.[41] During the post-1969 years in issue, the taxpayer received net income of expenses resulting from its award by the city of concession rights along the parade route but also incurred expenses for the staged invasion and the parade.[42] The pertinent issue presented in *Krewe* was whether the taxpayer was entitled to offset its invasion and parade expenses against its concession income.[43] In this case, the court averred that the resolution of this issue depended upon whether the costs were "directly connected with" the generation of the concession income within the meaning of section 512(a)(3)(A).[44] The *Krewe* court held that, since the words "directly connected with" also appear in section 512(a)(1) of the Code, the regulations under that section can be used for interpreting the phrase as it appears in section 512(a)(3)(A).[45] The court stated Treasury Regulation section 1.512(a)-1(a) takes the position that the "directly connected with" language imposes a requirement in addition to that otherwise applicable to a claimed deduction; to meet such a requirement, an expense must have a "proximate and primary" relationship to the carrying on of the unrelated taxable

34. 799 F.2d at 838 (noting the facts of the *Brook* case).
35. *See infra* notes 36-58 and accompanying text.
36. 50 T.C.M. (CCH) at 962.
37. 80 T.C. 755 (1983).
38. 50 T.C.M. (CCH) at 962.
39. 80 T.C. at 756-57.
40. *Id.* at 756.
41. *Id.* at 757.
42. *Id.* at 758-59.
43. *Id.* at 765.
44. *Id.*
45. *Id.* at 766-67.

business.[46] Under this rationale, a social club's earnings from a specific activity in a given year would place a ceiling on the deductions that such activity could generate in that year. Losses from one taxable activity could not offset gains from another. The court went on to hold that the invasion and parade were activities carried on independently of the operation of the concessions and that expenses of those activities were independent from the production of concession income.[47] Therefore, the taxpayer was not entitled to offset its invasion and parade expenses against its concession income.[48]

In *Brook*, as in *Krewe*, the taxpayer sought to net the excess expenses from one activity (i.e., the food and beverage sales to nonmembers) against the income from another activity (i.e., investments).[49] The court held that, since no direct nexus between such activities had been demonstrated by the taxpayer, pursuant to *Krewe* the excess expenses could not serve to offset independent net investment income under section 512(a)(3)(A) during the years at issue.[50]

It is interesting to note that The Brook petitioned for reconsideration of this case. On this motion, both the taxpayer and the Commissioner claimed in part that the Tax Court's interpretation of section 512 of the Code conflicted with the intent of the statute.[51] Specifically, both parties claimed that, in certain situations, section 512(a)(3) of the Code allows the expenses of one nonexempt function activity to be deducted from unrelated business taxable income.[52] This differs from the Tax Court's holding in *Brook* that losses cannot be aggregated to offset income from two or more unrelated businesses entered into for profit unless there exists a nexus between them.[53] However, in a supplemental decision issued on December 17, 1985, the Tax Court disagreed with the position of the taxpayer and the IRS.[54]

The Tax Court in *Brook* also found support for its conclusion

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46. *Id.* at 766. *See* Treas. Reg. § 1.512(a)-1(a) (as amended in 1983).
47. 80 T.C. at 767.
48. *Id.*
49. 50 T.C.M. (CCH) at 962.
50. *Id.* at 962-63.
51. The Brook, Inc. v. Commissioner, 51 T.C.M. (CCH) 133, 133-35 (1985), *aff'd*, 799 F.2d 833 (2d Cir. 1986).
52. *Id.*
53. *See supra* notes 36-50 and accompanying text.
54. *Id.* at 133.

in the legislative purpose behind the enactment of section 512(a)(3).[55] The court said that the legislative history accompanying section 512(a)(3) made it clear that the statute was enacted particularly to tax investment income.[56] To support this finding, the Tax Court quoted a Treasury Department proposal that the court said resulted in the enactment of section 512(a)(3):

> Thus, under the proposal, all income other than that from members in exchange for exempt function facilities, would be included in gross income whether or not the activities generating the income, were sufficient to meet the requirements of a 'trade or business regularly carried on' generally applicable under the unrelated business tax. Income from an investment [footnote omitted] would be subject to the [unrelated business income] tax whether or not the activities engaged in by the social club in generating that income were sufficient to meet the taxpayer business test of the unrelated business income tax.[57]

Thus, the court undoubtedly reasoned that the statute was enacted particularly to tax investment income because the Treasury Department specifically set forth investment income as one type of income that would be subject to the unrelated business income tax. The court held that, since section 512(a)(3) was enacted to tax investment income in particular, the taxpayer must not be allowed to offset its excess expenses from its sales of meals to nonmembers against its investment income.[58]

C. The Sixth Circuit Court of Appeals' Decision in the Cleveland Athletic Club Case

On December 23, 1985, in *Cleveland Athletic Club, Inc. v.*

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55. 50 T.C.M. (CCH) at 963.

56. *Id.*

57. *Technical Explanation of Treasury Tax Reform Proposals, Hearings on the Subject of Tax Reform before the Comm. on Ways and Means*, 91st Cong., 1st Sess. p. 14, 5050, 5139-41 (1969) [hereinafter cited as the *Treasury Tax Reform Proposals*], *quoted in* 50 T.C.M. at 961.

58. 50 T.C.M. at 963. The *Brook* court stated in its holding:

> [W]e think that this holding comports with the purpose of section 512(a)(3), which was to tax income, and particularly investment income, which a social club receives from non-members sources. If the taxpayer's position were adopted, its investment income would wholly avoid taxation . . . .

