

LTR-RUL, UIL No. 0501.07-01 Exception from tax on corporations, certain trusts, etc. (Exempt v. not exempt); Social clubs; Profit v. not for profit. IRS Letter Ruling 200846034 (Aug. 12, 2008)  
LTR 200846034, August 12, 2008

Symbol: Not Given

Uniform Issue List No. 0501.07-01

[Code Sec. 501]

**Exception from tax on corporations, certain trusts, etc. (Exempt v. not exempt); Social clubs; Profit v. not for profit.**

Dear

In a determination letter dated March 12, 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 October 1, 20XX. This is a final adverse determination letter with regard to your status under section 501(c)(7) of the Code.

We previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On March 5, 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 have filed taxable returns on Form 1120, *U.S. Corporate Income Tax Return*, for the years ended September 30, 20XX through September 30, 20XX with us. For future periods, you are required to file Form 1120 with the appropriate service center indicated in the instructions for the return.

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 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

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

Sincerely, Marsha A. Ramirez Director, EO Examinations.

Form 886-A  
(Rev. January  
1994)

EXPLANATION OF ITEMS

Schedule number  
or exhibit

\*\*\*\*\*

Name of  
taxpayer  
ORG

Tax Identification Number  
\*\*\*\*\*

Year/Period  
ended  
9/30/20XX-9/30/20XX

ORG = Organization name  
XX = Date  
XYZ = State  
Address = address  
City = city

**ISSUES:**

1. Should ORG. ("ORG") continue to be exempt from federal income tax under Internal Revenue Code ("Code") §501(c)(7) as a social club?
2. Should ORG be exempt from federal income tax under Code §501(c)(4) as a homeowners association?
3. Is ORG exempt from federal income tax under Code §501(a)?

**FACTS:**

According to the XYZ State Secretary of State website, the organization was incorporated March 8, 19XX, as a non-profit corporation in the State of XYZ. The ORG Articles of Incorporation ("Articles") state the following purposes for which the corporation was formed:

1. To purchase or otherwise acquire, construct, improve, develop, repair, maintain, operate, care for and/or dispose of streets, roadways, easements, parkways, playgrounds, open spaces and recreational areas, tennis courts, beaches, boat landings, mooring basins, floats, piers, clubhouses, swimming pools and/or swimming areas, bathhouses, places of amusement, community buildings, community clubhouses and in general community facilities appropriate for the use and benefit of its members, and/or for the improvement and development of the property hereinafter referred to.
2. To build, improve and maintain roadways, culverts, bridges and drainage area and to provide for the improving, cleaning and sprinkling of streets, and for collection and disposal of the street sweepings, garbage, ashes, rubbish and the like; to prevent and suppress fires, to provide police protection, and to make and collect charges to cover the costs and expenses therefore.
3. To improve, light and/or maintain streets, roads, alleys, courts, walks, gateways, fences and ornamental features now existing or hereafter to be created or erected, and shelters, comfort stations and/or buildings and improvements ordinarily appurtenant to any of the foregoing; to improve, plant and maintain grass plots and other areas, trees and plantings within the lines of the street immediately adjoining or within the property hereinafter described or referred to.
4. So far as it can legally do so, to grant franchises rights of way and easements for public utilities or other purposes upon, over, and/or under any of said property.

5. To acquire by gift, purchase, lease or otherwise, and to own, hold, enjoy, operate, maintain and to convey, sell, lease, transfer, mortgage and otherwise encumber, dedicate for public use and/or otherwise dispose of, real and/or personal property and interest therein wherever situate.
6. To enforce assessments, liens, charges, restrictions, conditions and covenants existing upon and/or created for the benefit of parcels of real property in the plat or added to the plat of ORG., Section Address and the ADDRESS Section Address and ADDRESS Section Address, and ADDRESS of Section Address (all of the foregoing in City, XYZ) to which said parcels may be subject, and to pay all expenses incidental thereto.
7. To pay the taxes and assessments which may be levied by any public authority upon any of the said property now or hereafter used or set apart for roadway, easements, parks, parkways, play-grounds, open areas, tennis courts, beaches, boat landings, mooring basins, community clubhouses, community club buildings, places of amusement and/or recreation areas, or upon such other recreation spaces wherever situate as may be maintained for the general benefit and use of the owners of lots in said property: to pay taxes and assessments levied by any public authority upon any property which may be held in trust for said corporation.
8. To exercise such powers of control, interpretation, construction, consent, decision, determination, modification, amendment, cancellation, annulment and/or enforcement of covenants, reservations, restrictions, liens and charges imposed upon said property, and as may be vested in, delegated to, or assigned to said corporation and such duties with respect thereto as may be assigned to and assumed by said corporation.
9. To appropriate, purchase, divert, acquire, and store water from streams, water courses, wells or any other source, and to distribute the water so appropriated and acquired to its members for use upon the lands of said members and for domestic purposes: to acquire, own, construct, hold, possess, use and maintain such pumping plants, tanks, pipe lines, reservoirs, ditches, buildings, roads, trails and appliances, and such other property, including water rights and shares of stock in other corporations as said corporation may from time to time desire to acquire or purchase for furnishing and supplying water to its members; provided that this corporation shall not use or dispose of such water as a public utility, but solely for the use and benefit of its members and for the irrigation of lands and domestic and other useful and beneficial purposes.
10. To fix, establish, levy and collect annually such charges and/or assessment. As may be necessary in the judgment of the board of trustees, to carry out any or all of the purposes for which this corporation is formed, but not in excess of the maximum from time to time fixed by the By-Laws.
11. To expend the moneys collected by said corporation from assessments and charges and other sums received for the payment and discharge of costs, expenses and obligations incurred by said corporation in carrying out any or all of the purposes for which said corporation is formed.
12. Generally, to do any and all lawful things which may be advisable, proper, authorized and/or permitted to be done by said corporation under or by virtue of any restrictions, conditions, and/or covenants or laws affecting said property, or any portions thereof (including areas now or hereafter dedicated to public use); and to do and perform any and all acts which may be either necessary for, or incidental to, the exercise of any of the foregoing powers or for the peace, health, comfort, safety, and/or general welfare of owners of said property, or portions thereof, or residents thereon.
13. To borrow money and mortgage, pledge or hypothecate any or all of the real or personal property of said corporation as security for money borrowed or debts incurred; and to do any and all things that a corporation organized under laws of the State of XYZ may lawfully do when operating for the benefit of its members or the property of its members, and without profit to said corporation.

