Internal Revenue Service
Appeals Office

Department of the Treasury

Person to Contact:
****
Employee ID Number:
****
Tel: ****
Fax: ****
Refer Reply to:
****
In Re:
****
Tax Period(s) Ended:
****
EIN:
****

Date: JUN 30 2011

Number: **201138054**
Release Date: 9/23/2011

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CERTIFIED MAIL

UIL: 501.07-05

Dear ****:

This is a Final Adverse Determination as to your exempt status under section 501(c)(7) of the Internal Revenue Code (the Code). Our favorable determination letter to you dated **** is hereby revoked and you are no longer exempt under section 501(a) of the Code effective ****.

Our adverse determination was made for the following reasons:

Your organization fails to meet the requirements for exemption under IRC section 501(c)(7). IRC section 501(c)(7), as amended by the Tax Reform Act of 1969, provides for the exemption of clubs organized and operated 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.

Public Law 94-568 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 membership without losing their exempt status. It is also intended that 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.

As a result of a recent audit of your organization's activities and Form 990, it was determined that your organization has exceeded the safe harbor limitations on non-member income as outlined in Public Law 94-568. Further, an analysis of all facts and circumstances surrounding your organization's operations revealed that the extent of nonmember use of your facility established a nonexempt purpose.

You are required to file converted Forms **** for any years which are still open under the statute of limitations beginning with the year ending ****. You should file any returns due for these years with the Internal Revenue Service TEGE: EO: 1100 Commerce St. MC 4920 DAL: Mandatory Review, Dallas, TX 75242-1027. Forms **** for tax periods beginning on and after **** should be filed with the Department of the Treasury, Internal Revenue Service Center, **** as applicable for Form ****.

You have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance. Or you can contact the nearest Taxpayer Advocate office by calling ****, or writing to: Local Taxpayer Advocate, ****.

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax 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.

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

Sincerely yours,

/s/
Appeals Team Manager

cc: ****.

Internal Revenue Service

Department of the Treasury
1352 Marrows Road, 2nd Floor
Newark, DE 19711-5445

Taxpayer Identification Number
Form:

Date OCT 1 5 2009
Tax Year(s) Ended:
ORG
ADDRESS

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 revocation 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 revoking your 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 Lough
Director, EO Examinations

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

Form **886-A** (Rev. January 1994)	**EXPLANATIONS OF ITEMS**	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 20XX12 ISSUE

LEGEND
ORG = Organization name XX = Date CO-1 & CO-2 = 1st & 2nd COMPANIES

ISSUE

• Whether the ORG will continue to qualify as an exempt social club under section 501(c)(7) of the Code?

FACTS:

The ORG ("ORG") was granted exemption as a social club exempt from Federal income tax under Internal Revenue Code section 501(c)(7) pursuant to a ruling issued in June, 19XX. Its purposes as stated in its Articles of Incorporation are: "Promote the social endeavors of its members." ORG's By-Laws stated purposes are: The maintenance of a suitable club house and other buildings, the ownership and maintenance of a golf course, the promotion of the sport of golf and other sports generally, and the social enjoyment of its members?

ORG's principal activity is providing facilities and services for the pleasure and recreation of its members and their guests. They operate a restaurant and bar and maintain a golf club, pool and tennis courts on the grounds. ORG allows nonmembers to attend their dub's facilities and participate in club events.

During the examination, it was determined that ORG did not fully comply with the record-keeping requirements of Revenue Procedure 71-17, 1971-1 C.B. 683. However ORG receives income from outside its membership. Based on examination of ORG's Form 990 return for the period ending December 31, 20XX, 20XX and 20XX and review of their books and records, the percent of gross receipts from nonmember use of facilities exceeded 15% for the 20XX12 year of the exam as well as for the prior and subsequent years, while investment income was less than 20% for all years. These receipts are noted in the following chart:

Year/Period Ended	% of gross receipts from nonmember use	% of gross receipts from investment income	Total % investment income / nonmember income
December 31, 20XX			
December 31, 20XX			
December 31, 20XX			

There was also evidence that the organization advertises ORG's banquet facilities on the Internet and in the Yellow Pages. They advertise that they have banquet facilities for all special events such as weddings, corporate meetings/functions, parties, graduations, reunions, anniversaries, Bar/Bat Mitzvahs with accommodations up to 300.

LAW:

Organizations exempt from federal taxes as described in IRC Section 501(c)(7) include clubs 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.

Section 1.501(c)(7)-1 of the Income Tax Regulations, relating to the requirements of exemption of such clubs under section 501(a), reads in part as follows:

(a) 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 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 dub 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.