Id.

United States,[59] the Sixth Circuit reversed the district court's decision and held that a social club can offset its excess expenses from the sales of meals to nonmembers against its net income from investments. The circuit court reasoned, as the district court did not, that the challenged deductions need not come within the section 162 trade or business allowance.[60] In support of its decision, the Sixth Circuit compared the definition of "unrelated business taxable income" as it applies to section 501(c)(7) organizations under section 512(a)(3)(A) to the general definition of "unrelated business taxable income" as provided in section 512(a)(1).[61] As stated previously, section 512(a)(3)(A) provides that the term "unrelated business taxable income" is "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) . . . ."[62]

Under section 512(a)(1), the general definition of "unrelated business taxable income" is:

> the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).[63]

One major distinction between the two definitions is that section 512(a)(1) refers to a "trade or business" while section 512(a)(3)(A) does not.[64] The Sixth Circuit concluded that the difference in the language established that section 512(a)(3)(A) does not have a profit motive requirement.[65] The omission of the phrase

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59. 779 F.2d 1160 (6th Cir. 1985).
60. *Id.* at 1165.
61. *Id.*
62. I.R.C. § 512(a)(3)(A).
63. I.R.C. § 512(a)(1).
64. *Compare* I.R.C. § 512(a)(1) *with* I.R.C. § 512(a)(3)(A).
65. 779 F.2d at 1165. The court of appeals in *Cleveland Athletic Club* also argued that Rev. Rul. 81-69, *supra* note 22, is an improper interpretation of section 512(a)(3)(A). 779 F.2d at 1166. As noted above, Rev. Rul. 81-69 held on facts similar to the facts of the *Brook* and the *Cleveland Athletic Club* cases that a claimed deduction may be taken only if the activity it is connected with is a profit-seeking activity. *See supra* note 22. Therefore, the Second Circuit held that the revenue ruling is also invalid under the law. 799 F.2d 833. The court attacked Rev. Rul. 81-69 by arguing that its authority was weak. 799 F.2d at 1166. Specifi-

"trade or business" in section 512(a)(3)(A) undoubtedly helped the court to reach its conclusion. In addition, the Sixth Circuit held that the profit-motivation requirement was important only for distinguishing between an activity carried on as a "trade or business" as opposed to that of a hobby.[66] Moreover, the court stated that the deductions at issue were allowable merely if they are ordinary and necessary to the production of income with economic gain as their basic purpose and that deductibility under section 512(a)(3)(A) does not depend on whether an entity entered into nonmember business activity with the purpose of generating a tax profit.[67]

The Sixth Circuit, citing to a congressional report, also stated:

> [A]ll income other than exempt function income would be included in gross income regardless of whether the activity generating the gross income met the requirements of a 'trade or business regularly carried on' which generally apply under the unrelated business income tax. That publication [the congressional report] also stated that to remain consistent 'deductions would be allowable if directly connected with an activity generating income subject to tax rather than only if directly connected with an unrelated trade or business regularly carried on.'[68]

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cally, the Sixth Circuit claimed that the only legal authority cited in the revenue ruling and that forms the basis for that ruling is Iowa State Univ. of Science and Technology v. United States, 500 F.2d 508 (1974). *Id.* The Second Circuit distinguished *Iowa State* by noting that, unlike *Cleveland Athletic Club*, *Iowa State* dealt with the attempted deduction of expenditures produced by the operation of an exempt activity from income produced by a nonexempt function. *Id.* In addition, the Second Circuit found that *Iowa State* was decided under sections 501(c)(3) and 512(a)(1), not sections 501(c)(7) and 512(a)(3)(A), which were at issue in *Cleveland Athletic Club*. *Id.* The *Cleveland Athletic Club* court successfully distinguished *Iowa State* from the *Cleveland Athletic Club* case. Therefore, Rev. Rul. 81-69 has no legal force and effect in the type of case that the *Cleveland Athletic Club* court addressed.

66. *See* 779 F.2d at 1165. The court cited the following for its authority: "The profit factor is really only significant insofar as it is a means of distinguishing between an enterprise carried on in good faith as a 'trade or business' and an enterprise carried on merely as a hobby." 4 A. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.08 (1972), *quoted in* Trustees of Graceland Cemetary Improvement Fund v. United States, 515 F.2d 763, 778 (1975), *quoted in* 779 F.2d at 1165.

67. 779 F.2d at 1165.

68. 779 F.2d at 1165-66 *quoting Tax Reform Studies and Proposals, U.S. Treasury Department House Ways and Means Comm. and Senate Finance Comm.*, 91st Cong., 1st Sess., pt. 3 at 325 (1969) [hereinafter cited as *Tax Reform Studies and Proposals*].

Although the court never stated its reason for relying on this authority,[69] these propositions support the assertion that section 512(a)(3)(A) has no profit-motivation requirement, since the report claimed that deductions would be allowable regardless of whether they were connected with an unrelated trade or business.

The Sixth Circuit also held against the IRS on another ground.[70] Specifically, the court averred that section 512(a)(3)(A) allows all unrelated business income and losses to be aggregated rather than treated separately.[71] In support of this position, the court cited a proposed Treasury regulation that has since been withdrawn.[72] The Sixth Circuit stated that, while a proposed Treasury regulation has no legal force and effect, it still supplies some evidence of Treasury's application for the interpretation of section 512(a)(3)(A).[73]

Another distinction between the language of sections 512(a)(3)(A) and 512(a)(1) further supports the Sixth Circuit's aggregation rule.[74] Specifically, the word "such" prefaces the reference to "trade or business" in section 512(a)(1).[75] The proper interpretation and plain meaning of the phrase "*such* trade or business"[76] can only be that a particular trade or business is at issue. Therefore, the statute mandates the segregation of losses, deductions, gains, or credits of a specific business. Since the word "such" is not found in section 512(a)(3)(A),[77] the statute appears not to limit the deductions to any particular source. Therefore, by negative implication, section 512(a)(3)(A) would allow all unrelated business income and losses to be aggregated.

