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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director
Key District Office (EP/EO)
Information Copy: Chief, EP/EO Division

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Group Exemption Number:

Years Involved:

Date of Conference:

LEGEND:

"M" -

"N" -
"O" -
"Q" -

ISSUES:

1. Whether, under the circumstances described, "M" meets the requirements for continued recognition of exemption under section 501(c)(4) of the Internal Revenue Code.

2. Whether "M" meets the requirements for recognition of exemption as an organization described in section 501(c)(19) of the Code.

3. Whether contributions to "M" are deductible under section 170(c)(3) of the Code.

4. Whether "M" would qualify as an organization described in section 501(c)(7) of the Code.

5. Whether "M" would qualify as an organization described in sections 501(c)(8) or (10) of the Code.

6. In the event "M" does not meet the requirements for recognition of exemption under the above mentioned subsections of the Code, whether "M" should be granted relief under section 7805(b) in connection with revocation of its tax-exempt status under section 501(c)(4).

7. Whether "M" is subject to excise taxes based upon revenue from pull tab activities occurring in connection with the bar operations.

8. Whether the arrangement between "M" and a poker machine operator is a partnership within the meaning of sections 761 and 7701 of the Code.

FACTS:

"M's" Background

"M" is a veterans' organization, which is exempt under section 501(a) of the Code as an organization described in section 501(c)(4), and which has deductibility of contributions under sections 170(c)(3) and 2522(a)(4). "M" is included in the "N" group exemption. Both "M" and "N" are affiliated with "O," which is exempt under section 501(c)(19). "M" was issued a charter by "O."

"M" was formed for fraternal, patriotic, historical and educational purposes; to preserve and strengthen comradeship among its members; to assist worthy comrades; to perpetuate the memory and history of its dead and to assist its widows and orphans; to maintain true allegiance to the Government of the United States of America and fidelity to its Constitution and laws; to foster true patriotism; to maintain and extend the Institutions of American freedom; and to preserve and defend the United States from all her enemies, whomsoever.

"M's" bylaws are in accordance with the constitution and bylaws of "O."

"M's" Membership

Membership is restricted as provided by the constitution and bylaws of "O" to individuals who have served honorably as

officers or enlisted men in the Army, Navy, Air Force, or the Marine Corps of the United States in any foreign war, insurrection, or expedition, which service has been recognized as campaign medal service and governed by the authorization of the award of a campaign badge of the government of the United States.

As of August 15, 1993, "M" had approximately 3,000 war veteran members and no non-qualified social members. However, the membership numbers could not be verified by the Key District Office ("KDO") during its examination. "M" did not maintain the membership roster from "O" and did not maintain any records of DD-214's. "M" provided the KDO a membership roster that was a listing of all members by Zip Code.

"M" sold social memberships in 1991 and purportedly discontinued the sale of these memberships in 1992. No documentation was ever presented concerning the discontinuance. "M" had at least 115 social members.

Minutes of a meeting dated March 23, 1991, indicate that social memberships would be eliminated, but donor recognition cards would be issued in their place and would afford the card carriers all of the privileges of social member status in the Post.

Social members are not entitled to attend membership meetings, to vote at such meetings, or to hold office. Social members are issued key cards, as are regular members and auxiliary members. These key cards permit social members to enter the facility without having a bona fide member sign them in. "M" did not remit any portion of the social member dues to "N" or "O."

"M's" Facility

"M's" facility consists of a building with a paved parking lot accommodating between two hundred fifty and three hundred vehicles, a bar, dining room, kitchen, main hall, small hall, basement coat room, upstairs office, outside picnic tables, barbecue pit, and marquee in front of the building that announces "M's" coming events, affairs and dances.

"M's" Activities

"M's" activities consist of social welfare activities and the operation of a bar and restaurant. Social welfare activities conducted by "M" consist of:

·Light-a-Bike and Vet mobile programs,
·distributing funds to various organizations,

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- teaching the pledge of allegiance and flag etiquette in local schools,
- participating in memorial services, ceremonies and dedications,
- donating small classroom flags,
- visiting the sick at veterans hospitals,
- participating in local Memorial Day parade, and
- participating in Loyalty Day and Buddy Poppy Queen ceremonies.

"M's" representative stated that documentation of its social welfare activities consists of submitting reports to "N" that detail its community activities. "M" also maintains scrapbooks that detail its activities. Members of "M" and "Q" participate in the social welfare activities. Initially these reports were not provided, but were subsequently made available. In addition to reviewing scrapbooks, these reports detailed that "M" spent the following hours on social welfare activities for the years under examination:

Year	Number of Hours	"M" Member Hours
1989	2,417	207
1990	4,540	2,125
1991	2,597	1,855

"M's" Operation of the Bar and Restaurant

"M's" primary activity is the operation of its bar and restaurant. There was no evidence provided that would indicate that admission to the bar and restaurant was limited to bona fide members and their guests. Members of other veterans' organizations were provided access to "M's" facility.

An analysis of the guest register from August 1993 indicated that there were many guest entries where members did not sign in the guests. "M's" commander stated that the guest sheets are discarded after use. During the KDO's examination great difficulty arose in determining whether the members who signed in the guests were members of "M." There is no prohibition on guests of members paying for services. Substantially all of the revenues and expenses generated by "M" are the result of its bar and restaurant operation (and attendant gambling activities, see infra), with the bar being the predominant activity. The bar is operated every day of the week, and the restaurant, which has approximately 25 tables, is open Tuesday though Saturday with breakfast service on Sunday. Bartenders, waitresses and cooks receive compensation. Bands play at the bar on Friday, Saturday and Sunday nights.

