M. GAMBLING ACTIVITIES OF EXEMPT ORGANIZATIONS

1. Introduction

Gambling, including bingo, is becoming an increasingly common activity for exempt organizations.

The term "gambling" includes such a vast array of activities that to attempt to create an all-inclusive definition is an exercise in futility. Whether or not a particular activity constitutes "gambling" is defined by the case law of the state in which the activity occurs. Although there is no general prohibition against gambling under federal law, Congress has enacted several restrictions which are designed to facilitate state enforcement of gambling activities. Most of the federal restrictions on gambling activities, however, are not relevant for any determinations to be made by the specialist. In general, gambling may be defined as the wagering, betting, or laying of money or other thing of value on the transpiring of any event whatsoever, whether it be on the result of a game of chance or on a contest of skill, strength, speed, or endurance, whereby one party gains and the other loses something for nothing, whether the parties betting be the actors in the event on which their wager is laid or not. Hardison v. Coleman, 121 Fla. 892, 164 So. 520 (1935).

2. Legality

The conduct of illegal activities by exempt organizations is a developing area of interest to the Service. Both the Tax Court in Aviation Country Club, Inc. v. Commissioner, 21 T.C. 807 (1954), acquiescence, 1953-1 C.B. 109, and the Service in Rev. Rul. 69-68, 1969-1 C.B. 153, have held that the conduct of illegal gambling activities, in and of itself, by an exempt organization will not affect its exemption.

For a more in-depth discussion of how to handle exempt organizations that conduct activities that are illegal or contrary to public policy, see the Exempt Organizations Continuing Educational Technical Instruction Program for 1985, p. 109.

3. The Gambling Glossary

Although the game of Bingo may be known throughout the world, other less common forms of gambling are not so universally known. The following descriptions of gambling activities do not represent legal definitions, but are included in this

discussion so as to acquaint the gambling neophyte to the terms of the gambling veteran.

"Pari-Mutuel Betting" is a form of betting on horse races through the use of a machine which records the number of bets placed on each horse to win and returns to the bettor a ticket evidencing his bet. Once a winner has been determined in the horse race, the total amount of wagers received, less a commission to the machine's owner, is divided among the bettors who chose the winning horse.

"Calcutta Wagering" is a system of wagering in which bids are made for competing golfers in an auction. The proceeds of the purchase of players are pooled for distribution to winners according to a scale of percentages.

"Lottery" has no precise legal definition although its meaning has been interpreted by the courts, legal scholars, and even statutes. In Horner v. United States, 147 U.S. 449 (1893), the United States Supreme Court described a lottery as a distribution of prizes and blanks by chance, a game of hazard in which small sums are ventured for the chance of obtaining a larger value either in money or in other articles. To ascertain whether or not a particular activity is a "lottery," the appropriate state statutes and case law should be consulted.

4. Gambling Activities and UBIT

The Service recently released Announcement 89-138, 1989-45 I.R.B. 41 (November 6, 1989), which provides a general summary of the rules regarding whether the income from the public conduct of bingo and other forms of gambling by tax-exempt organizations results in unrelated business income. Most of the information contained in the Announcement is dealt with below.

In general, IRC 511 and 513 provide that an exempt organization is subject to the tax on unrelated business income for revenues derived from the conduct of an unrelated trade or business, which is regularly carried on by the organization, the conduct of which is not substantially related to the exempt purposes constituting the basis for the organization's exemption under IRC 501(c). Thus, if an organization can establish that a particular activity is "substantially related" to its exempt purposes, or is not "regularly carried on" by the organization, it will not be taxed on the receipts derived from the activity. Also excluded from the definition of unrelated trade or business are qualified public entertainment activities (IRC 513(d)(2)), certain bingo games (IRC 513(f)) and activities in which substantially all the work in carrying on

such trade or business is performed for the organization without compensation (IRC 513(a)(1)).

