

Internal Revenue Service

Department of the Treasury
Internal Revenue Service

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Taxpayer Identification Number:

Form:
990EZ

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 revocation 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 revoking your 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.

Thank you for your cooperation.

Sincerely,

R. C. Johnson.
Director, EO Examinations.

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

Year: _____

ISSUES

1. Whether the tax-exempt status of an organization that operates an aircraft and provide sport parachuting facilities for the pleasure, recreation and use of accepted members and guests should be revoked?
2. Alternative Issue, if exemption status is maintained, should the non-member income be taxed as unrelated business income?

BRIEF EXPLANATION OF FACTS

The subject organization is recognized as 501(c) (7) tax-exempt organizations. According to its articles of incorporation, the primary purpose of the organization is to provide sport parachuting facilities in the area. The by-law (adopted further broke the purpose down to providing sport parachuting, aircraft and equipment for the pleasure, recreation and use of members and guests, to provide for student training, provide for competition and promote sport parachuting to the general public. The organization had seven classes of members, and later modified to six types; Paid, Pilot/Jumper, Pilot, Honorary, Lifetime-Active and Lifetime-Inactive. The only change was the removal of the language; "Student Members" from the by-law. Membership benefits include, reduced skydiving/jump rates, participation at all club functions & competitions and active participation in all functions and meetings.

The organization provides training to members and the general public who are interested in parachuting and sky-diving. The student pay a flat rate fee for training provided and each jump participated in. Income from the students is outside income, thus; unrelated business income because 1) they are not members of this organization, 2) they pay at a higher rate to receive the services or to participate in the jumps. In both fiscal year _____, income received from the training of students is over 40% of the total revenue of this organization as highlighted below:

<u>Description</u>	<u>Fiscal</u>		<u>Fiscal</u>	
	<u>Amount</u>	<u>%</u>	<u>Amount</u>	<u>%</u>
Membership Dues		4.62%		5.0%
Program Services Fees:		61.81%		49.0%
Special Events:		-7.04%		0%
Student Income:		40.61%		46%
Total		100.00%		100.00%

**UNAGREED REVOCATION
WITH ALTERNATIVE ISSUE**

Year

Year	Member	Non-Member	Total Income	Non-Member %
	\$	\$	\$	41%
	\$	\$	\$	46%

In the 990 return submitted for _____, the organization reported all program services revenue and student income as "Direct Public Support", An IRC 501(c)(7) organization should not even have any direct public support at all. The revenue lines were not broken out so as to disguise the sources.

The increasing trend of non-member income could be seen in both years _____ and _____. In _____ and _____ the organization received 41% and 46% respectively of their income from non-members. This indicates that the organization is using income from non-members to support the activities of its members. Evidence that support the fact that the organizational activities are open to the public includes advertisement to the public. The organization have a web-site, whereby they advertise to train students in the act of sky-diving requesting that they will only "accept cash only and no checks" which will prevent accurate tracing of revenue received from the public. Also posted on their website are different jump rates for various heights desired by clients. Since they invite public to train and pay for these services at a higher rate than regular members, it is operating more like a regular commercial entity. This activity is pursued regularly carried on and not substantially related to their exempt function. There is no restriction placed on number of students trained or how often they are trained.

Based on the interview of the officer; (treasurer), and review of books and records, there is no adequate evidence that commingling between members is ongoing. There are no minutes or chronology of events that shows that regular commingling is allowed.

In addition to non-member income and little commingling, there is inurement. The organization paid for car insurance for one of its members and the asset was not listed in the books of the organization. Although the car is old, payment for personal expenses of members not related to the exempt activity should not be allowed.

In _____ the organization said, 2 airplanes reported on the books have been destroyed. After several attempts to secure the proof that the two airplanes were destroyed, the organization provided a factual aviation report by National Transportation Safety Board that indicated one of the airplanes was destroyed. The other airplane could not be accounted for. Proper books and records were not kept to differentiate between non-member and members income. Organization did not provide information distinguishing member and non-member income.

In addition to the above issues, the organization is not inactive presently because they have no airplane, which is the major equipment used for their activity. The hanger has been closed down. The treasurer informed me that the organization is trying to re-organize, but currently they are not operating.

LAW**Issue 1.**

Section 501(c)(7) of the Code exempts from federal 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.

Social clubs are exempt from federal income tax under IRC 501(a) as organizations described in IRC 501(c)(7) if they are "organized for pleasure, recreation, and other non-profitable purposes". Generally, social clubs are membership organizations primarily supported by dues, fees, charges or other funds paid by their members.

The central purpose of social clubs is to provide benefits to members, including access to social and recreational facilities such as club houses, golf courses, and swimming pools. When such benefits are funded by members, exemption has been justified by Congress on the theory that the members will be in the same position as if they had paid for the benefits directly. The practical effect of the exemption is to allow individuals to join together to provide themselves with recreational or social opportunities on a mutual basis without further tax consequences. The individual member is in substantially the same position as if he or she had spent his or her after-tax income on pleasure or recreation without the intervening organization.

Consequently, the exemption for social clubs operates properly only if the club's income is derived exclusively from members. For many years, however, income derived by clubs from outside of their membership (e.g., investment income), operated to subsidize the recreational facilities or activities for the members with revenue that was taxed neither to the members nor to the club.

Section 1.501(c)(7)-1(a) of the Income Tax Regulations states, "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."

