INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

Number: **201430019**
Release Date: 7/25/2014

Area Director, Area 4 TE/GE Appeals,
Cleveland, OH

April 30, 2014

UILS: 0501 .07-04
0501 .07-05

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's ID No.:

Year(s) Involved:

Conference Held:

LEGEND

Organization =
State 1 =
State 2 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Car =
Magazine =
Event =

This memorandum responds to a request dated May 18, 2012, from Appeals, Area 4 for technical advice regarding an organization exempt under I.R.C. § 501(c)(7) during its 2006, 2007 and 2008 tax years. Our analysis and conclusion are set forth below.

Issues:

1. Whether three specific activities engaged in by Organization, the solicitation and receipt of advertising income for a club magazine from nonmembers, the solicitation and receipt of Car racing event sponsorship payments from nonmembers, and the conduct of an annual raffle

limited to members, constitute the active conduct of businesses not traditionally carried on by social clubs exempt under I.R.C. § 501(c)(7).

2. In determining the amount of gross receipts relating to the sponsorship payments, which amount should be used as gross receipts – actual gross amounts received or actual gross amounts received less qualified sponsorship payments (as defined in I.R.C. § 513(i)(2)).

3. If any or all of these activities are determined to be nontraditional, is the extent to which they are engaged (and/or the amount of income generated by them) enough to jeopardize Organization's exempt status?

4. If Organization's exempt status should be revoked, is it entitled to relief from retroactive application under the provisions of I.R.C. § 7805(b)?

Facts:

Organization was originally incorporated in State 1 on Date 1 to promote interest in motoring activities and to encourage safe and skillful driving classes, publications, and activities related to motor touring. Organization was recognized as exempt under I.R.C. § 501(c)(7) on Date 2 and issued an I.R.C. § 501(c)(7) group ruling on Date 3.

In Date 4, Organization relocated to State 2 and incorporated as a nonprofit organization on Date 5. On Date 6, Organization filed Articles of Merger in which the State 1 organization was merged into the State 2 club. On Date 7, Organization applied for recognition of exemption. Organization received a determination letter recognizing it as exempt under I.R.C. § 501(c)(7) on Date 8. Organization received a § 501(c)(7) group exemption letter on Date 9.

Organization's Form 1024 Application states that its mission is to enhance the Car experience for its members by providing services, support, information, and activities that promote camaraderie and encourage social awareness and responsibility. Organization is an owner-support network and includes Car owners of classic and current models. Organization offers a range of services to members, such as publication of a monthly magazine, Magazine, several driving events, an annual national club gathering, Event, and an annual raffle of Cars.

Organization's monthly publication, Magazine, contains various articles, monthly columns, letters to the editor, product reviews and technical information relating to Car ownership. Magazine accepts paid advertising from both members and nonmembers. However, advertising is limited to items and events that specifically relate to Car ownership. Organization does not solicit or receive general advertising and has a policy to only accept advertising from vendors who serve the interest of enhancing the Car ownership experience.

Organization's national club gathering, Event, includes driving education and other driving and racing activities, technical sessions, vendor displays and presentations as well as social events for members. Organization accepts sponsorship payments from outside vendors for Event as well as other club racing activities. In exchange for sponsorship payments for Event, sponsors receive booth space to exhibit their products, program book advertising, and other benefits. Similar to its guidelines for the type of Magazine advertisements it accepts, Organization limits sponsorship opportunities to entities having a connection to Car motoring and ownership.

Organization also has an annual car raffle that takes place at Event. Raffle tickets are sold online or by mail and may only be purchased by Organization's members who are in good standing. The winner need not be present at Event but winning tickets cannot be assigned, sold, or transferred.

Organization receives income from membership dues, merchandise sales to members, registration and vendor fees at various gatherings, investment income, mailing list rentals, an affinity credit card agreement, book royalties, as well as from advertising, sponsorship of club events, and an annual raffle event.

It is the income from the conduct of the following activities that is the subject of the request: (1) advertising in Magazine, (2) sponsorship income from Event, and (3) an annual raffle.

During all tax years in question, Organization's gross receipts from nonmembers were less than 35 percent of its total gross receipts.

Law:

I.R.C. § 501(c)(7) provides for the federal tax exemption of 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 or individual.

I.R.C. § 512(a)(3)(A) sets forth special unrelated business income tax rules for organizations described in § 501(c)(7). It provides that the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in I.R.C. §§ 512(b)(6), (10), (11), and (12).

I.R.C. § 512(a)(3)(B) provides that, for purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

Rev. Rul. 68-535, 1968-2 C.B. 219, holds that a social club that regularly sells liquor to its members for consumption off its premises is not entitled to exemption under I.R.C. § 501(c)(7). The revenue ruling states that the regular sale of liquor is a service to a social club's members that is neither related to nor in furtherance of a social club's exempt purposes. Since such activity is neither social nor recreational, the club is not operated exclusively for pleasure, recreation, and other nonprofitable purposes within the meaning of § 501(c)(7).

