



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service
Exempt Organizations
5104 N. Blythe Ave. #203
Fresno, CA 93722

July 25, 2008

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UIL Code: 501.03-00

ORG

ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

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.

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,

Francisco N. Favila
Revenue Agent

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

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer: ORG		Year/Period Ended April 30, 20XX

LEGEND

ORG = ORGANIZATION NAME XX = DATE CITY = CITY STATE = STATE

ISSUE:

Is ORG properly operating as described in Internal Revenue Code 501 (c) (7)?

FACTS:

ORG, ORG, received tax exempt status under Internal Revenue Code, IRC, 501 (c) (7) in February 19XX, per IDRS INOLES print dated 09/26/XX. ORG did not have the Determination Letter nor a copy of the Articles of Incorporation, therefore the exact date ORG was granted exemption or the exact date of incorporation could not be determined.

ORG is the local branch of the CO-1 (CO-1), headquartered in City, State. The branch constructed a facility for the benefit of its members in the early 19XX's. To contain any liability that may arise from the facility to the local branch, a separate entity, ORG, was created to hold title of the facility and to conduct the social activities to benefit its members.

The membership to ORG is restricted to members of the CO-1. Membership to the CO-1 is restricted to individuals who are enlisted military service members on active duty, retired, and reserve of the United States Navy, Marine Corp, or Coast Guard. Membership to ORG is contingent on membership to the CO-1. The CO-1 provides members with membership identification cards which must be presented upon request by ORG personnel.

ORG provided a copy of its Bylaws dated 12/12/XX. Article 2 states that ORG will be operated as a private ORG, on private property, for the exclusive use of members of the CO-1, Units of the Ladies Auxiliary of CO-1, and bona fide guests.

ORG operates a bar with a small kitchen and a hall. ORG is open seven days a week, except on some holidays, from 11 am to usually 7 pm. ORG also hosts Bingo games on Sunday and Tuesday nights. ORG does not have any "members only" signs posted.

ORG's sources of revenue include the sale of food, beverage, and hall rental to members, bona fide guests, and the general public. ORG does not have any membership dues revenue because the membership dues are paid to the CO-1. ORG does not have any investment income.

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ORG is patronized by members, bona fide guests and by the general public. ORG maintains a member guest sign in log at the front entrance of ORG, the log contains the member's and the guest's names. ORG hosts Bingo games on Sunday and Tuesday nights, which, due to a local city ordinance, must be open to the general public. According to ORG management, approximately 60 to 100 people attend the bingo games and up to one half of the patrons are nonmembers. ORG does not utilize the member log on Bingo nights. ORG did not maintain any records of nonmember sales.

ORG rents the hall to the CO-1 and to individuals. The CO-1 conducts the Bingo games on Sundays and Tuesdays. The CO-1 pays ORG \$ for each day the hall is rented and paid a total of \$ from May 1, 20XX to April 30, 20XX. The CO-1 keeps the proceeds of the Bingo games. ORG did not keep adequate records to substantiate any hall rental income from members.

ORG is under examination for the tax period ending April 30, 20XX. During the course of the examination it was discovered that ORG did not report any unrelated taxable income which ORG had received from nonmembers. It was also discovered that ORG did not maintain proper records on nonmember use of ORG's facilities as required by Revenue Procedure 71-17. Based on the examination of the books and records it was determined that ORG had at minimum \$ of nonmember income generated from hall rental and \$ additional hall rental income which was not properly document and as such will be treated as nonmember income. Due to the lack of records, the exact amount of nonmember revenue from all sources can not be determined.

The percentage of known gross nonmember income generated from hall rental to ORG's total gross income is as follows:

	End 04/30/XX	End 04/30/XX
Nonmember hall rental income	\$	
Total gross receipts	\$	
Percentage	20%	22%

ORG claimed tax exemption status under IRC 501 (c) (4) on Form 990, filed for tax period ending 04/30/XX. The Form 990 was prepared using the previous years Form 990 as a guide. ORG was unable to produce any supportive documentation granting tax exempt status under IRC 501 (c) (4).

LAW:

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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.

