

**INTERNAL REVENUE SERVICE
TE/GE TECHNICAL ADVICE MEMORANDUM**

Uniform Issue List

501.07-05
501.07-00
7805.04-01

5/13/05

T. E. O. E.

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Year Involved:

Date of Conference: None Held

Legend:

M =
N =
O =

ISSUES:

- (1) Whether the exemption of M under section 501(c)(7) of the Internal Revenue Code should be revoked.
- (2) If M's section 501(c)(7) exemption is revoked, should the Service grant relief under section 7805(b) of the Code, and if so, for what taxable periods?
- (3) If M's section 501(c)(7) exemption is revoked, and it does not meet the requirements of section 528 of the Code, may M file a Form 1120 as a taxable membership organization within the meaning of section 277?

FACTS:

M was incorporated under the laws of the State of N in . The Articles of Incorporation provided that the purpose of M "...is the formation of a recreational club, the special purpose of which shall be to acquire, provide, maintain and operate a club house, boat house, docks and other facilities necessary for such purposes, designed for promoting recreation, fellowship and safe boating ... and to build and construct such buildings and facilities as may be desired for the use, benefit, recreation and enjoyment of the members..."

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Item 10 of M's Exemption Application, submitted in , stated its sources of income were "Certificates of Beneficial Interest, Dues, Rent of Lots, Rent of Boat Slips, and Sale of Gasoline and Oil." In Item 7 of the Exemption Application, M stated that its specific purposes were "Recreation and Social Activities." In response to Item 11 of the Exemption Application, inquiring as to the purposes for which expenditures are made, M stated, "Developing of our land, construction of Docks and Boat Slips, and Caretaker." In response to Item 12 of the Exemption Application, inquiring as to M's activities during the past two years, M stated, "Boating, Skiing, Fishing, Hiking, and camping out." Item 15a of the Exemption Application, asking whether any part of M's property is rented or leased to members, M stated "To Members Only."

The History section of M's information booklet for year states that M was formed for the purpose of operating a nonprofit organization of families to promote recreation, fellowship, and safe boating on Lake O. M's property consists of about acres of land stretched along nearly a mile of shoreline. The History section also states that, "Activities sponsored include Boat Safety Courses, Coast Guard Auxiliary inspections, Life Saving and First Aid training, flotilla cruises, picnics, water sports activities, boating instruction, church service every Sunday during the summer season, and frequent gatherings of members, families, and guests." The following facilities are offered to M members: launching ramp; pavilion; rest room; drinking water; full-time management; marine supplies (gas and oil); wet boat slip storage; dry land boat storage; lot rentals; and protected swimming.

M owns all of the land used for residences and for boating, recreational, and social activities. All M land and facilities are accessed through a gate that requires a pass code for entrance. Currently, M owns lots, of which have houses. There are permanent residents on lots. The lots are leased to members on an annual basis. The lease is for a term of ten years, and may be renewed for two additional terms of ten years, although the amount of the lease rental may change. M provides water, garbage pick-up, and maintenance of all common areas, including roads.

Written approval by the Building and Grounds Committee is required for any clearing or cutting, excavation, remodeling, replacement, new construction, or any changes in the use of the lots. Some lots are restricted to houses while others may have a mobile home that meets specified criteria in an effort to blend with the houses.

The Building and Grounds Committee conducts annual inspections of all buildings and building areas. An inspection report is sent to all building owners who have items that need improvements, and they are allowed 30 days to make necessary repairs and maintenance. A follow-up inspection is then made.

M's treasurer estimates that M spends about 75 percent of its time on social and boating activities and 25 percent of its time on the maintenance of common residential areas.

Data from the year under examination and M's prior Forms 990 and 990-T show gross nonmember sales from the sale of gasoline and oil have consistently exceeded 15 percent of

the gross receipts (exclusive of initiation fees and capital contributions) for M's tax years beginning with . The percentages have ranged from a low of in to a high of in .