Rev. Rul. 69-68, 1969-1 C.B. 153, holds that operation of gaming devices by a social club organization for the pleasure of its members and guests does not affect the club's exempt status, even though the operation of gaming devices is illegal under local law. The ruling notes that maintenance of gaming devices for members and guests of a club is an activity for their pleasure and recreation within the meaning of I.R.C. § 501(c)(7).

In Santa Barbara Club v. Commissioner, 68 T.C. 200 (1977), the court held that a social club that sold bottled liquor to its members for consumption away from the club's premises, where the sales from this activity exceeded 25 percent of the club's total gross receipts, did not qualify for exemption under I.R.C. § 501(c)(7).

In Chicago Metropolitan Ski Council v. Commissioner, 104 T.C. 341 (1995), the court considered whether a social club exempt under I.R.C. § 501(c)(7) could deduct all of its publication expenses under Treas. Reg. § 1.512(a)-1(f). The taxpayer, a ski club, published a quarterly magazine and received advertising revenue from advertisers primarily related to the ski industry. These included ski resorts, travel agencies, ski equipment manufacturers, and other businesses related to the ski industry.

Analysis:

Pub. L. 94-568 (1976) amended the requirements for I.R.C. § 501(c)(7) social clubs. This new legislation provided that social clubs must have activities that are substantially for pleasure, recreation, and other nonprofitable purposes. Prior law required that § 501(c)(7) organizations be organized and operated "exclusively" for these purposes.

The Senate Report on Public Law 94-568, S. Rept. 94-1318 (1976), 2d. Sess., 1976-2 C.B. 597, clarified several points. The report notes that the Tax Reform Act of 1969 extended the unrelated business income tax to I.R.C. § 501(c)(7) social clubs. Due to this change in law, all income derived from nonmembers as well as investment income is subject to tax, even though the organization itself is still classified as an exempt organization. Thus, the report noted, while it is necessary to require that social clubs must still be substantially devoted to the personal, recreational, or social benefit of members, the extent to which such a club can obtain income from nonmember sources can be somewhat liberalized.

The Senate Report also explains the two-fold effect of the new legislation. First, the report notes that it is intended to make clear that I.R.C. § 501(c)(7) organizations may receive some outside income, including investment income, without losing their tax-exempt status. Second, the report states that it is intended that a social club be permitted to derive a somewhat higher level of income than was previously allowed from the use of its facilities or services by nonmembers without the club losing its exempt status. The decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based on all the facts and circumstances. However, the facts and circumstances approach is to apply only if the club earns more than is permitted under the new guidelines. If the outside income is less than the guidelines permit, then the club's exempt status will not be lost because it receives some nonmember income.

The report also provides that it is intended that I.R.C. § 501(c)(7) organizations be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside their membership without losing their tax-exempt status. It is also intended that within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. If an organization has outside income in excess of the 35 percent limit (or 15 percent limit in the case of gross receipts derived from nonmember use of a club's facilities), all the facts and circumstances are to be taken into account in determining whether the organization qualifies for exempt status.

The Senate Report provides that gross receipts are defined for this purpose as those receipts from normal and usual activities of the club (that is, those activities they have traditionally conducted) including charges, admissions, membership fees, dues, assessments, investment income (such as dividends, rents, and similar receipts), and normal recurring capital gains on investments, but excluding initiation fees and capital contributions. The report also states that it is not intended that I.R.C. § 501(c)(7) organizations should be permitted to receive, within the 15 or 35 percent

allowances, income from the active conduct of businesses not traditionally carried on by these organizations.

Activities that are not "normal and usual activities" of a social club are considered nontraditional activities. For the purpose of defining what are "normal and usual activities" of a social club, it is helpful to refer to Rev. Proc. 71-17, 1971-1 C.B. 683, as the committee reports indicate Congress did in defining gross receipts for purposes of the 15 percent limitation. In that revenue procedure, "normal and usual activities" encompass those social and recreational activities upon which the club's exemption is based. Extension of these traditional exempt social club activities to the general public gave rise to unrelated business income; they resulted in revocation of exemption only if the five percent limitation (now 15 percent) was exceeded (and, additionally, if a facts and circumstances test was not satisfied).

Based on the foregoing legislative history, it is clear that Congress intended to distinguish between traditional and nontraditional activities. Traditional business activities are subject to a 15 percent rather than a five percent limitation for nonmember use of a social club's facilities or services by the general public. Nontraditional business activities continue to be prohibited (subject to an insubstantial, trivial, and nonrecurrent test) for businesses conducted with both members and nonmembers.

