



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

501.07-00

Date: April 30, 2010

Release Number: 201032046
Release Date: 8/13/2010

LEGEND

ORG = Organization name XX = Date
Address = address
ORG
ADDRESS

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

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear _____ :

In a determination letter dated January 12, 19XX, you were held to be exempt from Federal income tax under section 501(c)(7) 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)(7) of the Code. Accordingly, your exemption from Federal income tax is revoked effective April 1, 20XX. This is a final adverse determination letter with regard to your status under section 501(c)(7) 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 April 3, 20XX, you signed Form 6018-A, *Consent to Proposed Action*, agreeing to the revocation of your exempt status under section 501(c)(7) of the Code.

You are required to file Form 1120 U. S. Corporation Income Tax Return with the Ogden Service Center. You have filed taxable returns on Form 1120 U. S. Corporation Income Tax Return for the years ended March 31, 20XX and March 31, 20XX with us. In addition, 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, 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,

Nanette M. Downing
Director, EO Examinations



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
55 N. Robinson, MC 4900-OKC:EO-as
Oklahoma City, OK 73102

March 10, 2009

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,

Sunita B. Lough
Director, EO Examinations

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

Form 886A	Department of the Treasury - Internal Revenue Service	
Explanation of Items		
Name of Taxpayer		Year/Period Ended
ORG (EIN:)		3-31-20XX

LEGEND

ORG = Organization name XX = Date Address = address City = city CO-1, CO-2, CO-3, CO-4, CO-5, CO-6 & CO-7 = 1ST, 2ND, 3RD, 4TH, 5TH, 6TH, & 7TH COMPANIES

Issue: Is ORG exempt from federal income tax as an organization described in Internal Revenue Code ('IRC') section 501(c)(7).

Facts:

The following facts were determined in the examination of ORG's Form 990, Return of Organization Exempt From Income Tax, and Form 990-T, Exempt Organization Business Income Tax Return, for the year ended March 31, 20XX:

ORG was originally issued a charter as an organization whose stated purpose was to "support ... any educational undertaking, and particularly to bring together business leaders of various industries and professions to discuss, review, promote and aid activities of the various citywide philanthropic and business organizations of the City of City, ... shall have no social, athletic or sporting events, activities or features, which are subordinate and merely incidental to the active furtherance of the predominant purposes of said corporation..."

ORG had applied for and been determined to be an organization exempt under IRC section 501(c)(6). That exempt status was changed and in a letter dated January 12, 19XX, from the Internal Revenue Service's District Director, ORG was advised that its exempt status is changed to IRC section 501(c)(7) effective April 1, 19XX.

ORG's restated Articles of Incorporation dated September 21, 19XX states that it is "...not organized for profit, but it is organized and shall be operated exclusively for pleasure, recreation and other non-profitable purposes. The purpose of the Corporation is to organize and sponsor organized group social and recreational activities for its members and to promote, encourage and sponsor good fellowship among its members."

The ORG's club facility is currently located in the CO-1 address. It currently operates a restaurant for its members that is open Monday through Friday for breakfast and lunch (buffet and a la carte dining) and Tuesday through Friday for dinner. Its members pay an initiation fee and monthly dues, with the amount of the monthly dues based on membership class.

Non-membership receipts:

ORG's house rules states that members are expected to escort their guests at all times unless the member has made special arrangement in advance with ORG. Its members are allowed, with prior arrangement, to have 12 different guests use the club without the member being present during a 12 month period. A nonmember who uses ORG as a member's guest in this manner is charged a \$ guest fee in addition to the charges for the guest's food and beverage. ORG recorded these guest fee charges and food and beverage charges of those guests of members who used ORG without the member being present as member receipts. ORG reported these nonmember receipts on its Form

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990 as member revenues. These nonmember receipts were not reported as gross unrelated business income by ORG on its Form 990-T.

ORG derived additional nonmember receipts through its participation in a reciprocal arrangement in which a ORG member may use the facility of a participating social club though not a member of that social club and members of participating social clubs may use ORG's facility though not a member of ORG. Nonmembers who use ORG pay ORG for their food and beverage service. ORG reported the food and beverage charges of this nonmember patronage of ORG through the reciprocating arrangement as member revenues on its Form 990. ORG did not report the nonmember food and beverage receipts as gross unrelated business income on its Form 990-T.

ORG derived revenues (referred to as 'billable income' by ORG) for room rental and other services where ORG incurred charges in providing the events' services. These incurred charges include charges from event services providers, chair rentals, interior decorations, parking services, flowers, cakes, and other items specific to the event. The examination determined that for these 'billable income' charges ORG netted the revenue against the related expenses (e.g. the cost of the flowers or cake) and had reported the net amount on the Form 990. Where ORG had identified the customer as a nonmember, the net amount was reported on the Form 990-T.

ORG makes its facility available to members and nonmembers for banquets. The charges for food and beverage service are dependent upon the dates and times of rental and the extent of food and beverage service. ORG reported as nonmember revenues banquet food and bar sales to groups it had identified as nonmembers.