14. Generally, to do and perform any and all acts which may be either necessary or proper for or incidental to the exercise of any of the foregoing powers and such powers granted by the provisions of Title , Revised Code of XYZ, and other laws of the State of XYZ relating to non-profit corporations.

15. Nothing contained in these Articles of Incorporation shall be construed as authorizing or permitting said corporation to own, manage or operate any real or personal property for profit. It is the intention and purpose that the business of said corporation shall not be carried on for profit either to itself or for the benefit of its members, and wherever it is authorized to collect charges or assessments it shall have no power or authority to use said charges or assessments except as necessary to cover the actual cost or expense of the act, duty, power, or transaction performed.

16. All of the foregoing purposes and powers are to be exercised and carried into effect for the purpose of doing, serving and applying the things above set forth for the benefit of all property situated in the plat or added to the plat of ORG., Section Address and the ADDRESS Section Address and Address Section Address and Address of Section Address (all of the foregoing in City, XYZ).

The ORG Bylaws contain the following stated purposes:

1. To promote community welfare of the members and their families.
2. To make ORG a better place to live and enjoy life for the benefit of the members and their families;
3. To exercise all powers of non profit organizations and home owners' associations pursuant to the laws of the State of XYZ, including \*\*\*\*\* chapters \*\*\*\*\* and \*\*\*\*\* , or as amended.

ORG applied for and was granted exemption from federal income tax in March of \*\*\*\*\*. The determination letter issued by the Internal Revenue Service gave ORG exemption under Code §501(a) as an organization described in Code §501(c)(7).

As required in Part II of the application for exemption (Form 1024, Application for Recognition of Exemption) ORG provided a detailed narrative description of all the activities of the organization. For purposes of this report the ORG response has been duplicated below and can be seen in Exhibit 1 of this report:

1. To purchase or otherwise acquire, construct, improve, develop, repair, maintain, operate, care for and/or dispose of streets, roadways, easements, parkways, playgrounds, open spaces and recreational areas, beaches, boat landings, mooring basins, floats, piers, clubhouses, swimming areas, community buildings, community club houses and general community facilities appropriate for the use and benefit of its members, and/or for the improvement and development of the property hereinafter referred to.
2. To build, improve and maintain roadways, culverts, bridges and drainage areas and to provide for the improving, cleaning and sprinkling of streets, and for the collection and disposal of street sweepings, garbage, ashes, rubbish and the like, to prevent and suppress fires.
3. To improve, light and/or maintain streets, roads, alleys, courts, walks, gateways, fences and ornamental features now existing or hereafter to e created or erected.
4. To enforce assessments, liens, and/or charges.
5. To operate a restaurant and lounge for the social and recreational use of the members.
6. To provide social activities for the members, including banquets, dances and other social occasions.

7. To operate additional recreational facilities for the benefit of the membership, such as tennis courts, swimming and boating locations.

On June 20, 20XX, an examination of ORG was initiated by the Internal Revenue Service (“IRS”). On July 30, 20XX, the examining agent interviewed Agent who was then the current President of ORG. Below is a partial transcript of that interview that pertains to this report:

The questions asked are listed below, with responses immediately following the numbered question.

1. Did you receive Publication 1, have you read it, and do you have any questions concerning your rights?

Yes, it was received and there were no questions.

2. To get a full understanding of your organization, please describe the history of your organization and all of its activities.

The organization was originally incorporated in the 19XX's. It was started by three land developers. The roads that go through the property are owned and maintained by City.

The golf course is open to the public. However, the restaurant and lounge below the office area are for members only. The organization has a 10% social member rule. The club may have up to 10% of its total membership as social members. Social members may use the restaurant and lounge area below the office. The revenue generated by the social members is counted and reported as public or non-member revenue.