5. Substantially Related Exception

Several categories of exempt organizations, hereinafter referred to collectively as the "Social Groups," have as part of their exempt purposes the fostering of goodwill among members or other social or recreational purposes. The Social Groups, for purposes of this article, include social clubs exempt under IRC 501(c)(7), fraternal beneficiary societies exempt under IRC 501(c)(8), domestic fraternal societies exempt under IRC 501(c)(10), veterans organizations exempt under IRC 501(c)(19), and organizations exempt under IRC 501(c)(23). Although social clubs exempt under IRC 501(c)(7) and veterans organizations are defined by statute to be organized for pleasure and recreational purposes, see IRC 501(c)(7) and Reg. 1.501(c)(19)-1(c), no similar language is found in the statutory definitions of the other Social Groups, the fraternal organizations. The Service stated in G.C.M. 39061, however, that inherent in the definition of "fraternal" is the provision of social and recreational activities by a fraternal organization to its members, thereby opening the door for fraternal organizations to sponsor gambling activities for their members. Consequently, the conduct of gambling activities sponsored by the Social Groups to the extent of members' participation has a substantial causal relationship to the exempt social and recreational purposes of such organizations and, therefore, the income derived from such activities will not constitute unrelated business income.

However, when nonmembers participate in the gambling activities of Social Groups, even if they participate as guests of members, the receipts from their participation are generally subject to the tax on unrelated business income. In G.C.M. 39061 (November 21, 1983), gambling activities conducted by two different veterans' organizations were held not to be an unrelated trade or business to the extent of participation by members of the organization. The G.C.M. states that the gambling activities conducted by the organizations provided recreation to members and, thus, to the extent of participation by members, had a substantial causal relationship to the exempt social and recreational purposes of the organizations. The G.C.M. also concluded, however, that the provision of recreational activities to nonmembers by the veterans' organizations, did not have a substantial causal relationship to their exempt purposes and, therefore, the income derived from nonmembers must be considered income from an unrelated trade or business.

While the Social Groups may claim that gambling activities have a substantial causal relationship to their exempt social and recreational purposes, organizations

which are exempt under other provisions of IRC 501(c) (hereinafter referred to collectively as the "Non-Social Groups") may have far more difficulty sustaining such a claim since social and recreational purposes are not ordinarily inherent in their exempt purposes. Prior to the Tax Reform Act of 1976, revenues received by Non-Social Groups from the conduct of gambling activities (including bingo) were technically income from an unrelated trade or business, although the tax may not have always been assessed. (Churches, for example, did not become subject to UBIT until 1969, and then had a five-year phase-in for tax on pre-existing unrelated activities.) See Rev. Rul. 68-505, 1968-2 C.B. 248, which holds that a county fair association exempt under IRC 501(c)(3) that conducts a horse racing meet with pari-mutuel betting is engaged in an unrelated trade or business. See also Smith-Dodd Businessman's Association, Inc. v. Commissioner, 65 T.C. 620 (1975), which held that a businessman's association exempt under IRC 501(c)(4) is subject to the tax on unrelated business income on the revenues derived from the operation of public bingo games. The Tax Court concluded without elaboration that gambling activities clearly do not promote 501(c)(4) purposes and, therefore, constitute an unrelated trade or business.

6. Activities "Not Regularly Carried On" Exception

A final exception to the tax on unrelated business income is where the gambling activities are "not regularly carried on" within the meaning of Reg. 1.513-1(c)(1). As in the volunteer workers exception, application of this exception to gambling activities is to be consistent with its application to other unrelated trades or businesses. For a discussion on whether or not activities are "regularly carried on" by an organization, see Exempt Organizations Continuing Professional Education Technical Instruction Program for 1982, p. 127.

