

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201501015**

Release Date: 1/2/2015

Date: September 15, 2014

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

August 31, 20XX, 20XX, 20XX

Person to Contact/ ID Number

Contact Numbers:

Phone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear _____ :

In a determination letter dated December, 19XX, you were held to be exempt from Federal income tax under section 501(c)(7) of the Internal Revenue Code (the Code).

Based on recent information received, we have determined you have not operated in accordance with the provisions of section 501(c)(7) of the Code. Accordingly, your exemption from Federal income tax is revoked effective September 1, 20XX. This is a final letter with regard to your exempt status.

We previously provided you a report of examination explaining why we believe revocation of your exempt status was necessary. On June 13, 20XX you signed Form 6018-A, Consent to Proposed Action, agreeing to the revocation of your exempt status under section 501(c)(7) of the Code.

You are required to file Federal income tax returns for the tax period(s) shown above. If you have not yet filed these returns, please file them 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

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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

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

Thank you for your cooperation.

Sincerely,

Barbara L. Harris
Acting Director, EO Examinations

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ISSUE:

Whether _____ failed the gross receipts test and whether they will continue to qualify as an exempt social club under section 501(c)(7) of the Internal Revenue Code (Code).

FACTS:

(Club) is exempt from federal income tax under section 501(a) of the Code, as an organization described under section 501(c)(7) of the Code which was effective in December of 19XX.

The activities as they are stated in the Articles of Incorporation were difficult to read and were, overall, illegible. However, there was language that the Club will foster social activities among the members.

Historically the Club has mirrored the activities of east coast and west coast "gentlemen's clubs" in that they offered, in part, a place to gather and smoke cigars. It has since evolved to where it is now open to women as well. The membership is limited to individuals who hold a bachelor's degree from a four-year college or university. Generally the Club offers several event-type rooms that are made available for rent; in addition the facility offers dining facilities for members that are used for the day-to-day activities. There are two squash courts that are provided for use as well.

Nonmember Use:

Throughout the minutes there is a recurring theme of the financial challenges the Club has been encountering for the past several years. There are recorded in the minutes, issues regarding the marketing efforts by the Event Coordinator to increase outside, nonmember participation such as partnering with _____; talking to the Convention Center; maintaining a good profile on _____ website; visiting _____ shows, etc. Also recorded in the minutes is the Club's reliance on the function business or outside business to support a substantial portion of the general operating costs of the restaurant and clubhouse.

The Club's website contains solicitation of public patronage such as the following example:

The Club is known to the general public as an option to host a private event. _____ has featured the Club on its _____ publication. In addition the Club has been featured in the _____ as one of _____ top 0.

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As it was stated by the Event Coordinator, nonmembers are welcome to reserve event rooms. Nonmember events are provided a member-sponsor when needed but typically the nonmember knows a member who will be willing to sponsor the event. All nonmembers are issued an account number for their particular event.

Overall the Club did not comply with the record keeping requirements as they are outlined in Revenue Procedure 71-17. In computing the gross income tests it was determined that the Club had nonmember income for the years ending August 31, 20XX, 20XX and 20XX with percentages of 45%, 30% and 27% respectively. It should be emphasized that the nonmember income percentages are without consideration of a complete analysis of the day-to-day sales which does in fact contain non-member income. In addition, for the 20XX and 20XX years, these percentages do not consider the nonmember events sponsored by members that include weddings and numerous other nonmember events; nor does it include the cash sales. These revenue items were not pursued at this time due to time constraints and the fact that the Club had exceeded the 15% limitation without their consideration.

LAW:

Organizations exempt from federal taxes as described in section 501(c)(7) of the Code include 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.

Section 1.501(c)(7)-1 of the Income Tax Regulations, relating to the requirements of exemption of such clubs under section 501(a), reads in part as follows:

- (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 non-profitable purposes, but does not apply to any club if its net earnings inure 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 non-profitable 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.

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Section 512(a)(3)(A) of the Code states that in the case of an organization described in paragraph (7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be treated as not directly connected with the production of gross income.

