

Internal Revenue Service

Appeals Office

Release Number: **201824013**

Release Date: 6/15/2018

Date; March 22, 2018

Department of the Treasury

Employer Identification Number:

Person to Contact:

Employee ID Number:

Tel:

Fax:

Certified Mail

UIL: 501.07-00

Dear ..:

This is a final adverse 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 favorable determination letter issued to you in September XXXX is hereby revoked and you are no longer exempt under section 501(a) of the Code effective January 1, XXXX.

The adverse determination was made for the following reason(s):

You are not operated exclusively for pleasure, recreation, and other nonprofitable purposes.

You are required to file Federal income tax returns on Forms 1120. 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.

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.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please contact the clerk of the appropriate court for rules and the appropriate forms for filing petitions for declaratory judgment by referring to the enclosed Publication 892. You may write to the courts at the following addresses:

United States Tax Court
400 Second Street, NW
Washington, DC 20217

US Court of Federal Claims
717 Madison Place, NW
Washington, DC 20005

U. S. District Court for the District of Columbia

333 Constitution Ave., N.W.
Washington, DC 20001

Processing of income tax returns and assessments of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Code.

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 matter 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, 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

Department of the Treasury
Internal Revenue Service
Tax Exempt and Government Entities Division
Exempt Organizations: Examinations

Date:

April 29, 2016

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Manager's name:

Manager's contact number:

Response due date:

Certified Mail – Return Receipt Requested

Dear

Why you are receiving this letter

We propose to revoke your status as an organization described in section 501(c)(7) of the Internal Revenue Code (Code). Enclosed is our report of examination explaining the proposed action.

What you need to do if you agree

If you agree with our proposal, please sign the enclosed Form 6018, *Consent to Proposed Action – Section 7428*, and return it to the contact person at the address listed above (unless you have already provided us a signed Form 6018). We'll issue a final revocation letter determining that you aren't an organization described in section 501(c)(7).

If we don't hear from you

If you don't respond to this proposal within 30 calendar days from the date of this letter, we'll issue a final revocation letter. Failing to respond to this proposal will adversely impact your legal standing to seek a declaratory judgment because you failed to exhaust your administrative remedies.

Effect of revocation status

If you receive a final revocation letter, you'll be required to file federal income tax returns for the tax year(s) shown above as well as for subsequent tax years.

What you need to do if you disagree with the proposed revocation

If you disagree with our proposed revocation, you may request a meeting or telephone conference with the supervisor of the IRS contact identified in the heading of this letter. You also may file a protest with the IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information including a statement of the facts, the applicable law, and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

You also may request that we refer this matter for technical advice as explained in Publication 892. Please contact the individual identified on the first page of this letter if you are considering requesting technical advice. If we issue a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, no further IRS administrative appeal will be available to you.

Contacting the Taxpayer Advocate Office is a taxpayer right

You have the right to contact the office of the Taxpayer Advocate. Their assistance isn't a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate can't reverse a legally correct tax determination or extend the time you have (fixed by law) to file a petition in a United States court. They can, however, see that a tax matter that hasn't 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:

Internal Revenue Service
Office of the Taxpayer Advocate

For additional information

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,

Margaret Von Lienen
Director, EO Examinations

Enclosures:
Report of Examination –RAR 886-A

Form 4621-A
Form 6018
Publication 892
Publication 3498

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer		Year/Period Ended December 31, 20XX
EIN:		

Issue:

Whether or not the _____, qualifies for exemption under Section 501(c) (7) of the Internal Revenue Code?

Facts:

The _____ received tax exempt status as an organization described in Internal Revenue Code section, 501(c)(7) on October 1, 20XX.

The _____ provided a copy of its Form 1024 Application for Recognition of Exemption dated March 29, 20XX. Part II of Form 1024 'Activities and Operational Information', states that the purpose of the organization is to purchase and operate a marina in _____, as a non-profit boating social club exempt under IRC section 501(c)(7). Anyone can become a member of the organization. The only requirements are to purchase a boat slip from a for profit business, that goes by the name '_____, d/b/a _____' and pay the annual dues to the _____. In the year under examination the dues are roughly zero (\$0). The organization also puts together a fishing tournament every year. A majority of the individuals who paid to be part of this tournament in 20XX were non-members.