The organization owns and maintains its own water system. The organization owns a number of wells that water is pumped from and provided to members for a monthly fee. The water system has their own Board of Directors, checking account, budget and employees. However, it is wholly owned by ORG and the final say on matters is decided by the ORG Board of Directors. The revenue and expenses are reported on the ORG Form 990.

3. What does the organization consider its recreational areas? Please explain which areas are for use by members only?

The parks, beaches, tennis courts and hiking areas are for members only. This area consists of about 200 acres and is maintained by ORG. The lake itself is 3 1/2 miles around. Non-members are allowed to fish on the lake via a state owned boat launch. The state stocks the lake with fish and thus it agreed with the state that non-members may use the lake as long as non-members are actively engaged in the activity of fishing. However, non-members are not allowed to swim, ski or use the beach areas.

The water program is not available to non-members and/or the public. The water services are provided to members only for a \$ per month fee.

Non-members (10% social members) are limited with the amount of time that they can use the restaurant and lounge areas.

4. Does your organization administer and enforce covenants to preserve appearance or architecture? If so, how? Please give examples?

Yes, ORG enforces covenants. It is a three step process. If a covenant is violated the member is afforded two warning letters. The third warning letter usually accompanies a fine. A lien may be placed on the residence for non- payment of dues and assessments.

The covenants enforced are found in the Architectural Committee Guidelines. Examples of covenants that can be enforced by ORG include but are not limited to:

- Setbacks so many feet from the lake;
- Obstructing views of other members;
- Fences along properties have to meet certain specifications;
- Any built structure on properties requires approval of the Architecture Committee;
- Any structural modifications to the exterior of houses or outbuildings require the approval of the Architecture Committee;
- Noise ordinances like loud or obnoxious dogs are enforced by ORG;
- The building of a deck requires approval of said committee.

5. Does your organization offer police and/or other security services? Garbage? Utilities?

Yes, ORG provides security and protection services for its members. ORG hired an individual who owns his own security business with his spouse. He only works 30 hours a week on a typical basis.

No, ORG does not provide garbage services to its members as City handles that and other utility services with exception of water.

6. What is Social and Architecture Revenue of \$?

This is revenue collected from members who apply for building permits and/or fines from covenant infractions.

During the examination of ORG the examining agent requested and received any and all documents pertaining to enforced covenants and/or restrictions on members. The examining agent received the two following documents that specifically address covenants and restrictions enforced by ORG:

1. ORG Covenants, Conditions and Restrictions & Architectural Committee Guidelines: This is a 12 page document that was notarized on July 12, 20XX. The document states in Section I that ORG shall be binding on the purchasers of any lot within said divisions. Section II states that the Architecture Committee that is composed of 3 or more members must approve of most architectural changes on said lots. Section II also contains a subsection entitled Restrictions Common to All Divisions which outlines rules and restrictions common to all lots and another subsection entitled

Specific Restrictions by Division. The document clearly conveys restrictions regarding domestic pets, storage sheds, signs on property, fences, metal roofs, green houses, trees, and general appearance of property and houses.

2. Resolution No. 20XX-10 Violations of Covenants, Articles, Bylaws, Resolutions and Other Rules: This document states that ORG “has the authority to enforce its Protective Covenants, Articles of Incorporations, Bylaws, Resolutions, and other Rules that apply to the ORG development.” The document specifies a “Process” in which complaints and referrals can be heard on violations of said restrictions. Violators of said restrictions are granted a hearing in cases in which there are disagreements with the findings of the committee. The document describes the fines that may be imposed by said Committee on those that violate said restrictions. Fines are imposed on a tiered scale from \$100 to \$1,000 depending on

the number of times a restriction is violated. The document states that ORG has the authority to place a lien on ones property for “any amounts due the Association pursuant to this Resolution, including fees, and costs as set forth above”.

ORG has a water program and committee that is responsible for providing water utility services to the ORG members. Members are charged \$ per month for water that is pumped out of three wells on ORG property. When asked why the organization provides water to its members the officers stated that it is a County and/or State requirement. During the examination of ORG the examining agent reviewed the following two documents available for public inspection at:

1. Water Committee: This document describes the purpose of the Water Committee. In part, the water committee is to determine and recommend to the Board of Directors an appropriate rate structure providing for the continued operation of the system and the accumulation of adequate reserves to complete emergency repairs and upgrades to the system. The document states that the Water Committee does not have the authority to act for the Board of Directors with respect to any final decisions; rather, it recommends to the Board based on its investigations, experience, and deliberations.
2. \*\*\*\*\*, Purpose and Scope ORG Water System (Water System Bylaws): This document states that the Water System is charged with the operation and maintenance of the water system. Furthermore, the document states in part that in order to retain a private water system classification with the XYZ State \*\*\*\*\* Commission it is required that ORG Water System supply only to ORG property and members in good standing. The monies collected by the Water System are used solely for the operation, maintenance and improvement of the Water System facilities.