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69. *See* 779 F.2d at 1165-66.

70. *See infra* notes 71-73 and accompanying text.

71. 779 F.2d at 1166.

72. Prop. Treas. Reg. § 1.512(a)-3(b)(3), 36 Fed. Reg. 8808 (1971)(withdrawn in 52 Fed. Reg. 2724 (1987)), *cited in* 779 F.2d at 1166. Proposed Treasury Regulation section 1.512(a)-3(b)(3) provided:

> (3) Income from more than one source. In the case of a social club or an employees' association which derives gross income [excluding exempt function income] from two or more sources, its unrelated business taxable income is computed by aggregating its gross income from all such sources and by aggregating its deductions allowed with respect to such gross income.

73. 779 F.2d at 1166.

74. *See infra* notes 75-77 and accompanying text.

75. I.R.C. § 512(a)(1).

76. *Id.* (emphasis added).

77. I.R.C. § 512(a)(3)(A).

D. The Second Circuit Court of Appeals' Decision in the Brook Case

In *The Brook, Inc. v. C.I.R.*,[78] decided August 21, 1986, the Second Circuit affirmed the decision of the Tax Court and held against the taxpayer. However, the circuit court reached its ruling for different reasons.[79] The Second Circuit also adhered to the Sixth Circuit's "aggregation" theory and it disagreed with the Tax Court's position that the "directly connected" phrase in section 512(a)(3)(A) creates a requirement that an expense may be offset only against income it directly helped to generate.[80] The court based this conclusion on two grounds.[81] First, it pointed out that section 512(a)(3)(A) plainly states that allowable deductions should be taken from "gross income," and the statute only requires that the deductions be related to the production of that "gross income."[82] The circuit court noted that section 61 of the Code defines "gross income" as "all income from whatever source derived."[83] The court determined that the term refers to the sum total of the taxpayer's income except for that which is specifically excluded.[84] The Second Circuit concluded that section 512(a)(3)(A) on its face allows deductions to be taken against the sum total of a social club's nonexempt gross income, not just from the portion related to the particular deduction.[85] Moreover, the court explained that the "directly connected" language simply requires that the deductions arise from the generation of gross income, disregarding any exempt function income, i.e., that the deduction be related to the production of some portion of the social club's total taxable gross income.[86]

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78. 799 F.2d 833.
79. *See id.* at 837-38.
80. *Id.*
81. *Id.*
82. *Id.* at 837.
83. *Id. See* I.R.C. § 61(a).
84. 799 F.2d at 837.
85. *Id.*
86. *Id.* The Second Circuit also reinforced its argument on this issue by claiming that legislative history supported its reading of the statute. *Id.* The court stated that the Treasury Department noted, when proposing section 512(a)(3)(A) to the House and Senate, that "gross income" as used in section 512(a)(3)(A) meant "*all* income, other than that from members in exchange for exempt function facilities." *Tax Reform Studies and Proposals, supra* note 68, at 325, *cited in id.* The Second Circuit court claimed that the Treasury Department did not suggest that deductions would exceed the income produced by the activity for which

The court also disagreed with the Tax Court's "directly connected" theory because the Second Circuit believed that such proposition was inconsistent with Congress's intent in adopting section 512(a)(3)(A).[87] The court quoted House and Senate reports that stated Congress enacted section 512(a)(3)(A) "to allow individuals to join together to provide recreational or social facilities on a mutual basis, *without tax consequences* . . . [so that] the individual is in substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization."[88] The Second Circuit, citing to the same congressional reports,[89] stated that the legislative intent behind the enactment of the statute was to insure that social club members should not suffer tax losses or receive tax benefits merely because they had banded together in a social club for recreation or pleasure.[90] The court reasoned that, if the club members had acted as individuals or a nonexempt corporation, they would be allowed to offset the expense of engaging in an activity for profit against total gross income without any requirement that the income from a specific business enterprise in any given year exceed the deductible costs of that activity.[91] The Second Circuit concluded that the effect of the Tax Court's interpretation would be to punish social clubs by not allowing them to aggregate deductions and income generated from an unrelated business activity as allowed by section 162 to other taxpayers.[92]

Although the appellate court disagreed with the Tax Court's

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the deduction was taken. 799 F.2d at 837. The court further noted that, to the contrary, the Treasury Department stressed that "deductions would be allowable if directly connected with *an activity generating income* subject to tax." *Tax Reform Studies and Proposals*, *supra* note 68, at 325, *cited in id.* (emphasis in original).

87. 799 F.2d at 837.

88. S. REP. No. 552, 91st Cong., 1st Sess. 71 (1969), *reprinted in* 1969-3 C.B. 423, 469-70); H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 47 (1969), *reprinted in* 1969-3 C.B. 200, 231; *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1693, 2027, 2100, *quoted in* 799 F.2d at 837 (emphasis in original).

