



DEPARTMENT OF THE TREASURY

Internal Revenue Service
TE/GE EO Examinations
1100 Commerce Street MC 4920 DAL
Dallas, TX 75242

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: **MAY 01 2018**

Number: **201833025**
Release Date: 8/17/2018

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to:
EIN:

**LAST DATE FOR FILING A PETITION
WITH THE TAX COURT:**

UIL Code: 501.03-00

CERTIFIED MAIL - Return Receipt Requested

Dear :

This is a Final Adverse Determination Letter as to your exempt status under section 501(c)(7) of the Internal Revenue Code (IRC). The denial of your tax-exempt status under IRC section 501(c)(7) is effective January 1, 20XX.

Our adverse determination was made for the following reasons:

You have not established that you are operated substantially for pleasure and recreation of its members or other non-profitable purposes and no part of the earnings inures to the benefit of private shareholder within the meaning of IRC section 501(c)(7).

You have made your services, use of recreational and social facilities available to the general public. You have exceeded the non-member income test for tax year ending December 31, 20XX.

You failed to keep and maintain books and records as required by Rev. Proc. 71-17.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the year ending December 31, 20XX and for all years thereafter.

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

If you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91st day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS that can help protect your taxpayer rights. We can offer you help if your tax problem is causing a hardship, or you've tried but haven't been able to resolve your problem with the IRS. If you qualify for our assistance, which is always free, we will do everything possible to help you. Visit taxpayeradvocate.irs.gov or call 1-877-777-4778.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

A handwritten signature in black ink that reads "Maria Hooke". The signature is written in a cursive, slightly slanted style.

Maria Hooke
Director, Exempt Organizations Examinations

Enclosures:
Publication 892



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

Date:
September 11, 2017
Taxpayer Identification Number:

Form:

Tax year(s) ended:

Person to contact / ID number:

Contact numbers:
Phone Number:
Fax Number:
Manager's name / ID number:

Manager's contact number:
Phone 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)(3) 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)(3).

After we issue the final revocation letter, we'll announce that your organization is no longer eligible for contributions deductible under section 170 of the Code.

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,

Maria Hooke
Director, EO Examinations

Enclosures:
Report of Examination
Form 6018
Publication 892
Publication 3498

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Years/Period ended 20XX

ISSUE:

Whether _____ continues to qualify for exemption under Internal Revenue Code (IRC) §501(c)(7)?

FACTS:

_____ filed Form 202, *Certificate of Formation Nonprofit Corporation*, with the Secretary of State for the State of _____ on October 28, 20XX. Their purpose is to operate a private club for recreation. The form stated that the club would only be supported by membership dues with all receipts going to expenses. The form was organized and executed by 20XX. The Directors of the organization are: _____, _____, and _____. The club was granted §501(c)(7) exempt status November 1, 20XX.

The Registered Agent for _____ is _____ filed Form 205, *Certificate of Formation Limited Liability Company*, with the Secretary of State for the State of _____ on October 21, 20XX. The Registered Agent and Governing Authority is _____. The company was formed to operate a restaurant. The Secretary of State reports that _____ is the Registered Agent of _____ and _____.

The _____ Franchise Tax Public Information Report list 20XX as the Officer of _____ for 20XX through 20XX.

The Club signed a *Management Services Agreement* with _____ on November 1, 20XX. The Agreement was to be effective for one year and would automatically be renewed if both parties agreed. _____ would provide the following services:

- Use of employee time for purpose of serving and complying with all certifications
- Use of point of sale system for tracking sales to members
- Use of utilities
- Use of supplies, office and machines
- Use of entertainment

_____ leases space for _____ at _____ from _____ signed a sublease agreement with _____ on November 6, 20XX allowing the club access to the space. The agreement requires the Club to pay _____ a monthly rental of 0% of the gross revenue derived from the service charge of alcoholic beverages.

For the leased space, there is one entrance for Club members and another entrance for Café customers. Once inside the premises, the examiner didn't note a barrier separating the 0 entities or anything other than the entrances that distinguished the restaurant from the bar (see *diagram*).