On July 31, 20XX, the examining agent toured the facilities of ORG accompanied by the Office Manager. Digital photographs were taken of the properties. Digital photographs were taken with permission of the Office Manager of the following:

1. A posted sign next to the beach area adjacent to the business office that read “ORG - Private Property No Trespassing - Members Only - Guest Must be Accompanied by Member.
2. Tennis Courts - The tennis courts are for members only as well.
3. Beach Front Property.
4. A Dock that extends in front of the business office - The dock is for member use only.
5. Maintenance Shop.
6. Parking Lot Area with Power Building in background.
7. Close up shot of the Power Building.
8. Pro Shop - Picture is of inventory for sale to members and non-members alike.
9. Pro Shop - Outside view.

The following data was obtained from the Profit & Loss Statements for 20XX and 20XX as provided by ORG:

The Notes to the Financial Statements for the Year Ended September 30, 20XX, contained the following disclosures:

—Note 9 - The association's board of directors levied a special assessment of \$ per lot for the funding of a new sprinkler system. The assessment was approximately \$ for the year ended September 30, 20XX.

—Other miscellaneous income included \$ for Administrative/Maintenance/Social, \$ Golf, and \$ Water.

#### Revenues and Expenses of ORG per Profit & Loss Statements

**\*Chart Omitted\***

The following is a representation of operating expenses per each functional unit. The data was extracted from the Profit & Loss Statements as provided:

**\*Charts Omitted\***

The Forms 990, Return of Organization Exempt from Income Tax, for the tax year ending September 30, 20XX and 20XX, reported the following gross receipts:

#### **Form 990 Part VII - September 30, 20XX and 20XX**

#### Revenues and Expenses of ORG per Profit & Loss Statements

**\*Chart Omitted\***

According to the response provided to the initial examination letter the Social & Architecture Revenue is income received from members applying for building permits and fines. Service Charges are Water Department related receipts.

#### **ISSUE #1: LAW**

#### **Internal Revenue Code**

Code §501(c)(7) exempts from income tax 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.

Code §512(a)(3)(A) provides that in the case of all exempt organizations, including social clubs described in Code §501(c)(7), the term “unrelated business taxable income” means the gross income (excluding any exempt function income), less deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income).

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



## Federal Tax Regulations

§ 1.501(c)(7)-1(a) of the federal Tax Regulations states that the exemption provided by section 501(a) for organizations described in Code §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.

§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 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.

## Court Cases

In Santa Barbara Club vs. C.I.R., 68 T.C. 200 (1977) [CCH Dec. 34,415], a social club that was exempt from federal income tax under Code §501(c)(7) derived a substantial amount of income from the sale of packaged liquor to its members for off-premises consumption. The bottled liquor sales were an ongoing and recurring operation of the club. In each of the years examined by the court, the dollar volume from the sale of bottled liquor for off-premises consumption was substantial (in this case more than 25% of the gross receipts from all sources), and the gross income (gross profit) derived from this service to members was not insignificant (in excess of 7% of gross income from all sources).

It was held by the court that in light of the club's ongoing and recurring sales of bottled liquor and the sizable percentages of gross receipts and gross income which such sales represented, that the club was not entitled to exemption under Code §501(c)(7).

In Allied Trades Club, Inc. vs. C.I.R., 23 T.C. 1017 (1955) F. 2d 906 (3<sup>rd</sup> Cir. 1956) [CCH Dec. 20,907], it was held that the operation of a death-benefits fund for members caused a social club to lose its exemption on the ground that such activity could not be classified as an operation for pleasure, recreation or social services.

## Revenue Rulings

In Revenue Ruling 68-535, 1968-2 CB 219, it was held that the sale of liquor to members for consumption off the club's premises does not constitute the raising of income from members through the use of the club's facilities or in connection with club activities within the meaning of §1.501(c)(7)-1 of the federal Tax Regulations. Neither was it considered income from the sale of merchandise to members through the operation of a restaurant or bar as provided in Revenue Ruling 44. Rather, the regular sale of liquor under the circumstances in the instant case was held to be a service to members that was neither related to nor in furtherance of a social club's exempt purposes. Furthermore, it was held that since said activity was neither social nor recreational, the club was not operated exclusively for pleasure, recreation, and other non-profitable purposes within the meaning of Code §501(c)(7).

In Revenue Ruling 55-716, 1955-2 CB 263, it was held that an organization that was formed for the purpose of furnishing television antenna service to its members was not entitled to exemption under Code §501(c)(7). Furthermore, the Ruling stated fellowship did not constitute a material part of the life of the organization, since the services (television antenna service) did not afford the opportunity for personal contacts and fellowship among members receiving said services.

In Revenue Ruling 68-119, 1968-1 C.B. 268, an equestrian social club that holds an annual one-day steeplechase meet which is open to the general public is found to be tax-exempt under IRC 501(c)(7). In this case, the club is said to derive a small amount of income from nonmembers in excess of expenses attributable to their participation and attendance. If any profit results, it is turned over to charity. Other club activities are supported by member dues. Therefore, the ruling holds, the income from non-members does not inure to the club's members.

In Revenue Ruling 69-281, 1969-1 C.B. 155, it was held that a club whose membership is limited to homeowners in a housing development and that provides recreational facilities that afford opportunities for fellowship and social commingling is exempt from federal income tax under Code §501(c)(7). Although the club was incorporated by a housing developer, it was not controlled by him nor operated as commercial venture for his benefit.