Section 512(a)(3)(B) of the Code states 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. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside.

Revenue Ruling 74-489, states that a country club that issues corporate membership is dealing with the general public in the form of the corporations' employees. Gross receipts from such members will be a factor in determining whether the club qualifies as a social club under section 501(c)(7) of the Code.

Revenue Ruling 58-589 sets forth the criteria for exemption under section 501(c)(7) of the Code, and provides that a club must have an established membership of individuals, personal contacts, and fellowship. It also provides that, while the regulations indicate that a club may lose 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, that is, persons other than members and their bona fide guests, or permit the general public to participate in its affairs, provided that such participation is incidental to and in furtherance of the club's exempt purposes, such dealings with the general public and the receipt of income therefrom does not indicate the existence of a club purpose to make a profit, and the income does not inure to club members.

Revenue Ruling 60-324 provides that a social club that made its social facilities available to the general public through its member-sponsorship arrangement can not be treated as being operated exclusively for pleasure, recreation, or other nonprofitable purposes and the club no longer qualified for exemption under 501(c)(7) of the Code.

Revenue Procedure 71-17 sets forth guidelines for determining the effect of gross receipts derived from nonmember use of a social club's facilities on exemption under Internal Revenue Code Section 501(c)(7) and recordkeeping requirements. Failure to maintain such records or make them available to the Service for examination will preclude use of the minimum gross receipts standard and audit assumptions set forth in this Revenue Procedure.

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If a club exceeds the 15/35% test, then it will maintain its exempt status only if it can show through facts and circumstances that "substantially all" of its activities are for "pleasure, recreation and other nonprofitable purposes."

The following are important facts and circumstances to take into account to determine whether a club may maintain its exemption under IRC 501(c)(7):

- The actual percentage of nonmember receipts and/or investment income.
- Frequency of use of the club facilities or services by nonmembers. An unusual or single event (that is, nonrecurring on a year to year basis) that generates all the nonmember income is viewed more favorably than nonmember income arising from frequent use by nonmembers.
- Record of nonmember use over a period of years. A high percentage in one year by nonmembers, with the other years being within permitted levels, is viewed more favorably than a consistent pattern of exceeding the limits, even by relatively small amounts. (See S. Rept. 94-1318, 2d Sess., 1976-2 C.B. 597,599).
- Purposes for which the club's facilities were made available to nonmembers.
- Whether the nonmember income generates net profits for the organization. Profits derived from nonmembers, unless set aside, subsidize the club's activities for members and result in inurement within the meaning of IRC 501(c)(7).

Prior to its amendment in 1976, IRC Section 501(c)(7) required that social clubs be operated exclusively for pleasure, recreation, and other non-profitable purposes. Public Law 94-568 amended the "exclusive" provision to read "substantially" in order to allow a section 501(c)(7) organization to receive up to 35 percent of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. The Committee Reports for Public Law 94-568 further state:

- (a) 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. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter does not represent more than 15 percent of total receipts. These percentages supersede those provided in Revenue Ruling 71-17, 1971-1 C.B. 683.
- (b) Thus, a social club may receive investment income up to the full 35 percent of its gross receipts if no income is received from non-members' use of club facilities.
- (c) In addition, the Committee Reports state that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facilities, that income is not to be included in the 35 percent formula.

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(d) The Senate report also indicates that even though gross receipts from the general public exceed this standard, it does not necessarily establish that there is a nonexempt purpose. A conclusion that there is a nonexempt purpose will be based on all the facts and circumstances including, but not limited to, the gross receipts factor.

TAXPAYER'S POSITION:

The Club has not provided its position at this time.

GOVERNMENT'S POSITION:

An organization exempt from federal income taxes as described in section 501(c)(7) of the Code must meet the gross receipts test in order to maintain its exemption. In order to meet the gross receipts test, an organization can receive up to thirty-five percent (35%) of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. Within this 35% amount, not more than fifteen percent (15%) of the gross receipts should be derived from the use of a social club's facilities or services by non-members.

has exceeded the 15% gross receipts standard for non-member income on a continuous basis for at least three years. The non-member receipts are earned throughout the year. There was no one single or unusual event that caused the club to exceed the 15% threshold.