An extension of the restaurant activity is the carryout operation, which is available to members of "M." A letter from a third party stated that "M" is engaged in the sale of carryout alcohol for its members. No records were maintained concerning any of the carryout sales. "M's" representative stated that the takeout sales are due to leftover food from fundraising events and disputed the third party allegation that "M" is engaged in the sale of carryout sales of alcohol.

"M's" Gambling Activities

"M's" gambling activities consist of the sale of pull tabs and the operation of video poker machines. The pull tabs are sold at the bar to anyone by the bartender. "M" also sells pull tabs through four so-called "stamp machines," two of which are located in the bar and two in the dining room. The stamp machines are accessible by anyone in the facility. No inventory records were maintained on these devices, and no records were maintained detailing the gross sales to bona fide war veteran members.

During the KDO's on-site examination a tour of "M's" facilities revealed that poker machines were located in the dining area. "M" has operated poker machines in the bar area for the last 15 years. Under state and county law it is lawful to operate poker machines for amusement only; it is unlawful to make pay outs. In response to an inquiry as to whether the poker machines paid out winnings, four of "M's" officers, including the Adjutant, Commander, Bar Chairman and Assistant Bar Chairman, stated that they did not know. Each of the officers referred all inquiries about the poker machines to the Quartermaster. Two bartenders, who were interviewed about whether the poker machines paid out, stated that they were unaware of such payouts. During the on-site examination the Adjutant was observed clicking off winnings from one machine and paying winnings to the player of that machine.

"M" had four machines in the dining area. During the on-site examination two deliverymen were observed in the restaurant area adjacent to the bar. The two deliverymen were served lunch, and one of the deliverymen went to play video poker. The individual playing video poker was never questioned by anyone connected with "M" as to whether he was a member. The Assistant Bar Chairman, who was informed about the deliveryman playing video poker, inquired as to whether he was a member of "M" or another veterans' organization. The deliveryman stated that he was not a member of "M" or another veterans' group. After asking the deliveryman to cease playing video poker, the Assistant Bar Chairman left the area. The deliveryman was then observed

playing video poker for another 15 minutes following the departure of the Assistant Bar Chairman.

"M's" Quartermaster was interviewed about the poker machines. He stated that his business, which is a sole proprietorship, owns the four poker machines in the dining area. The Quartermaster stated that "M" solicited his business and did not want to own the machines because it is easier for a contractor to repair them. The Quartermaster did not know the specific officer of "M" who solicited his business, nor did "M" provide any minutes that explained such solicitation.

There is no written agreement concerning the operation of the machines. Nothing was provided that explained whether "M" may remove the poker machines or that detailed how revenues would be split between "M" and its Quartermaster's business.

The Quartermaster described the services he provided with respect to the machines. He is the only person who has keys to the machines, because the state requires the owner of the machines to collect the money and remit the amusement tax. The machines are emptied twice a week for paper money, and the coins are left until they accumulate. The coins are removed approximately twice a month.

The machines do not have counters. When the machines are opened, the Quartermaster removes the funds and the payout box to the upstairs office. He first replenishes the payout box to $2,850. He then counts the remaining money, subtracts 10% for the state amusement tax, and divides the balance between "M" and his business on a 50/50 basis. "M" contends the counting of funds is done in the presence of the Commander or the Bar Chairman. The KDO disputes this fact, because during the on-site examination a poker machine count was observed being done solely by the Quartermaster.

The Quartermaster records the amount that is given to the Bar Chairman. No records of the payouts are maintained, and "M" did not indicate the reasons for not retaining such documentation. Records relating to poker machine counts were available only from 1992, as all other records were destroyed. The KDO indicated that a response was requested as to why such records were destroyed. No response was provided.

The Quartermaster then explained how payments are made to winners. He indicated that winnings are clicked off by the barmaid, Assistant Bar Chairman or Adjutant at the machine. After the winnings are clicked off, the individual is paid $.25 for each credit clicked off from a separate cash box. Members, guests, social members, ladies auxiliary and other veterans'

organizations' members will receive a payout if they request it. Payouts are not recorded when made, and when the cash box is replenished, no records are kept.

No records were maintained concerning payouts or gross income derived from the machines. A letter received by the KDO from a third party stated that "M" did not maintain records of revenues received from the poker machines.

The KDO could not determine whether the relationship between "M" and the Quartermaster's business is a partnership. "M" contends that the relationship is not a partnership because the risk of loss and all expenses are paid by the Quartermaster's business. The KDO contends that "M" pays the individuals who click off the winnings as well as the electricity to run the machines. Thus, in the KDO's view, the Quartermaster's business does not pay all expenses.

"M" has stated that it is paid rent for the machines sitting in its facility, and the money in fact belongs to the business of the Quartermaster.

Fundraising Events

Fundraising activities conducted by "M" included shrimp and crab feasts, dances and spaghetti nights. On a monthly basis, "M" holds an open house on weekends. Once a year, "M" conducts a day at the races. Wheels and pull tabs are also available on this day. The Commander indicated that tickets to any of these events are not available to the general public, but are sold only to members, which would include social members and ladies auxiliary members. Members of "M" may sell tickets to friends or other members of the general public.

Documentation was requested concerning the frequency of these events, as well as information concerning the gross receipts and disbursements. No such information was provided by "M."

Hall Rentals

"M" maintains a large hall that safely holds 360 people and a small hall that can accommodate 125 people. "M" uses the large hall for its events and bingo. Both the large hall and the small hall are available for rent to members and the general public. The Hall Chairman schedules the use and collects the income. An examination of the books and records relating to the hall rental revealed that "M" was paying people in cash to provide services such as parking lot control, bartending, coat room and cleaning. A third party letter submitted to the KDO stated that people

working at "M" are paid "off the books." "M" disputes this and asserts that all cleaning people and bartenders are employees paid by check. "M" states that one hall chairman paid people in the coatroom and parking lot by small check or petty cash; "M" does not consider these individuals to be its employees.