Revenue Ruling 75-494, 1975-2 C.B. 214, provides answers to inquires asking whether certain activities engaged in by clubs similar to the club described in Revenue Ruling 69-281, 1969-1 C.B. 155, will preclude their exemption under Code §501(c)(7). The ruling was given in question/answer format. The question/answers that are relevant to this report are shown below:

#### Question 2

Will a club fail to qualify for exemption under Code §501(c)(7) if it administers and enforces covenants for preserving the architecture and appearance of the housing development?

#### Answer

Yes. A club which administers and enforces covenants for the preservation of the architecture and appearance of the housing development is not operated exclusively for pleasure, recreation, and other non-profitable purposes as required by Code §501(c)(7).

#### Question 3

Will a club fail to qualify for exemption under Code §501(c)(7) if it provides the housing development in which members live with fire and police protection and trash collection service?

#### Answer

Yes. A club may provide these services in connection with maintenance and security of its social facilities. However, as soon as these services go beyond merely maintaining social facilities and begin to include services to residential areas, they are no longer exclusively in furtherance of pleasure and recreation. Thus, a club providing police and fire protection and a trash collection service to residential areas will not qualify for exemption under Code §501(c)(7).

In Revenue Ruling 66-149, 1966-1 C.B. 146, a club was held to be not exempt as an organization described in Code §501(c)(7) because it regularly derived a substantial part of its income from nonmember sources such as, for example, dividends and interest from investments it owned.

### **Revenue Procedures**

Rev. Proc. 71-17, 1971-1 C.B. 683, sets forth guidelines for determining the effect of gross receipts derived from nonmember use of a social club's facilities on the club's exemption under Code §501(c)(7). In §3.02 this Revenue Procedure defines the term 'total gross receipts'. Total gross receipts means receipts from normal and usual activities of the club including charges, admissions, membership fees, dues, and assessments. Excluded for this purpose are (a) initiation fees and capital contributions, (b) interest,

dividends, rents, and similar receipts, and (c) unusual amounts of income such as amounts derived from nonrecurring sales of club assets.

By Public Law 94-568, 90 stat. 2697, Code §501(c)(7) was amended to read:

Clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and not part of net earnings of which inures to the benefit of any private shareholder.

The Committee Report (S. Rep. No.94 - 1318, 94<sup>th</sup> Cong., 2<sup>nd</sup> Sess.1976) that accompanied P.L. 94-568, provides congressional intent to the limitations on revenue from outside membership. The report reads as follows:

“It is intended that a social club, national organization of a college fraternity or sorority, and any other organization exempt under Code §501(c)(7), may receive the full 35-percent amount of its gross receipts from investment income sources (reduced by any amount of nonmember income). This means that a national organization of a college fraternity or sorority that has no outside income from permitting the general public to use its facilities may receive investment income up to the full 35-percent amount of its gross receipts. On the other hand, in the case where a social club permits nonmembers to use its club facilities and receives 15 percent of its gross receipts from these nonmember sources, it may receive only up to 20 percent of its gross receipts from investment income.”

### **ISSUE #1: GOVERNMENT'S POSITION**

**Should ORG. (“ORG”) continue to be exempt from federal income tax under Internal Revenue Code (“Code”) §501(c)(7) as a social club?**

ORG no longer qualifies for exemption from federal income tax under Code §501(c)(7). ORG it is not operated for pleasure, recreation, and other non-profitable purposes, where substantially all of the activities of which are for such purposes for the following three reasons:

1. ORG fails the 15% Non-member income tests as outlined in S. Rep. No. 94-1318, 94th Cong., 2nd Sess. 4 (1976), 1976-2 C.B. 597, 599;
2. ORG receives a substantial amount of income from non-traditional business activities;
3. ORG administers and enforces covenants to preserve architecture and appearance of a housing development in violation of Revenue Ruling 75-494.

ORG had substantial non-traditional business activities during all years of examination which causes it to fail the 15 % test set forth in S. Rep. No. 94-1318, 94<sup>th</sup> Cong., 2<sup>nd</sup> Sess. 4 (1976), 1976-2 C.B. 597, 599.

In performing the 15 and 35% test we must first calculate the Adjusted Gross Receipts per Revenue Procedure 71-17. Using the definition of Gross Receipts found in said Revenue Procedure, the amount of Gross Receipts for the taxable year ending September 30, 20XX is calculated in the following manner:

**\*Chart Omitted\***

Next, the total amount of revenue generated from non-member usage must be calculated. The income from nontraditional activities is included in the 15% limit on income from non-member usage of club facilities and the 35% limit on non-member income overall. Although the Reports accompanying Public Law 94-568 described those limits in terms of member and non-member income, all nontraditional income must be included in the numerator and the denominator of the calculation even if the revenue was generated from members. Clearly, it was not Congress' intent to allow organizations with income from nontraditional activities to have a greater percentage of their total income from unrelated activities than organizations with all traditional activities.

