



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE
1100 Commerce, MC 4920 DAL
Dallas, TX 75242

501.07-00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201225018**

Release Date: 6/22/2012

Date: March 6, 2012

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ ID Number

Contact Numbers:

Phone:

Fax:

LEGEND

ORG - Organization name

XX - Date Address - address

ORG

ADDRESS

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear

In a determination letter dated July 29, 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 January 1, 20XX. This is a final letter with regard to your exempt status.

We previously provided you a report of examination explaining why we believe revocation of your exempt status was necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On December 30, 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 Federal income tax returns for the tax period(s) shown above. If you have not yet filed these returns, please file them 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 contact the person whose name and telephone number are shown at the beginning of this letter.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing
Director, EO Examinations

Internal Revenue Service
Tax Exempt and Government Entities Division
Exempt Organizations: Examinations
Attn: Jeffrey Davis, Mail Stop 39
2303 W. Meadowview Road
Greensboro, NC 27407

Department of the Treasury

Date: December 21, 2011

Taxpayer Identification Number:
Form:
Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

ORG
ADDRESS

Certified Mail – Return Receipt Requested

Dear

In a determination letter July 29, 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 our examination, we have determined you have not operated in accordance with the provisions of section 501(c)(7) of the Code. Accordingly, we are proposing revocation of your Federal income tax effective January 1, 20XX.

Enclosed with this letter is our Report of Examination explaining why we believe revocation of your tax exempt status is necessary. If you accept our findings, please sign and return the enclosed Form 6018-A, *Consent to Proposed 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.

Based on prior conversations, you have verbally agreed with the Service's position. You have also filed Forms 1120, U.S. Corporation Income Tax Return, for the tax years ending December 31, 20XX through 20XX with this office. These returns will be processed by our Mandatory Review staff after final approval of our examination findings. 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 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,

Nanette M. Downing
Director, EO Examinations

Enclosures:
Report of Examination
Form 6018-A
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 12/31/20XX

LEGEND

ORG - Organization name XX - Date City - city State - state

ISSUE:

Whether ORG qualifies for exemption under Section 501(a) as described in Section 501(c)(7) of the Internal Revenue Code.

FACTS:

ORG (the Organization) was formed and incorporated in the state of State on April 23, 19XX. According to the articles of incorporation, the purpose of the Organization is the operation and maintenance of a golf course and country club, swimming pools, tennis courts and other types of recreational facilities, a clubhouse, a professional golf shop, a restaurant, café and dining hall, and giving and conducting of entertainment for its members, their families and their guests; and to promote, encourage and foster all types of wholesome recreation and entertainment, both within and through the use of its own facilities, and through the use of other facilities located within the vicinity of the principal office of this corporation.

The Organization applied for exemption under §501(c)(7) using Form 1025, Exemption Application. The Organization was granted exemption from federal income taxes under IRC Section 501(a), as described in Section 501(c)(7), on July 29, 19XX.

The examination revealed that the Organization continues its operations as a recreation center in the town of City, State. However the organization receives a substantial amount of income from outside its membership. Along with income from the membership, the Organization received income from non-members for the use of its swimming pool, golf course, rental income for the use of its clubhouse building, and pro shop merchandise and concession sales.

The Organization received membership income primarily in the form of membership dues. The types of membership dues included golf and swimming pool memberships. Members were also allowed to rent the clubhouse building on an as-needed basis. The membership income was reported on Form 990.

The Organization's program service revenue included golf cart fees, green fees, golf tournament revenue, and pool guest income. The golf fees are paid by everyone, member or non-members that play on the course for its upkeep. The golf tournament income is income from tournaments held at the Organization's facilities from both members and non-members. The Organization did not maintain records that distinguished the member income from the non-member income.

The Organization also received a significant amount of income from the sale of inventory. The Organization's Pro Shop allows for the sale of concessions, as well as merchandise that is available to both members and non-members for purchase. The Organization also did not maintain records that distinguished the member income from the non-member income received from its Pro Shop sales.

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Income received by the Organization is detailed below for the year under examination, as well as the prior and subsequent years (that are not under examination, and are based on the Organization's filed Form 990, Return of Organization Exempt from Income Tax):

	<u>Year 20XX</u>	<u>Year 20XX</u>	<u>Year 20XX</u>
Program Service Revenue*	\$\$	\$\$	\$\$
Income received from Membership Support	\$ \$	\$ \$	\$ \$
Income received from Rental of Clubhouse*	\$ \$	\$ \$	\$ \$
Sale of Inventory (Concessions and Merchandise)*	\$ \$	\$ \$	\$ \$
Other Revenue	\$ \$	\$ \$	\$ \$
Gross Receipts	<u>\$\$</u>	<u>\$\$</u>	<u>\$\$</u>

* Denotes that the Organization did not maintain adequate records or documentation to distinguish whether the income was received from its members or the general public (non-members).

