DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Attn: Mandatory Review, MC 4920 DAL
1100 Commerce St.
Dallas, TX 75242

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: March 26, 2008

Number: **200825048**
Release Date: 6/20/2008

UIL: 501.07-01

LEGEND
ORG = Organization name Address = address XX = Date

ORG
ADDRESS

Employer Identification Number:
Person to Contact/ID Number:
Contact Numbers:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

In a determination letter dated June, 19XX, you were held to be exempt from Federal income tax under section 501(c)(07) of the Internal Revenue Code (the Code).

Based on recent information received, we have determined you have not operated in accordance with the provisions of section 501(c)(07) of the Code. Accordingly, your exemption from Federal income tax is revoked effective July 1, 20XX. This is a final adverse determination letter with regard to your status under section 501(c)(07) of the Code.

We previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On November 11, 20XX, you signed Form 6018-A, *Consent to Proposed Action*, agreeing to the revocation of your exempt status under section 501(c)(07) of the Code.

You have filed taxable returns on Form 1120, US Corporation Tax Return, for the years ended 20XX06, 20XX06, 20XX06 with us. For future periods, you are required to file Form 1120 with the appropriate service center indicated in the instructions for the return.

You have the right to contact the Office of the Taxpayer Advocate. Taxpayer

Advocate assistance is not a substitute for established IRS procedures, such as the formal Appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free, 1-877-777-4778, and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please contact the person whose name and telephone number are shown at the beginning of this letter.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations

DEPARTMENT OF THE TREASURY
Internal Revenue Service

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

October 1, 2007

ORG
ADDRESS

Taxpayer Identification Number:

Form:
990
Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear ,

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process,* explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues.* If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action.* We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Marsha Ramirez
Director, Exempt Organizations

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

LEGEND
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Issue:

Can the ORG retain its exempt status when it has investment income in excess of 35% and none of that income is set aside for charitable purposes?

Summary of Facts:

ORG was found to have investment income that constituted % of its total revenue for the year ended June 30th, 20XX, % for the year ended June 30th, 20XX, % for the year ended June 30th, 20XX and % for the year ended June 30th, 20XX. The organization did not file a Form 990-T for the years ended June 30th, 20XX, 20XX, 20XX, and 20XX and so could not declare any amount as set aside for charitable activity for those years.

The securities that generated the investment income are not state or municipal securities. The Other investment income was found to be loan repayments for loans made to ORG chapter(s) and was considered to be exempt function income.

Summary of Law:

Tax Regulation §1.501(c)(7)-1(a) states that the exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

Tax Regulation§1.501(c)(7)-1(b) states that a club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption. [Reg. §1.501(c)(7)-1.]

Internal Revenue Code Section 512(a)(1) states that except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on

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by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Internal Revenue Code Section 512(a)(3)(A) states that in the case of an organization described in paragraph (7), (9), (17), or (20) of section 501(c), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income).

Internal Revenue Code Section 512(a)(3)(B) states that for purposes of subparagraph (A), the term "exempt function income" means 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. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside for a purpose specified in section 170(c)(4).

Internal Revenue Code Section 512(a)(3)(B) defines 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. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside for Section 170(c)(4) purposes.

Internal Revenue Code Section 170(c)(4) states that in the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Revenue Ruling 76-337, 1976-2 CB 177, (Jan. 01, 1976) states that a social club exempt from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954 must include interest received on obligations issued by a State in gross income for the purpose of computing unrelated business taxable income under section 512(a)(3). Section 103(a) of the Code provides, in part, that gross income does not include interest on obligations of a State. *Held,* interest on obligations of a State received by a social club exempt under section 501(c)(7) of the Code is not included in gross income for the purpose of computing unrelated business taxable income under section 512(a)(3).

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Tax Regulation §1.6033-2(d)(1) states that organizations described in section 501(c)(8) or (10) (and, for taxable years beginning after December 31, 19XX, organizations described in section 501(c)(7)) that receive contributions or bequests to be used exclusively for purposes described in section 170(c)(4), 2055(a)(3), or 2522(a)(3), must attach a schedule with respect to all gifts which aggregate more than $ from any one person showing the name of the donor, the amount of the contribution or bequest, the specific purpose for which such amount was received, and the specific use to which such amount was put. In the case of an amount set aside for such purposes, the organization shall indicate the manner in which such amount is held (for instance, whether such amount is commingled with amounts held for other purposes). If the contribution or bequest was transferred to another organization, the schedule must include the name of the transferee organization, a description of the nature of such organization, and a description of the relationship between the transferee and transferor organizations. (2) For taxable years beginning after December 31, , such organizations must also attach a statement showing the total dollar amount of contributions and bequests received for such purposes which are $ or less.