7. Qualified Public Entertainment Activities Exception

Congress responded to Rev. Rul. 68-505, supra, by enacting IRC 513(d) as part of the Tax Reform Act of 1976. IRC 513(d)(1) provides an exception to the tax on unrelated business income for "public entertainment activity" described in IRC 513(d)(2) conducted in conjunction with public fairs or expeditions. This exception, applicable to organizations described in IRC 501(c)(3), 501(c)(4), and 501(c)(5), covers:

(1) public entertainment activity conducted in conjunction with an international, national, state, regional, or local fair or exposition,

(2) activity conducted in accordance with State law which permits the activity to be conducted only by that type of exempt organization or by a governmental entity, or

(3) activity conducted in accordance with State law which allows that activity to be conducted for not more than 20 days in any year and which permits the organization to pay a lower percentage of the revenue to the State than is required from other organizations.

The legislative history of the Tax Reform Act of 1976, found in Senate Report 94-938 of the 94th Congress, indicates that IRC 513(d) was intended to reverse Rev. Rul. 68-505. Within specified limits, IRC 513(d) allows income derived by some types of exempt organizations from parimutuel betting to escape unrelated business income taxation.

8. Certain Bingo Games Exception

In 1978, Congress added another exception to the tax on unrelated business income for income derived from certain bingo games. IRC 513(f) provides that the term "unrelated business income" does not include any trade or business which consists of conducting bingo games that are not normally carried out on a commercial basis and the conduct of which is not in violation of state or local law. Reg. 1.513-5(c)(2) provides that bingo games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried on, within the meaning of Reg. 1.513-1(c), by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis; however, if state law permits local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if State law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial business.

At the same time Congress enacted IRC 513(f), Congress created IRC 527(c)(3) which defines what constitutes exempt function income for political organizations recognized as exempt from federal income tax under IRC 527. IRC 527(c)(3)(D) provides that the term "exempt function income" means any amount received as proceeds from the conducting of any bingo game, as defined in IRC 513(f)(2).

Reg. 1.513-5 provides that IRC 513(f) does not apply, however, with respect to any bingo game otherwise excluded from the term "unrelated trade or business" by reason of IRC 513(a) and Reg. 1.513-1(e)(1) relating to trades or businesses in which substantially all the work is performed without compensation.

9. Volunteer Workers Exception

IRC 513(a)(1) provides that the term "unrelated trade or business" does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation. The application of this exception to gambling activities conducted by exempt organizations should be consistent with its application to other trades or businesses carried on by exempt organizations. In general, IRC 513(a)(1) excepts from the definition of unrelated trade or business, any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation. Although the term "substantially all" is undefined in the context of IRC 513(a)(1), an unofficial guideline, which is borrowed from other areas of the Code, is 85%. Please note, however, that few cases under IRC 513(a)(1) have applied the 85% test strictly. Instead, "substantially all" is to be applied in a general manner.

As to what constitutes compensation, an excellent discussion is contained in Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner, Docket No. 15696-79, T.C. Memo 1981-546, filed September 24, 1981. The court stated that the term "compensation" has broad application. The court added that even the provision of free drinks or food to workers may be considered compensation if the facts show that the free items are more than a mere gratuity and are intended to be compensation, however little, for the workers' services. For a more detailed discussion of the volunteer workers exception see Exempt Organizations Continuing Professional Education Technical Instruction Program for 1982, p. 124.

10. The North Dakota Situation

In 1984, Congress enacted section 311 of the Deficit Reduction Act (DEFRA) which provides that non-profit organizations are not subject to unrelated business income tax for income received from conducting games of chance (other than bingo) which do not violate State law and provided that as of October 5, 1983, there was "a State law" in effect which permitted the conducting of such game of chance by such non-profit organization, but the conducting of such game of chance by organizations which were not non-profit would have violated such law. The purpose of such law

was to exclude income derived by non-profit organizations from certain games of chance which were being conducted in the State of North Dakota. The effect of the legislation, however, was to except from unrelated business income tax the income derived by exempt organizations, regardless of their location, provided a State law was in effect as of October 5, 1983, which allowed the conduct of the games of chance by non-profit organizations.

Two amendments to section 311 followed in the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), that ultimately limited the exception to games of chance conducted by nonprofit organizations in the state of North Dakota.

