



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

**DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224**

Number: **200450041**  
Release Date: 12/10/04

Date: 09/13/04

Contact Person:

Uniform Issue List

- 501.07-00
- 501.07-01
- 501.07-02

Identification Number:

Contact Number:  
(202)  
FAX Number  
(202)

Employer Identification Number:

Legend:

- M =
- N =
- O =
  
- x =

Dear \_\_\_\_\_ :

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(7). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

**FACTS**

You were formed as a Limited Liability Company ("LLC" hereinafter) under the laws of the State of M on June 27, \_\_\_\_\_. Article III of your Articles of Organization states that you are formed for the "purpose of purchasing and owning as tenants in common, an N aircraft, registration number O, and operating the aircraft for the co-owners' business, training and pleasure or any use the co-owners may agree upon by majority vote of the co-owners. All aircraft operations must be in strict accordance with FAA regulations." Article IV sets forth the names and addresses of your initial four members and organizers.

The same \_\_\_\_\_ persons identified in your Articles of Organization entered in an Operating Agreement ("OA"), dated June 22, \_\_\_\_\_. The OA serves as your internal governance document. Article 1 of the OA reiterates the purposes stated in Article III of the Articles of Organization. Article 3 of the OA provides that each member shall make a capital contribution

of \$ x to the LLC upon its formation. This will constitute the beginning balance of each member's capital account. Members shall contribute a monthly sum to cover regular fixed costs including, but not limited to, tie-downs or hangar rent, required inspections, taxes, and insurance. Upon mutual consent, special assessments may be made against the members for such uses as the LLC may decide.

Article 5 of the OA provides that membership meetings shall be held at least four (4) times each year, once every three (3) months, or more often as agreed to by the members. Special meetings may be called by the Accounting Member (the member who maintains the books and records of the LLC).

Article 6 of the OA provides that decisions regarding the sale of the LLC assets and the operation of the aircraft shall be made by mutual consent.

Article 9 of the OA states that, "Individual capital accounts shall be maintained for each member and shall represent the ENTIRE value of his/her interest. The Capital Account shall consist of his/her capital contribution, increased or decreased (as the case may be) on any Valuation Date due to an increase or decrease in the net value of the LLC assets. The net value ... shall be determined annually as of June 30<sup>th</sup> of each year."

Article 12 of the OA provides, in part, that "No member shall, without the consent of the others, contract or obligate the LLC to the payment of any sum of money in excess of \$ x."

Article 13 of the OA provides that, "The aircraft shall at all times be flown and maintained in accordance with all applicable Federal Air Regulations and requirements of duly constituted authority. Any deficiencies which cause any civil penalties to be levied shall be borne by the person responsible for the violation."

Article 22 of the OA states that, "The LLC shall be limited to four members. Mutual and written consent of all members is required before additional persons can purchase any share of the assets."

Article 29 of the OA, entitled Scheduling Priorities, states that, "Members shall serve as Priority Pilots in weekly rotation, the change occurring at midnight Thursdays. ...the Priority Pilot may fly any time during his assigned period without checking with the other members." Article 30 sets forth the rules for priority time trades among the members.

Article 45 of the OA provides that upon the voluntary withdrawal of a member, the remaining members have the right of first option to purchase the withdrawing member's capital account value. "If the member(s) do not exercise the option to purchase created by these events, the LLC shall be terminated (and) then liquidated in accordance with the provisions of ARTICLE 52 of this operating agreement."

Article 46 of the OA, entitled Right of First Refusal, states, in part, that, "The withdrawing member shall offer his/her interest to the LLC at the lesser of the value of his/her capital account or any amount tendered by a third party offeror for that member's interest. The capital account is the agreed value established by actual asset acquisition cost and add-ons."

Article 52 of the OA, entitled Liquidation of Assets, provides that the LLC may be liquidated and dissolved upon mutual consent of the members. "Upon the dissolution and termination, the members shall promptly liquidate the assets and affairs of the LLC by satisfying all debts and obligations of the LLC and by distribution of all remaining property to the surviving members in the proportion of their equity accounts as of the date of the liquidation."