According to Article 1, Section 2 of the _____ bylaws, the purposes of the Club are set forth in the Club's Articles of Organization. Specifically, the purposes of the Club are; (1) to support recreational boating activities among its members;(2) to encourage and facilitate the interaction of its members through social events, educational programs, publications and activities related to boating and; (3) to provide programs in furtherance of the foregoing purposes as may be carried out and conducted by a Club organized under Chapter 180 of the _____ General Laws. The Club is organized as a nonprofit Club, and its activities shall be conducted for the aforesaid purposes in such a manner that no part of its net earnings shall inure to the benefit of any Director or officer thereof or any other individual.

The organization was formed by purchasing marina assets from an organization known as _____. The Installment Sale Agreement dated July 1, 20XX, sets the price of the Assets at (\$0). However, no evidence of the actual value of these assets is present in this agreement. The Installment Sale Agreement also goes on to state that the purchase price is subject to changes in accordance with paragraph (5), which states that the sale price is subject to market adjustment by Seller from time to time. The Agent requested more information about the purchase of assets and was informed no private valuation of the assets was conducted. The Agent was also told it was an arms-length transaction and therefore private valuation was not completed. The Installment Sale Agreement is consistently written like a 'long-term sale agreement' rather than a 'installment sale agreement', as paragraph {5} of the Installment Sale Agreement allows the sale price to change. This is not typical in a sale agreement.

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As part of the examination, the Agent requested a copy of the signed Installment Sale Agreement between the parties. A review of the 'Installment Sale Agreement' determined that the directors of _____; who signed the Installment Sale Agreement, were _____ and _____. A review of the _____ directors at the time that this sale was negotiated showed that _____ was the organization's sole director. The Agent does not agree that this Installment Sale Agreement was at an arm-length transaction (see _____ response to IRS request #3, Explanation of #1).

Issue 1: Operations inure to the benefit of its members and its related party

The organization is supposed to be operated as a social club under IRC Section 501(c)(7). Section 1.501(c)(7) of the Regulations provides that this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. Members are entitled to (1) access to the club house; (2) a place to dock their boat; and (3) storage for their boat. According to the organization website and other publications produced by the _____, members are encouraged to lease out their slip or storage space if they do not plan to use them. Several members allow their slip space or storage space to be leased out. In fact, some members own more than one slip for the sole purpose of leasing out the additional space to non-members for financial benefit.

The Agent received a blank 'Lease Agreement Contract' that the _____ issues to non-members who wish to lease a slip or storage space for personal use. Below is the heading of this agreement.

'Acting as an agent on behalf of a _____ member ("Lessor") or of _____ ("Lessor"), the _____ hereby agrees to facilitate a leasing agreement between the Lessor and the individual named herein ("Lessee"), who is not a member, for space sufficient to accommodate the yacht listed herein for the purpose, period, and price specified.' (See Lease Agreement Contract)

It is clear that the _____ is not operating solely for an exempt purpose. Instead it is merely a leasing agent for its members and _____. Since the members own their own slips and _____ owns several slips, it is clear that the _____ is organized and operated in a manner which permits and encourages benefits to private individuals and companies and is not an organization exempt under 501(c)(7) of the Internal Revenue Code. A club which engages in business, such as making its social and recreational facilities available to the general public is not organized and operated exclusively for pleasure, recreation, and other 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.

