



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

TE/GE: EO Examinations

625 Fulton Street, Room 503

Brooklyn, NY 11201

**TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION**

Number: **200624069**
Release Date: 6/16/2006
Date: March 23, 2006
UIL: 501.07-01

Taxpayer Identification

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Dear _____ :

This is a final determination regarding your exempt status under section 501(c)(7) of the Internal Revenue Code (IRC). Recognition of your exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(7) is retroactively revoked to because it is determined that you have not established that you are observing the conditions required for the continuation of an exempt status.

We previously provided you a report explaining the proposed revocation of your tax-exempt status. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. By signing Form 6018-A, *Consent to Proposed Action*, you indicated that you accept our determination to revoke your organization's exempt status.

We have determined that you fail to qualify for exempt status under any other subsection of IRC 501(c).

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for all years beginning We have secured Form 1120-A for years ended

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez
Director, EO Examinations



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
Wells Fargo Building - Suite 1130B
Mail Stop 4925STP
St. Paul, MN 55101-4940

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Dear

We have enclosed a copy of our report of examination explaining why we believe an adjustment 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.

Letter 3610 (04-2002)
Catalog Number 34801V

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 modifying or revoking 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,

R.C. Johnson
Director, EO Examinations

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

Form 886-A	Explanation of Items	Sched. or Exhibit
Name of Taxpayer Org		Year/Period Ended Date 1

Legend:

- Org = Name and Address of Org.**
- Date 1 = Tax Period**
- Date 1A = Effective Date of Revocation**
- Date 2 = Date of Incorporation**
- A = Alumni Assoc.**
- B = University**
- C = Cities**
- D = State**

Issue under Consideration

Does Org qualify to be exempt from Federal income tax under Internal Revenue Code section 501(c)(7)?

Facts

The Org was incorporated in Date 2 and was granted tax exemption under Internal Revenue Code (IRC) 501(c)(7) as a social club in a letter from the Internal Revenue Service.

The purpose of the Org is to work in conjunction with A. in promoting, by organized effort, the best interests of the B. The organization wants to establish closer contact among alumni in the C and encourage qualified young people to attend B. Per the bylaws stated the organization wanted to offer scholarships to State and western State youth and to perform community service within C. Membership was limited to former students, faculty members or anyone who has an interest in B.

There were no articles of incorporation given by the taxpayer. Per microfiche file request, I was able to receive a copy of the articles of incorporation and noted that the purpose of the organization was very similar to the purpose in which the taxpayer gave me.

Law and Argument

Internal Revenue Code 501(c)(7) describes as exempt, as provided under IRC 501(a), "clubs organized for pleasure, recreation, and other non-profitable 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." The tax treatment of social clubs is designed to allow individuals to join together to provide themselves with recreational or social facilities on a mutual basis without tax consequences. It operates properly only when the club's sources of income are limited to its membership, so the member is in substantially the same

Form 886-A	Explanation of Items	Sched. or Exhibit
Name of Taxpayer Org		Year/Period Ended Date 1

position as if he had spent his after-tax income on pleasure or recreation without the intervening organization.

Section 501(c)(7) was amended in 1976 to provide that social clubs could receive some income from sources outside the membership without losing their exempt status. The legislative history indicates that Congress intended to liberalize prior IRS limitations on the portion of income a social club may receive from nonmember use of its facilities and investment income. However, the Senate committee report states the intent is not "that these organizations should be permitted to receive, within permitted allowances, income from the active conduct of businesses not traditionally carried on by these organizations."

The Committee Reports for Public Law 94-568 (Senate Report No. 94-1318 2d Session, 1976-2 C.B. 597) state that it is intended that social clubs should be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their memberships without losing their exempt status.

- (a) Within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter do not represent more than 15 percent of total receipts.
- (b) Thus, a social club may receive investment income up to the full 35 percent amount of its gross receipts, where a social club receives no income 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.

