

**Internal Revenue Service**  
Appeals Office  
Attn:  
Royal Palm One, Suite 350  
1000 South Pine Island Road  
Plantation, FL 33324

Number: **200919072**  
Release Date: 5/7/2009  
Date: **FEB 13 2009**

\*\*\*\*\*  
\*\*\*\*\*  
\*\*\*\*\*

**Department of the Treasury**

**Person to Contact:**

Employee ID Number:  
Tel:  
Fax:  
**Refer Reply to:**  
AP:FE:FLL:GRP  
**In Re: \*\*\*\*\***  
**Year(s):**

UIL: 7428.05-00

To :

We have considered your appeal of the revocation your tax-exempt status under section 501(c)(7) of the Internal Revenue Code for the \*\*\*\*\*.

Your exemption from Federal income tax under Section 501(c)(7) of the Internal Revenue Code is hereby revoked. This is a final adverse determination letter. You are required to file Federal income tax returns on Form 1120 for any years, which are still open under the statute of limitations.

Consideration was given to whether you qualify for exemption under other subsections of section 501(c) of the Code; however, we have concluded that you do not qualify under another subsection.

We will notify the appropriate State officials of this action, as required by Code section 6104(c).

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely,



Charles F. Fisher  
Appeals Team Manager



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service  
TE/GE EO Examinations  
1100 Commerce St.  
Dallas, Texas 75242

January 8, 2007

ORG  
ADDRESS

Taxpayer Identification Number:

Form:

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 A. Ramirez  
Director, EO Examinations

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

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer		Year/Period Ended
ORG		December 31, 20XX

**LEGEND**

ORG = Organization name      XX = Date      motto = motto

**ISSUES UNDER CONSIDERATION**

Issue 1: Whether an organization that receives more than an insubstantial amount of their income from nonmember sources qualifies for exemption under Internal Revenue Code section 501(c)(7)?

Issue 2: Whether the receipts from motto inure to the benefit of the members?

**FACTS**

The ORG was incorporated in 19XX and was granted tax exemption under Internal Revenue Code section 501(c)(7) as a social club in a letter from the Internal Revenue Service dated October 9, 19XX.

The purpose of the ORG is to operate a social club for the benefit of the members, and to support by all reasonable and necessary means, the raising of funds for charitable endeavors.

The organization achieves its purpose by conducting gaming activities and providing a restaurant to its members. The activities for this organization are providing a venue for its members to play various card games.

The ORG operates gaming activities (motto) that are being conducted with members of the general public. The breakdown of income from unrelated sources and the corresponding percentage of total revenue is as follows:

	Tax Year Ended 12/31/20XX			
Nonmember Use of Facilities				
Investment Income				
Total Unrelated Business Income				
Total Revenue				
UBI Percentage of Total Revenue	33.35%	79.09%	29.43%	37.58%
Percentage of Nonmember Use of Facilities	33.09%	78.99%	29.07%	37.13%

Form <b>886A</b>	Department of the Treasury · Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer  <b>ORG</b>		Year/Period Ended  December 31, 20XX

Percentage of Investment Income	0.25%	0.11%	0.36%	0.45%
---------------------------------	-------	-------	-------	-------

The amounts for the tax year ended December 31, 20XX are significantly larger than the prior and subsequent two years as a result of the examination. The examination revealed that the organization reported the net motto receipts on Form 990-T, and the revenue in the table above lists gross receipts as determined during the examination for the tax year ended December 31, 20XX. The figures for the prior and subsequent two years are based upon the information on the organization's Forms 990 and 990-T which were not examined. The organization uses 95 percent of gross receipts for motto as the non-member amount reported on Form 990-T as unrelated business income. The organization does not currently keep records of the non-member activity but uses the percentage based on the amount of non-members at the motto games when records were kept on this activity.

The motto receipts from the gaming activities are used to fund activities for the social club. The organization uses proceeds from the motto receipts to fund other activities for members of the club.

#### LAW AND ARGUMENT

Internal Revenue Code 501(c)(7) describes as exempt, as provided under IRC 501(a), "clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder... An organization which engages in business such as making its social and recreational facilities available to the general public... is not organized and operated for pleasure, recreation, and other non-profitable 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 organization is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes..."

The tax treatment of social clubs is designed to allow individuals to join together to provide themselves with recreational or social facilities on a mutual basis without tax consequences. It operates properly only when the club's sources of income are limited to its membership, so the member is in substantially the same position as if he had spent his after-tax income on pleasure or recreation without the intervening organization.