In response to Part II, 1, of Form 1024, exemption application, you described your activities as follows: "Ownership, maintenance, and operation of a single engine aircraft, 4 place, general aviation N (O). By members since . . . ." The percentage of time for this activity is stated to be 100%.

Under Part II, 7, of Form 1024, relating to qualifications for membership and classes of membership, you respond as follows: "must be licensed pilots; no classes of membership, each member has one vote; . . .no solicitation material or certificates; new members must be unanimously approved."

In your letter dated August 2, 2004, you provided the following additional information: You organized as an LLC because this format was perceived "as a quick, convenient way for individuals to purchase an airplane and provide a formal, liability limiting way to do so." You were not aware that forming as an M nonprofit corporation was an option. Further, concerning meetings of members and any social commingling, you state that, "The members meet regularly, both formally and informally, at least once or twice per month to socialize and to discuss the affairs of our ownership, such as maintenance, schedule, repair and etc." In the final part of your response, you state you have no current plans to solicit additional members unless one or more members decide to leave the LLC.

## **LAW**

Section 501(c)(7) of the Code provides for the exemption from federal income tax of clubs organized and operated for pleasure, recreation, and other nonprofitable purposes, substantially all 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(a)-1(c) of the Income Tax Regulations provides that the term "private shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(7)-1(a) of the regulations essentially repeats the language of section 501(c)(7) of the Code but also states that, 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.

Rev. Rul. 58-589, 1958-2 C.B. 266, discusses the various criteria for recognition of exemption under section 501(c)(7) of the Code. In order to establish that a club is organized

and operated for pleasure, recreation, and other nonprofitable purposes, “there must be an established membership of individuals, personal contacts and fellowship. A commingling of the members must play a material part in the life of the organization.”

Rev. Rul. 70-32, 1970-1 C.B. 132, describes a club organized to own and operate aircraft suitable for business or personal use by its members, to enable its members to improve their flying abilities, and, through the ownership and maintenance of flying equipment, to provide economic flying facilities for its members. Membership is open to all persons who are interested in flying. The revenue ruling cites section 501(c)(7) of the Code and states that in order for a club to qualify for exemption under this section, “there must be an established membership of individuals, personal contacts, and fellowship. Furthermore, a commingling of members must play a material part in the activities of the organization.” The revenue ruling concluded by stating the club does not qualify for exemption under section 501(c)(7) of the Code because its sole activity is rendering flying services to its members and there is no significant commingling among its members.

Rev. Rul. 74-30, 1974-1 C.B. 137, describes a club that owns and operates several small aircraft, which only members of the club may fly. Applicants for membership must be interested in flying as a hobby and must be approved by two-thirds of the membership. Members do the work required to maintain and operate the aircraft, but occasionally hire outside experts for certain repairs. Officers earn two hours of flying time per month. Members earn one hour of flying time for each three hours of manual work on the aircraft, such as washing, polishing, changing tires, etc. The club’s income is derived from membership fees, dues, and the sale of flying time to its members. All of the club’s expenditures relate to the ownership, operation, and maintenance of its aircraft. Members are constantly in personal contact with each other by formal meetings of the board and the general membership, and by informal meetings to schedule the use of aircraft. Further, many are in contact to assist in training, to wash the planes, to inspect the aircraft and to make maintenance decisions regarding work to be done and who will be hired to do it, to ferry aircraft to service shops, to admit new members, to review and pay bills, to review financial reports, to handle delinquent accounts, to purchase or sell aircraft, to comply with FAA directives, etc. In addition, small groups of members also fly together in the club’s aircraft.

Rev. Rul. 74-30 cites section 501(c)(7) of the Code and Rev. Rul. 58-589, supra, to the effect that for a club to qualify under this section, “a commingling of members must play a material part in the activities of the organization.” In holding the club qualifies for exemption under section 501(c)(7) of the Code, Rev. Rul. 74-30 points to the facts the club’s work is shared among the membership and there is frequent personal contact among the members. Thus, the club members are jointly participating in the hobby of flying for pleasure and recreation within the meaning of section 501(c)(7).