(b) 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 fade evidence that ORG 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.

Prior to its amendment in 1976, IRC Section 501(c)(7) required that social clubs be operated exclusively for pleasure, recreation, and other non-profitable purposes. Public Law 94-568 amended the "exclusive° provision to read "substantially° in order to allow a section 501(c)(7) organization to receive up to 35 percent of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. The Committee Reports for Public Law 94-566 further state:

(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. These percentages supersede those provided in Revenue Ruling 71-17, 1971-1 C.B. 683.

(b) Thus, a social club may receive investment income up to the full 35 percent of its gross receipts if no income is received 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.

(d) The Senate report also indicates that even though gross receipts from the general public exceed this standard, it does not necessarily establish that there is a nonexempt purpose. A conclusion that there is a nonexempt purpose will be based on all the facts and circumstances including, but not limited to, the gross receipts factor.

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Revenue Ruling 58-589 sets forth the criteria for exemption under section 501(c)(7) of the Code, and provides that a club must have an established membership of individuals, personal contacts, and fellowship. It also provides that, while the regulations indicate that a club may lose its exemption if it makes its facilities available to the general public, this does not mean that any dealings with nonmembers will automatically cause a club to lose its exemption. A club may receive some income from the general public, that is, persons other than members and their bona fide guests, or permit the general public to participate in its affairs, provided that such participation is incidental to and in furtherance of ORG's exempt purposes, such dealings with the general public and the receipt of income therefrom does not indicate the existence of a club purpose to make a profit, and the income does not inure to club members.

Revenue Ruling 60-324 provides that a social club that made its social facilities available to the general public through its member-sponsorship arrangement can not be treated as being operated exclusively for pleasure, recreation, or other nonprofitable purposes and ORG no longer qualified for exemption under 501(c)(7) of the Code.

Revenue Ruling 66-149 provides that a social club is not exempt from federal income tax as an organization described in section 501(c)(7) of the code if it regularly derives a substantial part of its income from non-member sources such as, for example, dividends and interest on investments.

Revenue Ruling 68-119 provides that a club will not necessarily lose its exemption if it derives income from transactions with other than bona fide members and their guests, or if the general public on occasion is permitted to participate in its affairs, provided such participation is incidental to and in furtherance of its general club purposes and the income therefrom does not inure to members.

Revenue Procedure 71-17 sets forth guidelines for determining the effect of gross receipts derived from nonmember use of a social club's facilities on exemption under Internal Revenue Code Section 501(c)(7) and recordkeeping requirements. Failure to maintain such records or make them available to the Service for examination will preclude use of the minimum gross receipts standard and audit assumptions set forth in this Revenue Procedure.

If a dub exceeds the 15/35% test, then it will maintain its exempt status only if it can show through facts and circumstances that "substantially all" of its activities are for "pleasure, recreation and other nonprofitable purposes."
The following are important facts and circumstances to take into account to determine whether a club may maintain its exemption under IRC 501(c)(7):

. The actual percentage of nonmember receipts and/or investment income.

- Frequency of use of ORG facilities or services by nonmembers. An unusual or single event (that is, nonrecurring on a year to year basis) that generates all the nonmember income is viewed more favorably than nonmember income arising from frequent use by nonmembers.

- Record of nonmember use over a period of years. A high percentage in one *year by*

nonmembers, with the other years being within permitted levels, is viewed more favorably than a consistent pattern of exceeding the limits, even by relatively small amounts. (See S. Rept. 94-1318, 2d Sass., 1976-2 C.B. 597,599).

- Purposes for which the dub's facilities were made available to nonmembers.

- Whether the nonmember income generates net profits for the organization. Profits derived from nonmembers, unless set aside, subsidize ORG's activities for members and result in inurement within the meaning of IRC 501(c)(7).

TAXPAYER'S POSITION:

ORG does not agree to a proposed revocation of their tax exempt status as described in IRC section 501(c)(7). ORG states that the past and current economic conditions resulting in a decline in membership is the mitigating factor that prompted the need for additional nonmember receipts to operate ORG during these periods.

GOVERNMENT'S POSITION:

An organization exempt from federal income taxes as described in IRC section 501(c)(7) must meet the gross receipts test in order to maintain its exemption. In order to meet the gross receipts test, an organization can receive up to thirty-five percent (35%) of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. Within this 35% amount, not more than fifteen percent (15%) of the gross receipts should be derived from the use of a social club's facilities or services by non-members.