Because of the Congressional oversight, the net effect of section 311 of DEFRA, as amended, is to exclude from unrelated business income tax the income from games of chance (other than bingo) conducted in North Dakota after June 30, 1981, that do not violate State or local law. Additionally, for the period from June 30, 1981, through October 22, 1986, games of chance (other than bingo) conducted outside of North Dakota are not subject to the tax on unrelated business income as long as a State law was in effect on October 5, 1983, that permitted the conduct of such games only by a non-profit organization.

11. Inurement

In addition to being cognizant of the provisions taxing their unrelated business income, exempt organizations that sponsor gambling activities must also be certain that the net earnings derived from those activities do not inure to the benefit of any private individual. IRC 501(c)(3), (6), (7), (9), (11), (13), (14), 526, and 528 preclude exemption where inurement is present. Although all of the above Code sections proscribe inurement, the specialist is not likely to be faced with cemetery companies holding weekly Bingo games. Inurement problems resulting from gambling activities are most likely to occur in organizations which are exempt under IRC 501(c)(3), (6), and (7).

Inurement problems may arise in a variety of situations. In the context of gambling activities, inurement problems are most likely to arise when the sponsoring organization's bylaws provide for different membership classifications or when the sponsoring organization receives income from nonmembers to defray costs normally borne by members.

Inurement problems may arise when membership organizations create different classes of membership with a varied dues structure. In Pittsburgh Press Club v. United States, 536 F.2d 572 (3d Cir. 1976), the court rejected the Government's argument that inurement exists whenever a club, which maintains a varied dues structure, affords equal rights and privileges to all of its members. The Government argued that when one class of members pays substantially lower dues and initiation fees than other classes of members, the lower-paying member receives benefits and services they would not receive but for the greater dues and initiation fees paid by the other classes; therefore, the net earnings of the club inure to the benefit of some of its private shareholder. The court recognized that although inurement may exist where a club has a differential dues schedule, the particular dues schedule adopted by the Pittsburgh Press Club did not violate the inurement provision of IRC 501(c)(7). The court based its decision on the fact that the use made of the club by each membership class was roughly proportional to the dues charged. Additionally, the court held that any benefit received by the lower-paying members was de minimis in this situation.

Despite the court's opinion, however, the extent of the actual use of a club's facilities by those members who pay higher dues and initiation fees should be irrelevant when all members of the club have equal right to the use of such facilities. It may have been merely fortuitous in Pittsburgh Press Club v. United States, supra, that the amount of dues paid by affiliate and associate, who paid dues two and three times those paid by the active members, made greater use of the club's facilities.

Prior to Pittsburgh Press Club v. United States, supra, a number of cases were litigated on the effect on a social club's exempt status of nonmember receipts. The theory underlying the decisions was not only that substantial non-member receipts tend to disprove a club's claim of operation for exempt purposes, but also that such receipts constitute inurement of net earnings to the membership because they help to subsidize physical facilities that would otherwise have to be underwritten through higher dues and initiation fees. A number of cases stressed that receipts from nonmember sources were available to carry "as large and luxurious a plant as the members might like without the payment of burdensome dues." West Side Tennis Club v. Commissioner, 111 F.2d 984 (2d Cir. 1940). None of the cases, however, analyzed individual members' use of the improved facilities. Rather, the point made was the availability to club members of facilities subsidized by nonmember receipts, not the actual use of such facilities. See Aviation Club of Utah v. Commissioner, 162 F.2d 984 (10th Cir. 1947) and West Side Tennis Club v. Commissioner, supra.

Therefore, for example, if a social club wishes to encourage membership of those employed in a profession that may not be lucrative enough to enable them to

afford high dues, and at the same time wishes to maintain a substantial physical plant as a center for club activities, the club would be better advised to structure itself so that it charges a basic membership fee entitling all members to certain basic club privileges, and an additional fee correlated with actual use of, or access to, the club's more expensive facilities. Additionally, in situations where a social club uses a varied dues schedule, the fact that those members required to pay higher dues make concomitantly greater use of the club's facilities is irrelevant for purposes of determining whether the dues structure results in inurement of earnings to members who pay lower dues when all members have equal rights to use such facilities.