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DIAGRAM DELETED

was selected for examination on January 13, 20XX with the following *potential issues*:

1. Non-member and investment income-exemption or unrelated business income (UBI)
2. Missing Form 990-T, *Exempt Organization Business Income Tax Return*
3. Missing Form 1099

During the examination, 20XX, provided the history of the Club. operates (originally). County was unable to sell alcoholic beverages in 20XX, per . She stated that told her that a private club could not be for profit. was formed as a neighborhood club for residents of and County. The membership dues were \$0 for the initial visit and was good for 0 days. The member's driving license was swiped each visit to prevent nonmembers from receiving alcohol. Nonmembers were allowed temporary membership (Charter Member) for a day by paying dues of \$0. No records were maintained as required by Revenue Procedure 71-17.

For the year under examination, 20XX, County allowed the sale of alcohol. The Club still had members but they didn't have to pay membership dues. Nonmembers (the public) could also purchase alcohol without becoming a member and paying dues. The Club was operating as a commercial establishment.

Audit issue No. 1, questioned whether the reported revenue was from nonmember sources or investments. This issue pertains to the gross receipts test for a 501(c)(7) organization. A 501(c)(7) organization can receive up to 35% of their gross receipts, including investment income, from sources outside their membership without losing their exempt status. Within the 35%, not more than 15% should come from the use of the social club's facilities or services by the public (nonmembers). The Club's Form 990 didn't indicate the source of income other than that it was Program Service Revenue. stated that the Club's income came solely from the sale of alcohol to their members. As explained above, in 20XX, the Club wasn't charging membership dues to the County residents, or any of the visitors to the establishment.

Audit issue No. 2, mentions investment-type income with no Form 990-T filed. This issue is the subsequent action required if the Club had unrelated business income.

Audit issue No. 3, states that there was compensation and Form 1099 wasn't filed. The Club reported Management fees of \$0. stated that the Management fees were for . She said she wasn't aware of the requirement to file and issue a Form 1099. She said the income was included because she prepared the returns for all companies (, and).

website

lists the kitchen's hours of operation.

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Monday and Tuesday ----- 5pm-9pm
Wednesday ----- 11am-2pm & 5pm-10pm
Thursday ----- 11am-2pm & 5pm-9:30pm
Friday ----- 11am-2pm & 5pm-10pm
Saturday and Sunday-----11am-10pm

The bars hours of operation were posted in the facility.

Bar Hours

Wednesday - Friday, Sunday..... 11am-12am
 Saturday..... 11am-1am
 Monday - Tuesday..... 3pm-12am

The website lists available features and activities:

- 0 Flat Screen TVs
- 0" Projection Screen TV
- Golden Tee
- Poker
- Pool
- Darts
- Cornhole
- BuzzTime Trivia
- Live Trivia
- Video Poker

The Café's online calendar lists activities and specials on alcoholic beverages.

- Margaritas \$.0
- Draft 12 oz. \$0 (Tuesdays) & \$0 (Sundays)
- Crown & Down \$0
- Margaritas & Cosmos \$.0
- Wells & Shot specials \$.0
- Bloody Mary's & Mimosas \$0

CHART DELETED

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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CHART DELETED

liquor license () was issued January 27, 20XX and expires January 26, 20XX. It's for the premises of . The Club has the following permits from the ():

FB - FOOD AND BEVERAGE CERTIFICATE - A Food and Beverage Certificate may be issued to the holder of a Beer Retailer's On-Premise Permit or Wine and Beer Retailer's Permit if food service is the primary business being operated on the licensed premise or to the holder of a Mixed Beverage Permit or Private Club Permit if food service is available on the premises and the gross receipts of alcoholic beverages do not exceed 50% of total gross receipts. The holder must meet requirements of the Code and Rule 33.5 concerning minimum number of entrees served, hours of service, etc. Certificate allows holder to be exempt from posting a conduct surety bond.

PE - BEVERAGE CARTAGE PERMIT - Permit authorizes a Mixed Beverage, Private Club Registration, Private Club Wine and Beer or Private Club Exemption Certificate permittee who holds this permit to transport alcoholic beverages to the licensed premises from the place of purchase.

LAW:

§501(c)(7) of the Internal Revenue Code exempts from income tax clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all 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.

§1.501(c)(7)-1(a) of the Federal Tax Regulations states that 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.

