TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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Dear **********:

This letter responds to your letter dated April 28, 2004, which you sent to Steven T. Miller. Mr. Miller, who is now Commissioner of the TE/GE Division, forwarded the letter to me and asked that I respond directly to you. You requested a general information letter addressing six tax law principles you feel affect the adult fitness industry.

Section 3.04 of Rev. Proc. 2004-4, 2004-1 I.R.B. 125 states that an "information letter" is a statement that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. We cannot address your principles numbers two and three because there is no published precedent that is applicable to them.

To help address your remaining principles, the following information should be helpful. Fitness clubs generally are exempt under section 501(c)(3) of the Code in two contexts: First, a fitness club can be part of a larger system such as a section 501(c)(3) hospital system or a university. Second, operating a fitness club can be an organization's primary activity. In the first instance, the question is whether the fitness club activity is substantially related to an exempt purpose, or whether the activity is an unrelated trade or business. In the second instance, the question is whether the fitness club activity furthers an exempt or non-exempt purpose. In either case, the analysis is similar. The rationale contained in Rev. Rul. 59-310, 1959-2 C.B. 146, can be applied to fitness clubs. The revenue ruling states an organization providing recreational property and its uses which are dedicated to members of the general public of the community and are charitable in that they serve a generally recognized public purpose which tends to lessen the burdens of government is an exempt activity under section 501(c)(3). Rev. Rul. 67-325, 1967-2 C.B. 113, further states community recreational facilities may be classified as charitable if they are available for the use of the general public.

Rev. Rul. 79-360, 1979-2 C.B. 236, holds that income from the operation of fitness club facilities in a commercial manner by a section 501(c)(3) organization, whose purpose was to provide for the welfare of young people, constituted unrelated business taxable income. The organization had a two-tiered fee structure. A higher fee was charged for an "executive" fitness program that provided more luxurious facilities and services than those available to the general membership at rates comparable to those charged by commercial health clubs in the area. The fees were sufficiently high to restrict participation to a limited number of the members of the community.

Thus, the ruling is based on the underlying proposition that an organization must benefit either the community in general or a charitable class within the community to be recognized as charitable, and that in order to be exempt from unrelated business income tax, a fitness club

must benefit a significant segment of the local population. If the activity achieves the organization's exempt purposes, the fact that fees are charged does not detract from the "relatedness" of the activity unless the existence and magnitude of the fees charged preclude the general community from benefiting from the activity. Generally, high fees might inhibit participation in the organization's activity to an extent that only a relatively small class of people in the community benefits (e.g., a relatively affluent group residing in a predominantly middle-income community). Where fees prevent the general community from obtaining the benefits of the activity, the activity cannot be deemed charitable and related to the exempt purposes of the organization. The community benefit test must be applied on a case by case, community by community basis; charges that preclude sufficient availability in one community may not do so in another. There is no precedential guidance that addresses the issue of what constitutes a "significant segment of the local population." Each case is resolved on the basis of facts and circumstances, and on a community by community basis.

Further, although health club operations are characterized essentially as recreational and not health promoting, there are very limited circumstances in which the activities of a fitness club may be deemed to promote health, such as situations in which a hospital creates facilities for patients to undergo rehabilitation.

In determining whether a fitness club activity is an unrelated trade or business, the analysis focuses on whether the activity is substantially related to an organization's exempt purpose. In order to be an unrelated business activity, an activity must meet three criteria: (1) it must be a trade or business; (2) it must be regularly carried on; and (3) it must not be substantially related to the accomplishment of the organization's exempt purposes. In the case of fitness clubs, the substantially related test is the key.

Providing recreational facilities to the general public can be an exempt purpose under section 501(c)(3) of the Code as long as the facilities are available to a wide segment of the community. Similarly, in order to be exempt from unrelated business income tax (“UBIT”), a fitness club conducted as an activity of an exempt organization must benefit a significant segment of the local population. The community benefit test is applied on a case by case, community by community basis; in making this determination, the analysis consists of weighing the facts and circumstances of each case. The same type of analysis also applies when a fitness club offers various levels of memberships for different charges.

In cases involving some mixture of exempt and unrelated activities, the proper analysis is based on section 513(c) of the Code and section 1.513-1(d)(3) the Income Tax Regulations, which indicate that income from a particular activity may be deemed unrelated even where the activity is an integral part of a larger complex of activities that may be in furtherance of an exempt purpose. This is commonly known as the fragmentation rule. The fragmentation rule provides that with respect to fitness clubs that operate as part of a larger exempt organization, the fitness club is analyzed separately to determine whether it generates unrelated business income

("UBI"). Additionally, each fitness club activity can be further fragmented so that one fitness club activity may be deemed to be related to exempt purposes while another fitness club activity may result in imposition of UBIT.

To summarize, in most cases, community benefit provides the basis for distinguishing exempt fitness clubs from their commercial counterparts. As in all cases, the burden is upon the organization seeking exemption to establish that it is, in light of all the facts surrounding its operations, engaged in an activity that furthers an exempt rather than a commercial purpose. This burden is not met by a showing the organization is otherwise exempt, for example as a hospital or an educational institution. In appropriate circumstances, the activities of a fitness club may be fragmented so as to subject those activities, which are indistinguishable from their commercial counterparts, to UBIT.

In regard to your principle number one, it is well established that recreational facilities benefiting the community as a whole qualify for section 501(c)(3) tax-exempt status. Where an otherwise tax-exempt organization operates a facility not accessible to the general community, the organization is generally subject to UBIT on the net income generated from the operation of the facility. Thus, as you suggest in your letter, to qualify for exemption a fitness center must provide recreational facilities available to the entire community.

In regard to your principle number four, you do not feel that tax-exempt fitness organizations are justified in their expansion into areas already well served by proprietary facilities by stating that better-paying clients in more affluent areas subsidize poorer areas. You feel the only criterion for a fitness facility's exemption is community accessibility. The Service has ruled that providing recreational facilities to the general public can be an exempt purpose under section 501(c)(3) of the Code, provided the facilities are available to a wide segment of the community. Similarly, in order to be exempt from UBIT, a fitness club or clubs must benefit a significant segment of the local population. The community benefit test is applied on a case by case, community by community basis; in making this determination, the analysis consists of weighing the facts and circumstances of each case.

In regard to your principle number five, you feel that the obligation to fulfill the requirements for a fitness club's exemption is annual and continuing and not merely a goal at the time of initial organization. Exempt organizations have a continuing obligation to demonstrate they have fulfilled the relevant criteria for exemption. Exempt fitness clubs must do more than just make a general statement they serve the community as a whole. Exempt fitness clubs, on an annual basis, must support their claim their facilities serve a wide segment of the community. As you are aware, Form 990 currently requests information about how a fitness club fulfills its exempt purpose.

In regard to your principle number six, you feel tax-exempt fitness clubs that do not fulfill the community accessibility standard are subject to UBIT. If an exempt fitness club offers fitness programs which do not serve the community as a whole, such programs constitute an unrelated trade or business. Therefore, the revenue from such fitness programs would be subject to UBIT. The fact a fitness club may conduct some activities that qualify for exempt status, such as youth education, does not protect its other activities from separate analysis as exempt or

non-exempt. As noted previously, a fragmentation approach is used to evaluate which activities of a fitness club serve an exempt function and which activities should be subject to UBIT. Thus, those activities which do not serve the community as a whole will be subject to UBIT.

I hope this information is helpful. If you have any questions, please contact **** ******

Sincerely,

Lois G. Lerner by LMB

Lois G. Lerner
Director, Exempt Organizations
Rulings & Agreements