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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL,

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated August 25, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:
Club =
Partnership =
Location =
State =
Date 1 =
Date 2 =
W =
X =
Y =
Z =
M Percent =

ISSUE(S):
1. Whether certain membership fees paid to the Club, were exempt from federal income tax as contributions to capital under I.R.C. § 118 or taxable income as payments for goods or services.

2. If membership fees paid to a country club constitute payment of goods and services rather than contributions to capital, does the Service's correction of this item constitute a change in method of accounting.

CONCLUSION:
1. The initial membership fees paid by those who purchased Full Memberships are exempt from federal income tax as contributions to a capital under I.R.C. § 118. However, the fees paid by those who purchased the Nonresident Memberships are includible in income as payment for goods or services.

2. Even if the receipt of membership fees by a country club constitutes payment for goods and services, this involves a permanent change in lifetime income and, therefore, is not a change in accounting method.

FACTS:
The Club is a nonprofit[1] membership organization formed and operated for the purpose of owning and operating a golf, tennis, swimming and social club for pleasure and recreation and other non-profitable purposes. It was organized on Date 1, under the not-for-profit laws of State. It conducts its operations in Location -- an X-acre real estate development consisting of (among other things), a golf course, an Olympic-size swimming pool, tennis courts, a spacious clubhouse, garden homes, cluster homes, single family housing and estate homes and home sites.

The Club's organization and operations are subject to the provisions of the State nonprofit corporation laws. The Club is governed by a Board of Directors, all of whom are appointed by the Partnership, a for-profit State general partnership that owns the Location real estate development. Important for our purposes here, in Date 2, the Club entered into an option agreement with the Partnership, agreeing to purchase the Club facilities. The option agreement was conditioned upon meeting several contingencies, none of which are important for our purposes here.

The Club has two classes of membership: Full and Nonresident Memberships. Each class has specified rights. The most comprehensive membership is the Full Membership. The total number of memberships available in the Club is Y. The Partnership, probably by and through the Club's board of directors, approves or disapproves the applications of individuals seeking membership in the Club.

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[1]During the years in issue, the Club was not classified as an I.R.C. § 501(c)(3) tax-exempt organization.

An individual becomes a member of the Club upon the approval of his application and the payment of an initial membership fee.[2] In addition to paying the initial membership fee, all members are required to pay monthly dues for the use of the Club facilities and to pay for all goods and services provided. A nonresident member pays only one-half of the dues charged a Full Member. The facts do not indicate the initial membership fee that must be paid by the Nonresident Members.[3] None of the members have any right to participate in the proceeds of liquidation[4], receive dividends, or have any other interest in or title to any of the property or assets of the Club. Apparently, all members have the right to vote on whether the Club should exercise the option to purchase the Club facilities.

Full members have the right to vote, but that right is exercisable only after the Club and the partnership close on the sale of the Club facilities. Full members can resell their memberships back to the Club, which is required to buy the memberships back from the members.[5] The resigned Full Member is entitled to be paid the greater of the membership contribution the member actually paid for the Full Membership or
M Percent of the membership contribution then charged for the resigned member's Full membership. Thus, the Full Member has a right to a return of the total amount of initial membership fee he or she paid.

A nonresident member has few rights. He or she does not have the right to vote. A nonresident membership is not transferable. If such membership is terminated, the terminated member forfeits all right in the Club and is not entitled to receive a return of any portion of his or her membership fees or dues regardless of how long he or she had been a member.

LAW AND ANALYSIS

Applicable Law

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[2]At present, a Full Membership may be purchased for $ W.

[3]Some of the facts suggest that the initial Nonresident Membership fee is considerably less than that charged for a Full Membership.

[4]The Club's articles of incorporation provide that, in the event of dissolution or final liquidation of the Club, after paying the closing costs, all the property and assets of the Club shall be distributed to a not-for-profit organization.