Ladies Auxiliary

"Q" is a separate entity from "M," but has not yet obtained an employer identification number. "Q" utilizes the employer identification number of "M." Members of "Q" hold bingo, flea markets, bake sales and other similar events. It keeps its own records and prepares an annual report to "M." "Q" had received a plaque for its annual contribution of $100 to the "O" PAC for the years 1988-1992. "Q" has never filed a Form 990 or 1120-POL.

Reporting Requirements

The examination revealed that "M" failed to complete properly any of the Forms 990 as required by the instructions to the return. Incorrect or missing items related to reporting gross revenues from all activities and segregating the various activities, segregating social membership dues from qualified membership dues, not reporting amounts attributable to the bar or other inventory on the balance sheet, engaging in an activity not previously reported to the IRS thereby incorrectly completing an item on page four of the Form 990, and reporting gross receipts and disbursements from veterans who could not qualify for membership in "O."

Forms 990-T were filed for all years under examination relating to gross receipts from hall rentals.

ISSUE 1-LAW:

Section 501(c)(4) of the Code provides for the exemption of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2) of the Income Tax Regulations describes the promotion of social welfare as promoting in some way the common good and general welfare of the people of the community, such as bringing about civic betterments and social improvements. An organization is not operated 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.

Rev. Rul. 74-361, 1974-2 C.B. 159, holds that a volunteer fire company that charges a fee for admission to public dances it conducts each week may qualify for exemption under section 501(c)(4) of the Code because it is promoting the common good and general welfare of the community through its primary activity of providing fire and ambulance service to the community. As an adjunct to its fire fighting and rescue services, the fire company engages in other activities, such as recruiting volunteers and training them in first aid and rescue techniques, buying and maintaining fire fighting equipment, and raising funds for the company through mail and door-to-door solicitation of contributions.

In Rev. Rul. 68-455, 1968-2 C.B. 215, a war veterans' organization was held exempt under section 501(c)(4) of the Code even though it operated a resort concession. It was primarily engaged in the promotion of social welfare and expended the funds from its concession to acquire, maintain and operate buildings used in its active program of social welfare.

Rev. Rul. 68-46, 1968-1 C.B. 260, describes another veterans' post. After an analysis of all the facts and circumstances, the Service determined that the post's primary activity was the conduct of a business rather than social welfare activity. The organization's business activities involved the rental of its commercial office building and operating a public banquet and meeting hall with a bar and dining facilities. Although the organization carried on veterans' programs and other social welfare activities, based on an analysis of the whole operation, it was concluded that the business activities relating to the operation of the facility exceeded all other activities, and the social welfare programs were not its primary activity.

Rev. Rul. 68-45, 1968-1 C.B. 259, provides another example of the primary activity test imposed by section 501(c)(4) of the Code. It describes a war veterans' post whose principal source of income is from bingo games open to the general public, but whose principal activity is not bingo. Membership in the post is limited to war veterans. In concluding that the organization is primarily engaged in social welfare activities even if it receives a substantial portion of its funds from bingo, the Service emphasized the importance of determining the primary activity as opposed to the primary source of income. A determination of primary activity requires an analysis of all facts and circumstances. The Revenue Ruling states that an organization is not 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.

Rev. Rul. 66-221, 1966-2 C.B. 220. superseded by Rev. Rul. 74-361, supra, holds that an organization whose primary activity is maintaining and operating a volunteer fire department for the benefit of the community is exempt from federal income tax under section 501(c)(4) of the Code even though the principal source of its income is from operating social facilities for its members and holding regular public dances. The ruling recognized the general principle that nonprofit volunteer fire companies engaged in fighting fires and related activities promote the common good and general welfare of the people of the community as a whole. In determining the primary activity of an organization, the Service did not look solely to the organization's principal source of revenue. Rather, it determined that based on an analysis of all the facts and circumstances, the organization was principally engaged in activities which benefit the community as a whole, and that the social activities were not the primary activity of the volunteer fire department.

Rev. Rul. 66-179, 1966-1 C.B. 139, provides that the extent to which an organization engages in social activities for the benefit of its members is a factor in determining whether it is primarily engaged in social welfare activities. Even if a substantial part of an organization's activities consists of social functions for the benefit, pleasure and recreation of its members, it may qualify for exemption under section 501(c)(4) of the Code, if it is operated primarily to bring about civic and social improvements. The Rev. Rul. holds that a garden club that instructs the public on horticultural subjects, holds public flower shows, makes awards for horticultural achievements and also conducts substantial social activities qualifies as a social welfare organization under section 501(c)(4).

Rev. Rul. 66-150, 1966-1 C.B. 147, considers the exemption of a subsidiary of a veterans' organization described in section 501(c)(4) of the Code. The subsidiary's primary purpose is to operate social facilities for members of the veterans' organization and their guests including a bar, restaurant and game room. It was held that this subsidiary does not qualify as an organization described in section 501(c)(4). The rationale for this ruling is that the subsidiary organization engages in no social welfare activities and its primary purpose is operating a social club.

Rev. Rul. 61-158, 1961-2 C.B. 115, describes an organization that was created exclusively for the promotion of social welfare, but whose principal activity was conducting a lottery on a weekly basis with the general public. Its principal source of income was the gross receipts from the weekly lottery. The major portion of the profits of the lottery was used for the payment of general expenses of the organization, and only a small portion

was used for social welfare purposes. The ruling holds that the organization is not operated exclusively for the promotion of social welfare because its primary activity is the conduct of a business for profit. Accordingly, it is not exempt under section 501(c)(4) of the Code.