Section 501(c)(7) was amended in 1976 to provide that social clubs could receive some income from sources outside the membership without losing their exempt status. The legislative history indicates that Congress intended to liberalize prior IRS limitations on the portion of income a social club may receive from nonmember use of its facilities and investment income. However, the Senate committee report states the intent is not "that these organizations should be permitted

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer  ORG		Year/Period Ended  December 31, 20XX

to receive, within permitted allowances, income from the active conduct of businesses not traditionally carried on by these organizations."

The Committee Reports for Public Law 94-568 (Senate Report No. 94-1318 2d Session, 1976-2 C.B. 597) states that it is intended that social clubs should be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their memberships without losing their exempt status.

(a) Within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter do not represent more than 15 percent of total receipts.

(b) Thus, a social club may receive investment income up to the full 35 percent amount of its gross receipts, where a social club receives no income from non-members' use of club facilities.

(c) In addition, the Committee Reports state that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facilities, that income is not to be included in the 35 percent formula.

Internal Revenue Code (IRC) section 512(a)(1) states that "unrelated business taxable income" is the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business.

IRC section 512(a)(3)(A) states that in the case of an organization described in IRC section 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed which are directly connect with the production of the gross income (excluding exempt function income).

Internal Revenue Code 512(a)(3)(B) exempts social clubs only to the extent of their "exempt function income," which is defined as the gross income from dues, fees, charges, and other income generated by club members pursuant to the organizations' nonprofitable purposes. Income received from the general public or from investments is treated as unrelated business taxable income and is taxed at general corporate rates.

Examples of taxable income include investment income or income generated from nonmembers through traditional activities: i.e., those activities that if conducted with members further a social purpose.

Revenue Procedure 71-17 details Public Law 94-568 and sets forth the guidelines for

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer  ORG		Year/Period Ended  December 31, 20XX

determining the effect gross receipts derived from use of social club's facilities by the general public has on the club's exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code. These guidelines will be used in connection with the examination of annual returns on Forms 990 and 990-T filed by social clubs. This revenue procedure also describes the records required when nonmembers use a club's facilities and the circumstances under which a host-guest relationship will be assumed, which are relevant both for purposes of determining adherence to the exemption requirements and for computing exempt function income under section 512(a)(3) of the Code.

Section 3.01 of Revenue Procedure 71-17, describes the minimum gross receipts standard, and states, in part, as follows:

"A significant factor reflecting the existence of a nonexempt purpose is the amount of gross receipts derived from use of an organization's facilities by the general public. As an audit standard, this factor alone will not be relied upon by the Service if annual gross receipts from the general public for such use is \$ 2,500 or less or, if more than \$ 2,500, where gross receipts from the general public for such use is five percent or less of total gross receipts of the organization . . ."

Prior to the enactment of Public Law 94-568, an organization was required to be organized and operated exclusively for pleasure, recreation and other non-profitable purposes.

The Committee Reports show that the wording change was intended to make it clear that social clubs may receive up to 35 percent of their gross receipts, including investment income from sources outside their membership without losing their exempt status. Within this 35 percent limitation, no more than 15 percent of gross receipts may be derived from non-member use of the organization's facilities and/or services.

Section 4 of Revenue Procedure 71-17 provides the recordkeeping requirements. Section 4.03 of Revenue Procedure 71-17 states that the occasions involving use by non-members the club must maintain books and records of each such use and the amount derived therefrom. This requirement applies even though the member pays initially for such use. In each instance, the record must contain the following information:

- 1) the date;
- 2) the total number in the party;
- 3) the number of non-members in the party;
- 4) the total charges;

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer		Year/Period Ended
ORG		December 31, 20XX

5) the charges attributable to non-members;

6) the charges paid by nonmembers; and

7) where a member pays all or part of the charges attributable to non-members, a statement signed by the member indicating whether the payment has been or will be reimbursed for such non-member use, and if so, the amount of the reimbursement.

Section 4.04 of Revenue Procedure 71-17 provides that if a club fails to maintain or make available the records required by that revenue procedure, the percentage guidelines may not be used in the determination of whether the club has a non-exempt purpose.

In addition, the statute prohibits exemption under section 501(c)(7) if any part of the organization's net earnings inures to the benefit of any private shareholder.

Traditionally, inurement has been found to be present where an organization derives income from non-member sources and uses it to reduce the cost of providing services to members.

Revenue Ruling 58-589, published in Cumulative Bulletin 1958-2, page 266, states, in part, as follows:

"Net earnings may inure to members in such forms as an increase in services offered by the organization without a corresponding increase in dues or other fees paid for organization support or as an increase in the organization's assets which would be distributable to members upon the dissolution of the organization."

