

Part I

Section 512.--Unrelated Business Taxable Income

26 CFR 1.512(a)-1: Definition.

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ISSUE

In computing the unrelated business income tax it owes under § 511(a)(2)(A) of the Internal Revenue Code, is it proper for a social club described in § 501(c)(7) to claim the credit under § 45B for a portion of employer social security taxes paid with respect to employee tips received from both members and nonmembers?

FACTS

A is a social club that is exempt from federal income tax under § 501(a) as an organization described in § 501(c)(7). A was formed to operate a country club with a private golf course and related amenities. A has a clubhouse where food and beverages are served to members and their nonmember guests. In addition to dues, fees, and payments from members, A receives an insubstantial amount of income from nonmembers, who use A's golf course and purchase food and beverages at A's dining facility. Such nonmember income is treated as gross income from an unrelated trade or business under § 512(a)(3).

Employees who serve food and beverages in A's clubhouse are paid by the hour and also customarily receive tips from both members and nonmembers. The tips are reported to A as the employer by the employees and are reported on A's employment tax returns. A also pays social security tax on the reported tips.

A files Form 990-T, Exempt Organization Business Income Tax Return, reporting nonmember income as gross income from an unrelated trade or business. In computing liability for unrelated business income tax, A claims the credit under § 45B for employer social security taxes paid with respect to tips paid to its employees who serve food and beverages. A calculates the credit based on all tips received by its employees.

LAW

Section 501(c)(7), in part, provides for the exemption from federal income tax of clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all 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 511(a), in part, provides for the imposition of tax on the unrelated business taxable income (as defined in § 512) of social clubs described in § 501(c)(7).

Section 512(a)(3)(A) provides, in part, that in the case of social clubs described in § 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by Chapter 1 that are directly connected with the production of the gross income (excluding exempt function income), both computed with certain modifications provided in § 512(b).

Section 512(a)(3)(B) defines the term "exempt function income" as 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 the exemption of the organization to which such income is paid.

Section 45B provides for a credit for a portion of employer social security taxes paid with respect to employee tips.

Section 45B(a) provides that for purposes of the general business credit under § 38, the employer social security credit is an amount equal to the excess employer social security tax paid or incurred by the taxpayer.

Section 45B(b)(1) defines the term "excess employer social security tax" as any tax paid by an employer under § 3111 with respect to tips received by an employee during any month, to the extent such tips - (A) are deemed to have been paid by the employer to the employee pursuant to § 3121(q) (without regard to whether such tips are reported under § 6053), and (B) exceed the amount by which wages (excluding tips) paid by the employer to the employee during such month are less than the total amount that would be payable (with respect to such employment) at the minimum wage rate applicable to such individual under § 6(a)(1) of the Fair Labor Standards Act of 1938 (determined without regard to § 3(m) of such Act).

Section 45B(b)(2) provides that in applying § 45B(b)(1), there shall be taken into account only tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary.

ANALYSIS

To compute its unrelated business taxable income under § 512(a)(3), a social club described in § 501(c)(7) must first ascertain its gross income. Exempt function income is excluded. Gross income is then reduced by allowable deductions that are directly connected with the production of the social club's gross income (with the exclusion of exempt function income) to arrive at unrelated business taxable income. In

calculating the amount of tax due, a social club may claim allowable credits, such as the general business credit under § 38. The general business credit is the sum of several other credits, including the employer social security credit under section 45B, which provides for a credit for employer social security taxes paid with respect to employee tips.

The § 45B credit has the effect of limiting the employer's social security tax liability to the amount that would be due if an employee were to receive only the minimum wage, no matter how much the employee actually earns. The employee's earnings record and individual income tax liability are not affected by the credit.

Here, A has paid social security taxes on all tips earned by its employees, including tips paid by both members and nonmembers. These tips meet the requirements under § 45B(b)(2) because the tips were received in connection with food and beverage service at A, and tipping of employees is customary at A. Section 45B does not prohibit social clubs described in § 501(c)(7) from claiming the credit, nor does it limit the credit to social security taxes paid in connection with a social club's unrelated trade or business. Therefore, A may calculate the § 45B credit on the basis of all tips received by its employees, not only the tips received by employees from nonmembers.

HOLDING

In computing the unrelated business income tax it owes under § 511(a)(2)(A), it is proper for a social club described in § 501(c)(7) to claim the credit under § 45B for the portion of employer social security taxes paid with respect to employee tips received from both members and nonmembers.

DRAFTING INFORMATION

The principal author of this revenue ruling is Charles Barrett of the Tax Exempt and Government Entities Division, Exempt Organizations. For further information regarding this revenue ruling, contact Mr. Barrett at (202) 283-8944 (not a toll-free number).