Section 6001 of the Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time prescribe.

Section 6033(a)(1) of the Code provides, except as provided in section 6033(a)(2), every organization exempt from tax under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts and disbursements, and such other information for the purposes of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.

Section 1.6001-1(a) of the regulations in conjunction with section 1.6001-1(c) provides that every organization exempt from tax under section 501(a) of the Code and subject to the tax imposed by section 511 on its unrelated business income must keep such permanent books or accounts or records, including inventories, as are sufficient to establish the amount of gross income, deduction, credits, or other matters required to be shown by such person in any return of such tax.

Section 1.6001-1(e) of the regulations states that the books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained as long as the contents thereof may be material in the administration of any internal revenue law.

Section 1.6033-1(h)(2) of the regulations provides that every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as may be required by the district director for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of subchapter F (section 501 and the following), chapter 1 of the Code and section 6033.

Rev. Rul. 59-95, 1959-1 C.B. 627, concerns an exempt organization that was requested to produce a financial statement and statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to

furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provisions of section 6033 of the Code and the regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of exempt status.

ISSUE 1-RATIONALE:

Section 501(c)(4) of the Code imposes an operational test on organizations described in that section. Social welfare organizations are not precluded from engaging in business activities per se, either as a means of providing direct community benefit or as a means of financing their social welfare programs. Thus, in Rev. Ruls. 66-221 and 68-45, supra, the fact that the organizations engaged in some activities characterized as business with the general public (public dances, bingo) for the purpose of raising funds, rather than to provide direct community benefit, did not preclude a finding that they were nevertheless described in section 501(c)(4). An analysis of these organizations as a whole showed that the business of operating the fire departments and conducting veterans' activities (activities that directly benefit the community as a whole) were the organizations' primary activities.

On the other hand, a business activity conducted as an organization's primary activity precludes exemption under section 501(c)(4) of the Code. Thus, in Rev. Ruls. 68-46 and 61-158, supra, exemption was precluded by a finding that the business activities of operating banquet facilities and conducting a public lottery were the organizations' primary activities. These activities, standing alone, provide no special benefit to the community independent from the monies raised. They differ little from the operation of commercial businesses other than the fact that the profits were earmarked for social welfare purposes.

The regulations state that the promotion of social welfare does not extend to the operation of a social club for the benefit of its members. Nor does it include carrying on business with the general public in a manner similar to organizations operated for profit. Therefore, in determining whether an organization is primarily engaged in social welfare activities, it is important to consider the extent to which it participates in business and social activities.

The use of proceeds derived from business or fundraising activities by a social welfare organization for private purposes, such as providing special benefits for members, will cause denial

of exemption. However, in characterizing the use of an organization's income, the promotion of social welfare may involve services to members as well as services to the community at large.

Although relatively little documentation has been provided with respect to "M's" exempt activities during the years in question, it is recognized that "M" conducts social welfare activities, including patriotic activities, membership meetings and various charitable activities. Thus, the major issue of concern is whether the bar and restaurant, social activities and gambling activities are of such magnitude that they, rather than the social welfare activities, have become "M's" primary activity, and thus prevent it from continuing to qualify as an organization described in section 501(c)(4) of the Code.

An analysis of the information obtained by the District and submitted by "M" indicates that the primary activity of "M" is the operation of a bar and restaurant with the sale of carryout food, together with gambling activities, some of which, i.e., the operation of poker machines, may be illegal under state or county law. While the operation of a bar, whether for qualified "war" veteran members, auxiliary members and bona fide guests may constitute exempt activities under section 501(c)(19) of the Code, it does not serve to promote social welfare within the meaning of section 501(c)(4).

"M's" activities are distinguishable from the social/ recreational activities that were an integral part of the volunteer fire department's activities described in Rev. Rul. 74-361, supra. The sole purpose of the bar, restaurant, and gambling activity is to raise money or make profits. The conduct of the business itself, apart from recreation, provides no direct benefit to the community separate from the use of the funds it raises. The business activities relating to the operation of the bar and restaurant with attendant gambling exceed all other activities. "M" is operated in a manner similar to the organizations described in Rev. Ruls. 68-46 and 61-158, supra, because it is primarily engaged in carrying on a business with the general public in a manner similar to organizations which are operated for profit.

In accordance with the above cited provisions of the Code and regulations under sections 6001 and 6033, organizations recognized as exempt from federal income tax must meet certain reporting requirements. These requirements relate to the filing of a complete and accurate annual information return (and other required federal tax forms) and the retention of records sufficient to determine whether such entity is operated for the

purposes for which it was granted tax-exempt status and to determine its liability for any unrelated business income tax.

The District's examination revealed that "M" failed to complete accurately the Forms 990 for the years under examination. There were incorrect or missing items relating to reporting gross revenues from activities and segregating the various activities. Form 990-T was filed for unrelated business income, but was incorrect since it did not include all gambling income and all restaurant income. No Forms 11-C and 730 were ever filed by "M."

Section 6001 of the Code requires organizations exempt from tax to retain minimum records sufficient to detail their exempt function activities. "M" has failed to maintain sufficient records on gross receipts from various sources, including, but not limited to, gambling revenues, hall rentals, membership dues and amounts derived from various fundraisers.

Based upon the information presented, "M" is operated primarily as a commercial concern with its primary activity the operation of a bar and restaurant and gambling activities. Also, "M" has not maintained the records required under section 6001 of the Code to determine whether it is operated for social welfare within the meaning of section 501(c)(4).