Revenue Ruling 79-145, published in Cumulative Bulletin 1979-1 on page 360, states that "amounts paid to a social club by visiting members of another social club are amounts paid by nonmembers, even though both clubs are of like nature and the amounts paid are for goods, facilities, or services provided by such social club under a [reciprocal] arrangement with such other social club."

## GOVERNMENT'S POSITION

### Issue 1:

A social club's exemption does not operate properly when it receives income from sources outside its membership, because the members will receive a benefit not contemplated by the statute in that untaxed dollars are used by the organization to provide pleasure or recreation to its membership. To prevent club members from receiving benefits not contemplated by IRC 501(c)(7), the receipt of nonmember income and investment income is permitted up to certain limits without jeopardizing exemption, but the net income from these sources is made taxable by

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer  <b>ORG</b>		Year/Period Ended  December 31, 20XX

the clubs by IRC 512(a)(3).

A nonmember is considered to be a person from the general public who is provided recreational and social services by the organization and pays for these services. A paying nonmember is a purchaser of the goods or services provided by the organization, and is a direct recipient of those goods or services from the organization. Such a nonmember is not considered to be entertained by a member even when accompanied by a member but is instead considered to be a principal in a business transaction with the organization. The host-guest relationship is missing when the nonmember pays.

A social club may derive up to 15% of its gross receipts from nonmember use of club facilities and/or services without jeopardizing its exempt status. It is important to distinguish nonmember use from member use of the facilities and services. An issue that arises is whether an individual or a group is a true guest of a member. This is important because income from bona-fide guests is treated as member income. The amendment to IRC 501(c)(7) by P.L. 94-568 does not affect what constitutes public use of club facilities and prior precedent on this question should still be followed.

Where goods or services are furnished to nonmembers who provide payment for such goods or services, their furnishing is outside the scope of section 1.501(c)(7)-1(b) of the regulations. Generally, if an organization has not kept adequate books and records concerning its financial transactions with nonmembers and more than 15 percent of its gross receipts are derived from sales transactions to non-members, the presumption will be that the organization's exempt status should be revoked because it is not primarily engaged in section 501(c)(7) activities.

All income of an organization that is otherwise organized and operated within the meaning of IRC 501(c)(7) should be considered as income from unrelated business if no records are maintained to determine if such income is related to exempt activities/purposes, (note: IRC 512(b) provides modifications to the definition of unrelated business taxable income. Therefore, income from sources not related to exempt activities/purposes might not be considered as unrelated business taxable income. For example, hall rental income would not be unrelated business taxable income (UBTI) unless services are rendered or the property is "debt-financed".)

Income that an organization claims is related or partially related to exempt activities/purposes of the organization must be substantiated by the maintenance of records by the organization in sufficient detail to determine whether the income is related to the exempt activities/purposes of the organization and whether the income is derived from members or nonmembers.

Based on completing a four-year income analysis during tax periods ending December 31, 20XX to December 31, 20XX, it has been determined that the organization has been unable to provide an accurate account of nonmember income as outlined in Public Law bulletin 94-569.

Furthermore, the organization has failed to maintain books and records regarding member and

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
Name of Taxpayer		Year/Period Ended
ORG		December 31, 20XX

nonmember income. In addition, using the organization's estimate of 95 percent of motto activities as non-member the organization fails to meet the income allowed in PL 94-569 as income from sources outside of a social club's membership.

**Issue 2:**

The motto receipts from the gaming activities are used to fund activities for the social club. The organization uses proceeds from the motto receipts to fund other activities for members of the club. By funding other activities the organization is reducing club expenditures which in turn reduces membership dues. A reduction of membership dues due to income from nonmembers constitutes inurement to the members of this organization. Section 501(c)(7) of the Internal Revenue Code prohibits inurement to members of organization exempt under this Section.

**CONCLUSION**

During the examination it was determined that the gross receipts that were attributed to nonmembers use of the organization's facilities were approximately 79% for the period ending December 31, 20XX, 33% for the period ending December 31, 20XX, 29% for the period ending December 31, 20XX, and 37% for the period ending December 31, 20XX. Therefore, nonmember income is substantial and is not within the 15% or 35% limited established under Public Law 94-568.

The net receipts from the gaming activities inure to the benefit of the members, the expenses of the social club are reduced, due to the fact the gross receipts from the gaming activities are being used to bring more funds into the club. Section 501(c)(7) states that no part of the net earnings shall inure to the benefit of any private shareholder or individual.

Based upon the information noted above, it is proposed the exempt status of the organization be revoked as of the fiscal year, December 31, 20XX.