In *Pittsburgh Press Club v. U.S.*, 536 F.2d 572 (1976); 579 F.2d 751 (1978); and 615 F.2d 600 (1980), the court found that a substantial portion of the club's total gross receipts was from nonmember use of club facilities (determined to be between 11-17% of gross income). This indicated to the court that the club was engaged in business with the general public. Other factors noted by the court to consider in addition to the level of nonmember income include the purposes for which the club's facilities were made available to nonmember groups, the frequency of use of the club facilities by nonmembers, and the amount of net profits derived from the nonmember income. In determining a club's net profits from nonmember use, the court found it proper to charge against the outside banquet income the cost of goods sold, as well as those variable costs directly attributable to outside banquets (such as sales taxes, salaries of employees earned while assigned to outside functions, and supplies used specifically for the outside functions). The court found it improper, however to charge against the outside banquet income fixed costs which the club's members would have to bear in the absence of nonmember income (such as rent, depreciation, utilities, maintenance, etc.). The court sanctioned this allocation method only with regard to determining net profits from nonmember income. For example, this situation should be distinguished from the proper method of allocating expenses for the purpose of determining unrelated business income tax in cases involving dual use of facilities or personnel provided for in Reg. 1.512(a)-1.)

Public Law 94-568, 1976-2 C.B. 596 changed the language of IRC 501(c)(7) from "exclusively" to "substantially all" activities should be exempt function activities in order to remain qualified to be an exempt organization. It also imposed what is called the 35/15 percentages. No more then 35% of gross receipts can be from non-exempt sources out of which no more then 15% can be from non-members. Organizations that have gross receipts in excess of these amounts can loose their exempt status subject to a facts and circumstances determination.

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Revenue Procedure 71-17 states that those activities not associated with members must provide records proving that the non-members are quests of the members, the members pay for their quests, and the records and documents kept by the club shows and verifies this assertion. Otherwise, all non-member revenue is considered an unrelated business activity.

In *Portland Golf Club v. Commissioner, supra.*[2], the Supreme Court held that the IRC 501(c)(7) exempt social club is allowed to offset investment income by losses incurred in sales to nonmembers only if those sales were motivated by an intent to profit. The Supreme Court further held that an intent to profit is determined by using the same method to allocate fixed costs to nonmember sales as that used to compute the club's actual profit or loss. Applying this standard, the Court determined that Portland failed to show that it had intended to earn gross income from nonmember sales in excess of its total cost. Therefore, the club lacked the requisite profit motive with regard to this activity. The Court initially considered the issue of whether Portland Golf Club must show that nonmember sales were motivated by an intent to profit in order to offset investment income with losses from such sales. It held that profit motive is essential.

To come to this conclusion, the Court analyzed the language of IRC 512(a)(3)(A). IRC 512(a)(3)(A) defines the term "unrelated business taxable income" as it relates to social clubs as meaning "the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income)." The Court viewed the inclusion of the phrase "allowed by this chapter" as limiting deductions to Chapter 1. Thus, only deductions that meet the criteria of IRC 162(a) are permitted. Under IRC 162(a), expenses must be incurred in connection with a "trade or business." The Court cited a previous ruling[3] in stating that trade or business activities fall within the scope of IRC 162(a) only if an intent to profit has been shown.

Although conceding that generally a profit motive is vital in determining whether an activity is a trade or business, the Club argued that by including receipts from nonmember sales within the definition of "unrelated business taxable income" as that term is used in IRC 512(a)(3)(A), the Code has implicitly designated such sales as a trade or business. Consequently, there is no reason to question an intent to profit from this source; the activity is already within the definition. The Court dismissed that argument. In its opinion, the use by Congress of the word "business" within the phrase "unrelated business taxable income" in IRC 512(a)(3)(A) to refer to all receipts other than payments from members "hardly manifests an intent to define as a 'trade or business' activities otherwise outside the scope of IRC 162." The opinion noted further that the club's reading would "render superfluous the words 'allowed by this chapter' in IRC 512(a)(3)(A): if each taxable activity ... is 'deemed' to be a trade or business, then *all* of the expenses 'directly connected'... would presumably be deductible." The Court concluded that a social club is required to demonstrate an intent to earn gross receipts in excess of both variable and fixed costs

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to show an intent to profit. In so doing, the Court also determined the proper method of allocating a share of the fixed costs to nonmember sales.