[5]There is a condition precedent to this requirement. Before the Club is required to repurchase the Full Memberships, it must have first sold Z of the Y available memberships.

Section 118 provides that, “In the case of a corporation, gross income does not include any contribution to capital of the taxpayer.”

Treas. Reg. § 1.118-1 provides in relevant part:

> If a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. ... However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.

In Board of Trade of Chicago & Subsidiaries v. Commissioner, 106 T.C. 369 (1996), the Tax Court enunciated a test under which amounts collected by a corporation can be excluded as a capital contribution. In that case, taxpayer was a taxable membership corporation that operated a futures exchange. In its operations, it collected from its members various fees, including transfer, application, registration, badge, and miscellaneous fees. At issue in the case were the transfer fees. When a membership on the exchange is transferred, the transferee must pay taxpayer a transfer fee. The fee is used to purchase, retire, or redeem the mortgage on the taxpayer’s building, which houses the trading floor. Taxpayer did not include the transfer fees in income, claiming that they were contributions to capital. The Service disagreed. The Tax Court held for the taxpayer, finding that the members were in the nature of shareholders and made the payments with an investment motive. This latter fact is evidenced by (1) the earmarking of the fees to reduce taxpayer’s mortgage, (2) the increase in members’ equity resulting from fee payments, and (3) the members’ opportunity to profit from the payment of the transfer fees since there were little, or no, restrictions on transferability of memberships.

In Paducah & Illinois Railroad Co. v. Commissioner, 2 B.T.A. 1001, 1006-07 (1925), acq., C.B. V-1, 4 (1926), railroad companies organized the taxpayer to provide bridge facilities across the Ohio River. Each company was to furnish funds to the taxpayer in proportion to its use of the facilities. The court held that the portion of those funds devoted to a sinking fund and the retirement of bonds, which were to be evidenced by the issuance of preferred stock, were capital contributions excludable from the taxpayer's income. The court determined that this portion was, on the one hand, investments of capital, and, on the other, receipts of capital for

which stock was required to be issued. However, insofar as the contributions were used or to be used for ordinary expenses, interest, taxes, and dividends, the court determined that the railroad companies were making payments for services rendered by the taxpayer, which constituted expenses to railroads themselves and, therefore, income to the taxpayer.

United Grocers, Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962), is frequently relied upon by the Service in cases where the contributors are both equityholders and customers or potential customers. There, the court held that required monthly membership payments by retail grocers to a wholesale grocery cooperative, which provided services to both members and nonmembers but which paid members a "patronage dividend," were in the nature of payments for goods and services rather than capital contributions. The court found that the following factors supported its holding: (i) members paid the same monthly amount prior to and after the recipient corporation began to treat the payments as capital contributions; (ii) the payments could be used for ordinary operating expenses, (iii) the **contributors were** not entitled to a return of paid-in "capital" on liquidation, but only a pro rata share of liquidation proceeds, (iv) the payments were not voluntary, but required as a quid pro quo for services, (v) the contributions were not actually required for capital uses, as other funds were available, and (vi) there were none of the "ordinary characteristics of capital contributions." The court held that the dominant purpose for members was to obtain merchandise and services at the lowest possible prices. Each member was a retail grocer who, as a practical matter, was not interested in an investment or the well-being of appellant, except as an incident to his need to purchase groceries at advantageous and competitive prices. It is reasonable to assume that a member would continue to pay the fees and monthly assessments only so long as the total amount paid remained less than the cost of similar merchandise and services elsewhere. Id. at 640. The court held that, where payments are a condition to entitlement to services, they will be held to be payment for those services unless the evidence shows that the **contributions carry** entitlements so characteristic of capital contributions as to negative mere payment for services as their exclusive or primary purpose. Id. The court noted that the Service did not dispute that payments made to a Guaranty Fund, which were returnable on the contributing member's resignation, were capital contributions. Id., 640 n. 13.