Rev. Rul. 74-30 distinguishes its operations and activities from the club described in Rev. Rul. 70-32, supra, that was held not to be exempt under section 501(c)(7) of the Code:

In that case the club was open to all persons who were interested in flying. The members did not join to participate as a group in the hobby

of flying for recreation, but to obtain economic flying facilities suitable for their individual business or personal use. The members had no expectation of personal relationship with the other members. The facts in the Revenue Ruling show that the club was operated primarily as a service to members, rather than for the pleasure and recreation of the members.

## ANALYSIS

The purpose stated in your Articles of Organization – “purchasing and owning as tenants in common, an N aircraft... and operating the aircraft for the co-owners’ business, training and pleasure or any use the co-owners may agree upon...” - is, with the exception of the word “pleasure”, completely outside the scope of section 501(c)(7) of the Code. Your purposes and operations are primarily of a business nature. This business purpose is evident from your formation under the LLC statute of M instead of under M’s nonprofit statute. The overriding business purpose is further evidenced by the language in your OA, which spells out at considerable length the financial interests and responsibilities of your four members. Many of these responsibilities focus on the operation and maintenance of the N aircraft that you purchased. The OA also sets forth the rules for the use of the aircraft by your members, including Scheduling Priorities.

Many of the provisions in your OA, as cited above, point to a business arrangement among your members, who are considered to be “private shareholders” under section 1.501(a)-1(c) of the regulations. Article 9 of the OA provides each of your members has a Capital Account in club assets. Articles 45 and 46 of the OA deal with the disposition of these Capital Accounts upon the withdrawal of a member. Article 52 of the OA provides that upon the dissolution of the club, remaining property is to be distributed to “surviving members in the proportion of their equity accounts as of the date of liquidation.” The above provisions in the OA, as well as others, are inconsistent with the concept of a social club formed for the pleasure and recreation of its members, as required under section 501(c)(7) of the Code. The fact that each of your members, upon withdrawing from the club, is entitled to a defined share of club assets, based on his/her Capital Account value, contravenes the requirements of section 501(c)(7) of the Code: club members do not have the right to take operational assets upon leaving the club. This can occur only when a club dissolves.

Further, your formation as an LLC is inconsistent with section 501(c)(7) of the Code. You, in essence, are functioning as a for-profit business or partnership where your members, instead of the club itself, directly control all club assets. This is apparent because each of your four members has a Capital Account in the LLC which gives them direct control over your assets.

Aside from the organizational defects noted above, we also conclude you do not meet the operational test under section 501(c)(7) of the Code because there is no evidence of regular meeting facilities or the required significant commingling among your membership. See the holdings in Rev. Ruls. 58-589, 70-32 and 74-30, supra. Your response to Part II, 1, of Form 1024 makes no mention of any social or recreational activities. Instead, all the evidence in the administrative file points to a time-sharing arrangement for the use of the N aircraft. This is

reflected in the provisions of the OA relating to the allocation of usage among your members, and the information provided in Form 1024, as noted above. We take into account your statement, in Response #2 of your letter dated August 2, 2004, that, your members meet on a regular monthly basis to socialize and "to discuss the affairs of our ownership, such as maintenance, schedule, repair...". Nevertheless, the available evidence shows there is very little commingling among your members in the context of the LLC operation. Basically, each of your members uses the N aircraft pursuant to rules set forth in the OA during his or her scheduled time, and ordinarily no other members are present.

## **CONCLUSION**

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(7) of the Code and you must file federal income tax returns.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.

In the event this ruling becomes final, it will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, and do not intend to protest our denial of exempt status, you should follow the instructions in Notice 437.

If you decide to protest this ruling, your protest statement should be sent to the address shown below. If you also disagree with our proposed deletions, you should send your comments on the deletions with your protest statement, and not to the address shown in Notice 437. If it is convenient, you may FAX your reply using the FAX number shown in the heading of this letter. Please call the contact person, shown in the heading of the letter, about the pending FAX before transmission.

Internal Revenue Service  
TE/GE (SE:T:EO:RA:T:4)

1111 Constitution Ave, N.W.  
Washington, D.C. 20224

If you do not intend to protest this ruling, and if you agree with our proposed deletions as shown in the letter attached to Notice 437, you do not need to take any further action.

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

Sincerely,

Lois G. Lerner  
Director, Exempt Organizations  
Rulings & Agreements

Enclosure  
Notice 437