§1.501(c)(7)-1(b) of the Federal Tax Regulations states that 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.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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Public Law 94-568 provides that social clubs are permitted to receive up to 35% of their gross receipts from sources outside of their membership without losing their tax-exempt status, and that within that 35%, not more than 15% of gross receipts should be derived from the use of a social club's facilities or services by the general public.

In *Spokane Motorcycle Club v. United States*, 222 F.Supp. 151, the court ruled that refreshments, goods, and services furnished to members of a charitable, nonprofit corporation from business enterprise net profits constituted benefits inuring to individual members, and, therefore, corporation was not exempt from federal income tax. Judge Powell further stated, "But it is clear that when a club, otherwise exempt, engages in a business from which it derives profits from outside sources wholly disproportionate to its nontaxable purposes, and such profits inure to the benefit of its members in the nature of permanent improvements and facilities, it loses its exempt status under the definitive provisions of the statute. It should be noted that to be exempt from taxation, the club must not only be organized exclusively for pleasure, recreation and other non-profitable purposes, but it must be operated exclusively for those purposes as well."

In *Aviation Club of Utah v. Commissioner of Internal Revenue*, 162 F.2d 984, the court upheld the position taken by the tax court in a previous ruling whereby the income received by the club from non-exempt activities was so disproportionate to the income received from exempt purposes that the club lost its exempt status. Judge Murrah invoked the same concept as that in *Spokane Motorcycle Club v. United States*, whereby if a club engages in a business from which it derives profits from outside sources wholly disproportionate to nontaxable purposes, and such profits inure to the benefit of its members in the nature of permanent improvements and facilities, the club loses its exempt status.

In Revenue Ruling 65-63, 1965-1 CB 240 an organization conducts various sports car events for the pleasure and recreation of its members and their guests. The events end up attracting the general public. The general public is admitted on a recurring basis upon payment of an admission fee. Public patronage is solicited by advertising. The Service ruled that public patronage or participation in club activities is permissible if incidental to and in furtherance of the club purposes, and if the net income therefrom does not inure to its members. Here however, the activities of the club, in permitting public patronage of its facilities, are of such a magnitude and recurrence as to constitute engaging in business and the club uses the income derived therefrom to acquire additional assets and to pay club expenses normally borne by its members. It was thus held that the organization in the instant case does not qualify for exemption under §501(c)(7) of the Internal Revenue Code.

In Revenue Ruling 68-119, 1968-1 C.B. 268 an equestrian social club that holds an annual one-day steeplechase meet which is open to the general public is found to be tax-exempt under IRC 501(c)(7). In this case, the club is said to derive a small amount of income from nonmembers in excess of expenses attributable to their participation and attendance. If any profit results, it is turned over to charity. Other club activities are supported by member dues. Therefore, the ruling holds, the income from non-members does not inure to the club's members.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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In *T.C. Memo 1962-18, Clements Buckaroos vs. Commissioner of Internal Revenue*, the organization has managed and promoted an annual one-day public event in the nature of a rodeo. All of the entry fees of the contestants with other funds of the organization are used for the payment of prize money for participants in the various events. There is no profit to the organization from such fees. In ruling that the organization is exempt from income tax, the judge specified that "traffic with outsiders was purely incidental". The judge also added that "It would, of course, be possible for the rodeo activities to become so preponderant that they could no longer be viewed as merely incidental".

In *Augusta Golf Association, Inc. vs. United States, 338 F.Supp. 272*, the court ruled, among other things, that the Association was exempt from federal income tax as a social club, despite practically all of the Association's income having been derived from "Calcutta" pools participated in by non-members. In the instant case, the social affairs at which the Calcuttas were featured were open only to members and their invited guests. The Association took a cut of 10% of the gross amount raised in these pools.

Rev. Rul. 58-589, 1958-2CB 266 examines the criteria for determining whether an organization qualifies for exemption under IRC section 501(a) as an organization described in section 501(c)(7) of the Code. This ruling states it is clear under the foregoing regulations that a club which engages in business, such as making its social and recreational facilities available to the public or by selling real estate, etc., may not be considered as being organized and operated exclusively for pleasure, recreation or social purposes. It is equally clear that the solicitation by advertisements or otherwise of public patronage of its facilities may be averse to the establishment of an exempt status.