ISSUE 1 - CONCLUSION:

Under the circumstances described, "M" does not meet the requirements for continued recognition of exemption under section 501(c)(4) of the Code.

ISSUE 2 - LAW:

Section 501(c)(19) of the Code provides for the exemption from federal income tax of a post or organization of veterans of the United States Armed Forces if such post or organization is:

> (a) organized in the United States or any of its possessions,
>
> (b) at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets, and

(c) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the regulations defines "private shareholder or individual" as persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(19)-1(c) of the regulations provides that an organization described in section 501(c)(19) of the Code must be operated exclusively for one or more of the following purposes:

(1) To promote the social welfare of the community as defined in section 1.501(c)(4)-1(a)(2) of the regulations,

(2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans,

(3) To provide entertainment, care and assistance to hospitalized veterans or members of the Armed Forces of the United States,

(4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,

(5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,

(6) To sponsor or participate in activities of a patriotic nature,

(7) To provide insurance benefits for their members or dependents of their members or both, or

(8) To provide social and recreational activities for their members.

With respect to the membership requirements under section 501(c)(19) of the Code, in Senate Report No. 92-1082, 92nd Cong. 2d Sess., Congress stated that "substantially all" means 90 percent. Therefore, of the 25 percent of the members that do not have to be past or present members of the Armed Forces of the United States, 90 percent have to be cadets, or spouses, etc. Thus, only 2.5 percent of a section 501(c)(19) organization's total membership may consist of individuals not mentioned above.

Inurement of net earnings to private shareholders or individuals may be in the form of substantial payments to

"insiders" of services, rents and compensation for services. See Founding Church of Scientology v. U.S., 412 F.2d 1197 (Ct. Cl. 1969); Birmingham Business College v. Commissioner, 276 F.2d 476 (5th Cir. 1960); Texas Trade School v. Commissioner, 30 T.C. 642 (1953), aff'd 272 F.2d 168 (5th Cir. 1959).

In People of God Community v. Commissioner, 75 T.C. 127 (1980), the court considered whether a percentage compensation arrangement for an organization's minister resulted in unreasonable compensation. The court noted that there was no upper limit on the amount of compensation the minister could receive. Because there was no upper limit, the court found that a portion of the church's earnings was simply being passed on to the minister

ISSUE 2 - RATIONALE:

To qualify for recognition of exemption under section 501(c)(19) of the Code, an organization must satisfy a membership test, its activities must exclusively further purposes listed in section 1.501(c)(19)-1(c) of the regulations, and none of its net earnings may inure to a private shareholder or individual. If any of these tests are not satisfied, then the organization will not qualify for exemption under section 501(c)(19).

An organization described in section 501(c)(19) of the Code. carries out activities in furtherance of its exempt purposes only when the activities are carried out exclusively in furtherance of the purposes listed in section 1.501(c)(19)-1(c) of the regulations. Among these purposes is the provision of social and recreational activities for its members. Therefore, when a veterans' organization described in section 501(c)(19) provides social or recreational activities for its members or for guests whose expenses are paid by members, it is engaged in activities in furtherance of its exempt purposes.

Where goods or services are furnished to nonmembers who provide payment for such goods or services, their furnishing is outside the scope of section 1.501(c)(19)-1(c) of the regulations. Generally, if an organization has not kept adequate books and records concerning its financial transactions with nonmembers and more than 50 percent of its gross receipts are derived from sales transactions (e.g. restaurant and bar sales), the presumption will be that the organization's exempt status should be revoked because it is not primarily engaged in section 501(c)(19) activities. However, this presumption may be rebutted. All facts and circumstances must be reviewed to determine whether the organization is primarily engaged in section 501(c)(19) activities.

"M's" membership requirements are governed by the constitution of "O." "M's" membership for purposes of satisfying the membership test under section 501(c)(19) of the Code should consist of only veterans described in the constitution of "O." The social members or guests of the Post are not members of "M," because they are not described in the constitution of "O." Any spouses of "M's" members are not bona fide members of "M," but instead are members of "M's" auxiliary. Since "M's" membership requirements are governed by the constitution of "O," it satisfied the section 501(c)(19) membership requirements for all years under examination, because its only bona fide members were past or present members of the Armed Forces of the United States.

"M's" activities conducted during the years under examination consisted of patriotic activities, membership meetings, various charitable activities, and social activities, which include the operation of a bar and restaurant and the sale of carryout food. The patriotic activities, charitable activities and membership meetings are activities that further exempt purposes as described in section 1.501(c)(19)-1(c) of the regulations. "M" was unable to provide evidence of hours spent on its charitable and patriotic activities during the years under examination.

The operation of the carryout service does not further exempt purposes as described in section 1.501(c)(19)-1(c) of the regulations because it does not further the social and recreational needs of "M's" membership. The carryout activities are completely unrelated to the exempt purposes of "M."

Based on the percentages of income and disbursements during the years under examination, "M's" primary activity was the operation of the bar and restaurant and gambling activity. Although it had key card access, "M's" facilities were open to individuals other than the veteran members and their bona fide guests. Evidence obtained during the examination indicates that "M" was open to the general public, served meals to individuals without any member of "M" questioning their membership status, and took inadequate action to prevent the playing of video poker by nonmembers. Furthermore "M's" facilities were open to social members or guests of the Post, members of other veterans' organizations and, to an unknown degree, members of the public.

Furthermore, during the years under examination there was no permanent mechanism in place to maintain records to distinguish between income from veterans and non-veteran income, social members and income from the general public. Also, there was incomplete information as to the exact income from the operation of the various activities, including the bar, video poker machines and pull tabs.