The Ninth Circuit, in remanding the case back to the Tax Court, had ruled that some allocation of the fixed costs was necessary but had left open the possibility that the social club could apply an allocation method different from that used in calculating its actual losses. This rationale was perceived by the Supreme Court as an "inherent contradiction." It ruled that a club must allocate fixed expenses between member and nonmember sales according to the same method used in computing actual profit or loss. According to the Court, since Portland Golf Club's calculation of actual losses rests on its position that a portion of its fixed expenses is properly deemed as attributable to the production of income from nonmember sales, these expenses cannot be ignored or attributed to the Club's exempt activities in determining whether the Club had acted with the required profit motive. Having relied on the gross-to-gross allocation method in figuring actual losses, Portland Golf, according to the Court, is then foreclosed from arguing that some other allocation method more accurately reflects the economic reality of intent to profit.

The Court noted that it is not advocating that any particular method of allocating fixed expenses must be used by social clubs. Rather, it was holding only that the allocation method used in determining actual profit or loss must also be used in determining whether a social club acted with a profit motive.

In Atlanta Athletic Club v. Commissioner, T.C. Memo 1991-83 (1991), cites Portland Golf Club as authority. In *Atlanta*, we get some insight as to the direction the Tax Court will follow in light of *Portland*. Atlanta Athletic Club is an exempt social club that had unrelated business taxable income from the following sources: (1) investment income; (2) food and beverage sales to nonmembers; (3) use of facilities, such as the golf greens and tennis, athletic, and aquatic centers, and amateur tournaments for nonmembers; and (4) two professional golf tournaments. The Club aggregated the income and expenses from the nonmember "undertakings" (the term used by the court to characterize all nonexempt, non-member functions), offsetting the losses from the sales of food and beverages to nonmembers and the nonmember golf days against the income received from the tournaments. The Club further offset the excess losses from the nonmember undertakings taken as a whole against its investment income.

Among the issues facing the court, pertinent ones for this discussion include: (1) whether the nonmember undertakings listed above constitute one activity or three separate activities; (2) if all nonmember activities are considered one activity, then whether Atlanta Athletic Club is entitled to offset its losses from all such undertakings against its gross receipts from all such undertakings; and finally, (3) whether the Club can offset losses from nonmember undertakings against its investment income.

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The Tax Court held that the Club is not entitled to offset the losses from its nonmember undertakings against its investment income for the taxable years in question because it did not enter into such undertakings with an intent to profit. It further held that the Club's undertakings, excluding investment income, constitute one activity; and, therefore, the Club is entitled to offset its losses from all such undertakings against its gross receipts from all such undertakings, excluding investment income.

In Zeta Beta Tau Fraternity V Commissioner of Internal Revenue (87 T.C. 421), the tax court held that it is intended that a social club, national organization of a college fraternity or sorority, and any other organization exempt under section 501(c)(7) may receive the full 35-percent amount of its gross receipts from investment income sources and that these sources are considered to be an activity not related to its exempt purpose.

Government Position:

The amount of money properly set aside is not subject to unrelated business income tax. However, it must be properly set aside. In order to make sure that the money is not taxable, ORG should show the set-aside money, and associated charitable activity and donations, in it's Form 990 return. Schedule G of the 990-T should have been filed, with the applicable attachments, disclosing the set aside revenue. None of this was done. There is no evidence to verify that the investment income was used for any charitable purposes.

Thus, the full amount of investment income is classified as unrelated business income and is taxable as such. No charitable deduction can be taken, because no charitable amount can be confirmed. Furthermore, the investment income exceeds the 35% of gross receipts limit established by Public Law 94-568, 1976-2 C.B. 596. In the absence of any additional evidence to consider, the exempt status of ORG should be revoked effective July 1st, 20XX.

The ORG will need to file 1120 tax returns for the years ended June 30th, 20XX, June 30th, 20XX and June 30th, 20XX with the Revenue Agent who performed the examination for the year ended June 30th, 20XX.

The total amount of taxes owed for the tax years ended June 30th, 20XX, June 30th, 20XX and June 30th, 20XX is:

Year	Taxable Revenue	Expense	Specific Deduction	Taxable Income	Tax
20XX06	$	$	$	$	
20XX06	$	$	$	$	
20XX06	$	$	$	$	

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Total Tax Due $

This chart summarizes the attached information. The amounts spent for ORG were not considered to be charitable expenses and were not deducted as such from the attached sheets. The above tax amounts are based on the filing of a Form 990-T.