INTERNAL REVENUE SERVICE
Number: 200636106
Release Date: 9/8/06
Date: November 8, 2005

DEPARTMENT OF THE TREASURY
10 MetroTech Center
625 Fulton Street
Brooklyn, NY 11201

Legend:
ORG =
Date1 =

UIL: 501.07-01

ORG

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to: TE/GE Review Staff

Dear :

This is a Final Adverse Determination as to your exempt status under section 501(c)(7) of the Internal Revenue Code.

Our adverse determination was made for the following reasons:

ORG fails to meet the requirement for exemption under IRC 501(c)(7). IRC 501(c)(7), as changed by the Tax Reform Act of 1969 provides for the exemption of clubs organized and operated 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.

Public Law 94-568 amended IRC 501 to reflect a twofold change under IRC 501(c)(7). First, it makes it clear that a social club may receive some investment income without losing its exempt status. Second, it permits a higher level of income from nonmember use of club facilities than was previously allowed.

In addition, Public Law 94-568 defines gross receipts as those receipts from normal and usual activities of a club including charges, admissions, membership fees, dues, assessments, investment income, and normal recurring capital gains on investments, but excluding initiation fees and capital contributions. Public Law 94-568 also states that it is intended that social clubs should be permitted to receive up to 35 percent of their gross receipts, including investment income, from sources outside of their membership without losing their exempt status. Within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of the social club's facilities or services by the general public. Thus, a social club may receive investment income up to the full 35 percent amount of gross receipts. If a club receives unusual amounts, of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in the 35 percent formula; that is, unusual income is not to be included in the gross receipts of the club.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues.* If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action.* We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns 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 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
Local Taxpayer Advocate

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,

R.C. Johnson
Director, EO Examination

Enclosures:
Publication 892
Publication 3498
Form 6018
Report of Examination
Envelope

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
1220 SW 3rd Ave.
Portland, OR 97204

Date: November 8, 2005
ORG

UIL:501.07-01

Taxpayer Identification Number:
NUM
Form:
990
Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:
Telephone:
Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear ,

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process,* explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

Your organization has exceeded the safe harbor limitations on non-member income as outlined in Public Law 94-568. As a result, it has been determined that you are not operating as a social club within the meaning of section 501(c)(7).

Based on the above, we are revoking your organization's exemption from Federal income tax under section 501(c)(7) of the Internal Revenue Code effective Date1

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for all years beginning after December 31, if you have not already done so. You have executed the Form 6018 agreeing to this revocation.

You are required to file Form 1120, U.S. Corporation Income Tax Return. Form 1120 must be filed by the 15th day of the third month after the end of your annual accounting period. A penalty of $20 a day is charged when a return is filed late, unless there is reasonable cause for the delay. However, the maximum penalty charged cannot exceed $10,000 or 5 percent of your gross receipts for the year, whichever is less. This penalty may also be charged if a return is not complete, so please be sure your return is complete before you file it.

You have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by writing to: Local Taxpayer Advocate, . Taxpayer Advocate assistance cannot be used as a substitute for established IRS Procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate can,however, see that a tax matter that may not have been resolved through normal channels, gets prompt and proper handling.

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

Sincerely yours,

Marsha A. Ramirez
Director, EO Examinations

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit 1
Name of Taxpayer ORG		Year/Period Ended

Legend;
ORG=
Date1=
Date2=

ISSUE

Whether the tax-exempt status of ORG, a social club that has significant revenue from non-members, and particularly from non-member use of facilities, should be revoked.

FACTS

ORG was granted tax-exemption under IRC §501(c)(7) in Date1. Per the Club's Articles of Incorporation, Form 990-EZ, and membership application, the purpose of the organization is "

Per the Club's Form 990-EZ, ORG's events are "open to the public". This was reiterated by the Club's Treasurer, during the initial interview, and later reaffirmed in a statement. The Club's most significant activity is the which is held twice annually in July and August. This is a competition in which participants compete for the best times The participants only pay if they do not win, or if their winnings are not sufficient to cover the entry fees. They thus "settle up" after they're done competing, either collecting their net winnings or paying their net fee owed. The Jackpot proceeds are split as follows: 1/3 goes to the Club and the remaining 2/3 is split amongst the cattle roping teams with the best times.