In determining whether there is inurement to a private shareholder or individual for purposes of section 501(c)(19), it must be determined whether there is an excessive benefit flowing to a key insider. Inurement to insiders may consist of a payment that is excessive and may be in the form of salary, rents or compensation for services. In determining whether the inurement proscription under section 501(c)(19) of the Code has been violated, it may be useful to review precedent arising under section 501(c)(3).

Any unjust enrichment, whether out of gross or net earnings of an organization described in section 501(c)(3) of the Code, may constitute inurement. See People of God Community v. Commissioner, supra. The inurement proscription applies to persons who, by virtue of their position of control or influence in the organization, have a personal and private interest in its affairs. Supra, at 133. Inurement need not be substantial, either in relative or absolute terms, in order to bar an organization from exemption under section 501(c)(3). See Spokane Motorcycle Club v. U.S., 222 F. Supp. 151 (E.D. Wash. 1963). Benefits to private interests which may violate the inurement proscription are not limited to monetary benefits but also include any "advantage, profit, fruit, privilege, gain, or interest." See Retired Teachers Legal Defense Fund, Inc. v. Commissioner, 78 T.C. 280 (1982). Inurement is generally considered to be confined to situations involving "insiders;" that is, persons who hold a position of control or dominance within an organization. Senior Citizens of Missouri, Inc. v. Commissioner, T.C. Memo 1988-493.

The inurement proscription does not bar an organization from paying reasonable compensation to its employees. Mabee Petroleum Corp. v. U.S., 203 F.2d 872 (5th Cir. 1953). The reasonableness of compensation is determined utilizing the same principles as are applied in cases involving section 162 of the Code.

"M" has not provided any evidence that its net earnings from the video poker machine have not inured to the benefit of "M's" Quartermaster, a "private individual" for purposes of section 501(c)(19) of the Code. "M's" officers put the responsibility of the poker machines in the hands of the Quartermaster. The information elicited by the KDO during the examination indicates that the Quartermaster owned the poker machines, provided some services, including emptying the machines, replenishing funds and counting funds, without a written agreement; the Quartermaster was the only individual with access to opening the machines; and, there was an unwritten 50% splitting of the gross revenues. There was no maximum dollar amount that the Quartermaster would receive for servicing the machines. The facts in this case

support a finding of inurement to "M's" Quartermaster. See People of God Community v. Commissioner, supra.

Based on the information submitted "M" would not qualify for exemption under section 501(c)(19) of the Code. It failed to establish qualification because of lack of adequate records during the years in question, the operation of a bar and restaurant, the conducting of gambling activities (some of which may be illegal) for other than "M's" members and their bona fide guests, and the net earnings of "M" inuring to its Quartermaster.

ISSUE 2 - CONCLUSION:

"M" does not meet the requirements for recognition of exemption as an organization described in section 501(c)(19) of the Code.

ISSUE 3 - LAW:

Section 170(a) of the Code provides the general rule that there shall be allowed as a deduction any charitable contribution, as defined in section 170(c), payment of which is made during the taxable year.

Section 170(c)(3) of the Code includes within the term "charitable contribution" as used in section 170 a contribution or gift to or for the use of a post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization organized in the United States or any of its possessions, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Rev. Rul. 78-329, 1978-1 C.B. 162, provides that if 90 percent or more of post members are war veterans, and the post is organized and operated primarily for purposes consistent with the current status as a veterans' organization, donors can deduct contributions made to or for the use of the organization as provided by section 170 of the Code. "War veterans" are defined as persons who have served in the Armed Forces of the United States during a period of war, including the Korean and Vietnam conflicts. Periods of war as described include:

(a) April 21, 1896, through July 4, 1902;
(b) April 6, 1917, through November 11, 1918;
(c) December 7, 1941, though December 31, 1946;
(d) June 27, 1950, through January 31, 1955; and
(e) August 5, 1964, through May 7, 1975.

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38 U.S.C. section 101, defines the term "period of war" and includes persons who served in the Armed Forces of the United States during the period of the Persian Gulf War.

Rev. Rul. 84-140, 1984-2 C.B. 56, provides that contributions to an organization, 90 percent of the membership of which is comprised of war veterans of the Armed Forces of the United States, are deductible under section 170(c)(3) of the Code. The fact that a small percentage of members have not served in a branch of the Armed Forces will not preclude the organization from being classified as a war veterans' organization.

ISSUE 3 - RATIONALE:

To qualify as a war veterans organization within the meaning of section 170(c)(3) of the Code, the organization must satisfy both a membership requirement and a purposes requirement. With respect to the purposes requirement, the organization must be organized in the United States and operated primarily for purposes that are consistent with its status as a war veterans' organization.

The organization described in Rev. Rul. 84-140, supra, had the following purposes:

(a) Furthering, encouraging, promoting and maintaining comradeship generally among persons who are or have been members of the Armed Forces;

(b) Honoring and perpetuating the memory of deceased veterans and members of the Armed Forces and aiding and comforting their survivors;

(c) Encouraging public interest in and maintaining the ideals of the Armed Forces by sponsoring and participating in activities of a patriotic nature, and

(d) Aiding hospitalized, disabled and needy war veterans and their dependents. However, the organization did not provide insurance benefits to its members.

As noted previously, during the years under examination, "M's" primary activity was the operation of a bar and restaurant and gambling activity. "M's" primary activity was not consistent with its being an organization of war veterans under section 170(c)(3) of the Code. Therefore, "M" may not qualify to receive contributions that are deductible under section 170(c)(3).

ISSUE 3 - CONCLUSION:

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Contributions to "M" are not deductible under section 170(c)(3) of the Code.