In Concord Village, Inc. v. Commissioner, 65 T.C. 142 (1975), the Tax Court found that payments made by members of a nonstock cooperative housing association to a replacement reserve qualified under I.R.C. § 118(a), while payments to a general operating reserve and a painting reserve did not. As to the replacement reserve, the court pointed to the following indicia of capital contribution status: (i) the reserve was maintained in a special account earmarked exclusively for replacement of structural and mechanical equipment, (ii) the funds were accumulated from assessments made against each member "pro rata according to the size and type

of his dwelling unit", (iii) the purpose of the reserve was to "maintain the value of membership by providing assurance that capital equipment will be replaced upon its wearing out," (iv) the member received no goods or services in exchange for the reserve assessment, and (v) the replacement reserve was required under governmental regulations. Memberships were transferrable, and members were entitled to receive a pre-established "transfer value" for their memberships.

As a contrary factor suggesting that the reserve was not capital in nature, the court noted that the transfer value was not tied to the amount of contributions which the member actually made. The court found that amounts placed in the general operating reserve account were includable in the cooperative's gross income. While the use of those funds was limited to occasions of "financial stress" and the repurchase of memberships, their use was not restricted to capital expenditures. The court held that funds contributed to the general operating reserve were payments to the cooperative to be used for ordinary expenses incurred in the course of rendering its services to its members. The fact that the payments were made in advance of any expenses incurred, or that expenses entailing the use of the reserve funds might never be incurred did not, in the court's opinion, change the character of those funds as part of the price of the cooperative's services. The court noted that members had no right to the funds in the general operating reserve and that the board of directors had sole discretion to determine how they would be spent. The court likewise characterized the painting reserve as an advance accumulation of operating expenses - "part of the price of [the cooperative's] services" - rather than as a capital asset.[6]

Washington Athletic Club v. United States, 614 F.2d 670 (9th Cir. 1980), a nonprofit membership organization assessed their members a surcharge, payable as part of their annual dues, which was allocated to a capital improvement fund. The monies were deposited in separate savings accounts and commercial paper, and expended only on capital improvements. The Court found that the surcharge amounts were taxable income since the payers received no entitlement of an investment nature or greater rights on liquidation of the association.

In Minnequa University Club v. Commissioner, T.C. Memo. 1971-305, the court stated that a non-stock corporation's owners must be put in the shoes of

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[6] Arguably, the Tax Court erred in its holding as to the replacement reserve in Concord Village. In particular, an argument could be made that the payment to the replacement reserve failed to qualify under § 118(a) because, inter alia, the payment did not increase a member's equity interest inasmuch as the amount the member would receive on transfer of his interest had no relation to the amount contributed to the replacement reserve, and because the portion of each monthly payment placed in the replacement reserve was subject to the discretion of the board of directors.

stockholders. One of the issues in that case was whether amounts received by the non-stock corporation as special assessments from its members were income or contributions to capital to the non-stock corporation. The non-stock corporation ran a social club. The Court held that the special assessments levied on all members to repair and improve the club's buildings were contributions to capital rather than income from services rendered. The court noted that the terms of the assessments limited the use to be made of the funds. The funds were always maintained and accounted for separately, and the funds were actually expended on capital expenditures. The Court held that the amounts were capital contributions, and stated that the members must be put in the shoes of stockholders (apparently to determine their motivation in making the transfer).

In Lake Petersburg Association v. Commissioner, T.C. Memo. 1974-55, the taxpayer, a nonprofit recreational club, was established to purchase a tract of land, build a lake on a portion of it, and subdivide the remainder into lots to be leased for 99-year terms as recreational home sites. In order to obtain a lease on a lot, an individual was required to become a member of the club and to pay a membership fee. In addition, each member had to pay an "assessment," which was a pro rata share of the cost of the land and construction of the lake and roads, and an annual lot rental fee. The Tax Court rejected the Commissioner contention that the club members were lessees and that the assessments were advance rental payments constituting consideration for services. The court held that the sums were capital contributions. That decision turned on the court's conclusion that the club members were more analogous to shareholders in a corporation than to lessees, i.e., that an investment motive existed.

