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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service

May 26, 2004

UIL

501.07-05

Taxpayer Identification Number:

Form:

990

Tax Year(s) Ended:

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.

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:

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.

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Thank you for your cooperation.

Sincerely,

A handwritten signature in black ink, appearing to read "R. C. Johnson". The signature is written in a cursive style with a large initial "R" and "J".

R.C. Johnson
Director, EO Examination

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

EXPLANATION OF ITEMS

Name of Taxpayer

Year/Period Ended

ISSUES:

1. Whether an organization that receives more than an insubstantial amount of their income from non-member sources qualifies for exemption under section 501(c) (7) of the Internal Revenue Code?
2. Whether the receipts from the bingo and pull-tabs inured to the benefit of the fraternity members?
3. Whether a membership organization that is primarily engaged in providing a club for the social and recreational activities of its members can qualify for exemption under section 501(c)(4) of the Internal Revenue Code?

FACTS:

The _____ hereinafter referred to as _____ was granted exemption as a subordinate under a group ruling. The parent organization is _____ an organization that was granted exemption under 501(c)(7).

_____ was established for social purposes for the young men that are attending _____ members are involved in social activities (entertainment), leadership activities, scholarship activities, and environmental activities and gaming activities _____ was primarily formed to provide a social environment for the members of the fraternity. Even though some of the activities are directed toward leadership activities, scholarships or environmental cleanup activities, the majority of their activities are directed toward social activities.

_____ gaming activities (bingo and pull-tab sales) are being conducted with members of the general public. It was determined that for the year ending June 30, 2001 approximately 65 percent of _____ gross receipts were from nonmembers. It was also determined for the year ending June 30, 2002 approximately 93 percent of _____ gross receipts were from non-members. (See Schedule A). The net gaming receipts from the gaming activities are used for social activities, t-shirts, and parent's weekend and some of the funds are used for leadership activities. During the years of the examination it was determined that generally the gaming revenues were not used for charitable or educational activities.

LAW:

Section 501(c)(7) of the Internal Revenue Code provides exemption to "Clubs organized for pleasure, recreation, and other non-profitable 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 relates to the exemption of social clubs, 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 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."

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"(b) An organization which engages in business such as making its social and recreational facilities available to the general public ... is not organized or operated 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 organization is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes..."

Revenue Procedure 71-17, published in Cumulative Bulletin 1971-1 C.B. 683 sets forth guidelines for determining the effect of gross receipts derived from nonmember use of a social organization's facilities on the organization's exemption under section 501(c)(7), and states, in part, as follows:

" Where an organization makes its facilities available to the general public to a substantial degree, the organization is not operated exclusively for pleasure, recreation, or other non-profitable purposes. See Rev. Rul. 60-324, C.B. 1960-2,173; and Rev. Rul. 69-219, C.B. 1969-1, 153."

Section 3.01 of Revenue Procedure 71-17, describes the minimum gross receipts standard, and states, in part, as follows:

"A significant factor reflecting the existence of a nonexempt purpose is the amount of gross receipts derived from use of a organization's facilities by the general public. As an audit standard, this factor alone will not be relied upon by the Service if annual gross receipts from the general public for such use is \$2,500 or less or, if more than \$2,500, where gross receipts from the general public for such use is five percent or less of total gross receipts of the organization..."

Prior to the enactment of Public Law 94-568, an organization was required to be organized and operated exclusively for pleasure, recreation and other non-profitable purposes.

The Committee Reports show that the wording change was intended to make it clear that social clubs may receive up to 35 percent of their gross receipts, including investment income from sources outside their membership without losing their exempt status. Within this 35 percent limitation, no more than 15 percent of gross receipts may be derived from non-member use of the organization's facilities and/or services.

In addition, the statute prohibits exemption under section 501(c)(7) if any part of the organization's net earnings inures to the benefit of any private shareholder.

Traditionally, inurement has been found to be present where an organization derives income from non-member sources and uses it to reduce the cost of providing services to members.

Revenue Ruling 58-589, published in Cumulative Bulletin 1958-2, page 266, states, in part, as follows:

" Net earnings may inure to members in such forms as an increase in services offered by the organization without a corresponding increase in dues or other fees paid for organization support or as an increase in the organization's assets which would be distributable to members upon the dissolution of the organization."

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Revenue Ruling 79-145, published in Cumulative Bulletin 1979-1 on page 360, states that "amounts paid to a social club by visiting members of another social club are amounts paid by nonmembers, even though both clubs are of like nature and the amounts paid are for goods, facilities, or services provided by such social club under a <reciprocal> arrangement with such other social club."

Section 501(c)(4) of the Internal Revenue Code grants exemption to:

"Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare...."

Section 1.501(c)(4)-1(a)(2) of the Income Tax Regulations describes the promotion of social welfare, and states, in part, as follows:

"An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements."

Revenue Ruling 61-158, published in Cumulative Bulletin 1961-2 on page 115, held that an organization which conducts weekly drawings among members of the general public as its principal activity and uses the profits there from primarily for the payment of its general expenses is not entitled to exemption from Federal income tax as an organization described in section 501(c)(4) of the Internal Revenue Code of 1954. The ruling states, in part, as follows:

"The instant organization, by conducting a lottery on a weekly basis with the general public and using almost the entire proceeds there from to pay general expenses of the organization in the circumstances described above, is not operating exclusively for the promotion of social welfare, but is considered to be engaged in a business for profit. Accordingly, it is held that the organization is not entitled to exemption from Federal income tax under section 501(c)(4) of the Code."

Revenue Ruling 68-46, published in Cumulative Bulletin 1968-1 on page 260, held that a war veterans' organization does not qualify for exemption from Federal income tax under section 501(c)(4) of the Internal Revenue Code of 1954 where it is primarily engaged in renting a commercial building and operating a public banquet and meeting hall having bar and dining facilities.

Kansas State Law "Bingo Tax Law and Regulations"

79-4701(p) and (p)(3) Define nonprofit charitable organization and means any organization organized and operated, "for conferring direct benefits on the community at large: and of which no part of the net earning inures to the benefit of any private shareholder or individual member of such organization and has been determined by the administrator to be organized and operated as a bona fide charitable organization and which has been exempt from payment of federal income tax as provided by sections 501(c)(3), 501(c)(4), 501(c)(5), 501(c)(6), and 501(c)(7) of the federal internal revenue code of 1986 as amended, or determined to be organized and operated as a bona fide nonprofit charitable organization by the administrator".

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Conclusion:

During the examination it also determined that the gross receipts that were attributed to nonmembers were approximately 65% for the period ending June 30, 2001 and 93% for the period ending June 30, 2002. nonmember income is substantial and is not within the 15% or 35% limited established under Public Law 94-568.

The net receipts from the gaming activities inure to the benefit of the members, the members of the fraternity house expenses are reduced, due to the fact the gross receipts from the gaming activities are being used for non-charitable and non-educational house expenses. Section 501(c)(7) states that no part of the net earnings shall inure to the benefit of any private shareholder or individual."

was formed primarily to promote the social activities of the fraternity; therefore _____ could not qualify as a social welfare organization under 501(c)(4) or any other tax-exempt section of the Internal Revenue Code.

The information shown above substantiates the fact that _____ 501(c)(7) tax exempt status should be revoked as of _____ because _____ is not operating within the meaning of section 501(c)(7) of the Internal Revenue Code or any other tax- exempt Code Section.