ISSUE 4 - 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 of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

Public Law 94-568, October 20, 1976, amended the Code with respect to the requirements for tax exemption under section 501(c)(7). Senate Report No. 94-1318, Second Session 1976-2 C.B. 597, provides that the decision in each case as to whether substantially all of the organization's activities are related to its exempt purposes is to continue to be based upon all of the facts and circumstances. It is intended that these organizations be permitted to receive up to 35% of gross receipts, including investment income from sources outside their membership, without losing their tax-exempt status. It is also intended that within this 35% amount not more than 15% of the gross receipts should be derived from the use of a club's facilities or services by the general public. Gross receipts are to be interpreted for this purpose as those receipts from normal and usual activities of the club, including investment income. However, where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facility, that income is not to be included in the formula. That is, such unusual income is not to be included in the gross receipts of the club for purposes of the permitted 35 or 15 percent allowances. It is not intended that these organizations should be permitted to receive, within the 15 or 35 percent allowances, income from the active conduct of businesses not traditionally carried on by these organizations.

Rev. Proc. 71-17, 1971-1 C.B. 683, describes circumstances under which nonmembers who use a club's facilities will be assumed to be guests of members. These circumstances provide that income from bona fide guests will be treated as member income if the payment is made directly by the member.

ISSUE 4 - RATIONALE:

The difficulty with "M" being reclassified under section 501(c)(7) of the Code is that it would need to produce records showing the use of the bar and restaurant, rental activity and gambling activity by category (member, auxiliary member, bona fide guest, and nonmember use). See Rev. Proc. 71-17, supra, and

section 6001 of the Code. "M" maintained no records showing nonmember use, or any income received from members of other veterans' groups that would be nonmember income rather than exempt function income under section 501(c)(7).

Furthermore, exemption under section 501(c)(7) of the Code limits the receipt of nonmember income from the use of a club's facilities by the general public to 15% of total gross receipts. Based on the information submitted, "M" generated in excess of 15% gross nonmember income from the use of club facilities by the general public, which is not permissible under section 501(c)(7). Therefore "M" could not be reclassified as an organization described in section 501(c)(7).

Another difficulty with "M" qualifying for recognition of exemption under section 501(c)(7) of the Code is that benefits of membership for war veterans include the receipt of a death benefit and access to the insurance program. Such benefits would also preclude "M" from meeting the requirements for exemption under section 501(c)(7).

ISSUE 4 - CONCLUSION:

"M" has failed to establish qualification for tax-exempt status under section 501(c)(7) of the Code during the years in question.

ISSUE 5 - LAW:

Section 501(c)(8) of the Code provides, in part, for the exemption of fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

Section 501(c)(10) of the Code provides for the exemption of domestic fraternal societies, orders, or associations operating under the lodge system, whose net earnings are devoted exclusively to religious, charitable, scientific, literary, educational and fraternal purposes and which do not provide for the payment of life, sick, accident, or other benefits.

ISSUE 5 - RATIONALE:

"M" would not qualify for exemption under section 501(c)(8) of the Code, as it is not operating under the lodge system for the benefit of its members.

"M" would not qualify for exemption under section 501(c)(10) of the Code, as it is not operating under the lodge system, and its earnings are not devoted to the purposes mentioned above. The majority of "M's" earnings are devoted to the operation of a bar and restaurant and for conducting gambling activities.

ISSUE 5 - CONCLUSION:

"M" has failed to establish qualification for tax-exempt status under sections 501(c)(8) or (10) of the Code during the years in question.

ISSUE 6 - RELIEF UNDER SECTION 7805(b):

The Assistant Commissioner (Employee Plans and Exempt Organizations) in the exercise of the Commissioner's discretionary power has declined to grant "M's" request for relief under section 7805(b) of the Code in connection with the revocation of "M's" tax-exempt status under section 501(c)(4).

ISSUE 7 - LAW:

Section 4401(a) of the Code imposes (1) on any wager authorized under state law a tax equal to 0.25 percent of the amount wagered and (2) on any wager not authorized under state law a tax equal to 2 percent of the amount wagered.

Section 4411(a) of the Code imposes a special tax of $500 per year to be paid by each person who is liable for the tax imposed under section 4401 or who is engaged in receiving wagers for or on behalf of any person so liable.

Section 4411(b) of the Code substitutes $50 for $500 in subsection (a) in the case of (1) any person whose liability for tax under section 4401 is determined only under paragraph (1) of section 4401(a) and (2) any person who is engaged in receiving wagers only for or on behalf of persons described in paragraph (1).

Section 4421 of the Code provides that wagers include lotteries conducted for profit, but section 4421(2)(B) excludes from the term "lottery" any drawing conducted by an organization exempt from tax under sections 501 and 521, if no part of the net proceeds derived from such drawing inures to the benefit of any private shareholder or individual.

Pull tab games have been determined to be forms of lotteries. See Rev. Rul. 54-240, 1954-1 C.B. 254, and Rev. Rul.

57-258, 1957-2 C.B. 418. Also, they are considered "drawings" for purposes of the exclusion provided by section 4421(2)(B).

ISSUE 7 - RATIONALE:

Amounts wagered in drawings conducted by exempt organizations are not subject to wagering tax as long as no part of the net proceeds inures to the benefit of any private shareholder or individual. Generally under the rationale of Knights of Columbus Council #3660 v. United States, 783 F.2d 69 (7th Cir. 1986), raising substantial revenue from wagering activities open to the public for a long period of time to defray organizational operating expenses and to subsidize membership, recreational, and social activities constitutes private inurement. If the wagering activities are not open to the public, but are limited to members and bona fide guests, the use of the proceeds to defray operating expenses, etc. does not constitute inurement. Also see Rochester Liederkrantz, Inc. v. United States, 456 F.2d 152 (2d Cir. 1972).