In 874 Park Avenue Corporation v. Commissioner, 23 B.T.A. 400 (1931), the taxpayer was incorporated for the purpose of acquiring, maintaining and operating a cooperative apartment building. The taxpayer purchased an apartment building, financing the purchase with a mortgage and with cash contributed by the shareholders in exchange of stock. Eight of the twenty-four apartments in the building were leased by stockholders under ninety-nine year proprietary leases at the nominal rent of $1.00 per year. The shareholder-tenants were also required to pay "additional rent and assessments" to be used for operating expenses and amortization of the mortgage to the extent these items were not paid out of income from non-shareholder rentals. The amounts assessed to pay the principal indebtedness secured by the mortgage were required by the leases to be recorded on the taxpayer's books as "paid-in" surplus," but were in fact entered on the taxpayer's ledger under the heading "assessments" in the capital stock account. The Court held that the additional assessments used to amortize the mortgages were contributions to the capital of the taxpayer.

In Rev. Rul. 75-371, 1975-2 C.B. 52, the Service treated a special assessment by a condominium association as an I.R.C. § 118 contribution to capital where the funds

were segregated in a separate account to be used for the replacement of outdoor furniture. The Service made **that holding even** though the association provided management services to the unit owners, who were shareholders of the association. While the payments were required once the assessment was approved, the payments were voluntary in the sense that they were approved by a majority shareholder vote. The assessment was made in 14 monthly installments. The ruling relied upon United Grocers, Ltd. v. United States, supra, to hold that motive or purpose and intent in making the contribution was the primary factor in determining whether it qualified under § 118(a). The ruling highlighted three factors as showing a § 118(a) intent: (i) the special assessment was "specifically earmarked and segregated for replacement of the furniture", (ii) the assessment was pro rata; and (iii) the replacement of the furniture enhanced the value of each contributor's capital interest in its condominium unit. By contrast, the ruling noted that funds collected for "normal operating expenses" were taxable as income to the association.

1. Full Membership fee payments constitute nontaxable contributions to capital.

In general, gross income includes income from all sources derived. I.R.C. § 61(a); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). Section 118(a) of the Code specifically excludes contributions to the capital of a corporation from gross income. Congress enacted I.R.C. § 118 to codify the preexisting concept of a capital contribution by a non-shareholder or shareholder. Board of Trade of Chicago, 106 T.C. at 378. However, this exclusion does not apply to any money or property transferred to a corporation in consideration for goods or services rendered, whether made by shareholders or nonshareholders. United Grocers, Limited v. United States, 308 F.2d 634 (9th Cir. 1962).

Here, the payors of the Full Membership fees are in the nature of stockholders. The Full Members are the Club's only owners.[7] See Minnegua University Club v. Commissioner, T.C. Memo. 1971-305 ("While the petitioner is a nonstock corporation, its members are its only owners and must be put in the shoes of stockholders"). See also Board of Trade of Chicago & Subsidiaries v. Commissioner, 106 T.C. 369 (1996); University Country Club, Inc. v. Commissioner, 64 T.C. 460 (1975); Lake Petersburg Association v. Commissioner, T.C. Memo. 1971-305, 33 T.C.M. 259. Full Members acquire the right to vote. Their memberships, like shares of stock, are transferable. Further, Full Members can recover 100%, and possibly more, of the amount they paid for their Full Membership. Although the rights of a Full Member are not the equivalent of those of a shareholder in a corporation, we conclude that a Full Member does possess more extensive rights than just the right to play golf or

[7]If these members are not the shareholders, then who is?

otherwise enjoy the facilities. See Lake Petersburg Association, 33 T.C.M. at 267 ("[T]he regular members did possess more extensive rights than those of a lessee. Accordingly, we conclude that the regular members were in the nature of shareholders).

