

## Insurance Against Loss Of Initiation Fees

By Mitchell L. Stump, CPA

(Reprint from The BoardRoom January, 2002, a publication for private club directors)

From time to time, new products come on the market in which private Clubs have an interest. Club accountants and attorneys are often asked about the legitimacy of new products, wanting to have assurances that the Club does not find itself in a situation which will get them into hot water. This article will address a new product currently being offered to clubs—an insurance policy that protects a new member against the loss of non-refundable initiation fees that may occur when he or she must unexpectedly resign from their club due to relocation of employment.

A possible scenario: A successful, middle aged, executive accepts a new position with an employer in a new city. Being an avid sports enthusiast, plus wanting to find a comfortable place for fine dining, socializing and meeting with others, a new club membership is pursued. There may be several club opportunities available within the community, ranging from "inexpensive" to "quite exclusive". The newly hired executive is extremely interested in the "quite exclusive" club, but has one significant reservation. The executive is required to pay a significant nonrefundable initiation fee to join the "quite exclusive" club. What happens if, or when, there is an employment related transfer to another city? Will there be an unreimbursed financial loss to the executive of the initiation fee? The answer to this question has often been yes, which may have kept similarly positioned executives from joining the "quite exclusive" club of choice. Loss of potential members, for any reason, is always a concern of clubs.

### New Product

I have been made aware of an insurance policy being marketed to clubs, to protect against the loss of a club member's nonrefundable initiation fees. A press release from the organization marketing this product states: "This insurance is designed to overcome a commonly-heard objection to buying club memberships - that a member may have to resign and lose his or her initiation fee due to a job transfer." This article is not intended to be an endorsement of the insurance product reviewed, which will remain unnamed, or any others like it. However, the tax ramifications of entering into such a transaction, if any, should be addressed to help decide if the product can really work for a club.

As is often the case, 501(c)(7) tax-exempt membership organizations will want to know how it may affect their income tax status. All clubs will want to know whether the expense is member or nonmember related. From my analysis of the product and the applicable law, it appears that the IRS as a member related expense should consider the payment of any insurance premium by a club, insuring against a risk such as this. Although there is not a known IRS ruling directly on point with this specific type of product, clubs do have a history of insuring against a number of unexpected events. Events such as wind storms, hurricanes, tornadoes, fires, slip and falls, etc. are regularly insured against. Thus, the answer to this first question appears to be that the expense should be deemed to be an ordinary and necessary member related expense for both 501(c)(7) and Section 277 taxable clubs.

A second question may be asked regarding why a club would want to enter into such an insured transaction in the first place. Shouldn't it be the concern of the prospective new member, and not that of the club? No doubt the new member would be the direct beneficiary of the payout from an insurance claim. Clubs may deem insuring against the new members' potential loss an excellent marketing tool to attract otherwise disinterested individuals fitting the fact pattern noted in the situation above. When the club completes a cost/benefit analysis, it is possible that this type of program is of interest and is cost effective. An additional factor, which will probably be considered in the pricing of the insurance product is whether there is an isolated sale to a new member with high risk, verses volume coverage of all new members spreading the risk around.

Is there a problem of changing the financial structure of the Club, differing from prior years to meet the needs of a mobile society? Clubs historically have had a variety of scenarios when it comes to their joining fees. Some Clubs have fully refundable joining fees while others have none. Other Clubs have a calculated amount of refundable fees, such as eighty percent of the then going value of the membership, or a declining scale, based upon the number of years as a member. The point to make is that there are no set rules as to what can, or can not, be returned to a member upon their resignation from the Club. The determination of the amount, if any, to be refunded, is based in

part on the club's position in the marketplace and its need for new members. Thus, offering a new type of insured refundable initiation fee program does not appear to be beyond the reach of a club. It is possible that by-laws may need to be changed to accommodate a change in the current structure. 501(c)(7) tax-exempt Clubs would be required to disclose any changes to the IRS with its next tax return, putting the IRS on notice of the change.

If a Club enters into one of these insured transactions and submits a claim to the insurance carrier, based on the timing of a resigning member, is the income to be recorded as member or nonmember related? If the transaction was deemed to be a member related expense in the above paragraph, it will obviously be argued that the income should be classified as member related. In comparison to other situations, insurance proceeds collected from member related insured events at a club have been historically recorded as member related. Thus, it is assumed this new insurable event would fall into the same category.

Will there be an income tax reporting requirement of this transaction to the departing member? Will a Form 1099 be issued to the resigning member, reporting the repayment of the initiation fee? Because the transaction is not a payment in exchange for an ownership interest in the club, (such as the redemption of Club certificates or stock) the Form 1099-B does not appear to be applicable. The payment is not for services rendered, thus the Form 1099-Misc does not appear to be required. There is not an interest or dividend factor involved, thus those Form 1099 rules are not engaged. If the payment is only a previously agreed upon refund of initiation fees, Form 1099's do not appear to be required.

This type of insurance program will obviously not be of interest for all clubs. Some clubs will deem the insurance expense to be too great in relationship to the nonrefundable portion of their new member initiation fee. There will be other clubs that will see this as another marketing idea to be considered, in conjunction with an assortment of ways to attract new club members. Clubs must make sure that all of their marketing efforts comply with the tax reporting rules and that the club does not find itself with a potential loss of income tax exemption if a tax-exempt 501(c)(7) membership organization.

This document is not to be referred to as tax authority. It should be used as a guide in identifying tax issues in the club industry.  
Consult your tax adviser to analyze your specific tax situation.