To sustain an assertion of tax, the facts must show the source and disposition of the net proceeds from wagering. For example, if it is shown that wagers were accepted from nonmember/guest sources, the wagering proceeds were commingled with other bar or bingo revenue, and those proceeds were applied in part for general operating expenses or to subsidize the bar and food operations and in part for charitable purposes, a proportionate amount of the wagering proceeds could be deemed to have inured to the benefit of the members. If, on the other hand, the wagering revenue is separately accounted and is earmarked solely for charitable purposes, no inurement can be attributed to the wagering activities and no liability for tax arises. The facts as presented do not adequately demonstrate that the proceeds have not inured to the benefit of private individuals.

If "M's" exemption is revoked, the exclusion from tax provided by section 4421(2)(B) of the Code for drawings conducted by section 501 organizations could not apply to the pull tab games during the periods in question. In addition, if "M's" exempt status is revoked, this may affect the rate of tax imposed on the wagering activities. An examination of applicable state law indicates that the authority for a veterans' organization to conduct wagering is controlled on a county by county basis.

ISSUE 7 - CONCLUSION:

Based upon the above, "M" has not met the exception of section 4421 of the Code as it has not shown that funds were not spent for operating expenses. "M" has not shown that inurement

did not occur. The licensing authority in the county where "M" is located should be contacted to determine if the 2 percent rate of tax instead of the .25 percent rate will apply.

ISSUE 8 - LAW:

Sections 761(a) and 7701(a)(2) of the Code provide that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

Sections 1.761-1(a) and 301.7701-3(a) of the regulations provide that the term "partnership" is broader in scope than the common meaning of partnership, and may include groups not commonly called partnerships.

In Commissioner v. Culbertson, 337 U.S. 733 (1949), the Supreme Court stated that a partnership exists for federal tax purposes when

> considering all the facts--the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent--the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. Id. at 742.

In Podell v. Commissioner, 55 T.C. 429 (1970), the Tax Court stated that the elements of a joint venture are:

> (a) A contract (express or implied) showing that it was the intent of the parties that a business venture be established; (b) an agreement for joint control and proprietorship; (c) a contribution of money, property, and/or services by the prospective joint venturers; and (d) a sharing of profits, but not necessarily of losses. Id. at 431.

ISSUE 8 - RATIONALE:

Rev. Rul. 92-49, 1992-1 C.B. 433, holds that whether an arrangement between an owner of coin-operated amusements and an owner of a business establishment is a lease or a joint venture

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is determined upon the particular facts. Under Rev. Rul. 92-49, it is clear that the primary concern of the Service is that the transaction is reported on some information return. The following revenue rulings and cases involve similar factual scenarios, but reach different conclusions relating to whether an arrangement is a lease or a joint venture.

In Rev. Rul. 57-7, 1957-1 C.B. 435, a corporation placed its own coin-operated amusement devices in various business establishments, repaired and maintained the devices, and was to bear the risk of loss from the devices. Someone from the corporation opened and counted the money in the devices (usually in the presence of the occupant of the business establishment) and gave the occupant a percentage of the devices' receipts as remuneration for permitting the devices to occupy space in the establishment. Rev. Rul. 57-7 held that the arrangement between the corporation and the occupant was a lease of the amusement space.

In Manchester Music Company, Inc. v. United States, 733 F.Supp. 473 (D. N.H. 1990), a music company placed coin-operated amusement devices on a proprietor's premises and agreed to service and repair the devices. Employees from the music company opened and counted the devices' money and then equally divided the receipts between the music company and the proprietor. The court chose not to follow the holding of Rev. Rul. 57-7, but instead held that the arrangement was a joint venture because, "the parties agreed to share in the profits as well as the expenses, each party being entitled, as a matter of right, to one half of the proceeds from the moment the monies started to come in." Manchester, 733 F.Supp. at 484.

Williamson Music Company, Inc. v. United States, 90-2 USTC ¶ 50,370 (D. Minn. 1990) held that an arrangement similar to the arrangement in Manchester between a coin-operated machine owner and a premises owner was a joint venture.

The arrangement between "M" and the poker machine operator is similar to the arrangements in Rev. Rul. 57-7 and Manchester, supra. Accordingly, the arrangement between "M" and the operator is arguably either a lease of the machine space, a lease of the machines or a joint venture. Because the arrangement could be either a lease or a joint venture, we recommend treating the arrangement the same as the coin-operated machine industry generally would treat (report) a similar arrangement, if that can be determined.

Rev. Rul. 92-49 holds that if the arrangement is a lease, the lessee must file under section 6041 of the Code, an information return on Form 1099 for any taxable year in which the

lease payments aggregate $600 or more. However, if the arrangement is a joint venture, the joint venture must file, under section 6031, a partnership return on Form 1065 and must provide each partner with the information necessary to report the partner's distributive share of the taxable income.

Because the arrangement between "M" and the operator (Quartermaster's business) is either a lease or a joint venture, "M" and the operator are required to file information returns under sections 6041 or 6031 of the Code. Regardless of whether the arrangement is a lease or a joint venture, "M" and the operator will have penalties under sections 6721 or 6698, if they have failed to file the information returns for the taxable years under audit.

ISSUE 8 - CONCLUSION:

The arrangement between "M" and the poker machine operator is arguably a partnership under sections 761 and 7701. However, the arrangement could be either a lease of the machine space or a lease of the machines. It appears that "M" has not filed any information returns under sections 6041 or 6031. Accordingly, the arrangement between "M" and the poker machine operator should be treated as the individuals in the industry who are filing information returns treat similar arrangements.

A copy of this memorandum is to be given to the organization. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

-END-