Internal Revenue Service

Department of the Treasury
801 Tom Martin Drive
Room 263
Birmingham, AL 35211

Taxpayer Identification Number:

Date: February 6, 2013

Form:

Number: 201418056
Release Date: 5/2/2014

Tax Year(s) Ended:

Person to Contact/ID Number:

ORG
ADDRESS
UIL: 501.07-00

Contact Numbers:
Telephone:
Fax:

CERTIFIED MAIL - RETURN RECEIPT REQUESTED

Dear :

We have enclosed a copy of our report of examination explaining why we believe revocation of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action.* We will then send you a final letter revoking your exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing
Director, EO Examinations

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

Form **886-A** (Rev. January 1994)	**EXPLANATION OF ITEMS**	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification number EIN	Year Period ended December 31, 20XX

LEGEND
ORG - Organization name XX - Date EIN - EIN

ISSUE

Whether or not the ORG continues to qualify for exemption under section 501(c)(7), since it has not kept adequate records to comply with Revenue Ruling 71-17?

FACTS

The ORG was granted exemption under section 501(c)(7) of the Internal Revenue Code. The purpose of the Club according to its Articles of Incorporation is to promote social and intellectual intercourse among its members, to promote and conduct boating educational projects, and for the purpose of promoting the foregoing objects, this corporation shall have the right to acquire, either by gift of purchase, and to hold own, sell, mortgage, or encumber in any manner, lease, and improve real estate and personal property for itself and others, either as trustee or otherwise. The facility owned by the organization is a club house and dock. The facility is used by members, but is also patronized by the general public. They have several annual and weekly events, which non-members also attend. At the time of the examination the organization did not have any records to distinguish how much of its income was received from members and how much was received from members. Since a social club exempt under section 501(c)(7) is required to maintain such records, the lack of this documentation requires that all of income from the rental of the facility and sale of the inventory be treated as unrelated business income.

	20XX	20XX	20XX
Interest on savings and temporary cash investments			
Non-member income			
Total Gross Revenue			
Percentage of non-exempt function income over Total Revenue			

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 organizations 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, 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 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 does 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 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 a 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 cannot be treated as being operated exclusively for pleasure, recreation, or other nonprofitable 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 non-members as bona fide guests of members is not unrelated business income. However, if the club fails to maintain these records and cannot 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

The taxpayer will have the opportunity to respond after receipt of this report.

GOVERNMENT'S POSITION

An organization exempt from federal income taxes as described in IRC section 501(c)(7) must meet the gross receipts test in order to maintain its exemption. In order to meet the gross receipts test, an organization can receive up to % of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. Within this % amount, not more than % 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. The ORG has acknowledged that it has failed to keep records with respect to the member or non-member status of the individuals who used the facilities. Because the club failed to maintain adequate records to substantiate member from non-member use of the facilities, $, $, and $ in 20XX, 20XX, and 20XX respectively (derived from program service revenue, investment income, rental income, and inventory sales) is considered non-member income. The non-member income accounts for approximately % of the ORG's gross income, well above the % maximum allowance from income outside the membership, and % maximum allowance of income from public use of the facilities.

The above information shows that the ORG fails the gross receipts test. The organization fails the gross receipts test and does not receive substantially more than half, or % of its income from its membership. Therefore, it is the government's position that the exempt status of the ORG should be revoked.

CONCLUSION

Because the organization acknowledges that it is patronized by nonmembers, but has not adequately maintained records to distinguish between the amount of income from members and the amount from non-members it is all deemed non-member income. Therefore, the limits for receipt of unrelated business income for a 501(c)(7) organization have been exceeded, and revocation of its exempt status is being proposed effective January 1, 20XX.

ALTERNATIVE ISSUE

In the alternative, if the organization qualifies for exemption under section 501(c)(7), should the actual net income from nonmembers and other non-exempt activity income not be taxable as unrelated business income under section 511 of the Code?

FACTS

The organization failed to file Information and Form 990-T, Exempt Organization Unrelated Business Income Tax Returns for the prior, current, and subsequent years prior to this examination. The delinquent returns secured before all the examination issues were fully developed that led to the decision to propose revocation.

LAW

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

Section 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 or funds of the use it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Section 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 or other endeavors which may not be related to the exempt purposes of the organization.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than the production of income). Further, it is "substantially related," for purposes (other than the production of income). Further, it is "substantially related," for purposes of section 513 of the Code only if the causal relationship is a substantial one. For this relationship to exist, the production or distribution of the goods or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of the exempt purposes.

TAXPAYER POSITION

Taxpayer has tentatively indicated that they do not agree with the examination findings. They did not file a formal protest, but did verbally state that they would not be signing Form 6018.

GOVERNMENT POSITION

The ORG failed to maintain records of member and non-member income as set forth in Revenue Procedure 71-17. Since there was non-member participation in the organization's activities all income from those activities has been classified and unrelated business income. Therefore, it is clear from this examination that the organization has exceeded the percent legal limit, and also not operated exclusively for its exempt purpose. It shows that the organization is not substantially supported by membership receipts as required under this Code. This represents inurement for the shareholders barred by IRC 501(a). Revocation of exempt status is warranted.

CONCLUSION

The ORG no longer qualifies for exemption under section 501(c)(7) of the Internal Revenue Code as nonmember income has exceeded the % threshold permitted by Public Law 94-568. Therefore, your exempt status under section 501(c)(7) of the Internal Revenue Code should be revoked effective January 01, 20XX. Should this revocation be upheld, Form 1120 must be filed starting with tax periods ending December 31, 20XX through December 31, 20XX.

Our examination of your exempt organization was primarily a compliance audit, and such audit is conducted to verify your continued compliance with IRC Section 501(c)(7). The Board of Directors has a fiduciary responsibility to ensure full compliance of the IRC Section 501(c)(7).