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Issue 2: Non-Member Income

As part of the examination, the Agent was able to determine that the [redacted] failed to report a significant amount of non-member slip rental income and several other fees collected from non-members on their filed Form 990 and Form 990-T for the period ending December 31, 20XX. In the organization's response to Information Document Request #3 (IDR-#3), the organization revealed \$0 in non-member income. In tax year 20XX, the organization charged Slip Rental Fees for the rental of members' slips, which totaled \$0. The organization reported \$0 in non-member fees on the Form 990. This represented zero percent (0%) of the total non-member income the organization attempted to receive. The organization also states in its response, that of the \$0 of invoiced slip rentals, \$0 was paid out to members, \$0 was uncollected and the remainder \$0 was kept by [redacted] to pay other member fees and/or note balances (see [redacted] response to IRS request #3, Explanation of #2).

In addition to the organization's response to IDR #3, the organization stated that it received 'Winter Storage Fee' and 'Summer Storage Fee' from its members, in the amounts of \$0 and \$0, respectively (see [redacted] response to IRS request #3, Explanation of #2). It was later determined that most of this income was non-member income as well. The Agent was able to determine this by comparing the last name invoiced to the organization membership fees list and determined many of the individuals were not members of the organization (See Non-Member Income work sheet). Following the same procedures the Agent also found that approximately \$0 in other non-member income was reported on the Form 990 under Section VIII, Line 2a: Members' Dues & Activities. It was determined that the income reported was in fact non-member income by comparing the organization's membership list, to the names invoiced on the detailed account transaction (See Non-Member Income work sheet).

After review of the organization's books and records, as well as the organization's response to the Agent's IDRs, it was determined that the non-member income was significant and was determined to be as high as zero (0%) (Refer to Member vs. Non-Member income worksheets). According to Revenue Procedure 71-17, non-member income should not exceed fifteen percent (15%) of the total income received by an organization exempt under 501(c)(7) of the Internal Revenue Code. The [redacted] had zero percent (0%) non-member income for tax year 20XX, equating to zero times the allowable amount of non-member income. Based on the facts of the examination, and the above mentioned Revenue Procedure 71-17, the organization does not qualify for exemption, since the income was more than insubstantially from non-members.

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Law:

Internal Revenue Code section 501(a) provides for exemption from taxation for certain organizations described in subsection (c).

Internal Revenue Code section 501(c)(7) describes social clubs as clubs organized for pleasure, recreation, and other 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.

Regulation 1.501(c)(7)-1(a) states in part that in general, the exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments.

Regulation 1.501(c)(7)-1(b) states that a club which engages in business, such as making its social and recreational facilities available to the general public is not organized and operated exclusively for pleasure, recreation, and other 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

Revenue Procedure 71-17, 1971-1 C.B. 683, describes the record-keeping requirements for social clubs exempt under *IRC 501(c)(7)* with respect to nonmember use of their facilities; it sets forth guidelines for determining the effect of gross receipts derived from public use of the club's facilities on exemption and liability for unrelated business income tax.

Gross Receipts Test/Public Law 94-568

Section 501(c)(7) was amended in 1976 by Public Law 94-568 to provide that *section 501(c)(7)* organizations could receive some outside income without losing their exempt status. Senate Report No. 94-1318 (1976), 2d Session, *1976-2 C.B. 597*, explains that a social club is permitted to receive up to 35 percent of its gross receipts, including investment income, from sources outside of its membership without losing its tax-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 (nonmembers). In effect, the latter modification increases from 5 percent (*Rev. Proc. 71-17, 1971-1 C.B. 683*) to 15 percent the proportion of gross receipts a club may receive from making its club facilities available to the general public without losing its tax exempt status.

Taxpayers Position:

The _____ does not agree with the Agent's position. The organization attests that the non-member income identified by the Agent is actual income from 'transient members'. The organization goes on to state members rent out their slips to transient members and the

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organization keeps a small fee and turns over the remainder of the money to the member. It was also made clear that the transient members do not have voting rights but have full access to the club as a traditional member. The organization also claims that it does not get involved in the rental of slips and that slips rented out by members to transient members does not constitute private benefit.