A prohibited nontraditional business is one that does not further the exempt purposes of the organization even if conducted solely on a membership basis. For example, the sale of liquor to members for consumption off the club's premises is a nontraditional business activity that precludes exemption. See, Santa Barbara Club v. Commissioner, 68 T.C. 200 (May 23, 1977), and Rev. Rul 68-535, supra.

In order for Organization to be exempt under I.R.C. 501(c)(7), two tests must be met: an activities test and a nonmember income test.

In determining whether an organization meets the activities test under I.R.C. 501(c)(7), we must first determine that it is organized for pleasure, recreation, or other nonprofitable purposes. Then each activity must be tested to determine if it furthers pleasure, recreation, or other nonprofitable purposes or is a nontraditional activity that precludes exemption.

Organization satisfies the activities test because substantially all of its activities are traditional, "normal and usual activities" for a social club. Publishing Magazine and conducting Car events are among the activities that Organization conducts that further its § 501(c)(7) exempt purpose. Organization's publication of Magazine includes various columns, articles, letters to the editor, product reviews, and technical information for Organization's members. Because the publication of Magazine furthers Organization's exempt purpose, it is a traditional activity.

Organization's Event and other racing events are similar to its Magazine publishing activity. Event is an annual national club gathering. Event includes driving education and other non-competitive driving events, club racing, technical sessions, vendor displays and presentations as well as social events for members who attend. Event furthers Organization's exempt purpose under I.R.C. § 501(c)(7) and is therefore a traditional activity.

Organization annually holds a raffle that is limited to its members. Prizes are awarded only to persons on Organization's membership list and winning tickets cannot be assigned, transferred or sold. The raffle drawing usually takes place at Event. Organization's raffle activity is a traditional,

gaming-type activity that furthers its exempt purpose under I.R.C. § 501(c)(7). See Rev. Rul. 69-68, supra.

Advertising and sponsorship activities are an insubstantial part of Organization's traditional Magazine publishing and Event activities. With respect to the Magazine advertising, Organization makes its magazine available to member and nonmember advertisers. Organization does not solicit or receive general advertising and limits the advertising it accepts to items and events that specifically relate to Car ownership. This advertising activity is similar to that carried on by the organization in Chicago Metropolitan Ski Council v. Commissioner, 104 T.C. 341 (1995), an I.R.C. § 501(c)(7) ski club that accepted ski-related advertising in its ski periodical.

With respect to its Event activity, Organization makes Event available to members and sponsors. In exchange for their payments, sponsors receive booth space, advertisements in the event program books and other benefits. Similar to its restrictions on its acceptance of Magazine advertisements, Organization limits sponsorship opportunities to entities having a connection to Car motoring and ownership.

In addition to the activities test, Organization meets the nonmember income test. The percentage of outside income that Organization receives from advertising in Magazine and sponsorship payments from Event is less than 35 percent of its gross receipts (receipts from normal and usual activities). These nonmember gross receipts give rise to unrelated business income under I.R.C. § 512(a)(3)(A).

Unlike the gross receipts from the Magazine advertisements and Event sponsorships, which are from nonmembers, the gross receipts from Organization's raffle are solely derived from its membership. Under I.R.C. § 512(a)(3)(B), these gross receipts constitute "exempt function income" and are therefore excluded from the definition of unrelated business taxable income under § 512(a)(3)(A).

The final issue is whether I.R.C § 513(i) applies to reduce the gross receipts Organization receives from Event sponsorships. As an organization recognized as exempt under § 501(c)(7), Organization is subject to the special unrelated business income tax rules of § 512(a)(3). Section 512(a)(3)(A) provides that the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in I.R.C. §§ 512(b)(6), (10), (11), and (12). Section 513(i) is not one of the enumerated modifications under § 512(a)(3)(A) and therefore does not apply in this case.

Based on the facts and representations we rule as follows:

1) The solicitation and receipt of advertising income for a club magazine from nonmembers, the solicitation and receipt of Car racing event sponsorship payments from nonmembers, and the conduct of an annual raffle limited to members, do not constitute the active conduct of businesses not traditionally carried on by social clubs exempt under I.R.C. § 501(c)(7).

2) In determining the amount of gross receipts relating to the sponsorship payments, I.R.C. § 513(i)(2) does not apply.

3) Organization's activities, and the amount of income generated by them, do not jeopardize its exempt status.

4) Because Organization's exempt status should not be revoked, we do not need to determine if it qualifies for relief from retroactive application under the provisions of I.R.C. § 7805(b).

This memorandum is based on the facts as they were presented and on the understanding that there will be no material change in these facts. This memorandum does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning federal income tax status, this memorandum should be kept in your permanent records.

A copy of this memorandum is to be given to Organization. Section 6110(k)(3) provides that it may not be used or cited as precedent.