The ORG has exceeded the 15% gross receipts standard for nonmember income on a continuous basis for at least three years. The nonmember receipts are earned throughout the year. There was no one single or unusual event that caused ORG to exceed the 15% threshold.

Based on the large percentages of gross nonmember income to total gross receipts of the dub, (i.e., 25%, 23%, and 19% as noted in the above table), which exceeds the limitation of 15% as set forth by IRC 501(c)(7) for each of these years and the fact that it advertises the use of its facilities to the public, it is the Government's position that ORG is no longer operated exclusively for the pleasure and recreation of its members and is not exempt under section 501(c)(7).

CONCLUSION:

The IRC Section 501(c)(7) tax exempt status of ORG should be revoked since the nonmember income received by ORG exceeded 15% of ORG's total gross receipts for the years under examination. Further, it advertises the use of their facilities to the general public reflecting evidence that ORG is engaged in a business and is not being "operated exclusively for pleasure, recreation, or social purposes."

The ORG no longer meets the requirements to qualify as exempt from federal income tax under IRC section 501(a) as described in section 501(c)(7). Therefore, your exempt status under 501(c)(7) of the Internal Revenue Code will be revoked effective January 1, 20XX.

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As a taxable entity, the organization is required to file Form 1120, U.S. Corporation Income Tax Return for the periods open under statute. Under 6501(g) these periods include the years ending December 31, 20XX and subsequent tax years.

Additionally, the organization is reminded of the provisions of IRC 277 concerning membership organizations which are not exempt organizations.

ALTERNATIVE ISSUE:

If the ORG continues to qualify as an exempt social club under section 501(c)(7) of the Code, what is its Unrelated Business Taxable Income ?

FACTS:

As a result of the examination of Form 990-T and the books and records for the period ended 20XX12, it was concluded that ORG's traditional nonmember income sources resulted in operating losses from bar, restaurant, greens and golf cart rentals activities. Forms 990-T for prior and subsequent years also showed operating losses for the same traditional nonmember activities.

During the examination, it was disclosed that ORG had non-traditional Unrelated Business Income for the 20XX12 year of the exam as well as for prior and subsequent years. The non-traditional Unrelated Business Income was in the form of advertising and acknowledgement income received from local businesses and vendors for ORG's annual member-guest golf outing. The non-traditional Unrelated Business Income was less than 1% for all years

In examining expense records for 20XX, it was disclosed that ORG made a contribution to the CO-1, an apparent charitable 501(c)(3) organization. Sales Journal entries confirmed that Account #, CO-2, was funded by member dues billings. The amount of the contribution for 20XX was shown on Form 990-T Schedule G as a set-aside deduction and expense to reduce ORG's reported Investment Income. A similar set-aside deduction was shown on Forms 990-T for 20XX an 20XX

LAW:

Revenue Ruling 81-69, 1981-1 C.B. 351 is a guide in determining proper Unrelated Business Income tax liability for exempt social clubs. The ruling involved a social club that had Unrelated Business Income from investments. It also sold food and beverages to nonmembers at prices insufficient to recover the costs of such sales. Such sales resulted in losses for several years, and there was every indication that they would continue to result only in losses for ORG.

The Revenue Ruling holds that an exempt social club, in determining its Unrelated Business Income, may not deduct from its net investment income losses incurred on sales of food and beverages to nonmembers under these facts. The ruling's rationale is that ORG's policy of continually setting prices on sales to nonmembers at levels insufficient to cover costs demonstrates that its conduct of the bar and restaurant activity with nonmembers is not profit motivated. The ruling concludes that, absent such a profit motive, no trade or business exists, so that such expenses in excess of gross income are not trade or

business expenses deductible under IRC 162, and are not available to offset investment income otherwise taxable under IRC 512(a)(3).

In general, Unrelated Business Taxable Income under IRC 512(a)(3) is calculated in the following manner:

- All gross income, excluding
- exempt function income, less
- deductions allowed by Chapter 1 of the Code which are directly connected with the production of gross income,
- computed with the following modifications:
- net operating losses—IRC 512(b)(6)
- charitable contributions—IRC 512(b)(10), (b)(11)
- standard deduction—IRC 512(b)(12)

Exempt function income includes: Amounts derived from dues, fees, charges or similar amounts of gross income from members; and Set-aside income

Set-aside income is income which would otherwise be taxable under section 512(a)(3) that is set aside for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.

Set-aside income may be temporarily invested or accumulated (as long as the amount and duration are not unreasonable), provided that it is earmarked or placed in a separate account.