89. S. REP. No. 552, 91st Cong. 1st Sess. 71 (1969), *reprinted in* 1969-3 C.B. 423, 469-70; H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 47 (1969), *reprinted in* 1969-3 C.B. 200, 231; 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1693, 2027, 2100, *cited in* 799 F.2d at 837.

90. 799 F.2d at 837.

91. *Id.* at 838.

92. *Id.*

reading of the law,[93] it held that The Brook was still required to establish that section 162 of Chapter One, which the court said is incorporated by reference in section 512(a)(3)(A), would allow a deduction from investment income of the losses incurred in serving meals to nonmembers.[94] The Second Circuit held that, since expenses of an activity can be deducted under section 162 only if such activity is engaged in for profit and The Brook stipulated that it had no profit motive when it engaged in the unrelated activity of selling meals to nonmembers,[95] the club could not take the deductions at issue.[96]

The Second Circuit faulted the Sixth Circuit's position that a social club may deduct expenses generated from activities in which it did not engage for profit so long as the club engaged in the activity with a basic purpose of economic gain.[97] The court said that such a rule would undermine Congress's express purpose that social clubs neither suffer nor benefit under the Code with respect to their unrelated business income.[98] The *Brook* court further stated that such a reading of section 512(a)(3)(A) would grant social clubs a tax advantage by permitting them to take section 162 deductions unavailable to other taxpayers, i.e., for costs arising from nonprofit activities.[99] The Second Circuit feared that under the Sixth Circuit's theory a social club could avoid paying any income tax whatsoever by utilizing otherwise taxable investment income to subsidize meal sales to nonmembers.[100]

The Second Circuit's fear is justified.[101] Section 61 states in pertinent part that gross income includes income from interest,[102] rents,[103] royalties,[104] or dividends.[105] If an individual taxpayer derived income from any of the sources enumerated in section 61, the

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93. *Id.* at 837. *See supra* notes 80-92 and accompanying text.

94. 799 F.2d at 838.

95. *Id.*

96. *Id.* at 838, 842.

97. *Id.* at 838. *See supra* notes 88-90 and accompanying text.

98. 799 F.2d at 838.

99. *Id.* at 838-39.

100. *Id.* at 839. The courts in *Brook*, 50 T.C.M. at 963, and *Krewe*, 80 T.C. at 767, also feared that if a social club deducted the expenses generated from activities which it did not engage in for profit, a subsidy situation could occur.

101. *See infra* notes 102-109 and accompanying text.

102. I.R.C. § 61(a)(4).

103. I.R.C. § 61(a)(5).

104. I.R.C. § 61(a)(6).

105. I.R.C. § 61(a)(7).

taxpayer generally would be taxed on such income.[106] Under the Code, a taxpayer cannot deduct the costs of paying other peoples' meals from the taxpayer's investment income.[107] Therefore, the taxpayer could use only after-tax investment dollars to pay for other peoples' meals. As the Second Circuit stated, when a social club offsets its investment income with the costs of meals sold to nonmembers, the club potentially could avoid paying income tax on otherwise taxable investment income by subsidizing the costs of such meals.[108] The Second Circuit noted that Congress's express purpose behind the enactment of section 512(a)(3)(A) was that social clubs must be treated neutrally with respect to their unrelated business income and neither suffer nor benefit under the Code.[109] Thus, the Sixth Circuit's holding in *Cleveland Athletic Club* is inconsistent with Congress's intent because it would allow a social club to avoid paying tax on certain income while an individual taxpayer would be taxable on the same income.

The Second Circuit also submitted that the Sixth Circuit suggested that, because section 162 requires that the profit-motive factor be established only to distinguish a "trade or business" from a hobby, use of the "economic gain" test in lieu of the "profit motive" test does not necessarily provide a social club with a tax advantage.[110] According to the Second Circuit, use of the "economic gain" test would provide social clubs with a tax advantage not allowed to other taxpayers; this view becomes clear when section 183 of the Code, the "hobby loss" provision, is analyzed.[111] Section 183 applies to "activit[ies] not engaged in for profit" and covers "any activity other than one with respect to which deductions are allowable . . . under section 162 or under paragraph (1) or (2) of section 212."[112] The court stated that, while hobbies can generate receipts

106. *See* I.R.C. §§ 61(a), 63, 1.

107. Under section 262 of the Code, a taxpayer generally cannot deduct personal expenses. If a taxpayer takes another out for a meal for personal purposes the cost of such meal is a personal expense and therefore cannot be deducted.

108. 799 F.2d at 839.

109. *See supra* note 98 and accompanying text.

110. 799 F.2d at 839.

111. *Id.*

112. I.R.C. § 183. Section 183 places a cap on an individual taxpayer's deduction of expenses in "activit[ies] not engaged in for profit." Roughly speaking, the statute allows deductions for the expenses of "activit[ies] not engaged in for profit" only to the extent that the gross income therefrom exceeds any expenses (such as taxes and interest) which would be permitted under Chapter One of the Code "without regard to whether or not such activity is engaged in for profit."

or "economic gain," taxpayers engaging in them are not entitled to a deduction under section 162; therefore, a taxpayer engaged in an activity from which he does not intend to profit cannot avoid section 183's proscription even though he may have entered into such activity with a basic purpose of economic gain.[113]

Finally, the Second Circuit criticized the Sixth Circuit's juxtaposition of section 512(a)(3)(A) with section 512(a)(1).[114] The Second Circuit stated that the absence of the phrase "trade or business" in section 512(a)(3)(A) constituted the major difference between the two statutes, but it also acknowledged that section 162 allows a deduction for expenses only of a trade or business.[115] According to the Second Circuit, the Sixth Circuit reasoned that, if section 162, via section 512(a)(3)(A), were applied literally, the "trade or business" requirement would be read back into the statute and thereby make meaningless the omission of the phrase.[116]