M submitted a letter from the Real Estate Division of the Corps of Engineers citing the reason for the fuel services provided by M. There was no commercial fuel or service facility on this portion of the lake. The letter also stated that M was expected to discontinue the sale of gasoline if and when a commercial concession was established. Further, M's authorized representative stated the following: although the gross receipts were over the 15% threshold, net profit from the sale of gasoline is a small percentage of the total revenue because gasoline prices can fluctuate greatly; therefore, the use of gross receipts alone can distort the actual impact of these sales upon M's revenue stream. Accordingly, these sales should not cause M to lose its tax exemption.

M has been examined only once previously. The past examination was for the tax period ended December 31, , and resulted in a "no change" letter. M has regularly filed Forms 990 and 990-T (when applicable). M's exemption under section 501(c)(7) of the Code should have been questioned in prior years and, in particular, the long term leasing of lots to members, which is specifically prohibited in Rev. Rul. 68-168, 1968-1 C.B. 269.

In a June 13, 2003 communication to the Service, M acknowledged the leasing of lots could nullify its section 501(c)(7) exemption. In a July 12, 2004 communication to the Service, M stated: it was in substantial agreement with the Service about the issues in the Request for Technical Advice dated June 20, 2002; M agreed its status as a section 501(c)(7) organization would be revoked on a prospective basis; M should be a taxable membership organization within the meaning of section 277 of the Code; and M will begin to file Form 1120 and pay income tax on its net taxable income.

LAW:

Section 501(c)(7) of the Code provides for the exemption from federal income tax of clubs organized and operated 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.

Section 1.501(c)(7)-1(a) of the Income Tax Regulations essentially repeats the language of section 501(c)(7) of the Code but also states that, 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.

Section 1.501(c)(7)-1(b) of the regulations provides 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 tax exempt. 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.

Rev. Rul. 58-589, 1958-2 C.B. 266, discusses the various criteria for recognition of exemption under section 501(c)(7) of the Code. In order to establish that a club is organized and operated for pleasure, recreation, and other nonprofitable purposes, "there must be an established membership of individuals, personal contacts and fellowship. A commingling of the members must play a material part in the life of the organization."

Rev. Rul. 58-589 also 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, etc., may not be considered organized and operated exclusively for pleasure, recreation, or social purposes. However, a social club will not be denied exemption merely because it receives income from the general public, that is, persons other than members and their bona fide guests, or because the general public on occasion is permitted to participate in its affairs, provided such participation is incidental to and in furtherance of its general club purposes. This is generally true where the receipts from nonmembers are no more than enough to pay their share of the expenses.

Rev. Rul. 68-168, supra, holds that a nonprofit organization that leases lots to its members on a long term basis does not qualify for tax exemption under section 501(c)(7) of the Code. The organization was formed to develop a lake and adjacent areas to provide facilities for the pleasure and recreation of its members. The organization acquired substantial acreage and, after developing recreational facilities on a portion thereof, subdivided the remaining land into building lots which it leases to members for 99 years. Application for membership and choice of lot are embodied in a single form and each member must lease at least one lot. The leased lots may be used for summer cabins or permanent residences, or left vacant. When a lease is executed, the member pays the organization an amount based on the lot value and thereafter pays a nominal annual rental. The organization's receipts are primarily derived from initial payments and annual rentals. Its expenditures are for acquiring, improving, and maintaining its properties. A lessee-member of the organization may transfer his leasehold interest only after obtaining written consent from the organization and the lessees of all adjacent lots.

Rev. Rul. 68-168 cites section 501(c)(7) of the Code, and section 1.501(c)(7)-1(a) of the regulations, which states that a club otherwise entitled to exemption will not be disqualified because it raises revenues from members through the use of club facilities or in connection with club activities. The revenue ruling also cites section 1.501(c)(7)-1(b) of the regulations, which provides that a club which engages in business, such as selling real estate, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes and is not exempt under Code section 501(a). Rev. Rul. 68-168 then sets forth the following rationale and conclusion:

The subdividing and leasing of lots in the manner described constitutes engaging in business. Although the revenues from this activity are derived from the organization's members only, the revenues are not raised from the members' use of recreational facilities, or in connection with the organization's recreational activities. The conduct of such real estate activity, whether with members only or with the general public, is not in furtherance of any purpose covered by section 501(c)(7) of the Code. Accordingly, the organization does not qualify for exemption from Federal income tax under that section.

