



Department of the Treasury  
Internal Revenue Service  
P.O. Box 2508  
Cincinnati, OH 45201

Release Number: **201515035**

Release Date: 4/10/2015

UIL code: 501.07-00

501.07-02

501.07-05

Date: 1/12/2015

Employer ID number:

Contact person/ID number:

Contact telephone number:

Form you must file:

Tax years:

Dear :

This letter is our final determination that you don't qualify for tax-exempt status under Section 501(c)(7) of the Internal Revenue Code (the Code). Recently, we sent you a proposed adverse determination in response to your application. The proposed adverse determination explained the facts, law, and basis for our conclusion, and it gave you 30 days to file a protest. Because we didn't receive a protest within the required 30 days, the proposed determination is now final.

You must file federal income tax returns for the tax years listed at the top of this letter using the required form (also listed at the top of this letter) within 30 days of this letter unless you request an extension of time to file.

We'll make this final adverse determination letter and the proposed adverse determination letter available for public inspection (as required under Section 6110 of the Code) after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in the Notice 437 on how to notify us. If you agree with our deletions, you don't need to take any further action.

If you have questions about this letter, you can contact the person listed at the top of this letter. If you have questions about your federal income tax status and responsibilities, call our customer service number at 1-800-829-1040 (TTY 1-800-829-4933 for deaf or hard of hearing) or customer service for businesses at 1-800-829-4933.

Sincerely,

Director, Exempt Organizations

Enclosures:

Notice 437

Redacted Letter 4034, *Proposed Adverse Determination under IRC Section 501(a) Other Than 501(c)(3)*

Redacted Letter 4040, *Final Adverse Determination under IRC Section 501(a) Other Than 501(c)(3) - No Protest*



Department of the Treasury  
Internal Revenue Service  
P.O. Box 2508  
Cincinnati, OH 45201

Date: 10/22/2014

Employer ID number:

Contact person/ID number:

Contact telephone number:

Contact fax number:

**Legend:**

C = Attorney  
D = Date  
E = Number  
N = Restaurant  
P = State  
Q = Number  
Y = Number  
Z = Number

**UIL:**

501.07-00  
501.07-02  
501.07-05

Dear \_\_\_\_\_ :

We considered your application for recognition of exemption from federal income tax under Section 501(a) of the Internal Revenue Code (the Code). Based on the information provided, we determined that you don't qualify for exemption under Section 501(c)(7) of the Code. This letter explains the basis for our conclusion. Please keep it for your records.

**Issue**

Do you qualify for exemption under section 501(c)(7) of the Code? No, for the reasons stated below.

**Facts**

You were incorporated in the state of P. Your Articles of Incorporation state you were organized to create a private club to perform social, fraternal, and hospitality activities within the meaning of the P Alcoholic Beverage Code.

Your activities consist of subletting a restaurant, N, in which beer and wine are sold. Food is also served at this restaurant. You are governed by three board members, namely a President-Treasurer, Vice President, and a Secretary. You operate under a management contract with N.

Your President-Treasurer signed and agreed to the terms of the management contract on behalf of both you and N. Your President-Treasurer is also the owner of N. Your Secretary endorsed the management contract on behalf of N as a member-manager. This contract states you will pay N E% of gross receipts from the service of alcohol each month.

Your Bylaws concerning membership criteria provide, in part:

“The Corporation will have one class of Members. The qualifications and rights of such class are as follows:

1. All members and their guests shall be at least twenty-one (21) years of age.
2. Members shall pay no annual dues.
3. Members shall each contribute to an initial fund in the amount of Z dollars to purchase alcohol.
4. Members shall vote only to elect or remove directors, or as requested by the Board of Directors.
5. Membership is a privilege and not a right. Each membership is for one (1) year.
6. Members shall be permitted the use of the facilities of the Club during the operating hours only, consistent with the requirements of all applicable laws.
7. Each Member shall participate pro rata in the purchase of alcohol for the Club Membership.
8. The Club shall operate under the pool system and establish an alcoholic beverage replacement account. The initial replacement percentage shall be Q percent of service charges for alcoholic beverages.

The Board of Directors shall manage all corporate and business affairs of the Corporation.”

