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501.07-05

INTERNAL REVENUE SERVICE

DEPARTMENT OF THE TREASURY

DISTRICT DIRECTOR

EO)

Date: JUL 8 0 1998

In Reply Refer to:

Person to Contact:

Contact Telephone Number:

Dear Sir or Madam:

On , you signed a statement which indicated that you were in agreement with revocation of your exempt status under section 501(c)(7) of the Internal Revenue Code (IRC).

Therefore, effective , your exempt status under IRC section 501(c)(7) is revoked. You are now required to file Federal income tax returns on Form 1120.

This is a determination letter.

If you have any further questions, please contact the person whose name and telephone number are shown above.

Sincerely,

Glenn E. Henderson

Glenn E. Henderson
District Director

Enclosures:
Examination report
Form 6018, Consent to Proposed Adverse Action
Determination Letter

Form 886-A	EXPLANATION OF ITEMS	Exhibit to Form 4621
Name of Taxpayer		Year/Period Ended
EIN:		

FACTS:

The organization was granted exemption from Federal Income Taxes under section 501(c)(7) of the Internal Revenue Code in .

There was a correspondence examination done by the Internal Revenue Service on the Forms 990 and 990T filed for tax years ending and .

The taxpayer operates a club for its members recreation. The facilities provided include a golf course, a pool, tennis courts and a club house. Individuals become members by purchasing a share of stock. Membership is open to all.

The club house is operated by a for profit management firm hired by the board of directors. The contract does not provide for inurement to the management company. The club house is managed by a management company that manages other restaurants in the town. In the minutes of the board meetings it was stated that the management company was willing to rent out the facility for weddings and functions if there was a member who would sponsor the event. This arrangement was discussed with the power of attorney and it was stated that this arrangement never actually occurred.

The prices of food and drinks are set at a level intended to make a profit for the club.

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A review of the financial records showed that some income items are reported on the Form 990 as net figures rather than at the required gross amount. The items reported as net figures include the interest income which was netted against the interest expense and the tournament income that was netted against the tournament expenses.

The gross interest income was reported on the Form 990T as taxable income.

The taxpayer operates a number of golf tournaments that are open to non-members. These tournaments are an important aspect of the club's operations.

The club house liquor license is an open license. The Treasurer indicated that there are private club licenses available but none have been issued in the county.

The taxpayer allows non-members to use the facilities. The non-member use exceeds the limit of 15% of the gross receipts that was set in Revenue Procedure 71-17 as cited below.

The books and records show that a total of $786,910 in sales were charged to the members. Some of those sales were actually to businesses and not to members, so $20,272 must be backed out of the sales charged to members. This results in sales charged to members of 80% and sales to non-members of 20% of the total gross sales. Of that 20% sales to non-members interest income is under 1%. Therefore the

non-member use is 19% of the total receipts.

As mentioned above the receipts from the golf tournaments were netted so the 20% figure may be larger if there was additional netting that was not found in the current examination.

The taxpayer has chosen to not comply with the record keeping requirements of Revenue Procedure 71-17, 1971-1 C.B. 683. Because the taxpayer does not comply with this revenue procedure certain safe harbors are not made available regarding the tax treatment of groups of members and non-members.

LAW:

Internal Revenue Code section 501(c)(7) provides exemption for 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. (underlining added)

Internal Revenue Regulations 1.501(c)(7)-1 regarding Social Clubs provides for:
(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 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.

(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 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. However, an incidental sale of property will not deprive a club of its exemption. (underlining added)

Revenue Ruling 58-589, 1958-2 C.B. 266 sets forth the criteria for exemption under section 501(c)(7) of the Code. It provides that even though the regulations provide that a club will loose 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 provided such participation is incidental to, and in furtherance of, the club's exempt purpose and the receipt of income therefrom does not indicate the existence of a club purpose to make a profit or the income does not inure to club members.

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Revenue Procedure 71-17, 1971-1 C.B. 683 provides guidelines for determining the effect of gross receipts derived from nonemmber use of a social club's facilities. This procedure sets an audit standard of five percent as the allowable limit of non-member gross receipts. If over five percent of gross receipts are received from the general public then a nonexempt purpose is indicated.

The five percent limit of Revenue Procedure 71-17 was amended by Public Law 94-568 to change the word "exclusively" to "substantially all". Senate Report 94-1318, 2d Session, 1976-2 C.B.597, 599 in effect raised the audit standard of Revenue Procedure 71-17 from 5% to 15%.

Revenue Ruling 79-145, 1979-1 C.B. 360, provides the definition of a "guest" of a nonprofit social club as an individual who is a guest of a member and who does not reimburse the member for the guest's expenses.

DISCUSSION:

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". It is intended to allow the individuals comprising the membership to provide themselves with recreation without further tax consequences. When nonmembers are

allowed to use the club facilities the profits from the nonmembers purchases inure to the benefit of the members.

Revenue Procedure 71-17, (1971-1 C.B. 683), lists the records required and some circumstances where a non-member may be a guest. Senate Report 94-1318, 2nd Session, 1976-2 C.B.597,599, made a change that provides that exempt social clubs may receive no more than 15% of their gross receipts may be from nonmember use of the clubs facilities without endangering the exemption. In this case the nonmember use exceeds the audit guideline and so the facts and circumstances must be explored. There is no explanation that would indicate that exceeding the audit standard is an unusual item or an exception for this one year. The club has indicated that they do not wish to comply with restrictions of exempt status. When discussed with the power of attorney he indicated that the taxpayer agreed with the proposed revocation.

The taxpayer has demonstrated that they have not complied with Revenue Procedure 71-17. The result of not complying with Revenue Procedure 71-17 is that more groups using the facilities may be classified as non-members as smaller groups are reviewed as well.

CONCLUSION:

The taxpayer has agreed to revocation of exemption beginning for the fiscal year ending

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The Form 1120 must be filed in place of the Form 990 for and for all years after. The Forms 1120 were not filed with Exempt Organizatios Division at the time this case was closed.

In filing the Form 1120 the taxpayer must apply Code section 277. IRC 277 was passed by Congress to equalize the treatment of the non-exempt social clubs. The IRC 277 language, among other things, limits the member loss to the membership receipts and separates the non-member income.