The Second Circuit asserted that the difference in the wording of sections 512(a)(3)(A) and 512(a)(1) did not mean that Congress wanted to amend section 162 to give social clubs an advantage.[117] The court stated that, to the contrary, the difference arises from Congress's intent to tax organizations such as social clubs more comprehensively than religious and charitable institutions that are organized and operated for more altruistic purposes.[118] The Second Circuit noted that section 512(a)(1) taxes a tax-exempt organization's income only if it arises from a trade or business whose operation is not substantially connected with the performance or exer-

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I.R.C. § 183(b)(1). The legislative history behind the enactment of the statute makes clear that the provision's aim was to eliminate tax benefits in situations "where taxpayers are not carrying on a business to realize a profit, but rather are merely attempting to utilize the losses from the operation to offset their other income." S. REP. No. 552, 91st Cong., 1st Sess. 103 (1969), *reprinted in* 1969-3 C.B. 423, 489. In addition, although section 183 concerns "hobbies" such as dog training, the statute applies to any activity that is not operated for profit, notwithstanding whether the activity is similar to the conventional understanding of the word "hobby." *See, e.g., Brannen*, 722 F.2d at 702 n.5.

113. 799 F.2d at 839-40. The Second Circuit misreads the Sixth Circuit on this issue—the latter court did not suggest that adoption of the "economic gain" test in lieu of the "profit motive" test does not necessarily afford a social club a tax advantage. *See* 779 F.2d 1160. In fact, the Sixth Circuit never even discussed the issue of whether such a taxpayer could or could not receive a tax benefit. *Id.*

114. 799 F.2d at 840.

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

cise of its educational, charitable, or other purpose constituting the basis for its section 512 exemption.[119] Thus, the *Brook* court stated that section 512(a)(1) organizations may exclude from their taxable income interest, dividends, payments with respect to securities loans, annuities, rental receipts, and other items of income.[120]

In contrast, the Second Circuit continued, social clubs are taxed on all of their income except that portion arising from dues, fees, charges, or similar sums paid by members to provide them, their dependents, or guests with goods, facilities, or services in furtherance of the tax-exempt purpose of such members' club.[121] Thus, the *Brook* court held that social clubs, along with other types of organizations referred to in section 512(a)(3)(A), are subject to a more comprehensive tax than charitable entities and, accordingly, Congress caused the deductions permitted to each type of entity to correspond with the income to be taxed.[122]

The Second Circuit further stated that, since only "trade or business" income was taxed under section 512(a)(1), institutions could only take deductions "directly connected" with the carrying on of that trade or business.[123] The *Brook* court noted that this specifically eliminated deductions "directly connected" with producing income from such sources as interest, dividends, and securities loans, etc.[124] However, the court said that, since section 512(a)(3)(A) taxes a wider range of income of social clubs, it also permits more deductions, including many unavailable to section 512(a)(1) organizations.[125] As an example, the Second Circuit noted that social clubs may take deductions for section 212 expenses that arise from "non-trade" or "non-business" activities such as income from investments, renting land, sales of property, and research.[126]

From this, the Second Circuit deduced that the difference in the wording between section 512(a)(3)(A) and section 512(a)(1) does not mean that Congress intended social clubs to be exempt from the requirements of section 162 so that they would have a tax advantage over other taxpayers claiming deductions under that section; rather, Congress wished to subject social clubs to a farther

119. *Id.* at 840-41. *See* I.R.C. §§ 512(a)(1), 513(a).
120. 799 F.2d at 841.
121. *Id. See* I.R.C. §§ 512(a)(3)(A), 512(a)(3)(B).
122. 799 F.2d at 841.
123. *Id.*
124. *Id.*
125. *Id.*
126. *Id. See* I.R.C. § 212.

reaching tax than applied to section 512(a)(1) organizations.[127] The Second Circuit concluded that applying section 162 to social clubs in the same way as it is applied to other taxpayers does not diminish in any way the distinction between these two provisions of section 512.[128]

The Second Circuit made the correct decision on the issue of whether the taxpayer could deduct its net losses from sales of meals to nonmembers from its net investment income.[129] Section 512(a)(3)(A) allows for the aggregation of deductions.[130] In addition, some support exists for the Sixth Circuit's contention that the omission of the phrase "trade or business" from section 512(a)(3)(A) establishes that the statute does not have a profit-motive requirement.[131] However, the absence of this phrase also reinforces the theory that all unrelated business income and losses must be aggregated rather than treated separately.[132] Support for this contention arises from: one, the omission of the words "*such* trade or business" in section 512(a)(3)(A);[133] and two, the wording of this statute, which states that allowable deductions should be taken against "gross income" and the statute only requires that the deductions be related to the generation of that "gross income."[134] Since the absence of the phrase "trade or business" can also reinforce the aggregation proposition, the omission may only support that theory. This weakens the Sixth Circuit's contention. Thus, after examining all the arguments on this issue, it is clear that the Second Circuit's claim that the deductions at issue must be al-

127. 799 F.2d at 841.