The following activities are classified as nontraditional social club activities because they cannot be classified as operations for pleasure, recreation, social services and lack the commingling nature required under Code §501(c)(7):

**\*Chart Omitted\***

The aforementioned non-traditional sources of revenue are not unlike those found in Revenue Ruling 68-535 and *Santa Barbara Club vs. C.I.R.*, supra. Those organizations generated revenue by selling packaged liquor to members for off premises consumption. In both cases, it was held that this activity was a service to members and was neither related to nor in furtherance of a social club's exempt purpose. In both cases the income generated from this activity was not considered income from the sale of merchandise to members. In addition, in both cases the organizations were denied exemption under Code §501(c)(7) because of substantial nontraditional business activity.

Similarly, in the earlier case of *Allied Trades Club, Inc. vs. C.I.R.*, supra, the organization lost its exemption under Code §501(c)(7) because it carried on substantial nontraditional business activity. In this case the organization provided a death-benefits fund for members.

In the instant case, ORG provided a service to its members as well. Revenue was generated from providing water service to its members. In addition, revenue was generated from permit and service fees. These activities like the ones found in the aforementioned court cases and revenue rulings are not in furtherance of a social club's exempt purpose and are nontraditional business activities.

Both ORG Forms 990 and 990-T reported non-member sales of \$\*\*\*\*\* for 20XX.

The percentage of non-member receipts can now be calculated for the tax year ending September 30, 20XX, in the following manner:

**\*Charts Omitted\***

As can be seen in these calculations, the ORG fails the 15% non-member revenue test in both years under examination. The non-member income percentage is consistently exceeding the limit of 15% by just over 13 to 14%.

ORG receives a substantial amount of income from non-traditional business activities and thus is not operated for pleasure, recreation, recreation, and other non-profitable purposes, where substantially all of the activities of which are for such purposes.

In the tax year ending September 30, 20XX, ORG received 20% of its gross receipts from non-traditional business activities (\$/\$). Again in the year ending September 30, 20XX, ORG received 16% of its gross receipts from non-traditional business activities (\$/\$). These percentages are similar to that of Santa Barbara Club vs. C.I.R., supra. In that case the organization received 25% of their gross receipts from a non-traditional business activity. It was held by the court that in light of the club's ongoing and recurring sales of bottled liquor and the sizable percentages of gross receipts and gross income which such sales represented, that the club was not entitled to exemption under Code §501(c)(7). In like manner, ORG no longer qualifies for exemption under Code §501(c)(7) due to an unusually high percentage of gross receipts streaming from a non-traditional business activity that do not further its exempt purposes.

Lastly, ORG operates in direct violation of Revenue Ruling 75-494 by administering and enforcing covenants to preserve architecture and appearance of a housing development as evidenced by the following:

—The ORG articles of incorporation (article 6) expressly states that one of the purposes of this organization is to enforce conditions and covenants existing upon and/or created for the benefit of parcels of real property;

—The President of ORG in interview with the examining agent plainly stated that the organization enforces covenants to preserve architecture and appearance of a housing development and uses a three step process to do so;

—ORG has in its books and records a 12 page document entitled ORG Covenants, Conditions and Restrictions that outlines the covenants and restrictions that the organization enforces;

—ORG has in its books and records a document entitled Resolution No. 20XX-10 that gives the organization express authority to impose fines and place liens on properties to enforce said covenants;

Revenue Ruling 75-494 could not be clearer on the prohibition. It states “A club which administers and enforces covenants for the preservation of the architecture and appearance of the housing development is not operated exclusively for pleasure, recreation, and other non-profitable purposes as required by Code §501(c)(7).”

### **ISSUE # 1: TAXPAYER'S POSITION**

The taxpayer is being presented with this report at this time. The examining agent is awaiting their response as to this position.

### **ISSUE #2: LAW**

#### **Internal Revenue Code**

Code §501(c)(4)(A) provides for exemption from federal income tax Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

Code §501(c)(4)(B) states that subparagraph (A) shall not apply to an entity unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

## **Federal Tax Regulations**

§1.501(c)(4)-1(a)(1) of the federal Tax Regulations states that civic leagues or organizations may be exempt as an organization described in Code §501(c)(4) if:

- (i) it is not operated for profit; and
- (ii) it is operated exclusively for the promoting of social welfare.

§1.501(c)(4)-1(a)(2) of the regulations states that:

(i) **In general.** - 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. A “social welfare” organization will qualify for exemption as a charitable organization if it falls within the definition of “charitable” set forth in paragraph (d)(2) of §1.501(c)(3)-1 and is not an “action” organization as set forth in paragraph (c)(3) of §1.501(c)(3)-1.

(ii) **Political or social activities.** - The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

## **Revenue Rulings**

Revenue Ruling 74-99, 1974-1 C.B. 131, describes the circumstances in which a homeowner's association may qualify for exemption under Code §501(c)(4). The Ruling states that three elements must be satisfied:

- 1) It must serve a “community” that bears a reasonably recognizable relationship to an area ordinarily identified as governmental;
- 2) It must not conduct activities directed to the exterior maintenance of private residences, and
- 3) The common areas or facilities it owns and maintains must be for the use and enjoyment of the general public.

The Ruling also states that a “community”, in within the meaning of Code §501(c)(4) is not merely “an aggregation of homeowners bound together in a structured unit formed as an integral part of a plan for the development of real estate subdivision and the sale of purchase of homes therein.”