Your Organizational Meeting minutes state that:

“The Corporation shall proceed with due diligence to apply for and obtain a private club permit for service of alcohol in accordance with P Alcoholic Beverage Code. The President is authorized to act on behalf of the Corporation to submit and obtain said license.

When P Alcoholic Beverage Commission grants the desired permits, the Corporation will enter into a contract with the appropriate person or entity to provide overall management services for the private club. C presented and reviewed the proposed “Management Contract”. Upon motion duly made, seconded and unanimously adopted, it was:

RESOLVED, that the Board of Directors shall be fully empowered to negotiate and enter into a contract for management services for the private club, so long as the operation of the Club is in conformity with the P Alcoholic Beverage Code Rules and Regulations.”

Your Rules and Regulations document provides, in part, that persons may become regular members by providing the required information and the payment of your annual membership which is currently set at zero.

You explained you were created as a nonprofit because you were informed that the state of P requires it in order for beer and wine to be served at the restaurant, N. You further clarified that your only purpose was to allow you to sell beer and wine in your county. You explained that the restaurant lost tremendous money and as of D, you will no longer be operating.

You also explained that all beer and wine sold on your behalf was handled by N. Anyone coming into the restaurant, N, could obtain free membership to buy beer and wine. Both members and nonmembers could order

food at the restaurant, N. Funds from the food sales went to N. Funds from alcoholic beverage sales went to you with a percentage of gross receipts allocated to N.

## Law

Section 501(c)(7) of the Code provides for the exemption from federal income tax of clubs organized and operated for pleasure, recreation, and other nonprofitable purposes, substantially all 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(a)-1(c) of the Income Tax Regulations provides that the term "private shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(7)-1(b) of the regulations states that 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).

Revenue Ruling 55-716, 1955-2 C. B. 263, holds that an organization formed for the purpose of furnishing television antenna service to its members is not entitled to exemption from federal income tax under section 501(c)(7) of the Code. The term "club," as used within section 501(c)(7), contemplates the commingling of members, one with the other, in fellowship. Personal contacts and fellowship must play a material part in the life of an organization for it to come within the meaning of the term "club."

Revenue Ruling 58-588, 1958-2 C.B. 265, holds that a social club that sells an unlimited number of memberships to so-called "members," who have no voice in the management of the club and whose only rights are to use the club's facilities upon payment of specified fees, is not a tax-exempt social club within the meaning of section 501(c)(7) of the Internal Revenue Code. Income from the members was, in reality, income from the general public.

Revenue Ruling 58-589, 1958-2 C.B. 266, discusses the various criteria for recognition of exemption under section 501(c)(7) of the Code. In order to establish that a club is organized and operated for pleasure, recreation, and other nonprofitable purposes, "there must be an established membership of individuals, personal contacts and fellowship. A commingling of the members must play a material part in the life of the organization."

Revenue Ruling 66-225, 1966-2 C.B. 227, holds that a nonprofit organization which provides entertainment to its members does not qualify for exemption under section 501(c)(7) of the Code where it is controlled by a taxable corporation and operated as an integral part of such corporation's business.

Revenue Ruling 69-635, 1969-2 C.B. 126, holds that an automobile club whose principal activity is rendering automobile services to its members but has no significant social activities, does not qualify for exemption under section 501(c)(7) of the Code. The basis for this conclusion is the fact the club had no significant commingling of its members.

In Chattanooga Automobile Club v. Commissioner, Warren Automobile Club, Inc. v. Commissioner, 182 F. 2d 551 (6th Cir. 1950), the United States Court of Appeals 6th Circuit held that to be exempt under the Act of Congress, a club must have been organized and operated exclusively for pleasure, recreation, and other non-profitable purposes. The court further specified that the words "other non-profitable purposes" must be

construed as coming within the same classification as pleasure and recreation. In addition, there must be at least some sort of commingling of members to constitute a club. The court held that the two automobile clubs petitioning the court were not exempt under section 101(9) of the Internal Revenue Code of 1939 as a social club because the members of these clubs did not commingle.

