

Internal Revenue Service
Appeals Office
2525 Capitol Street, MS 201
Fresno, CA 93721

Number: 201408035
Release Date: 2/21/2014

November 27, 2013

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B

Certified Mail

Dear

This is a final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in Code section 501(c)(7).

The revocation of your exempt status was made for the following reason(s):

Your organization is not operated exclusively for pleasure, recreation and other non-profitable purposes as the majority of its activities are open to the general public. In addition, the Club's non-member income exceeds the limits on such income as per Public Law 94-568 and Revenue Procedure 71-17.

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit www.irs.gov.

Please show your employer identification number on all returns you file and in all correspondence with Internal Revenue Service.

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose*. Please review the Notice 437 and the documents attached that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437.

You also 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 matters that may not have been resolved through normal channels get prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit www.irs.gov/advocate for more information.

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

Sincerely Yours,

Appeals Team Manager

Enclosure: Publication 892 and/or 556

Department of the Treasury

Employer Identification Number:
C

Person to Contact:

Employee ID Number:
Tel: ()
Fax: ()

Tax Period(s) Ended:
D

UIL: 0501.07-00

Internal Revenue Service
Tax Exempt and Government Entities Division
Exempt Organizations: Examinations
801 Tom Martin Dr
Room 263
Birmingham, AL 35211

Department of the Treasury

Date: October 26, 2012

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

ORG
ADDRESS

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,

Nanette M. Downing
Director, EO Examinations

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

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| Explanation of Items | | |
| Name of Taxpayer ORG | | Year/Period Ended 20XX 20XX 20XX |

ISSUE

- Does ORG (EO) continue to qualify for exemption under Internal Revenue Code § 501(c)(7) given that it receives more than % of its gross receipts including investment income, from sources outside their membership,
- Within the % limitation, no more than % of gross receipts may be derived from nonmember use of club facilities and/or services.

FACTS

ORG opens its events to the general public and/ or non-members.

During these events, nonmembers pay an entry fee higher then members pay, and are allowed to purchase food and drinks. Nonmembers enter the events hosted by the ORG and receive a nonmember ticket once the nonmember admission is paid. The main activity that nonmembers have access to is the Event which is hosted in conjunction with the City of City. In 20XX the EO charged an entry fee for the Event and did not separate nonmember income from member income. In 20XX and 20XX the EO stated that no entry fee was charged for the Event but the event is open to the general public and no records were kept to separate member and nonmember income; therefore all monies received are considered nonmember income.

The ORG is organized and operating as an organization described in Internal Revenue Code § 501(c)(7) to provide social, recreational and other activities to its members. The benefits provided to the members include, but are not limited to priority ticketing to all of the dances and dinners and a member rate on tickets to all events.

The objective of the ORG, per its' Bylaws, is

- To promote good fellowship among members and friends.
- To retain and cherish our German Cultural Heritage.
- To extend our traditional sociability to the community at large.
- To provide land for future use, to erect a Event for members and friends in which to cultivate the above.

Your organization reported the following sources and amounts of revenue on Forms 990 for periods ending December 31, 20XX, December 31, 20XX and December 31, 20XX.

TABLE DELETED

While reviewing the general ledger, your website, as well as other internal documents provided by your organization, such as register reports and Income/Expense Report, it has been noted

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that your organization is open to the general public on a regular basis, as stated previously. The nonmember income has been recorded in the following accounts:

TABLE DELETED

TABLE DELETED

The register report is utilized by the organization during their events to record all member and nonmember activity and lists each event separate.

Based on conducting a three year analysis of gross receipts, it has been noted that the organization received %, %, and % respectively, during tax years ending December 31, 20XX, December 31, 20XX and December 31, 20XX from non-member sources. The gross receipts received by your organization are well over the % and % threshold permitted in Public Law 94-568.

LAW

Internal Revenue Code § 501(c)(7) exempts from Federal income tax: "Clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and not part of the net earnings of which inures to the benefit of any private shareholder."

Section 1.501(c)(7) of the Income Tax Regulations provides that, in general, the exemption extends to social and recreation clubs supported solely by membership fees, dues and assessments. However, a club that engages in a business, such as making its social and recreational facilities open to the general public, is not organized and operated exclusively for pleasure, recreation and other non-profitable purposes, and is not exempt under section 501(a).

Prior to its amendment in 1976, IRC § 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 an IRC § 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 (Senate Report No. 94-1318 2d Session, 1976-2 C.B. 597) further states;

(a) Within the 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.

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

(c) In addition, the Committee Report states 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.

Revenue Ruling 66-149 holds a social club as not exempt as an organization described in Internal Revenue Code § 501(c)(7) where it derives a substantial part of its income from non-member sources.

Revenue Procedure 71-17 sets forth the guidelines for determining the effect of gross receipts derived from the general public's use of a social club's facilities on exemption under Internal Revenue Code § 501(c)(7). Where nonmember income from the usage exceeds the standard as outlined in this Revenue procedure, the conclusion reached is that there is a non-exempt purpose and operating in this manner jeopardizes the organization's exempt status.

TAXPAYER'S POSITION

Taxpayer's position has not been provided.

GOVERNMENT'S POSITION

Your organization has exceeded the %/% non-member threshold on a recurring basis during tax years ending December 31, 20XX, December 31, 20XX and December 31, 20XX and therefore revocation of your organization's exempt status is warranted.