Rev. Proc. 71-17, 1971 WL 26186, 1971-1 C.B. 683 sets forth guidelines for determining the effect gross receipts derived from use of a social club's facilities by the public have on the club's exemption from federal income tax under section 501(c)(7) of the Code.

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 nonmembers in the party;
4. The total charges;
5. The charges attributable to nonmembers;
6. The charges paid by nonmembers;
7. 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;
8. Where the member's employer reimburses the member or makes direct payment to the club for the charges attributable to nonmembers, a statement signed by the member indicating the

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name of his employer; the amount of the payment attributable to the nonmember use; the nonmember's name and business or other relationship to the member; and the business, personal, or social purpose of the member served by the nonmember use.

9. Where a nonmember, other than the employer of the member, makes payment to the club or reimburses a member and a claim is made that the amount was paid gratuitously for the benefit of a member, a statement signed by the member indicating the donor's name and relationship to the member, and containing information to substantiate the gratuitous nature of the payments or reimbursement.

Exceptions to these records keeping requirements are:

1. Where a group of eight or fewer individuals, at least one of whom is a member, uses club facilities, it will be assumed for audit purposes that the nonmembers are the guests of the member, provided payment for such use is received by the club directly from the member or the member's employer.
2. Where 75 percent or more of a group using club facilities are members, it will likewise be assumed for audit purposes that the nonmembers in the group are guests of members, provided payment for such use is received by the club directly from one or more of the members or the member's employer.
3. Solely for purposes of 1 and 2, above, payment by a member's employer will be assumed to be for a use that serves a direct business objective of the employee-member.

Where a club makes its facilities available to the public to a substantial degree, the club is not operated exclusively for pleasure, recreation, or other non-profitable purposes.

TAXPAYER'S POSITION:

Taxpayer's position has not been provided.

GOVERNMENT'S POSITION:

Based on the examination, _____ does not qualify for exemption as a social club as described in IRC §501(c)(7) and Treas. Reg. §1.501(c)(7) which extends exemptions to social and recreation clubs which are supported solely by membership fees, dues, and assessments. The Club is operated as a commercial venture and is an integral part of _____, a taxable organization.

The organization's treatment of nonmembers (or the public) is inconsistent with the term "club" as used in IRC 501(c)(7) and disqualifies it from exemption. The membership requirements are vaguely stated and there are no dues or initiation charges. As per Revenue Procedure 71-17, without records of non-member sales, all income from alcohol sales can be assumed to be from non-members.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
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The registered agent of _____ is _____, who owns and operates _____ is listed as the sole member of _____ and is an officer of _____. The registered agent has close physical and financial ties to club activities. The cafe serves the club's members as well as its own patrons in the restaurant that's within the shared premises. All waitresses, bartenders, and other persons working at the club are employees of the café. All receipts from the alcoholic beverages are received directly by the café and its personnel.

_____ is a taxable organization that controls the Club through the control it has over the governing body. _____ uses this control to carry on a commercial enterprise by providing entertainment and services to not only the Club and its members but to the customers of the café.

The Food and Beverage Certificate from _____ states that the holder (the Club) must meet the requirements of the Code and Rule 33.5 concerning minimum number of entrees served, hours of service, etc. Rule 33.5 states that the primary business on the premises is food services and it would be the responsibility of the license holder (the Club) to provide financial and accounting records related to food and alcohol sales of all business entities sharing the licensed premise. The Cafe permits unrestricted use of its facilities by the public and advertises to that effect. The Club has an open liquor license allowing them to serve the public without a restriction to serve club members only. This further illustrates how the Club was an integral part of the Café.

CONCLUSION:

From the information described above, _____ organized the Club to sell alcoholic beverages in the city of _____ and _____ County to serve alcoholic beverages as an integral part of their restaurant business. The club is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes. Accordingly, it does not qualify for exemption under section 501(c)(7) of the Code and should be revoked.

The proposed date of the revocation is January 1, 20XX.

Form 1120, U.S. Corporation Income Tax Return should be filed for 20XX and thereafter as long as the organization continues to be subject to income tax.