In Keystone Automobile Club v. Commissioner, 181 F. 2d 402 (3rd Cir. 1950), the United States Court of Appeals 3rd Circuit defined the word "club" to include some type of mingling of people together as well as a common object. In this case, the court held that the Keystone Automobile Club was not exempt under section 101(9) of the Code for a number of reasons one of which was because they saw no evidence of the commingling of members.

In United States v. Fort Worth Club of Fort Worth, Texas, 345 F.2d 52, 57 (5th Cir. 1965), the court declared for a social club to qualify for exemption under section 501(c)(7), its outside profits must be (1) strictly incidental to club activities, not a result of an outside business, and (2) either negligible or nonrecurring.

### **Application of law**

#### Not operated for pleasure, recreation or other non-profit purpose

You explained that you formed as a nonprofit because the state of P required it in order to serve beer and wine at N's restaurant. An organization cannot be recognized as exempt under section 501(c)(7) unless it shows that it is both organized and operated substantially for pleasure, recreation or other non-profitable purpose. Your Articles of Incorporation state you are a private club that performs social, fraternal, and hospitality activities. Your facts indicate N operates a restaurant. Your primary activity consists of offering memberships where anyone paying your annual membership dues can purchase alcohol to be served with their food ordered at N restaurant. Currently, your annual membership is free. You are operated by the same people who own and operate N restaurant. Your sale of beer and wine demonstrates you are not operated for the purposes declared under section 501(c)(7). Rather, you were formed primarily to permit N to serve alcoholic beverages.

#### Transacting business with the general public, lack of membership requirements

Treasury Regulation 1.501(c)(7)-1(b) provides that 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. Because your primary purpose is to sell alcohol to the general public through your issuance of unlimited memberships, you are not organized exclusively for pleasure, recreation and other non-profitable purposes as required by Treasury Regulation 1.501(c)(7)-1(b).

Similar to the organization described in Rev. Rul. 58-588, you provide an unlimited amount of memberships demonstrated by the fact that anyone can become a member by eating at N restaurant and obtaining a membership to buy wine and beer from you. Therefore, income from your members is income from the general public.

You are also like the organization in Rev. Rul. 66-225. You are controlled by a taxable corporation, N, and are operated as an integral part of N's business. You sell the alcoholic beverages to individuals eating at N.

Also, according to Rev. Rul. 58-589, because N's facilities are made available to the general public and you provide a means for N to serve alcoholic beverages, you are engaged in a business and are not exempt under section 501(c)(7) of the Code.

#### Private Interests

You and N are managed by the same individuals. Therefore, your management contract that allows E% of gross sales to inure to N was not negotiated at arms-length. Accordingly, you are operated for the personal interests of N and your board who benefit from the operation of N. Section 501(c)(7) of the Code provides that no part of the net earnings shall inure to the benefit of any private shareholder. Section 1.501(a)-1(c) of the Income Tax Regulations provides that the term "private shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization. Because you operate for the financial benefit of your board you do not qualify for exemption under section 501(c)(7) of the Code.

Per United States v. Fort Worth Club of Fort Worth, Texas, 345 F.2d 52, 57 (5th Cir. 1965), for a social club to qualify for exemption under section 501(c)(7), its outside profits must be (1) strictly incidental to club activities, not a result of an outside business, and (2) either negligible or nonrecurring. You have no club activities other than the sale of alcohol. This activity is not incidental and is not negligible. This is a daily recurring activity that takes place in N. The sale of alcohol helps to increase business for N which is owned by your board members.

#### Lack of social activities or commingling among your members

To be operated for the purposes described in section 501(c)(7) of the Code, an organization must have an established membership of individuals who meet to make personal contacts and promote fellowship. The commingling of the members must play a material part in the life of a tax exempt social club. Like the organization in Rev. Rul. 55-716, you are simply furnishing a service to members by selling alcohol. In addition, per Rev. Rul. 58-589, commingling of the members must play a material part in the life of the organization. You have not substantiated you have commingling among your members. Members simply come to N to eat and drink.