The fact that Full Members are in the nature of stockholders does not inexorably lead to the conclusion that the membership fees paid by the Full Members were contributions to capital. United Grocers, Limited v. United States, 308 F.2d 634 (9th Cir. 1962) (contributions, whether made by shareholders or nonshareholders, of money or property which are transferred to corporation in consideration for goods and services are not exempt from taxation); Oakland Hills Country Club v. Commissioner, 74 T.C. 35 (1980). However, here, the very nature of the transaction is what makes the Full Members "shareholders." We think that this fact is very close to being determinative of the question of whether the payment constitutes a contribution to capital. In purchasing their Full Memberships, applicants became both equity owners of the Club as well as its customers (i.e., they became entitled to use the Club's facilities). [8]

The money here is used for capital expenditures. See Board of Trade of Chicago & Subsidiaries, supra; Paducah & Illinois Railroad Co. v. Commissioner, 2 B.T.A. 1001, 1006-07 (1925), acq., C.B. V-1, 4 (1926); Concord Village, Inc. v. Commissioner, 65 T.C. 142 (1975). It was clearly earmarked for purchase of the Club facilities. Pursuant to the agreement entered into with the Partnership, all membership contributions received by the Club from the initial issuance of memberships were required to be paid to Partnership. Such amounts were considered payments for the option to purchase the club facilities and would be applied against the purchase price upon the exercise of the option to purchase. Thus, the receipt of membership fees here is analogous to the receipt of seed money paid by investors in a corporation. In normal situations, investors inject capital funds into a corporation with the goal in mind of purchasing the building and infrastructure necessary for the corporation to operate. Such contributions are generally considered contributions to capital. The membership fee payments here were used to purchase the Club facilities, without which the Club would be unable to operate as a Country Club. If this money is not the initial capitalization, then what is?

The test for determining whether a payment qualifies under § 118(a) as a capital contribution is whether the payor had a motive or purpose and intent in making a

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[8]The fact that the members use the Club facilities does not prevent the membership fees from being contributions to capital. See Board of Trade of Chicago, 106 T.C. at 379. ("CBOT members' use of petitioner's trading facilities does not prevent the transfer fees from being contributions to capital").

contribution to capital. United Grocers, Ltd. v. United States, 308 F.2d 634 (9th Cir. 1962); Rev. Rul. 75-371, 1975-2 C.B. 52. If the payor had an investment motive in making the payment, then the payment would constitute a contribution to capital. Washington Athletic Club v. United States, 614 F.2d 670, 673-77 (9th Cir. 1980) (holding the investment motive to be the crucial element of capital contributions). We conclude here, for the reasons stated above and for the additional factors cited below, that an applicant for Full Membership had an investment motive in purchasing a Full Membership and, therefore, his or here initial membership fee constitutes a contribution to capital.

The following are additional factors supporting our determination:

1. The price set for a Full Membership was not based on the usage of the Club. Full Membership fees were made pro rata by the applicants.

2. Full Members had the opportunity to recover the full amount of membership fees they initially paid to the Club. If the membership fees were payments of services, then one would expect any rebate would be tied to the amount of services used. Here, a Full Member's right to recover his or her membership fee is no way tied to his or her use of the Club.

3. If the Full membership fee was viewed as payment for the use of the Club's services, then this would create the anomalous situation of Full Members paying more for their use of the Club facilities than Nonresident Members.

4. The possibility of making a profit supports our conclusion that the payment of the Full Membership fee constitutes a capital contribution. All applicants who bought Full Memberships were entitled to a full return of their investment and they could obtain more if the price of memberships increase in the interim between the time they purchase and the time they terminate their membership.