An analysis of the membership list and of records of individuals participating in the Jackpots reveals that most of the participants in these events during were not members of the Club. Based on the Club's records, 15 of the participants in these events were members, and 86 were not. $ was collected from members and $ was collected from non-members. The Club's records are muddled, reporting revenues gross in some instances and net in others. The Club's figures for revenue from the Jackpots, per its event summary worksheets, do not agree with the worksheets in which the Jackpot's receipts and disbursements were originally recorded. The Treasurer acknowledged that the amounts reported on the Form 990-EZ were inaccurate. The Club's gross receipts, as calculated by totaling all deposits, net of transfers between bank accounts, was $ in . This includes the proceeds from the sale of cattle, which had been purchased earlier in the year and which was then used in Club events. The cattle was purchased in for $ and sold later the same year for $. The eventual purchaser of the cattle was not a Club member. The Club also generated $ in revenue from the sale and display of advertiser/sponsor signboards in the Club's arena. These advertisers/sponsors are not Club members. The Club thus had at least 33% ($ /$)

of its gross receipts from non-member use of facilities and at least 73% ($--,---,---) of gross receipts from non-member sources overall.

The Club's Form 990-EZ was prepared by a CPA. Per line 28, Statement of Program Service Accomplishments, the Club "organized play days and trail rides for members and the general public to promote horsemanship and roping skills". According to the Club's records, the two Jackpots, held July, 10th and August 7th, , were participated in by 16 Club members and 111 non-members. Gross receipts is stated on the 990-EZ at $ which, according to line 39b, includes $ of gross receipts from public use of Club facilities. This representation is being taken as fact because the 990-EZ was prepared by a professional, whereas the 990-EZ required some reconstruction to arrive at a tenable figure for gross receipts and for non-member facility use receipts. During , the Club again purchased cattle used in Club events, this time for $, and later sold them for $. The Club again generated advertiser/sponsor signboard revenue, this time totaling $. Based on these figures, the ratio of gross receipts from non-member use of facilities was 58% ( ) for the year, while the ratio of gross receipts from non-member sources overall was 79% ($).

Annual dues for Club membership are $20 or $25 for "man and wife". Including spouses, there were 93 members in , and 96 in . The Club pays annual dues up to its one-time parent organization. Total "membership dues" collected by the Club for and were $ and $, respectively. Certain members pay an additional $100 in dues and are referred to as "Ropers". Total "roper dues" for and were $ and $ respectively. Expenses for licenses, taxes, utilities, insurance, and dues for and totaled $ and $, respectively.

In a letter from the Club soliciting donations from area businesses, the Club and its activities are described, noting that the main event is the Jackpot. The letter goes on to state that the Jackpot is advertised in the News, which goes out to approximately 4500 readers around the country. The letter further states that the Club's events will be widely advertised by posting flyers in prominent places of business throughout the local communities of County.

LAW

§501(c)(7) of the Internal Revenue Code exempts from 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.

§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.

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 nonprofitable 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.

The Club is not supported solely by membership fees, dues, assessments, and revenue from member use of club facilities, as contemplated by Treasury Regs. §1.501(c)(7)-1(b). The $ of total dues for would have left the Club only $ after paying for the most basic expenses of licenses, taxes, utilities, insurance and dues. The $ of total dues for would not have even covered these expenses, much less supported any Club activities such as Play Days, Trail Rides, or parties.