Rev. Rul. 75-494, 1975-2 C.B. 214, holds that a club which provides social and recreational facilities, whose membership is limited to homeowners of a housing development, will be precluded from qualifying for exemption under section 501(c)(7) of the Code because of owning and maintaining residential streets, enforcing restrictive covenants, or providing residential fire and police protection and trash collection service.

Public Law 94-568 (1976) amended section 501(c)(7) of the Code to allow social clubs to receive some outside income without jeopardizing their exempt status. Specifically, the Senate Finance Committee Report states a social club is permitted to receive up to 35% of its gross receipts, including investment income, from sources outside of its membership without losing its exempt status. However, within this 35% limit, 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.

Section 277(a) of the Code provides that in the case of a non-exempt membership organization that operates primarily to furnish services or goods to members, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members. If such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year.

Section 528(a) of the Code provides that a homeowners association (as defined in subsection (c)) shall be subject to tax only on its non-exempt function income and shall be considered a tax exempt organization for the purpose of any law that refers to organizations exempt from tax. Section 528(b) sets forth the amounts (percentages) of tax on the (non-exempt function) income of a homeowners association.

Section 1.528-8(a) of the regulations states an organization wishing to be treated as a homeowners association under section 528 of the Code for a taxable year must elect to be so treated. The election shall be made by filing of a properly completed Form 1120-H. A separate election must be made for each taxable year.

Section 1.528-8(e) of the regulations provides that if an organization is notified after the close of a taxable year that its exemption for such taxable year under section 501(a) of the Code is being revoked retroactively, it may make a timely election under section 528 for such taxable year. Such an election will be considered timely if it is made within 6 months after the date of revocation.

ANALYSIS:

There are three independent bases for revocation of M's tax exempt status under section 501(c)(7) of the Code. The first relates to the rental of lots to members, which is definitively covered in Rev. Rul. 68-168, supra; this is not an exempt activity of a social club. The second ground for revocation of exemption is M's maintenance of common roads and provision of trash collection services, for which activities M devotes 25 percent of its time, according to M's Treasurer. The third and final ground is M's sale of gasoline and oil to nonmembers, accounting for over 15 percent of gross revenues for all years under examination.

We are aware of the letter from the Corps of Engineers citing the need for the fuel services provided by M and that M is expected to discontinue the sale of gasoline if and when a commercial concession is established. However, P.L. 94-568 and the accompanying Senate Report make it clear the 15% threshold for nonmember income is based exclusively on gross receipts.

The financial data from the M's Forms 990 and 990-T, for the past and the current year under examination, show that M, as presently organized and operated, will not meet the income and expenditure requirements of section 528 of the Code. In other words, M will not meet the necessary percentages of exempt function income to qualify for exemption under this section. Therefore, the filing of Form 1120-H is not a realistic option.

Inasmuch as M's tax exemption under section 501(c)(7) of the Code will be revoked, the question is whether it can qualify as a taxable membership organization within the meaning of section 277. This determination is a factual one; M is clearly a membership organization and its activities primarily involve providing goods and services to its members. Accordingly, when M's section 501(c)(7) exemption is revoked, it will be a taxable membership organization within the meaning of section 277. At that time, M would be required to file Form 1120.

SECTION 7805(b) RELIEF:

The Commissioner, Tax Exempt and Government Entities Division, in the exercise of his discretionary authority, has granted M's request for relief under section 7805(b) of the Code in connection with the revocation of its tax exempt status under section 501(c)(7) for all taxable years up until the issuance of the revocation letter.

CONCLUSIONS:

- (1) M's exempt status under section 501(c)(7) of the Code should be revoked.
- (2) M is granted relief under section 7805(b) of the Code for all taxable years up until the issuance of a letter revoking its tax exempt status under section 501(c)(7).
- (3) M may elect to file a tax return as a homeowners association described in section 528 of the Code, but, as it realizes, it will not likely meet the requisite income and expenditure tests. Instead, it is a taxable social or membership organization described in section 277 and should file Form 1120.

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