Revenue Ruling 72-102, 1972-1 C.B. 149, states in order to be exempt under Code §501(c)(4), an organization must maintain common streets and sidewalks, which will be available for use by the community as a whole.

Revenue Ruling 74-99, 1974-1 C.B. 116, further emphasizes that such organizations must serve a community which bears a reasonable and recognizable relation to an area ordinarily identified as governmental, and that the common area it owns or maintains, must be for the use and enjoyment of the general public.

Revenue Ruling 80-63, 1980-1 C.B. 116, was issued to discuss, in question and answer format, certain issues raised by Revenue Ruling 74-99.

#### Question

Does Revenue Ruling 74-99 contemplate that the term “community” for purposes of Code §501(c)(4) embraces a minimum area or a certain number of homeowners?

Answer:

No. Revenue Ruling 74-99 states that it was not possible to formulate a precise definition of the term “community”. The ruling merely indicates what the term is generally understood to mean. Whether a particular homeowners' association meets the requirements of conferring benefit on a community must be determined according to the facts and circumstances of the individual case. Thus, although the area represented by an association may not be a community within the meaning of that term as contemplated by Revenue Ruling 74-99, if the association's activities benefit a community, it may still qualify for exemption. For instance, if the association owns and maintains common areas and facilities for the use and enjoyment of the general public as distinguished from areas and facilities whose use and enjoyment is controlled and restricted to members of the association then it may satisfy the requirement of serving a community.

#### Question

May a homeowners' association, which represents an area that is not a community, qualify for exemption under Code §501(c)(4) if it restricts the use of its recreational facilities, such as swimming pools, tennis courts, and picnic areas, to members of the association?

Answer:

No. Revenue Ruling 74-99 points out that the use and enjoyment of the common areas owned and maintained by a homeowners' association must be extended to members of the general public, as distinguished from controlled use or access restricted to the members of the association. For purposes of Revenue Ruling 74-99, recreational facilities are included in the definition of “common areas”.

#### Question

Can a homeowners' association establish a separate organization to own and maintain recreational facilities and restrict their use to members of the association?

Answer:

Yes. An affiliated recreational organization that is operated totally separate from the homeowners' association may be exempt. See Revenue Ruling 69-281, 1969-1 C.B. 155, which holds that a social club providing exclusive and automatic membership to homeowners in a housing development, with no part of its earnings inuring to the benefit of any member, may qualify for exemption under Code §501(c)(7).

#### Question

Can an exempt homeowners' association own and maintain parking facilities only for its members if it represents an area that is not a community?

Answer:

No. By providing these facilities only for the use of its members the association is operating for the private benefit of its members, and not for the promotion of social welfare within the meaning of Code §501(c)(4).

## ISSUE #2: GOVERNMENT'S POSITION

### **Should ORG be exempt from federal income tax under Code §501(c)(4) as a homeowners association?**

ORG does not qualify for exemption from federal tax under Code §501(c)(4) as a home owners association for the following two reasons:

1. The primary activity of ORG is the operation of a social club for the benefit, pleasure, or recreation of its members in direct conflict of federal Tax Regulations §1.501(c)(4)-1(a)(2)(ii).
2. ORG restricts access to its common areas to its members in direct conflict to various Revenue Rulings including Revenue Ruling 80-63.

The primary activity of ORG is the operation of a social club for the benefit, pleasure, or recreation of its members. This is evident when the activities and facilities of the organization are considered. They are as follows:

- The organization owns and operates a public golf course with a pro-shop;
- It owns and operates a restaurant that has limited public access;
- It owns lake beaches and hiking trails that are limited to member access;
- It owns tennis courts that are restricted to member's use.

Furthermore, it can be readily ascertained that a majority of the organization's expenditures and expenses are in furtherance of social club type activities. According to the Statement of Functional Expenses for 20XX, the organization had expenditures totaling \$. Of that amount \$( \$ + \$ ) were allocated to the Golf & Pro Shop and Restaurant. The percentage of expenditures allocated to social club activities totaled 51% according to ORG calculations. However, administrative expenditures totaled almost 31% of total expenditures (\$/\$). Surely, some of these "administrative and management" expenses could be allocated to the Golf & Restaurant areas.

With well over 50% of the ORG expenditures on social club type activities in conjunction with a quick review of the organization's facilities and activities it can easily be stated that ORG is operated primarily as a social club for the benefit, pleasure, or recreation of its members. Federal Tax Regulations §1.501(c)(4)-1(a)(2)(ii) clearly states that an organization is not operated primarily for the promotion of social welfare if its primary activity is operated a social club for the benefit, pleasure, or recreation of its members. If an organization is not operated exclusively for the promotion of social welfare, it cannot be exempt from federal income tax under Code §501(c)(4).

During all years under examination, ORG allowed public use of its golf course and pro shop. It allowed minimal public use of its restaurant. ORG has a 10% social member policy. That is 10% of its membership may be social members who are not members by means of being lot owners in the housing development. However, ORG restricted access to its beaches, lake, hiking trails, and tennis courts to members only.