Public Law 94-568 amended IRC section 501(c) (7) to allow these organizations to receive a greater amount of nonmember income without jeopardizing their exempt status. The committee reports provide that a section 501(c)(7) organization can receive up to 35% of its gross receipts from nonmember sources and investment income, as long as the nonmember gross income does not exceed 15% of the total gross receipts.

Revenue Procedure 71-17 sets forth guidelines for determining the effect gross receipts derived by the general public have on a club's exemption from Federal Income Tax under section 501(c)(7) of the Internal Revenue Code. Revenue Procedure 71-17 also describes the records a club must maintain 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 3 of Revenue Procedure 71-17 provides a set of assumptions as to the status of nonmembers using club facilities. If nonmember use can be classified into one of the assumptions listed in Revenue Procedure 71-17, then the income derived from these individuals will be income from guests and treated as if from members and therefore be classified as exempt function income. Clubs are required to provide detailed records of nonmember use to substantiate the assumptions

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Section 4 of Revenue Procedure 71-17 describes the records that a social club must maintain with respect to the assumption listed in section 3. Section 4.03 of Revenue Procedure 71-17 describes the books and records that must be maintained when the assumptions contained in Section 3.03 do not apply.

Section 4.04 of Revenue Procedure 71-17 states that failure to maintain such records or make them available to the Service for inspection will preclude use of the minimum gross receipts standard and audit assumptions set forth in this Revenue Procedure.

GOVERNMENT’S POSITION:

Based on the fact that appropriate records were not maintained by ORG to determine the total amount of nonmember income did not exceed the 15% limitation, existing records indicate a minimum of 20% of nonmember income, and the circumstances under which ORG operates, it is the Government’s position that ORG is no longer operating in the manner described in IRC 501 (c) (7) and as such tax exemption status should be revoked.

TAXPAYER’ POSITION:

The Taxpayer does not agree with the proposed revocation and did not provide a written position, but rather returned Letter 3610, Form 6018, and the RAR to Agent with a dated and signed post it note with a handwritten note saying “we chose not to sign this document”. Agent called the taxpayer several time and left voice messages, but they were not returned.

CONCLUSION:

The tax exempt status of ORG is revoked because it is not operating as a social ORG described in the Internal Revenue Code Section 501 (c) (7) for the exclusive benefit of its members and their guests, but rather the general public. Further ORG did not keep adequate records as described in Revenue Procedure 71-17.

ALTERNATIVE ISSUE:

Is ORG engaged in an unrelated trade or business as defined in IRC section 513(a) and liable for the tax on unrelated business taxable income as defined in IRC section 512(a)(3)?

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FACTS:

See "Facts" section previously stated.

LAW:

IRC section 511(a) imposes a tax on the unrelated business taxable income of an organization otherwise exempt from Federal Income Taxes.

IRC section 512(a)(3) provides special rules applicable to IRC section 501(c)(7) organizations, among others, to be used in defining "unrelated business taxable income". IRC section 512(a)(3)(A) defines "unrelated business taxable income" as the gross income (excluding exempt function income), less the deductions allowed by this chapter which are directly connected with the production of gross income.

IRC section 512(a)(3)(B) defines "exempt function income" as the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

IRC section 513(a) defines "unrelated trade or business" to mean any trade or business, the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose of function constituting the basis for its exemption under IRC 501.

Internal Revenue Code section 501(c)(7) describes social clubs as follows:

"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."

GOVERNMENT'S POSITION:

Based on the conclusion and government's position sections of this report relating to the primary issue, it is determined that the public use of ORG's facilities is not an exempt activity and therefore not related to it's tax exempt purpose. Thus, the public's use of ORG's facilities falls under the definition of a "unrelated trade or business" per IRC section 513 (a). Furthermore, the income from the general public is then taxable as "unrelated business taxable income" as defined in IRC section 512(a)(3)(A).

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TAXPAYER' POSITION:

The Taxpayer does not agree with the proposed revocation and did not provide a written position, but rather returned Letter 3610, Form 6018, and the RAR to Agent with a dated and signed post it note with a handwritten note saying "we chose not to sign this document". Agent called the taxpayer several time and left voice messages, but they were not returned.

CONCLUSION:

The revenue received from non members and the general public is unrelated taxable income as described in IRC Section 512 and therefore subject to tax under IRC section 511.