Chattanooga Automobile Club v. Commissioner, Warren Automobile Club, Inc. v. Commissioner, and Keystone Automobile Club v. Commissioner both show that organizations failing to meet the commingling requirement will be denied exemption. You have not demonstrated that members have any interaction other than being at the same location for the serving of food or beverage. There is no common interest among your members and your social activities are only incidental. Because you have demonstrated very little, if any, personal contact among members and there is no expectation of personal contact among members, commingling is not a material part of your activities. Like the organization described in Rev. Rul. 69-635, you are primarily providing services with insignificant or no commingling. By operating in such a way, you do not qualify for exemption under section 501(c)(7) of the Code.

#### **Your position**

You explained that you were formed to allow the sale of food and alcohol in N's restaurant. However, the restaurant, N, had lost money in this venture and was only open for six months. The funds received from alcohol sales were below \$Y. You proposed that upon approval of exemption, you will terminate and file final returns for both you and the restaurant.

## **Our response to your position**

You proposed to discontinue your activities because the business venture of N was not profitable. Your position further demonstrates you were formed for the purpose of promoting the sale of food at the restaurant, N. Your primary purpose for existence was not for pleasure, recreation and other nonprofitable purposes. Therefore, you do not qualify for exemption from federal income tax under section 501(c)(7) of the Code.

## **Conclusion**

Based on the information provided, we conclude that you are not operated for pleasure, recreation or other nonprofitable purposes described in section 501(c)(7) of the Internal Revenue Code. Any such activities that you engage in are merely incidental to the furtherance of performing social, fraternal, and hospitality activities within the meaning of the P Alcoholic Beverage Code. Further, N operates the restaurant for the general public and for the private benefit of your members. You do not meet the membership and commingling requirements for organizations qualifying for exemption from federal income tax under section 501(c)(7) of the Code and your net earnings inure to insiders. Accordingly, you do not qualify for recognition of exemption under section 501(c)(7) of the Internal Revenue Code.

## **If you don't agree**

You have a right to file a protest if you don't agree with our proposed adverse determination. To do so, you must send a statement to us within 30 days of the date of this letter. The statement must include:

- Your name, address, employer identification number (EIN), and a daytime phone number
- A copy of this letter highlighting the findings you disagree with
- An explanation of why you disagree, including any supporting documents
- The law or authority, if any, you are relying on
- The signature of an officer, director, trustee, or other official who is authorized to sign for the organization, or your authorized representative
- One of the following declarations:

### **For an officer, director, trustee, or other official who is authorized to sign for the organization:**

Under penalties of perjury, I declare that I examined this protest statement, including accompanying documents, and to the best of my knowledge and belief, the statement contains all relevant facts and such facts are true, correct, and complete.

### **For authorized representatives:**

Under penalties of perjury, I declare that I prepared this protest statement, including accompanying documents, and to the best of my knowledge and belief, the statement contains all relevant facts and such facts are true, correct, and complete.

Your representative (attorney, certified public accountant, or other individual enrolled to practice before the IRS) must file a Form 2848, *Power of Attorney and Declaration of Representative*, with us if he or she hasn't already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*.

We'll review your protest statement and decide if you provided a basis for us to reconsider our determination. If so, we'll continue to process your case considering the information you provided. If you haven't provided a basis for reconsideration, we'll forward your case to the Office of Appeals and notify you. You can find more information about the role of the Appeals Office in Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*.

**Where to send your protest**

Please send your protest statement, Form 2848, if needed, and any supporting documents to the applicable address:

U.S. mail:

Internal Revenue Service  
EO Determinations Quality Assurance  
Room 7-008  
P.O. Box 2508  
Cincinnati, OH 45201

Street address for delivery service:

Internal Revenue Service  
EO Determinations Quality Assurance  
550 Main Street, Room 7-008  
Cincinnati, OH 45202

You can also fax your statement and supporting documents to the fax number listed at the top of this letter. If you fax your statement, please contact the person listed at the top of this letter to confirm that he or she received it.

**If you agree**

If you agree with our proposed adverse determination, you don't need to do anything. If we don't hear from you within 30 days, we'll issue a final adverse determination letter. That letter will provide information on your income tax filing requirements.

You can find all forms and publications mentioned in this letter on our website at [www.irs.gov/formspubs](http://www.irs.gov/formspubs). If you have questions, you can contact the person listed at the top of this letter.

Sincerely,

Director, Exempt Organizations

Enclosure:  
Publication 892