CONCLUSION

ORG no longer qualifies for exemption under § 501(c)(7) of the Internal Revenue Code as your nonmember income has exceeded the %/ % nonmember threshold as outlined in Public Law 94-568. Therefore, your exempt status under § 501(c)(7) of the Internal Revenue Code should be revoked effective January 1, 20XX. Should this revocation be upheld, Form 1120 must be filed starting with tax periods ending December 31, 20XX, December 31, 20XX and December 31, 20XX.

Note: If you are planning to appeal the proposed revocation, please refer to Publication 892 which is enclosed. Appeal should contain statement of facts declared true under penalties of perjury. Please refer to Publication 892, page 3 for example of statement signed under penalties of perjury.

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ALTERNATIVE ISSUE

In the alternative, if the organization continues to qualify for exemption under Internal Revenue Code § 501(c)(7), should the net income derived from nonmembers be taxable as unrelated business income under section 511 of the Code?

FACTS

The ORG did not file a Form 990-T, Exempt Organization Business Income Tax Return, for the years ending December 31, 20XX, December 31, 20XX and December 31, 20XX. Its register report and bank statements, however, showed the following in gross receipts derived from nonmember and investment income:

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LAW

Internal Revenue Code § 511(a) imposes a tax upon the unrelated business taxable income of organizations exempt from federal income tax.

Internal Revenue Code § 512(a)(1) states, (1) General Rule--Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Internal Revenue Code § 512(a)(3) of the Code states, Special Rules Applicable to Organizations described in paragraph (7), (9), (17), OR (20) of section 501(c). —

IRC § 512(a)(3)(A) General Rule —In the case of an organization described in paragraph (7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions shall be treated as not directly connected with the production of gross income.

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IRC § 512(a)(3)(B) Exempt function income —For purposes of subparagraph (A), the term “exempt function income” means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside --including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

Internal Revenue Code § 513(a) defines the term unrelated trade or business as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income of funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Internal Revenue Code § 513(c) provides that a trade or business includes any activity which is carried on for the production of income from the sale of goods. An activity does not lose its identity as trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may not be related to the exempt purposes of the organization.

Section 1.512(a)-1 of the Income Tax Regulations provides the following:

(a) *In general.* —Except as otherwise provided in §1.512(a)-3, §1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines “unrelated business taxable income” as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in §1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be “directly connected with” the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business

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activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see §1.584-2(c)(3).

(b) *Expenses attributable solely to unrelated business activities.* —Expenses, depreciation and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167 or other relevant provisions of the Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167.

(c) *Dual use of facilities or personnel.* —Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167 or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of \$20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of \$2,000 (10 percent of \$20,000) would be allowable for the salary paid to its president.

TAXPAYER'S POSITION

Taxpayer's position has not been provided.

GOVERNMENT'S POSITION

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| | | 20XX |
| | | 20XX |

ORG is open to the public for the following activities and events:

TABLE DELETED

During these events, nonmembers pay an entry fee higher than members pay, and are allowed to purchase food and drinks. Nonmembers enter the events hosted by the ORG and receive a nonmember ticket once the nonmember admission is paid. The main activity that nonmembers have access to is the Event which is hosted in conjunction with the City of City. In 20XX the EO charged an entry fee for the Event and did not separate nonmember income from member income. In 20XX and 20XX the EO stated that no entry fee was charged for the Event but the event is open to the general public and no records were kept to separate member and nonmember income; therefore all monies received are considered nonmember income. Internal Revenue Code § 512(a) defines unrelated business taxable income as the gross income from any unrelated trade or business regularly carried on by the organization. The ORG operates from September until May each year. The organization is closed during the summer months. The organization rents a facility 6 times a year to host its member/non-member events. It is abundantly evident that ORG activity of being open to the public and inviting the general public to socialize at each event the organization host is considered to be regularly carried on and a great indicator that the club welcomes nonmembers.

The objective of the ORG, per its' Bylaws, is

- a. To promote good fellowship among members and friends.
- b. To retain and cherish our German Cultural Heritage.
- c. To extend our traditional sociability to the community at large.
- d. To provide land for future use, to erect a Event for members and friends in which to cultivate the above.

Being open to members of the general public on a regular basis does not contribute importantly to ORG purposes aside from the need for income or funds to exercise its functions. Therefore, the activity is not substantially related to ORG exempt purposes. In the case of an organization described under Internal Revenue Code § 501(c)(7), Internal Revenue Code § 512(a)(3), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income). The term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

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If revocation is not upheld, ORG is responsible for filing a delinquent Form 990-T for period ending December 31, 20XX, December 31, 20XX, and December 31, 20XX with the following entries:

TABLE DELETED

These amounts were derived utilizing the following allocations:

Each register report provided by your organization listed each event including member and nonmember income and expenses.

The expenses were allocated using the Gross Receipts Method. This means that the expenses pertaining to each event were allocated using the total of nonmember income over the total gross receipts. The percentage on nonmember income over total gross receipts was then multiplied by the total expenses per event.

For all future returns, expenses should be allocated on a reasonable basis and as they pertain to the activity.

If revocation is not upheld, an adjustment will be made ORG Form 990-T for period ending December 31, 20XX, December 31, 20XX and December 31, 20XX with the following entries:

TABLE DELETED

The UBIT amount does not include any penalties or interest.

CONCLUSION

If revocation is not upheld, as a result of our examination of your Forms 990 for periods ending December 31, 20XX, December 31, 20XX, and December 31, 20XX and Form 990-T for period ending December 31, 20XX, December 31, 20XX, and December 31, 20XX we have determined that ORG is liable for filing Form 990-T on an annual basis.

Please see attached Form 4549 and its Exhibits A and B for computations of the Income Tax Examination Changes.