128. *Id.* The Second Circuit's assertion concerning the Sixth Circuit's decision was incorrect: the Sixth Circuit never stated that applying section 512(a)(3)(A) literally to social clubs would read the "trade or business" requirement back into section 512(a)(3)(A). *See* 779 F.2d 1160. The Sixth Circuit, however, did compare 512(a)(3)(A) with 512(a)(1). *Id.* at 1165. But, as set forth above, this comparison was primarily made to show that the absence of the phrase "trade or business" in section 512(a)(3)(A) establishes that this provision does not have a profit-motive requirement. *See id.*

129. *See infra* notes 130-134 and accompanying text. *See also* Note, *The Unrelated Business Income Tax: The Treatment of Section 501(c)(7) Organizations' Outside Revenue and Losses*, 6 VA. TAX REV. 535 (1987)(claiming that the holding in the circuit court's decision in *Brook* has more merit than the Second Circuit's ruling in *Cleveland Athletic Club*).

130. *See supra* notes 70-77, 79-92 and accompanying text.

131. *See supra* notes 60-69 and accompanying text.

132. *See infra* notes 133-134 and accompanying text.

133. *See supra* notes 74-77 and accompanying text.

134. *See supra* notes 80-86 and accompanying text.

lowed under section 162 and have a profit motive is a stronger claim than the Sixth Circuit's opposing position.

The Second Circuit's decision does not imply that the Tax Court in *Brook* was incorrect when it claimed that the legislative history behind the enactment of section 512(a)(3) made it clear that the statute was enacted particularly to tax investment income.[135] However, the investment income of a social club is subject

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135. *See supra* notes 55-58 and accompanying text. The *Tax Reform Studies and Proposals* stated: "social clubs present a special problem with regard to any income from sources outside the membership, whether such income results from the conduct of an unrelated trade or business or passive *investments*." *Tax Reform Studies and Proposals*, *supra* note 68, at 316 (emphasis in original deleted, emphasis added). The proposals also stated: if a social club "has income from interest, dividends, rents, or royalties," the Treasury Department explained, "this income inevitably reduces the member's cost below the actual cost of providing the purely personal facilities made available by the organization." *Id.* at 42.

Congress apparently agreed with the Treasury's analysis. The House Report on Section 512(a)(3) explained the operation of the new provision as follows:

> The bill also imposes a tax on investment income of organizations which are exempt on the grounds of mutuality or common membership. Social clubs, for example, are operated for the benefit of members and any profit derived from rendering the services to members. Therefore, where a social club has income from *interest, dividends, rents, royalties*, etc., this income reduces the members' costs below the actual cost of providing the personal facilities made available by the organization. Because of this, the bill would tax the social clubs and these other membership organizations on all income other than that derived from rendering services to the members. This income would be treated and taxed as business income [emphasis added].

H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 47 (1969), *reprinted in* 1969-3 C.B. 200, 231. Both the House and Senate Reports further explained the rationale for section 512(a)(3)(A) as follows:

> Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from *investments*, upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation to its membership. For example, if a social club were to receive $10,000 of untaxed income from investments in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the ex-

to the unrelated business income tax to the same extent as any other income that is subject to the tax. Therefore, a club's deductions from other unrelated business activities that meet the requirements of section 162 can reduce the amount of such club's otherwise taxable investment income. Thus, the Tax Court incorrectly ruled against the taxpayer by relying on the legislative history accompanying section 512(a)(3) without considering that under section 512(a)(3) investment income must be treated in the same manner as other unrelated business taxable income.

III. THE CONSEQUENCES OF THE *CLEVELAND ATHLETIC CLUB* AND THE *BROOK* CASES

The above discussion demonstrates that *Cleveland Athletic Club* stands for the premise that the Sixth Circuit will allow a social club to offset its excess expenses from the sales of meals to nonmembers against its net income from investments.[136] The Second Circuit established in *Brook* that it will not allow this type of offset to occur.[137] These conflicting decisions may have a varying effect in their respective jurisdictions.[138] The Second Circuit correctly feared that, in a Sixth Circuit jurisdiction, a social club can now forego paying any income tax whatsoever by using otherwise taxable investment income to subsidize the meals of nonmembers.[139] As noted above, the Sixth Circuit's position negates Congress's express purpose behind the enactment of section 512(a)(3)(A) that social clubs neither suffer nor benefit under the Code with respect to their unrelated business income.[140]

Cleveland Athletic Club and *Brook* may also affect the amount of expenses that a club would be willing to expend for the

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> emption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose.

Id. at 48 (emphasis added). S. REP. No. 552, 91st Cong., 1st Sess. 71 (1969), *reprinted in* C.B. 423, 469-70.

136. *See supra* note 59 and accompanying text.

137. 799 F.2d 833.

138. *See infra* notes 139-149, 152-158 and accompanying text.

139. *See infra* note 140 and accompanying text; *see supra* notes 100-109 and accompanying text.

140. *See supra* notes 101-109 and accompanying text.

provision of meals to nonmembers.[141] Since a social club in a Sixth Circuit jurisdiction can take the deductions at issue, such a club may incur more expenses from the sale of food and beverages to nonmembers (i.e., by charging such nonmembers less for meals) than a club in a Second Circuit jurisdiction.[142] This could foster better relations between club members and nonmembers in a Sixth Circuit jurisdiction.[143]

In addition, the holding of the Sixth Circuit can lead to dangerous precedent.[144] As mentioned above, under section 512(a)(3)(A), a deduction must be "allowed by Chapter One."[145] The *Cleveland Athletic Club* court allowed the deduction for the excess meals expenses even though these expenditures did not meet the requirements of section 162.[146] However, section 162 is the only section in Chapter One under which such expenses could feasibly be deducted.[147] By still allowing these food and beverage expenses to be deductible under section 512(a)(3)(A), the Sixth Circuit in essence created a new deduction provision.[148] Thus, taxpayers in this jurisdiction may attempt to extend the Tax Court's holding by arguing that other currently nondeductible expenses should be allowed to offset income.[149]

The Sixth Circuit, however, is not wholly to blame for this incorrect decision.[150] Section 512(a)(3)(A) is ambiguous. The drafters of this statute should have enumerated the specific deduction provisions of the Code that they were referring to in the phrase "deductions allowed by this chapter."[151]

Although the two conflicting decisions will have some impact

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141. *See infra* note 142 and accompanying text.