To prevent club members from receiving benefits not contemplated by IRC 501(c)(7), Congress extended the unrelated business income tax to social clubs in the 1969 Tax Reform Act. In doing so, however, Congress decided that, unlike most other types of exempt organizations, which were exempted because they provide some sort of community service or public benefit, clubs should be taxed on all income derived from outside their membership, including investment income.

Regulations Section 1.501(c)(7)-1(b) provides 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).

Revenue Procedure 71-17, 1971-1 C.B. 683 sets forth guidelines for determining the effect of gross receipts derived from use of a social club's facilities by the general public have on the club's exemption under section 501(c)(7) of the Code. The revenue procedure states that where a club makes its facilities available to the general public to a substantial degree, the club is not operated exclusively for pleasure, recreation, or other non-profitable purposes. Clubs may receive up to 35% of their gross receipts, including investment income, from sources outside their membership. Within the 35% limitation, no more than 15% of the gross receipts may be derived from nonmember use of club facilities and services.

The term "general public" as used in this procedure means persons other than members of a club, their dependents, or guests. "Total gross receipts" is defined as the receipts from normal and usual activities of the club including charges, admissions, membership fees, dues and assessments.

Section 6001 of the Code states "Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title."

1) In Rev. Rul. 58-589 1958-2; 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. Therefore, to qualify for income tax exemption, a social club should not advertise its facilities for nonmember patronage since this would be prima facie evidence it was engaging in business.

2) In Rev. Rul. 69-219 1969-1 ; It was held that a social club that regularly holds its golf course open to the general public, charging established green fees used for maintenance and improvement of club facilities, is not exempt under section 501(c)(7) of the Code. The club was organized for social and recreational purposes. Its principal function is to operate a golf course for its members, who pay annual dues. However, the club regularly holds the golf course open to the general public for use upon the payment of an established green fee. Green fees from the general public have constituted a significant portion of the club's total receipts from all sources for each of the past five

Year: _____

years. The income from this source is used to help defray the expense of maintaining and improving the golf course.

3) In Rev. Rul. 65-63 1965- A nonprofit organization which conducts sports car events for the pleasure and recreation of its members, permits the general public to attend such events for a fee on a recurring basis and solicits patronage by advertising. It was held that this organization does not qualify for exemption as a club organized and operated exclusively for pleasure, recreation and other non-profitable purposes under section 501(c) (7) due to substantial public patronage.

TAXPAYER'S POSITION

The taxpayer did not provide its position.

GOVERNMENT'S POSITION

Based on the facts of the examination, the organization does not qualify for exemption; per revenue ruling 71-17; non-member income is more than 15 percent. Substantial skydiving fees, jump fees, tandem and training fees collected from students is non-member income and thus jeopardized the organization's exempt status. Because social clubs are primarily supported by their members' payments, their tax exemption has the practical effect of allowing the individuals comprising their membership to join together to provide themselves with recreational or social facilities without further tax consequences, when the club's income is limited to membership receipts. Thus, the exemption of social clubs is based on the logic of allowing members to pool their funds for recreational purposes, rather than by any compelling public benefit conferred by social clubs. This justification should not result in any tax advantage. By receiving such a large amount of nonmember income from the use of the facilities, the members do receive financial advantages.

CONCLUSION

Since the organization does not meet the requirements of 501(c)(7) because they received more than 15 percent of its income from non-members, the organization does not qualify for exemption under 501(c) (7) and its tax exempt status should be revoked.

ALTERNATIVE ISSUE

Should the net income from the student training be taxable as unrelated business income under section 511 of the Code?

Year: _____

BRIEF EXPLANATION OF FACTS

The organization received more than 35% of their gross receipts from sources outside their membership from services to non-members. (\$ _____ and \$ _____ in _____ and _____ respectively). They provided skydiving lessons and allowed non-members to use club facility for parachuting and skydiving jumps.

LAW

Section 511(a) of the Code imposes a tax upon the unrelated business taxable income of organizations exempt from federal income tax.

Section 512(a) defines unrelated business taxable income as the gross income from any unrelated trade or business regularly carried on by the organization.

Section 513(a)(3) of the Internal Revenue code states the term "unrelated business taxable income" means gross income (excluding any exempt function income), less the deductions allowed which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modification provided in paragraphs (c), (10), (11), and (12) of subsection (b). One of the organization subject to the provisions of the Internal Revenue Code subsection 512(a)(3) are membership organizations whose principal purpose is to provide social and recreational activities to its members. The reason for the special rule of the Internal Revenue Code subsection 512(a)(3) was to prevent membership organizations from providing increased benefits to their members from untaxed sources of non-membership income.

TAXPAYER'S POSITION

The taxpayer did not provide its position.

GOVERNMENT'S POSITION

If revocation is not upheld, then the organization should pay federal income tax on its unrelated business income received from non-member source.

CONCLUSION

If revocation is not upheld, then the organization should pay federal income tax on its unrelated business income received from non-member source. Income received from students is a non-member income and should be taxed as calculated below:.

Year: _____

Student Income _____

Plane Repairs _____

Fuel _____

Utilities/Occupancy _____

Student Expenses _____

Specific Deduction _____

Unrelated Biz Taxable Income after dedns _____

Tax (15%) _____

Total for _____

Assumptions:

- 1) Expenses for _____ were calculated using 41% of repairs, fuel and utilities expenses.
- 2) Expenses for _____ were calculated using 75% of student income because student training expenses reported by taxpayer could not be verified.