Internal Revenue Code (IRC) section 512(a)(1) states that "unrelated business taxable income" is the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business.

IRC section 512(a)(3)(A) states that in the case of an organization described in IRC section 501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed which are directly connect with the production of the gross income (excluding exempt function income).

Internal Revenue Code 512(a)(3)(B) exempts social clubs only to the extent of their "exempt function income," which is defined as the gross income from dues, fees, charges, and other income generated by club members pursuant to the organizations' nonprofitable purposes. Income received from the general public or from investments is treated as unrelated business taxable income and is taxed at general corporate rates.

Form 886-A	Explanation of Items	Sched. or Exhibit
Name of Taxpayer Org		Year/Period Ended Date 1

Examples of taxable income include investment income or income generated from nonmembers through traditional activities: i.e., those activities that if conducted with members further a social purpose.

Revenue Procedure 71-17 details Public Law 94-568 and sets forth the guidelines for determining the effect gross receipts derived from use of social club's facilities by the general public has on the club's exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code. These guidelines will be used in connection with the examination of annual returns on Forms 990 and 990-T filed by social clubs. This revenue procedure also describes the records required when nonmembers use a club's facilities and the circumstances under which a host-guest relationship will be assumed, which are relevant both for purposes of determining adherence to the exemption requirements and for computing exempt function income under section 512(a)(3) of the Code.

Section 4 of Revenue Procedure 71-17 provides the recordkeeping requirements. Section 4.03 of Revenue Procedure 71-17 states that the occasions involving use by non-members the club must maintain books and records of each such use and the amount derived therefrom. This requirement applies even though the member pays initially for such use. In each instance, the record must contain the following information:

- 1) the date;
- 2) the total number in the party;
- 3) the number of non-members in the party;
- 4) the total charges;
- 5) the charges attributable to non-members;
- 6) the charges paid by nonmembers; and
- 7) where a member pays all or part of the charges attributable to non-members, a statement signed by the member indicating whether the has been or will be reimbursed for such non-member use, and if so, the amount of the reimbursement.
- 8) Attached is a sample worksheet that includes these items

Section 4.04 of Revenue Procedure 71-17 provides that if a club fails to maintain or make available the records required by that revenue procedure, the percentage guidelines may not be used in the determination of whether the club has a non-exempt purpose.

Government's Position

A social club's exemption does not operate properly when it receives income from sources outside its membership, because the members will receive a benefit not contemplated by the statute in that untaxed dollars are used by the organization to provide pleasure or recreation to its membership. To prevent club members from receiving benefits not contemplated by IRC 501(c)(7), the receipt of nonmember income and

Explanation of ItemsName of Taxpayer
OrgYear/Period Ended
Date 1

investment income is permitted up to certain limits without jeopardizing exemption, but the net income from these sources is made taxable by the clubs by IRC 512(a)(3).

A nonmember is considered to be a person from the general public who is provided recreational and social services by the organization and pays for these services. A paying nonmember is a purchaser of the goods or services provided by the organization, and is a direct recipient of those goods or services from the organization. Such a nonmember is not considered to be entertained by a member even when accompanied by a member but is instead considered to be a principal in a business transaction with the organization. The host-guest relationship is missing when the nonmember pays.

A social club may derive up to 15% of its gross receipts from nonmember use of club facilities and/or services without jeopardizing its exempt status. It is important to distinguish nonmember use from member use of the facilities and services. An issue that arises is whether an individual or a group is a true guest of a member. This is important because income from bona-fide guests is treated as member income. The amendment to IRC 501(c)(7) by P.L. 94-568 does not affect what constitutes public use of club facilities and prior precedent on this question should still be followed.