Response to Taxpayers Position:

The organization states that it allows members to rent out their slip and membership to 'transient members' and that these transactions are between the member and the transient member. These transient members have the right to use the club but do not have voting rights and cannot attend member meetings. It goes on to state that the () only participates only in facilitating the transaction for the member.

A review of the current Rules-and-Regulations dated August 20XX and posted on the organization current website as of June 23, 20XX brings doubt to the claim, that the organization is only facilitating the transaction. rules and regulations section 24.1 Member Leasing Rights & Restrictions paragraph three states "will make every reasonable effort to rent the slip, subject to market demand and other variables (see Rules & Regulations Section 24.1 page 21-22). The Club, however, makes no representations or assurances as to its ability to do so." Paragraph four goes on to state the Board has the right to approve the transaction and individuals must execute a 'leasing contract' with the Club, which remains solely responsible for all leasing arrangements in its capacity as agent acting on behalf of the member. It is clear that the organization is not just facilitating a transaction, but the organization is clearly an active participant in the leasing of slips.

The organization invoices non-members or transient members as the organization refers to them in the response to the thirty day letter, but according to response to IRS request #3, Explanation of #2 the organization refers to them as non-members and goes on to state that fees are only paid out to members when the fee is collected from the non-member. These payouts are zero percent (0%) of the fee collected.

A further review of the organization's meeting minutes mention of transient slip rental, which describes the organizations legal obligation to make vacant slips available to transients (Board of Directors Minutes 02/27/20XX). There are no references to 'transient members' in the organization's meeting minutes. The organization does however make several references to members and renters in the board of director's minutes. In several instances the minutes describe the organization's general manager finding renters for the available

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slips, and future efforts to find renters at boat shows, open houses, ads on Craigslist, etc. (Minutes)..

The organization letter also states that there is little difference between members and transient members. However the organization has a complete 'rate schedule' posted on their website for current year 20XX, which shows various rates for members and renters. These rates are higher for renters and in some cases the organization will charge non-members a fee for the same service that members receive for no cost. The organization mentions that transient members are another class of members in the organization, but transient members do not pay annual dues, have no voting rights, and do not have an advocate on the Board of Directors.

During the year under examination the organization held a fishing tournament and the majority of individuals attending this tournament were non-members. This was easy to determine by comparing the membership annual membership fee paid, with the individuals who paid to attend the fishing tournament (see membership annual fee and fishing tournament fee collection).

The organization claims there is no private benefit from the rental of member slips to transient members. The organization allows its members slips to be rented out and zero percent of the proceeds are then turned over to the member. The use of club assets to produce financial gain for individual members is private benefit.

Government's Position:

Issue 1:

The government believes that revocation of the organization's exempt status should be sought. The organization does not qualify for exemption in part due to the organization's operations and the above stated law. It is clear that the _____ is not operating for an exempt purpose; instead it is merely a leasing agent for its members and _____. Since the members own their own slips and _____ owns several of the slips, it is clear that the _____ is organized and operated in a manner such that its net earnings benefits private shareholders. It is not an organization exempt under IRC section 501(c)(7) of the Internal Revenue Code.

Issue 2:

The government believes that revocation of the organization's exempt status should be sought. Based on the facts of the examination, the organization does not qualify for exemption. This

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organization substantially exceeded the 15% limitation for non-member income for the year ending December 31, 20XX.

Conclusion:

Based on the foregoing reasons, the organization does not qualify for exemption under *section 501(c)(7)* and its tax exempt status should be revoked. Accordingly, the organization's exempt status is revoked effective January 1, 20XX.

Per Section 277 of the Internal Revenue Code (Code), a non-exempt organization that is a membership organization is allowed a deduction for expenses that relate to the operation of the organization for its members. Section 277(a) states that "In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members, and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members)".

When completing the Form 1120 the organization must divide the income and expenses between the member and non-member activities. If there is a loss from the membership activity it cannot be used to offset the income from the non-member activities. A loss on the member activity can be carried forward to a later year to be taken against member income.

Form 1120 returns should be filed for the tax periods ending on or after December 31, 20XX.