The examination also determined that ORG had derived revenues from nonmembers of forfeited deposits and non-refunded overpayments. These revenues, totaling \$ are reported by ORG as member revenues.

The examination's review of the banquet revenues classified and reported by ORG as member revenues determined that ORG had not obtained nor maintained documentation for the event sufficient to establish the host-guest relationship where the party was more than eight persons. ORG's records indicated the number in the party but not the number of nonmembers nor the charges attributable to nonmembers or the charges paid by nonmembers. Its records did not include a statement from the member whether the member has been, or would be, reimbursed for the nonmember use. In those cases where the member may have been reimbursed by the member's employer, ORG did not obtain (nor did it maintain) a signed statement from the member as the employer's name, amount of payment attributable to the nonmember use, the nonmember's name and business or other relationship to the member and the business, personal or social purpose of the member served by the nonmember use.

The examination tested the banquet food sales (gross receipts of \$ of which 69.82%, \$ ORG identified as nonmember receipts). Banquet food receipts of March 20XX (\$) classified by ORG as member receipts were selected to determine if the records to substantiate the receipts as member sourced had been maintained by ORG. Of this \$ the examination determined that ORG had not

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maintained the records set out in Revenue Procedure 71-17, 1971-1 C.B. 683, to establish that \$ (83%) were member sourced receipts.¹ If these results were applied to the banquet food and bar sales, \$ of member banquet food sales of \$ would be reclassified as nonmember receipts and \$ of member bar sales of \$ would be reclassified as nonmember receipts.

The examination also determined that ORG did not obtain or maintain documentation sufficient to establish the host-guest relationship where the party was more than eight persons for those events recorded as member revenue to the 'billable income' account.

Gratuity charge:

ORG charged a 20% service charge on food and beverage charges as an automatic gratuity. In the year ended 3-31-20XX this 20% service charge totaled \$. This service charge was not reported as a revenue item on Form 990 (or Form 990-T) but was offset against wages so the amount reported as Wage expense on Form 990 and Form 990-T was net of this amount. .

Examination Adjustments to Reported Nonmember Revenues:

The examination made the following adjustments to ORG's gross nonmember revenue reported on the Form 990-T for the year ended 3-31-20XX:

	As Reported:		Adjusted:
	Total Gross Receipts	Nonmember Receipts	Nonmember Receipts, Adjusted
Banquet food revenue			
Banquet bar revenue			
Billable revenue			(d)
Gross Receipts, As reported:			
Examination Adjustments-			
\$ guest fee			(a)
Guest food and beverage charges:			(b)
Reciprocal (nonmember) guest charges:			(c)
Reported Net 'Billable' revenue:			(d)
Gross 'Billable' revenue:			(d)
Miscellaneous income			(e)
Gratuity			(f)
Gross Receipts, As adjusted:			

* * * *

¹ Comprised of: CO-2- \$ CO-1- \$; City of City- \$; CO-3- \$; CO-4- \$; CO-5- \$; CO-6- \$; CO-7- \$; CO-7- \$.

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Explanation of Adjustments:

- (a) 424 guest fee charges; fee of \$ per guest
- (b) As guest food and beverage charges had been included as dining room revenues and all such revenue reported as member revenue, an estimate of the year's nonmember guest food and beverage charges is made by multiplying the guest food and beverage charges of May 20XX, \$, by 12. Annual guest food and beverage charges is estimate as \$\$, not including the 20% gratuity added to all food and beverage sales.
- (c) Reciprocal nonmember receipts were \$\$.
- (d) ORG had reported net 'billable' revenues, net of the expenses that were associated with these revenues. The adjustment reverses the net amount and reports the gross amount for nonmember events identified by ORG.
- (e) The adjustment classifies as nonmember receipts the Miscellaneous income that had been reported as member receipts.
- (f) The 20% gratuity charged on food and beverage charges that had been netted against wage expense is classified as revenue. The gratuity on nonmember food and beverage charges of \$\$ (\$\$, \$\$, and adjustments of \$\$, \$\$) is \$\$.

The nonmember receipts as a percentage of total receipts, as reported and as adjusted, increased from 50% to 57%:

For year ended 3-31-20XX:	Total Gross Receipts	Nonmember Receipts
As Reported:	_____	_____
Nonmember receipts as percentage of total receipts:	_____	#DIV/0!
As Adjusted:	_____	_____
Nonmember receipts as percentage of total receipts:	_____	#DIV/0!

This adjusted nonmember receipts of 57% does not give effect for the reclassification of member banquet food and bar receipts from member to nonmember because ORG did not have documentation set out in Revenue Procedure 71-17 to substantiate classification as member sourced receipts. If the testing results for March 20XX were applied to the banquet and bar receipts classified as member receipts by ORG, nonmember receipts would be \$\$,² 67% of total gross receipts.

A review of ORG's Form 990 and 990-T of the prior and subsequent year determined that its nonmember receipts comprised a substantial portion of its total receipts, 45% for the year ended 3-31-20XX and 46% for the year ended 3-31-20XX:

* * * *

² \$\$ is sum of adjusted nonmember receipts of \$\$ and reclassified member banquet food receipts of \$\$ and banquet bar receipts of \$\$.