142. A club that can take the deductions at issue can offset more taxable income and therefore have more disposable income than a club that cannot.

143. This is based on the assumption that allowing nonmembers to pay less for meals causes them to have better feelings toward members than do nonmembers who pay more for meals.

144. *See infra* notes 145-149 and accompanying text.

145. *See supra* note 25 and accompanying text.

146. 779 F.2d 1160.

147. *See supra* notes 26-27 and accompanying text.

148. This newly created section allows deductions for ordinary and necessary trade or business expenses for activities not engaged in for profit.

149. This is based on the idiomatic premise: "You give 'em an inch and they'll take a yard!"

150. *See infra* note 151 and accompanying text.

151. *See* I.R.C. § 512(a)(3)(A).

on the taxation of social clubs,[152] *Brook* has narrower precedential value, even in its own jurisdiction, than it would appear at first glance.[153] As mentioned above, the taxpayer in *Brook* stipulated that its sale of meals to nonmembers lacked a profit motive.[154] Therefore, after the Second Circuit decided that section 512(a)(3)(A) requires that the proposed deduction at issue must still have a profit motive,[155] the taxpayer's stipulation made it easy for the court to apply its rule and hold against The Brook.[156] It is uncertain how the Second Circuit or many other courts, other than the Sixth Circuit, would decide a case where a social club wishes to deduct expenses from sales of meals to nonmembers and the club does not stipulate whether or not the sales activity was entered into with a profit motive. This may cause some administrative inconvenience because courts might have to grapple with whether the activities at issue are entered into for a profit. If the IRS has to claim that a social club's sales of food and beverages to nonmembers are not a profit-motivated activity, it may stand on weak ground.[157] In *Pittsburgh Press Club v. United States*,[158] the government argued successfully that a social club's nonmember food and beverage sales activity may operate at a tax loss and still constitute a profitable business for purposes of revoking the club's tax-exempt status.

Finally, the IRS' future litigation plans with regard to *Cleveland Athletic Club* can be found in its action on decision issued on

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152. *See supra* notes 138-149 and accompanying text.

153. *See infra* notes 154-158 and accompanying text.

154. *See supra* note 34 and accompanying text.

155. 799 F.2d at 838.

156. *See id.*

157. *See infra* note 158 and accompanying text.

158. 536 F.2d 572 (3d Cir. 1976), *after remand*, 579 F.2d 751 (3d Cir. 1978), *after second remand*, 615 F.2d 600 (3d Cir. 1980). In *Pittsburgh Press Club*, the IRS audited the taxpayer social club in 1970. 615 F.2d at 602. The government determined that the club's gross receipts from nonmembers were in excess of 11, 16, and 17 percent of its total receipts (excluding initiation fees) for the fiscal years 1967, 1968, and 1969 respectively. *Id.* at 604. The IRS further found that nonmember receipts in the three years under audit totaled over $281,000. *Id.* Treas. Reg. § 1.301(c)(7)-1(b) (1987) sets forth that a club that engages in business, such as by making its facilties available to the public, is not exempt. Rev. Rul. 60-324, 1960-2 C.B. 173, 175, and Rev. Proc. 64-36, 1964-2 C.B. 962, provided guidelines for permissible levels of nonmember receipts. In *Pittsburgh Press Club*, the taxpayer exceeded these guidelines. 615 F.2d at 604. Therefore, the *Pittsburgh Press Club* court upheld the IRS' revocation of the club's exempt status pursuant to section 1.501(c)(7)-1(b). *Id.* at 606.

May 14, 1986.[159] In this action on decision, the IRS recommended not requesting certiorari of the Sixth Circuit's decision in *Cleveland Athletic Club*.[160] In deciding not to seek certiorari, even though the IRS believes that "the Sixth Circuit's opinion subverts Congressional intention," the IRS said that it "could not now establish a case for administrative importance warranting Supreme Court review."[161] Moreover, the IRS noted that a potential for developing an inter-circuit conflict existed in *Brook* and stated that in the interim it would stop litigating the issue in the Sixth Circuit.[162] As of this writing, the IRS has not appealed *Cleveland Ath-*

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159. *Cleveland Athletic Club*, 779 F.2d 1160, *action on decision*, 1986-026 (May 14, 1986).