This case differs from *Clements Buckaroos vs. Commissioner of Internal Revenue*, in that, the facts of that case were such that the organization in question did not derive any profit from the non-member use of facilities. ORG' records initially indicated that a profit of $ was generated from the Jackpot, although the Revenue Agent's analysis of Club records and the CPA's assertion concerning expenses yield a net income of $. Applying the ratio of non-member participants (86 out of 101, or 86%) to the latter, more conservative assumption yields a net income of $ from non-member use of facilities. Based on Club records and a careful analysis of the Profit & Loss statement as compiled by the CPA, the net income to the Club from the Jackpots was $. Applying the ratio of non-member participants (111 out of 127, or 87%) yields a net income of $ from non-member use of facilities. Therefore, the Club clearly did derive profit from non-member facility use. Further, the judge in the *Clements* case pointed out that "the traffic with outsiders was purely incidental". In the case of ORG, not only was traffic with outsiders not purely incidental, but rather intentional. The judge in *Clements* further observed that it would be possible for the rodeo activities to "become so preponderant that they could no longer be viewed as merely incidental". Given that, out of the Club's 96 members, only 15 participated in the Jackpots in any revenue-generating sense in , and only 16 in , compared with 86 non-members in and 111 non-members in , the overriding non-member nature of these events precludes the revenue from non-member use of Club facilities from being regarded, in any way, as incidental.

This case differs from Revenue Ruling 68-119, in that, the scenario in the ruling involved an organization which made only a small profit from non-member facility use and turned over any such profit to charity. In the case of ORG, however, a significant profit was realized from non-member facility use, and no facts have come to light that would suggest that any of these profits were turned over to charity. Rather, the profits inure to the membership by simply by allowing the Club to conduct its other member activities.

This case differs from *Augusta Golf Association, Inc. vs. United States* because, in that case, the Association took only a 10% cut of the gross amount raised, and the events were open to members and their *invited guests* only. ORG, by contrast, takes a 33% cut. Further, ORG' advertisement of the Jackpots, the Treasurer's statement that Club events are "open to the public", and the sheer number of non-member participants in the Jackpots serve as evidence that no invitation is needed to participate.

The Club's letter to area businesses soliciting donations references advertisement for public patronage of Club facilities, and thus represents prima facie evidence that the club is engaging in a business, is not being operated exclusively for pleasure, recreation, or social purposes, and is thus in direct conflict with Treasury Regs. §1.501(c)(7)-1(b). The Treasurer's statement on the Form 990-EZ, verbal statement during the interview, and signed statement affirming that Club events are open to the public, and the analysis of the membership list with the records of Jackpot participants provide further evidence that the facilities are open to the public and thus, that the club is engaging in a business. Both the 35% limit on non-member gross receipts, and the 15% limit on non-member facility use gross receipts provided for in Public Law 94-568 are far exceeded by any calculation. As in the cases of *Spokane Motorcycle Club v. United States* and *Aviation Club of Utah v. Commissioner*, here the concept of the amount of revenue derived from a non-exempt activity being wholly disproportionate to exempt revenue - namely membership dues and assessments - is applicable. Furthermore, the rather nominal annual dues of $20 for members and $25 for "man and wife", and even the $100 dues for "ropers" speak to the fact that these non-member revenue sources supplement member dues and finance Club expenses above and beyond the most basic costs of licenses, property taxes, insurance, utilities, and dues. The non-member revenue thus inures to the members. Finally, the case referenced in Revenue Ruling 65-63 is analogous to the case of ORG, in that ORG advertises its events to the public, and the public attends events with such a magnitude and recurrence (in large numbers relative to members and twice every year) as to constitute engaging in a business.

CONCLUSION

Based on the above facts and circumstances, and in light of the statutory law and rulings cited, the Club does not qualify for tax-exemption under IRC §501(c)(7) and should be revoked. Form 1120, U.S. Corporation Income Tax Return should be filed for 2003 and thereafter as long as the Club continues to be subject to income tax.

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10 MetroTech Center
625 Fulton Street
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Sincerely yours,

Marsha A. Ramirez
Director, EO Examinations