Documentation such as reservation/banquet book, party function sheets, reservation sheets for club functions, member billings, non-member income record keeping logs, and rental agreements were requested on Information Document Requests (IDRs) dated March 19, 20XX, and May 5, 20XX to determine the amount of use of the facilities by non-members. The Organization failed to provide documentation that distinguished non-member income from income received from its membership.

The Organization has opened its facilities to the general public in an effort to continue operating. The Organization has placed advertisements in publications in the City, State area inviting the general public to partake of its facilities.

LAW:

IRC Section 501(a) states that an organization described in subsection (c) or (d) shall be exempt from taxation under this subtitle unless such exemption is denied under Section 502 concerning feeder organization or Section 503 concerning organizations engaged in prohibited transactions.

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,

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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 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.

- (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 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 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.

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 94-568 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.

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 the club's exempt purposes, such dealings with the general public and the receipt of

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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 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 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 non-profitable purposes and the club no longer qualified for exemption under 501(c)(7) of the Code.

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. Revenue Procedure 71-17 requires section 501(c)(7) organizations to substantiate the status of individuals that use the organization's facility as either member or non-member. For groups of eight (8) people or less, the presumption is that the non-members in that party are guests of the member provided the member or the member's employer pays for such use of the facility. For groups larger than eight (8) persons, the organization can substantiate the status of the non-members as guests if records are kept that show that seventy-five percent (75%) or more of the persons in such a group are members and that a member or the member's employer pays for such use of the facility. In either of these circumstances described above, the activities involving the individuals is considered to be an exempt social function carried on by the club, and the income derived by the club for the entertainment of the non-members as bona fide quests of members is **not** unrelated business income. However, if the club fails to maintain these records and can not show that the conditions set forth above have been met, **all** such income derived by the club is assumed to be non-member income; this income is subject to taxation as unrelated business income and is not considered exempt function income.

TAXPAYER'S POSITION:

ORG verbally agreed with the Service's proposal to revoke its tax exempt status. The Organization acknowledged that the reliance on income from the general public does not further their exempt purposes. The Organization maintains that it will not be able to survive without a substantial amount of revenue obtained from non-members.

The Organization has submitted Form 1120, U.S. Corporation Income Tax Return, for the tax years ending December 31, 20XX, December 31, 20XX, December 31, 20XX and December 31, 20XX for processing following the revocation of its tax exempt status.

GOVERNMENT'S POSITION:

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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.

Revenue Procedure 71-17 governs the record keeping, and substantiation requirements with respect to the use of the facilities of a Section 501(c)(7) social club. ORG has acknowledged that it has failed to keep records with respect to the member or non-member status of the individuals that used the facilities. Because the Organization failed to maintain adequate records to substantiate member from non-member use of the facilities, \$ (derived from program service revenue, clubhouse rental income, and inventory sales) is considered non-member income. The non-member income now accounts for approximately 71% of the Organization's gross income, well above the 35% maximum allowance from income outside the membership, and 15% maximum allowance of income from public use of the facilities.

The above information shows that The Organization fails the gross receipts test. The Organization fails the gross receipts test, and does not receive substantially more than half, or 65%, of its income from its membership.

The Organization has also indicated that it has opened all its facilities to the general public for use in order to continue operating. This admission, along with the lack of documentation required under Revenue Procedure 71-17 lends to the conclusion that the Organization would not qualify under the 35% maximum allowance from income outside the membership, and 15% maximum level of income from public use of its facilities in future years (although not examined).

CONCLUSION:

ORG no longer qualifies as an exempt organization under the provisions of Section 501(a) as an organization described in Section 501(c)(7) of the Internal Revenue Code. The activities of the Organization are not conducive of an organization of which substantially all its activities are described as exempt function activities in IRC §501(c)(7). The Organization's activities are not inconsequential with respect to the exempt activities income, nor are they unusual or non-recurrent in nature. Therefore, your exempt status should be revoked effective January 1, 20XX.

Should this revocation be upheld, the Form 1120, U.S. Corporation Income Tax Return, filed for the 20XX – 20XX tax years should be processed by the Exempt Organization Mandatory Review staff.

Please note that this is not a final report. This report is subject to review by EO Mandatory Review staff that may modify it as a result of their review. You will receive the final report from EO Mandatory Review.