Where goods or services are furnished to nonmembers who provide payment for such goods or services, their furnishing is outside the scope of section 1.501(c)(7)-1(b) of the regulations. Generally, if an organization has not kept adequate books and records concerning its financial transactions with nonmembers and more than 15 percent of its gross receipts are derived from sales transactions (e.g. restaurant and bar sales) to non-members, the presumption will be that the organization's exempt status should be revoked because it is not primarily engaged in section 501(c)(7) activities.

All income of an organization that is otherwise organized and operated within the meaning of IRC 501(c)(7) should be considered as income from unrelated business if no records are maintained to determine if such income is related to exempt activities/purposes. (note: IRC 512(b) provides modifications to the definition of unrelated business taxable income. Therefore, income from sources not related to exempt activities/purposes might not be considered as unrelated business taxable income. For example, hall rental income would not be unrelated business taxable income (UBTI) unless services are rendered or the property is "debt-financed".)

Income that an organization claims is related or partially related to exempt activities/purposes of the organization must be substantiated by the maintenance of records by the organization in sufficient detail to determine whether the income is related to the exempt activities/purposes of the organization and whether the income is derived from members or nonmembers.

Based on completing a two-year income analysis during tax periods ending Date 1, it has been determined that Org has been unable to provide an accurate account of nonmember income as outlined in public law bulletin 94-569. Furthermore, the organization has failed to maintain book and records regarding member and nonmember income.

Explanation of ItemsName of Taxpayer
OrgYear/Period Ended
Date 1**Organization's Position**

The treasurer, of the Org agreed to revocation of their 501(c) (7) exempt status due to unable to accurately substantiate member vs. nonmember income. He stated that he believes that the organization will dissolve as opposed to reapplying for exempt status. The expectation of his responsibilities is way greater than he anticipated and he will not be able to fulfill his position.

Conclusion

Based upon the information noted above, it is proposed the exempt status of the organization be revoked as of the fiscal year, Date 1A. Forms 1120, *U.S. Corporation Income Tax Return* should be obtained for the fiscal years, Date 1 and Date 1.

Amended Forms 990-T cannot be filed for these years to differentiate member and nonmember income because records on non-member usage of the facilities have not been kept according to Revenue Procedure 71-17.

The organization may re-apply for tax exemption under IRC 501(c)(7) but should use improved recordkeeping procedures that will comply with Revenue Procedure 71-17 (noted above) and which could also include such factors as:

- All members should provide a membership number to purchase restaurant and bar services and the membership number entered on the receipt. If the membership number is not on the receipt, the presumption is that services are to nonmembers.
- Carbons of the receipts will be retained by the organization. To distinguish member and nonmember receipts, the copies of member receipts should be a different color from the copies of nonmember receipts.
- When the member pays for the services rendered to a guest or guest, the income will be considered member income. A member will be issued a member receipt indicating the member paid for the services provided to the guest.
- If the member brings nonmembers but does not pay for them, they cannot be considered guests, and these nonmembers should receive nonmember receipts for services provided to them. The member will receive a member receipt for services provided to the member.

Explanation of ItemsName of Taxpayer
OrgYear/Period Ended
Date 1

- Where a member pays all or part of the charges attributable to nonmembers, a statement signed by the member indicating whether he has been or will be reimbursed for such nonmember use and, if so, the amount of the reimbursement.
- Where a nonmember makes payment to the organization or reimburses a member and a claim is made that the amount was paid gratuitously for the benefit of a member, a statement should be signed by a member indicating the donor's name and relationship to the member, and containing information to substantiate the gratuitous nature of the payment or reimbursement.
- For occasions in which the organization is dealing with nonmembers and wishes to contest the presumption that the income is subject to the unrelated business income tax, the organization's books and records must contain the following information:
 - (a) the date
 - (b) purpose of function
 - (c) the total number in the party
 - (d) whether a member sponsors the function and, if so, the name of the sponsor
 - (e) the number of members in the party
 - (f) the number of nonmembers in the party
 - (g) the total charges
 - (h) the charges paid by a member
 - (i) the charges paid by nonmembers