Section 1.6664-4(a) of the Regulations states, in general, to mean —No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion.

TAXPAYER'S POSITION

ORG agrees that the income from advertising at its annual member-guest golf outing is a source of non-traditional Unrelated Business Income and subject to Unrelated Business Income Tax. In addition, ORG agrees that contributions to the CO-2 is not income that would otherwise be taxable under section 512(a)(3) and is not qualified set aside income.

GOVERNMENT'S POSITION:

If ORG remains tax-exempt under 501(c)(7) of the Code, it will be liable for Unrelated Business Income Tax as shown in the attached report of examination, Form 4549. ORG's Unrelated Business Income shall be limited to its Net Investment Income and its net non-traditional nonmember income and there is no qualified set-side.

The Net Operating Losses from the sales to nonmembers will be limited in accordance to Revenue Ruling 81-69. ORG's food and beverage, greens and carts activities applicable to nonmembers has failed

to show profits for the past two or three years Accordingly, it is concluded that the nonmember sales activity may or may not constitute a trade or business for which expenses would be deductible under section 162(a) of the Internal Revenue Code. Thus, the net operational losses for the periods ending December 31, 20XX and December 31, 20XX have been thereby limited to the net receipts from these activities.

Therefore, the net losses sustained from ORG's nonmember sales may not be used to offset investment income or other traditional net unrelated trade or business sources for the purpose of computing ORG's Unrelated Business Income Tax liability.

The accuracy related penalty imposed under section 6662(a) will be assessed because there was no evidence of a reasonable cause related to the non-reporting of taxable non-traditional advertising income for the computation of Unrelated Business Income Tax under section 511 of the Code.

CONCLUSION:

Your organization is advised to monitor your level of non-member receipts to insure that you are in compliance with Public Law 94568. Organizations exempt under Section 501(c)(7) may lose their exempt status if they receive gross receipts from non-member sources (defined as income from passive sources and gross receipts from non-member use of facilities or the sale of goods to non-members) in excess of 35% of total receipts. Also, within this 35% limit, no more than 15% of gross receipts may be derived from non-member use of ORG facilities.

During our examination of your Form 990, we noted that you did not comply with the record keeping requirements of Revenue Procedure 71-17, 1971-1 C.B. 683. This Revenue Procedure provides that a social club must maintain specific records as to the use of its facilities in order to substantiate a host1guest relationship for determining member versus non-member usage. Failure to maintain such records may result in all income derived from the use of your facilities being presumed to be unrelated business income. To avoid such a presumption, you should take appropriate steps to insure that you comply with this Revenue Procedure in the future.

Section 512(a)(3)(B) of the Internal Revenue Code of 1986 requires a social dub exempt under Section 501(c)(7) to include all gross income, including reciprocal income, (other than "exempt function income") as Unrelated Business Income. "Exempt function income is defined as gross income derived from members and includes such items as dues, assessments, fees, or similar amounts paid by members, their dependents, or bona fide guests for the provision of goods, facilities or services which are in furtherance of the exempt purposes of the dub. Please insure that for all future returns, unrelated business income is properly reflected on Form 990-T.

Section 512 of the Internal Revenue Code of 1986 provides that where an organization uses its facilities or personnel for both exempt and non-exempt purposes, expenses must be allocated on a reasonable basis. In addition, an organization is required to maintain appropriate documentation to substantiate the reasonableness of the allocations made. In the future, please insure that appropriate documentation is maintained for any allocated expenses.

Our examination of your nonmember income revealed that that there is doubt whether your banquet, bar and restaurant activities, greens activity and golf cart activity are engaged for a profit motive. We have

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restricted excess expenses from such activities. The net operational losses for the periods ending December 31, 20XX and December 31, 20XX have been thereby limited to the net receipts from these activities.

Your Club's food and beverage, greens and carts activities applicable to nonmembers has failed to show profits for the past two or three years Accordingly, it is concluded that your nonmember sales activity may or may not constitute a trade or business for which expenses would be deductible under section 162(a) of the Internal Revenue Code.

Thus, in the future, the net losses sustained from your nonmember sales may not be used to offset your investment income or other traditional net unrelated trade or business sources for the purpose of computing your unrelated business taxable income tax liability.

For future filings of Form 990-T, please file these returns in accordance to Revenue Ruling 81-69 and within the guidelines of section 1.183-2 of the Income Tax Regulations, which determines when an activity is not profit motivated. Generally, if an organization has incurred losses in at least 3 out of 5 previous years, this is an indicator that the activity lacks a profit motive.