

200628040

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

SET: EO

4-18-06

U.L 501.07-01

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

**CERTIFIED MAIL – RETURN RECEIPT REQUESTED**

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 appeal rights. By signing Form 6018, *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).

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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 for years ended ..... and .....

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.

Thank you for your cooperation.

Sincerely,

Marsha A. Ramirez  
Director, EO Examinations

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DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
300 N. Los Angeles Street, MS 7300  
Los Angeles, CA 90012

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Taxpayer Identification Number:

Form:

Tax Year Ended

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Dear Taxpayers:

We have enclosed a copy of our draft report of examination explaining why we believe revocation of your exempt status under 501(c)(7) of the Internal Revenue Code is necessary.

Please review the report (Form 886-A) and the enclosed publications. If you accept our findings please sign the enclosed Form 6018 and return the form to our office within 10 days. If you do not accept our findings please contact me immediately to discuss the proposed adjustments. You may also schedule a meeting with my manager to discuss the proposed adjustments.

Thank you for your cooperation.

Sincerely,

Laura Spencer  
Revenue Agent

Enclosures:  
Form 886-A, Form 6018  
Publication 3498, Publication 892

Form <b>886A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>		<b>Year/Period Ended</b>

**ISSUE:**

Should ORG's tax exemption under 501(c)(7) of the Internal Revenue Code be revoked because it has not met the requirements of 501(c)(7) and Revenue Procedure 71-17?

**FACTS:**

ORG was recognized as a tax exempt organization under 501(c)(7) of the Code. Currently located in State, its facilities include a large building and a smaller building in back with a basketball court between the buildings. The large building consists mainly of a dance floor area with a stage and a kitchen area next to the dance floor. The large building is used for all the organization's activities and it is rented out for parties. The smaller building is set up to play games for adults and children. It is also used for storage and planned to be used for office space.

Reported income per Form 990 was as follows:

Direct public support  
 Program service revenue  
 Membership dues & assessments  
 Rental income  
**TOTAL REVENUE**

Income received from direct public support was donations from non-members and income from advertising. Program service revenue was income received from member events primarily from members. Rental income was income received from non-members for the rental of the organization's facilities for non-member events and parties (i.e. unrelated business income).

In support of the rental income received, the organization provided rental agreements and contracts for each rental. The contracts and agreements were all executed with non-members during the year. Therefore, it was determined during the examination that all of the income received from the rental of the organization's facilities was from non-members during the year

The organization did not file a Form 990-T for the exam year for the rental income received from non-members (i.e. unrelated business income). A prior audit report issued during        for the examination of the tax periods ending years        reported that Forms 990-T were required to be filed but were not filed by the organization. During the        examination Forms 990-T were secured as delinquent returns. The        audit report also advised the organization that a Form 990-T must be filed in any year which there is unrelated business income of \$1,000 or more. During the current examination of the year        it was determined that the

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organization did not comply with the 1985 audit report and file a Form 990-T for the unrelated business income received from rental income which exceeded \$1,000.

However, it is noted that, due to the current examination, the organization filed a Form 990-T for the year which reported non-member income of \$34,500 and total gross receipts of \$80,538.

**LAW:**

Internal Revenue Code Section 501(c)(7) exempts from Federal income tax "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."

Income Tax Regulation 1.501(c)(7)-1(a) states, "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 any part of 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."

Income Tax Regulation 1.501(c)(7)-1(b) also states, "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). 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 sets forth guidelines for determining the effect gross receipts derived from use of a social club's facilities by the general public have on the club's exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code of 1954. The term "general public" as used in the Revenue Procedure means persons other than members of a club or their dependents or guests. Revenue Procedure states that where a club makes its facilities available to the general public to a substantial degree, the club is not operated exclusively for pleasure, recreation, or other nonprofitable purposes.

Revenue Procedure 71-17 provides that a significant factor reflecting the existence of a nonexempt purpose is the amount of gross receipts derived from use of club facilities by the general public. It provides that gross receipts in excess of \$2,500 and which make up more than 5% of total gross receipts will demonstrate a nonexempt purpose.

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Public Law 94-568 passed in 1976 later changed the allowable portion of income received from the general public to not more than 15%. Revenue Procedure 71-17 defines "total gross receipts" as receipts from normal and usual activities of the club including charges, admissions, membership fees, dues, and assessments. Excluded for this purpose are (a) initiation fees and capital contributions, (b) interest, dividends, rents, and similar receipts, and (c) unusual amounts of income such as amounts derived from nonrecurring sales of club assets.

Internal Revenue Code Section 512(a)(3)(A) provides in pertinent part that the unrelated business taxable income of an organization described in section 501(c)(7) means the gross income (excluding any exempt function income), less deductions allowed by Chapter 1 of the Code which are directly connected with the production of the gross income (excluding exempt function income).

Internal Revenue Code Section 512(a)(3)(B) of the Code defines the term "exempt function income" for purposes of subparagraph (A) as the gross receipts from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guest goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

Revenue Ruling 58-589 sets forth criteria for determining whether an organization qualifies for exemption from tax under IRC 501(c)(7) including a discussion of income from non-member sources used to reduce the cost of providing services to members.

Revenue Ruling 60-324 ruled that a 501(c)(7) organization may lose its exemption if it makes its club facilities available to the general public on a regular, recurring basis since it may no longer be considered to be organized and operated exclusively, for its exempt purpose.

Revenue Ruling 69-220 provided that a social club that receives a substantial portion of its income from the rental of property and uses such income to defray operating expenses and to improve and expand its facilities is not exempt under IRC 501(c)(7).

#### **GOVERNMENT'S POSITION:**

Based on the examination, ORG has exceeded the 15% threshold of gross receipts allowed from non-members during the year per Revenue Procedure 71-17 determined as follows:

Direct Public Support	\$ 3,412
Program Service Revenue	\$21,269
Membership Dues	\$11,840
Rental Income	<u>\$39,650</u>

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Total Gross Receipts Per Rev. Proc. 71-17	\$76,171
Total Non-member Gross Receipts per Rev. Proc. 71-17 (\$3,412 + \$39,650)	\$43,062
Percentage of Non-member gross Receipts (\$43,062 / \$76,171)	56.53%

In addition, the organization filed Form 990-T for the year subsequent to the year under examination. The Form 990 for year shows that non-member income from rental of its facilities (\$34,500) is 42.8% of the organization's total gross receipts (\$80,538).

Therefore, based on the examination, ORG is not operated substantially for pleasure, recreation, and other nonprofitable purpose because it is engaged in the business of making its facilities available to the general public. ORG is not entitled to tax exemption under 501(c)(7) of the Code and its tax-exempt status should be revoked.

#### **TAXPAYER'S POSITION:**

The taxpayer signed the Form 6018, Consent to Proposed Action – Section 7428, to agree the revocation of its exemption on July 27, 2005. The taxpayer filed 1120 returns and paid corporation income taxes for years .

#### **CONCLUSION:**

ORG is not entitled to tax exemption under 501(c)(7) of the Code and its tax-exempt status should be revoked.