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	Total Gross Receipts	Nonmember Receipts
For year ended 3-31-20XX:		
As Reported:	_____	_____
Nonmember receipts as percentage of total receipts:	_____	#DIV/0!
For year ended 3-31-20XX:		
As Reported:	_____	_____
Nonmember receipts as percentage of total receipts:	_____	#DIV/0!

Law:

IRC Section 501(a) provides an exemption from federal income tax for organizations described in section 501(c), including organizations described in section 501(c)(7). An organization is described in Section 501(c)(7) if it is a club 'organized for pleasure, recreation, and other nonprofitable 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.'

Income Tax Regulation ('Regulation') 1.501(c)(7)-1(a) states, in part exemption is provided only to "clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes..." and "...exemption extends to social clubs and recreation clubs which are supported solely by membership fees, dues, and assessments."

Income Tax Regulation ('Regulation') 1.501(c)(7)-1(b) states, in part, "(a) club which engages in business, such as making its social and recreational facilities available to the general public ... is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a)."

That a social club will not qualify as an organization described in IRC section 501(c)(7) if it makes its social and recreational facilities available to the general public is defined in Revenue Procedure 71-17, 1971-1 C.B. 683, as amended by Public Law 94-568. Revenue Procedure 71-17, as amended by Public Law 94-568, provides certain gross receipts safe harbor for business with the general public, i.e. nonmembers. It provides that social clubs may receive up to 35% of their total gross receipts, including investment income, from sources outside of their membership without jeopardizing their IRC 501(c)(7) tax exempt status. Within that 35% limit, no more than 15% of the social club's gross receipts may be derived from nonmember use of the social club's facilities and/or services or from other activities not furthering the social and recreational purposes of members.

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 be permitted to receive up to 35% of their gross receipts, including investment income, from sources outside of their membership without losing their

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tax exempt status. It is also intended that within this 35% amount not more than 15% of the gross receipts should be derived from the use of a social club's facilities or services by the general public.

Revenue Procedure 71-17, 1971-1 C.B. 683 provides guidelines for recordkeeping when nonmembers use a social club's facility and the circumstances under which a host-guest relationship will be assumed, relevant in determining whether the social club has adhered to the requirements for exemption under IRC section 501(c)(7). The revenue procedure provides that for groups of eight or fewer individuals where the social club maintains records to substantiate that at least one of the group is a member and payment is received directly from that member (or member's employer) it is assumed that the others in the party are guests of the member.

Revenue Procedure further provides that for parties of more than eight, where the social club maintains records to substantiate that 75% or more of the group are members and payment is received from one or more members, it is assumed that nonmembers are guests of members. For all other situations the Revenue Procedure states that the host guest relationship must be substantiated by the records identified. To establish that the revenues are member sourced revenues for these other situations, these records must contain the following information:

- the date,
- the total number in the party,
- the number of nonmembers in party,
- total charges,
- charges attributable to nonmembers,
- charges paid by nonmembers,
- if the members pays all or part of the nonmember's charges a statement signed by member indicating whether he has been or will be reimbursed for nonmember's use and the amount of the reimbursement,
- if the member's employer reimburses the member or makes payment directly to the social club a statement signed by the member indicating the name of the employer, the amount of the payment attributable to the nonmember's use, the nonmember's name and business relationship to the member, the business, personal or social purpose of the member served by the nonmember's use.
- If the nonmember pays the social club or reimburses the member and a claim is made that the amount was paid gratuitously for the member's benefit, a statement signed by the member indicating the donor's name and relationship to the member and containing information to substantiate the gratuitous nature of the payment or reimbursement.

Government's Position:

ORG's nonmember receipts of \$\$ in the year ended 3-31-20XX is in excess of 57% of total gross receipts. ORG also failed to maintain documentation set forth in Revenue Procedure 71-17 to substantiate the classification of certain banquet and bar revenues as member receipts. Where such unsubstantiated member revenues were reclassified, ORG's nonmember revenues would be as much as 67%.

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ORG, having exceeded the limitation that not more than 15% of the social club's gross receipts should be derived from the use of the social club's facilities by the general public, fails to qualify as an organization described in IRC 501(c)(7). ORG's status as an exempt organization described in IRC 501(c)(7) is revoked, effective 4-01-20XX.

As a taxable entity, ORG is required to file Form 1120, U.S. Corporation Income Tax Return, for the years ended 3-31-20XX and 3-31-20XX. In subsequent years, ORG is required to file Form 1120 by the due date for that return.

Taxpayer's Position:

The taxpayer's position is solicited.

Conclusion:

If ORG agrees with this determination, an authorized officer must sign and return Form 6018-A along with Forms 1120 for 3-31-20XX and 3-31-20XX to me at the following address:

In preparing Form 1120, ORG must keep in mind the provision of IRC section 277 that deductions attributable to furnishing services and other items of value to members will be allowed only to the extent of income from transactions with members. IRC 277(a) states that in the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members.

If ORG does not agree it is requested to provide in writing the facts, if different from those stated in this report, the law on which its disagreement is based it, and its position to me within 30 days from the date of the letter transmitting this report.