Based on the percentages of gross non-member income to total gross receipts of the Club (e.g. 45%, 30% and 27% as noted in the above table) which exceeds the limitation of 15% as set forth by section 501(c)(7) of the Code for each of these years, it is the Government's position that the Club is no longer operated exclusively for the pleasure and recreation of its members and is not exempt under section 501(c)(7) of the Code.

The Club did not satisfy the Facts and Circumstances test in that the Club allowed for consistent and regular nonmember use of the Club's facilities through numerous outside, nonmember events.

From reviewing the Club's website it is apparent that there is a significant amount of marketing devoted to attracting non-member business use particularly . Also in a " " search there were various vendors who mention the Club as an ideal venue.

Overall the minutes speak of the decline in membership and that more are needed in addition to the day-to-day member usage to sustain the Club. There is also the overarching discussion of the Function activity as being one the primary revenue makers. As such the Event Coordinator actively seeks outside events such as to be held at the Club. _____ has posted photos taken at the Club to advertise that the Club is available for

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The Event Coordinator also purchased software to increase sales. It is evident that the Event Coordinator, as directed by the Club, actively markets for public patronage.

Section 1.501(c)(7)-1(b) of the Income Tax Regulations states in relevant part 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 non-profitable purposes and is not exempt under section 501(a) of the Code. 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.

Based on the marketing activities of the Club it is clearly prima facie evidence of the Club's intent to open its facilities to the general public which is inconsistent with an organization described in section 501(c)(7) of the Code. For this reason it is the Government's position that the Club is no longer operated exclusively for the pleasure and recreation of its members and is not exempt under section 501(c)(7) of the Code.

CONCLUSION:

The tax exemption of _____ under section 501(c)(7) of the Code should be revoked since the non-member income received by the Club exceeded 15% of the Club's total gross receipts for the years under examination. Further, it advertises the use of its facilities to the general public reflecting evidence that the Club is engaged in a business and is not being operated exclusively for pleasure, recreation, or social purposes.

_____ no longer meets the requirements to qualify as exempt from federal income tax under section 501(a) as described in section 501(c)(7) of the Code. Therefore, the exempt status under 501(c)(7) of the Code will be revoked effective September 1, 20XX.

As a taxable entity, the organization would be required to file Form 1120, U.S. Corporation Income Tax Return for the periods open under statute. Under 6501(g) of the Code these periods include the years ending August 31, 20XX; 20XX and 20XX.

Additionally, the organization is reminded of the provisions of section 277 of the Code concerning membership organizations which are not exempt organizations.

TAXPAYER'S OPTIONS:

1. If you AGREE please provide the following documents:
 - Original signed copy of the enclosed Form 6018-A

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- Original signed copies of the Forms 1120 for the tax years ending August 31, 20XX, 20XX and 20XX.

2. If you **DO NOT AGREE** please provide the following documents:

- A detailed explanation of your current position. Provide documents and legal authority that will support your position.
- As an alternative, you have the option of presenting your case to an appeals officer in a Fast Track Settlement setting.

TE/GE Fast Track Settlement (FTS) offers taxpayers an alternative to resolving unagreed issues during the examination process. Working with the Tax Exempt/Government Entities Division (TE/GE) and Appeals, taxpayers can use the settlement authority and mediation skills of Appeals while shortening their overall experience with the Internal Revenue Service. FTS can reduce a taxpayer's combined TE/GE and Appeals audit process time by as much as one year.

If any issues remain unresolved at the conclusion of the FTS process, taxpayers retain their traditional appeal rights as explained in Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*.

Enclosed is Publication 5092, Fast Track Settlement, that briefly explains the process. Also enclosed is a partially completed application (Form 14017) should you decide to consider this offer.