

To: HBHYC Owners
From: Treasurer (Jay Kikkawa, I-19)

12/2/17

Dear Owners,

I am writing to update you on the Club's response to the IRS audit and to provide information about required changes to our lease policy. The IRS served HBHYC with two major document requests, one arriving in early August, and the second in September of this year. I have worked with our accountants at Mercadien to gather the requested information, and consulted with members of the Board and our lawyer Christine Li in formulating a response.

Many years ago, our Club filed a non-profit application as a 501C.7 "Social Club". More can be found at in the following IRS links:

<https://www.irs.gov/charities-non-profits/other-non-profits/social-clubs>

<https://www.irs.gov/pub/irs-tege/eotopic96.pdf>

As stated in the second link, these types of Clubs "should be taxed on all income derived from outside their membership, including investment income". A focus of inquiry for the IRS was our income from both short- and long-term leases, as well the consistency of our practices with our non-profit status. Mercadien played an important role in a communicating with the IRS to better understand the nature of the specific objections that they raised.

Short term leases (less than 30 days) are what we call "transient" leases, and HBHYC keeps 30% of the lease amount which is taxable as unrelated business income because transients are not members. Every source of advice on this topic appears to concur that transient income was taxable, and in fact we did declare the income as taxable in 2015 and 2016. In 2014 we did not. As part of the audit response we have filed an amended IRS 990T tax return to properly declare tax on 2014 transient income. After deduction of expenses, the net tax owed was minor (a few hundred dollars).

Long term leases (30 days or more, referred to as "seasonal" leases) presented questions that challenged our non-profit status. We needed to be careful how to respond to these questions and did so after extensive discussions with Mercadien, the IRS (through Mercadien), our lawyer, and the Board (as well as a few owners who were able to attend the last Board meeting). Our governing documents state that our facility is to be used only by "members". Transient boaters cannot be considered members in the Club due to their short length of stay, but that is consistent with this policy because they are not allowed to use the clubhouse. Thus, they have limited use of the facility. Our governing documents declare that lessees who stay 30 days or more are "associate members", and as such they are able to use the Club and its amenities, but who cannot vote as owners do. Thus, the fee that HBHYC collects from the leases it handles (10%) has not been considered taxable by HBHYC as it comes from "members".

Non-profits must never give services for free, or take money in excess of services provided (e.g.- profit). The IRS has correctly determined that certain private leases pay nothing to the Club, only an agreed lease amount to the slip owner. The IRS has stated that this practice is inconsistent with our non-profit status because the tenants do receive "associate membership status". The IRS remarked that this benefit appears to be provided for free by the Club. The IRS advised that HBHYC require an associate

member fee to be consistently paid with seasonal leases for the privileges of “associate membership”, regardless of the origin of the lease.

Some may argue that the tenant *indirectly* pays fees by reimbursing the owner for their lost use of the facility. Mercadien reported that this interpretation gained no traction with the IRS, who responded that an owner should not be able to “sell their membership” in a Social Club. Thus, even if an owner leases their slip, the IRS feels the owner should still be able to walk on the property, attend meetings, use the pool, etc., during the period of that lease. The bottom line is that certain tenants pay nothing to the Club and the IRS wants to see a fee consistently paid with each lease that confers “associate membership”, i.e.- any lease exceeding 30 days. Some might say that the 10% fee was a “management fee” for HBHYC obtaining the lease, but the IRS feels that even if this were the case the tenant should explicitly also pay for the benefits of their membership status. Others have suggested that our Club redefine itself as a different type of association, not a 501C.7 Social Club. Mercadien reports that the IRS feels that change would be irrelevant until it is enacted, and the Board believes that a petition to change our tax-exempt classification requires careful thought, legal advice, and extensive owner involvement and discussion.

The Board has concluded that to protect our current tax exempt status for the benefit of all owners, our best course of action is to alter the 10% fee that we currently collect on seasonal leases as follows: (A) **These fees will be renamed “associate membership fees”** in accord with the IRS suggestion. (B) **These fees need to be independent of the negotiated rate for the slip**, so they can no longer be defined as 10% of that rate (if a slip owner agrees to take \$1 for their share of a seasonal lease, the fee to HBHYC should not fall to 10 cents). (C) Owners may still negotiate whatever lease amount they collect from a tenant, but an Associate Membership Fee will be collected from **all tenants**. Item (C) effectively ends private leases, and we would like to point out that many private tenants have in recent years not even signed a contract agreeing to the terms of usage and the Rules and Regulations of the Club. Their rights to use the Clubhouse, Pool, etc, have not been clearly defined, and for many of them Mark did not have any insurance on file. Moving forward, a benefit of eliminating the private leases will be to hold all lessees to the same standards.

We believe owner discussion and input should determine the amount that we should charge for lease fees, and will hold open discussions during the summer of 2018 on this issue. Meanwhile, because leases for 2018 are being contracted now, and in order to comply quickly with the IRS, we have set the new fee for 2018 to be revenue neutral (i.e.to render the same total fees paid as collected under the prior 10% fee structure). The new fee schedule for 2018 is below showing a decrease in the fee to HBHYC compared to the 10% fee we already charge most leases in 2017. This decrease has been calculated to offset new fees that will be generated from a handful of existing private leases. The total recommended lease is unchanged from 2017, and therefore the recommended amount to the slip owner is increased. The fees will be pro-rated for partial leases.

Slip Length (ft)	2017 Summer 90% to Owner	2017 Summer 10% Fee to HBHYC	2017 Summer Lease Total	2018 Summer Lease to Owner	2018 Summer Fee	2018 Summer Total	2017 Winter 90% to Owner	2017 Winter 10% Fee to HBHYC	2017 Winter Lease Total	2018 Winter Lease to Owner	2018 Winter Fee	2018 Winter Total
35	\$ 4,552	\$ 505.80	\$ 5,058	\$ 4,606.39	\$ 451.61	\$ 5,058	\$ 783	\$ 87	\$ 870	\$ 792.32	\$ 77.68	\$ 870
40	\$ 4,832	\$ 536.90	\$ 5,369	\$ 4,889.63	\$ 479.38	\$ 5,369	\$ 895	\$ 99	\$ 994	\$ 905.25	\$ 88.75	\$ 994
45	\$ 5,111	\$ 567.90	\$ 5,679	\$ 5,171.95	\$ 507.05	\$ 5,679	\$ 1,007	\$ 112	\$ 1,119	\$ 1,019.09	\$ 99.91	\$ 1,119
50	\$ 5,391	\$ 599.00	\$ 5,990	\$ 5,455.18	\$ 534.82	\$ 5,990	\$ 1,119	\$ 124	\$ 1,243	\$ 1,132.02	\$ 110.98	\$ 1,243
60	\$ 5,951	\$ 661.20	\$ 6,612	\$ 6,021.64	\$ 590.36	\$ 6,612	\$ 1,343	\$ 149	\$ 1,492	\$ 1,358.79	\$ 133.21	\$ 1,492