160. *Id.*

161. *Id.*

162. *Id.* Evidence of the IRS' position with regard to the *Brook* and the *Cleveland Athletic Club* cases can also be found in Tech. Adv. Mem. 87-29-001 (Dec. 29, 1986). In this ruling, the issue was whether losses that consistently arose over a number of years from a section 501(c)(7) organization's sales of meals to nonmembers could be offset against income from temporary investments in order to determine such entity's unrelated business income tax. Tech. Adv. Mem. 87-29-001 (Dec. 29, 1986). The IRS stated that, although the *Cleveland Athletic Club* court arrived at a different holding, both Rev. Rul. 81-69 and the *Brook* court state that a social club cannot offset losses from such sales against its investment income. *Id.* The government further claimed that there is no reason why income from short term investments should change the treatment of losses from the sales of meals to nonmembers. *Id.* Accordingly, the section 501(c)(7) organization was not allowed to take the deductions at issue. *Id.*

The most recent indication of the IRS' position with regard to the *Brook* and the *Cleveland Athletic Club* cases arises from an action on decision which dealt with South End Italian Indep. Club, Inc. v. Commissioner, 87 T.C. 168 (1986) *action on decision*, 1987-015 (June 15, 1987). In *South End*, a tax-exempt social club conducted bingo games. 87 T.C. at 169. Under Massachusetts law, the net proceeds of such games had to be donated for charitable, religious, and educational uses. *Id.* The club donated its net proceeds from its bingo games pursuant to the Massachusetts law. *Id.* at 171. The club also had unrelated business taxable income. *Id.* at 170. The Tax Court, citing, from among other sources, the appellate decision in *Cleveland Athletic Club* and *Tax Reform Studies and Proposals*, *supra* note 68, pt. 3, at 325, *supra* note 66, stated that a social club can take deductions allowed by section 162 against any taxable income, whether or not generated by a trade or business. *Id.* at 174. Thus, the court allowed the donations to be deductible from its unrelated business taxable income as an expense under section 162. *Id.* at 177. In the action on decision, the IRS agreed that the South End Italian Club's distribution of net proceeds from the bingo games pursuant to the Massachusetts law constituted ordinary and necessary business expenses under section 162. Action on Decison 1987-015. However, the government disagreed with the court's decision that a social club may deduct expenses under

letic Club.

IV. RECENT DEVELOPMENTS

In *North Ridge Country Club v. Commissioner*,[163] decided on September 15, 1987, the Tax Court dealt with somewhat the same issue that was presented in the *Brook* and the *Cleveland Athletic Club* cases. In this case, the taxpayer, an exempt social club, received nonexempt income from interest and the following nonmember activities: golfing fees, golf cart rentals, and guest fees.[164] The taxpayer also incurred net unrelated business losses from the sales of food and beverages to nonmembers.[165] On its 1979 tax return, the taxpayer offset its net losses from the sales of meals to nonmembers against its net nonexempt income.[166] The IRS objected to these proposed deductions.[167]

The Tax Court, retreating from its earlier position in *Krewe*[168] and *Brook*,[169] held that excess expenses arising from different unrelated business activities could be aggregated.[170] The court based its decision on the language of section 512(a)(3)(A) and its legislative history.[171] The Tax Court also held that a deduction under section 512(a)(3)(A) requires a profit motive.[172] However, unlike

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section 162 notwithstanding whether the activity at issue is a trade or business. *Id.* The action on decision cited in *Brook*, 799 F.2d 833 and Rev. Rul. 81-69, 1981-1 C.B. 351(*see supra* note 22) as authority for its claim. *Id.*

163. 89 T.C. _____, No. 40 (1987).

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. 80 T.C. 755 (1983). *See supra* notes 39-48 and accompanying text.

169. 50 T.C.M. (CCH) 959 (1985), *aff'd*, 51 T.C.M. (CCH) 133, *aff'd*, 799 F.2d 833 (2d Cir. 1986). *See supra* notes 36-54 and accompanying text.

170. 89 T.C. _____, No. 40.

171. *Id.* The court quoted congressional reports which stated in pertinent part:

> The computation of income subject to the tax would be similar in most respects to the computation presently applicable under the unrelated business income tax in general. However, consistent with the elimination of the 'trade or business regularly carried on' tests, deductions would be allowable if directly connected with an *activity generating income* subject to tax, rather than only if directly connected with an unrelated trade or business regularly carried on.

Treasury Tax Reform Proposals, supra note 57, at 5139-41, *cited in* 89 T.C. _____, No. 40.

172. 89 T.C. _____, No. 40.

the Second Circuit in *Brook*, the Tax Court decided that the profit-motive requirement was satisfied merely upon a showing that a social club has the objective of having an "incremental increase in available funds" rather than a "taxable profit."[173] This seems to mean that the court essentially adopted the Sixth Circuit's "economic gain" theory. The Tax Court, ruling in favor of the social club, found that the taxpayer entered into the meal sales with a profit motive.[174]

If *North Ridge Country Club* is appealed, the appeal would be to the Ninth Circuit.[175] It would be interesting to know what approach the Ninth Circuit would utilize to resolve the issue.

V. SUMMARY AND CONCLUSION

There now exists a split of decisions between the Second and the Sixth Circuits involving a social club's ability to deduct its excess expenses from sales of meals to nonmembers against its net investment income. Both courts agree that section 512(a)(3)(A) allows for the aggregation of deductions. However, while the Second Circuit claims that the section 162 requirement must be met before a club can offset its expenses from its sales of meals against its net investment income, the Sixth Circuit does not impose this requirement. The Second Circuit espouses the correct position. These conflicting decisions can be rectified if Congress would enumerate with greater specificity the deductions that can be taken under section 512(a)(3)(A).

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173. *Id* at 1162.

174. *Id* at 1164. *Accord* Portland Golf Club v. Commissioner, 55 T.C.M. (CCH) 212 (1988) (holding in favor of the taxpayer on the basis of *Northridge Country Club*).

175. The taxpayer's principal place of activity and business is Fair Oaks, California. The Ninth Circuit's jurisdiction embodies California. *See* Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd.* 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971).