Revenue Ruling 80-63 plainly states that the use and enjoyment of common areas owned and maintained by a homeowners' association must be extended to members of the general public, as distinguished from controlled use or access restricted to the members of the association. Therefore, by limiting access to common areas and recreational facilities ORG is not entitled to exemption from federal income tax under Code §501(c)(4).



## **ISSUE # 2: TAXPAYER'S POSITION**

The taxpayer is being presented with this report at this time. The examining agent is awaiting their response as to this position.

## **ISSUE #3: LAW**

Code §277(a) provides that in the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, 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 (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year 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. The deductions provided by Code §§ 243, 244 & 245 (relating to dividends received by corporations) shall not be allowed to any organization to which this section applies for the taxable year.

Code §528, as added by Code §2101 of the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1525, provides an elective exemption for certain homeowners associations that are described in Code §528(c).

Code §528 exempts from federal income tax any dues and assessments received by qualified homeowners' associations that are paid by property owners who are members of the association, where the assessments are used for maintenance and improvements of the association property.

Code §528 defines a "homeowners' association" as an organization which is a condominium management association or a residential real estate management association if:

—It is organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property,

—It elects to have the section apply for the taxable year,

—No part of the earnings of the association inures to any private shareholder or individual,

—60 percent or more of the association's gross income consists solely of amounts received as membership dues, fees, assessments from owners of residential units or residences or residential lots (exempt function income), and

—90 percent or more of the association's expenditures for the taxable year are expenditures for the acquisition, construction, management, maintenance, and care of association property.

## **ISSUE # 3: GOVERNMENT'S POSITION**

### **Is ORG exempt from federal income tax under Code §501(a)?**

ORG is no longer qualified for exemption from federal income tax under Code §501(c)(7). Neither is ORG qualified for exemption under Code §501(c)(4).

The government contends in its position that the ORG exemption from federal Income Tax should be revoked back to the tax period ending September 30, 20XX.

Form 1120, U.S. Corporation Income Tax Return, should be filed for the tax period ending September 30, 20XX through September 30, 20XX. Rules contained in Code §277 should be adhered to in determining the correct amount of tax liability for those years. In any subsequent year ORG may annually elect to be treated as a taxable home owners association under Code §528 by timely filing Form 1120-H, U.S. Income Tax Return for Homeowners Associations. ORG must first determine if they meet the criteria outlined in Code §528 prior to making said election.

### **ISSUE # 3: TAXPAYER'S POSITION**

The taxpayer is being presented with this report at this time. The examining agent is awaiting their response as to this position.

### **CONCLUSION**

Issue # 1: ORG no longer qualifies for exemption from federal income tax under Code §501(c)(7) for the following reasons:

1. ORG fails the 15% non-member incomes tests as outlined in S. Rep. No. 94-1318, 94th Cong., 2nd Sess. 4 (1976), 1976-2 C.B. 597,599,
2. ORG receives a substantial amount of income (20%) from non-traditional business activities, and
3. ORG administers and enforces covenants to preserve the architecture and appearance of a housing development in violation of Revenue Ruling 75-494.

Issue # 2: ORG does not qualify for exemption from federal income tax under Code §501(c)(4) for the following reasons:

1. The primary activity of ORG is the operation of a social club for the benefit, pleasure, or recreation of its members in direct conflict of federal Tax Regulations §1.501 (c)(4)-1(a)(2)(ii);
2. ORG restricts access to its common areas to its members in direct conflict to various Revenue Rulings including Revenue Ruling 80-63.

Issue # 3: ORG does not qualify for exemption from federal income tax under Code §501(a). ORG was previously granted exemption under Code §501(c)(7) but no longer qualifies under that Code section. Neither does it qualify for exemption as a home owner's association under Code §501(c)(4). As such, the government's position is that the exemption of ORG from federal income tax is to be revoked as of October 31, 20XX.

ORG will be required to file Forms 1120 for the tax periods ending September 30, 20XX through September 30, 20XX. The rules contained in Code §277 should be used to determine the correct tax amount.

In subsequent years ORG may potentially qualify for the annual election as a taxable homeowners association under Code §528. An election must be made by timely filing a Form 1120-H. The criteria for said election are found in Code §528, corresponding federal Tax Regulations, and in the instructions to the Form 1120-H.

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain 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.

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

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

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:

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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, Marsha A. Ramirez, Director, EO Examinations Division.

Gary Porter, CPA is licensed by the California Board of Accountancy and the Nevada Board of Accountancy. His practice is limited to common interest realty associations consisting of condominium, homeowners, timeshare, cooperative and condo hotel associations. Mr. Porter is the creator and coauthor of PPC's (Practitioners Publishing Company) Guide to Homeowners Associations and Other Common Interest Realty Associations and Homeowners Association Tax Library, in addition to more than 200 articles. Mr. Porter has been quoted or published in The Wall Street Journal, Kiplinger's Personal Finance, Money Magazine, The Practical Accountant, Common Ground, Condo Management, and CAI's The Ledger Quarterly. He has been working with homeowners associations since 1976, and has been a frequent presenter at industry and CPA venues; speaking at events for more than 30 state CPA societies.