Although we find that the payment of a Full Membership fee constitutes a contribution to capital, we find the Nonresident Membership fees to be payments for goods and services. The Nonresident Member pays only one-half dues charged a Full Member. The Nonresident Member does not have the right to vote nor does he or she acquire any ownership interest in the taxpayer or the facilities. The Nonresident Member does not receive a return of his or here membership fee upon termination. The only right the Nonresident Member appears to have is the right to use the Club facilities. Further, since Nonresident Members pay one-half of the annual dues charged a Full Member, this supports treating the nonresident members initial membership fee as paid in lieu of annual membership dues.

2. Recharacterizing the nonresident fee payments as taxable payments for goods or services does not constitute a change of accounting method.

The change at issue is from treating membership fees as contributions to capital (not income) to fees paid for goods and services (income). Recharacterizing the contributions to capital so that they would be included in taxable income affects lifetime taxable income rather than the timing of when taxable income is reported. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. Rev. Proc. 97-27, 1997-1 C.B. 680, Section 2.01(1), citing Rev. Proc. 91-31, 1991-1 C.B. 566.

The legal issue in this case is analogous to Saline Sewer v. Commissioner, T.C. Memo. 1992-236, a case which the Service lost. Although an AOD has not been issued for the case, in general, the Service is not favorably inclined to relitigate the Saline issue. In Saline, the Service argued that the recharacterization of customer fees from nontaxable contributions in aid of construction to taxable connection fees was a change in method of accounting because a timing question for recognizing income or claiming deductions was involved in addition to the recharacterization concern. The argument was that because the taxpayer failed to report the monies as taxable income and also incorrectly reported them as a credit or reduction to the depreciable basis of assets, it effectively reduced its depreciation expense over the life of the underlying assets.

A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Treas. Reg. §1.446-1(e)(ii)(a). The Tax Court, though, noted that to constitute a change in method of accounting, there must have been a change in the treatment of a material item. Thus, when an accounting practice merely postpones the reporting of income, rather than permanently avoiding the reporting of income over the taxpayer's lifetime, it involves the proper time for reporting income. Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500,510 (1989). The court stated that it was not faced with the question as to the proper time at which the fees should be reported in income, but rather whether the fees should be reported at all.

In addition, when the depreciable basis of assets is decreased (as when payments are treated as nontaxable contributions in aid of construction), a corresponding amount of depreciation expenses is permanently forfeited. Accordingly, the restoration of the depreciable basis is also not a timing issue. That is, the Tax Court viewed the corresponding effect on depreciation as parallel to the primary issue and resulting in the same answer. That is, the change from nontaxable "contribution in aid of construction" and permanently forfeited depreciation to taxable connection fee

and restored depreciable basis is not a timing question but involves whether fees should be reported in income at all. "Correcting determinations regarding the taxability or nontaxability of income, including determinations of income character, are not changes in methods of accounting because the determinations do not involve the proper time for the inclusion of an item in income or the taking of a deduction." Underhill v. Commissioner, 45 T.C. 489,496 (1966).

Similarly, we believe in your case that the exclusion of taxable membership fees from gross income by treating them as contributions to capital involves whether items would be reported, not when they would be reported. Thus, the exclusion from gross income did not involve a timing issue, and a subsequent change to requiring inclusion in income would not constitute a change in method of accounting. Saline Sewer v. Commissioner, T.C. Memo. 1992-236 ("[t]he failure to report customer connection fees as income, and instead treat them as contributions to capital pursuant to section 118, is clearly not a timing issue.").

In summary, the initial membership fees paid by applicants for Full Memberships constitute contributions to the Club's capital and, therefore, not includable in the Club's gross income. However, the initial membership fees paid by applicants for Nonresident Memberships constitute payment for goods and services and, therefore, are includible in the Club's gross income. Finally, although the payments for the Nonresident Memberships constitute payment for goods and services rather than contributions to capital as originally reported, does not involve a change in accounting method.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:
None.

If you have any further questions, please call George Johnson at (202) 622-7930.

DEBORAH A. BUTLER

By: _____
STEVEN J. HANKIN
Branch Chief, Corporate Branch
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cc: Regional Counsel
Assistant Regional Counsel (LC)