Inurement problems may also arise where nonmember income is used by an exempt organization to help defray costs normally borne by the members. In Augusta Golf Association v. United States, 338 F. Supp. 272 (1971), the court held that where no profit motive underlay the formation of a non-profit golf association, and its membership, both individually and collectively, had never profited from golf calcuttas conducted by the corporation, the association was entitled to exemption under IRC 501(c)(7). The court found that in the years at issue, the calcuttas were not operated as a business with the general public, but were conducted for members and invited guests. The events were directly related to the purposes for which the association was operated and the retained share of pooled funds was not used for the financial benefit of any member. Any costs associated with social affairs sponsored by the Augusta Golf Association were borne by participating members to the same extent as participating nonmembers. The court also found that during the period the calcuttas were open to the general public, the calcuttas were an essential part of the association's social and recreational activities as well as a means of financing its promotion of the game of golf. Based on the foregoing, the court, although explicitly recognizing the closeness of the case, concluded that the organization was exempt under IRC 501(c)(7).

The result of Augusta Golf Association is best explained by Reg. 1.501(c)(7)-1(a), which provides that a club otherwise entitled to exemption under IRC 501(c)(7) will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities. (Emphasis added.) The income received by the Augusta Golf Association from the conduct of calcutta wagering pools came solely from the pockets of the club's members and their invited guests and was not used to defray any of the costs otherwise required to be paid by members.

Given the demands of administrative convenience, as well as other factors, a de minimis rule should be applied in IRC 501(c)(7) inurement cases. The determination as to whether or not an amount of income is de minimis should not be based on a set

dollar amount or formula, but instead should be determined on a case-by-case examination.

G.C.M. 37490 (April 3, 1978) provides that for purposes of determining that proscribed inurement exists and for purposes of applying the de minimis rule, the amount of net earnings said to inure to members should be examined at the organization level rather than at the individual level. Thus, the proscription against inurement should operate to deny exemption to a club in which only one person, e.g. an overcompensated manager, or a small "in-group" of people reaps a share of the club's net earnings; and to a club in which all members share, although indirectly and to a lesser extent, in the club's earnings. See the several decisions in Pittsburgh Press Club, supra.

12. Nonmember Income

Closely related to the inurement issue, is the amount of support an exempt membership organization may receive from nonmembers. Membership organizations include, among others, the same organizations referred to as "Social Groups" throughout this discussion; i.e. organizations described in IRC 501(c)(7), 501(c)(8), 501(c)(10), and 501(c)(19) and 501(c)(23).

Prior to the Tax Reform Act of 1969, the unrelated business income tax was applicable only to certain tax-exempt organizations, including IRC 501(c)(3) organizations (except churches), IRC 501(c)(5) organizations, and IRC 501(c)(6) organizations. Due to the substantial increase in commercial activities by the other types of exempt organizations, Congress, in the Tax Reform Act of 1969, broadened the applicability of the unrelated business income tax to include churches, social clubs and fraternal organizations.

The addition of social clubs to the list of organizations subject to the tax on unrelated business income created an anomaly in the law surrounding such clubs. Prior to the Tax Reform Act of 1969, the Service had already noticed the commercial-type activities being conducted by social clubs and published Rev. Proc. 64-36, 1964-1 C.B. 962, which strictly limited the amount of nonmember income social clubs were allowed to receive. Rev. Proc. 64-36 created a five-percent audit standard for social clubs, which limited the amount of gross receipts social clubs could receive from nonmembers to five-percent of their total gross receipts. If nonmember income exceeded five-percent of a social club's gross receipts, the club's exemption could be revoked. Although Rev. Proc. 64-36 was superseded by Rev. Proc. 71-17, 1971-1 C.B. 683, the five-percent audit standard remained intact. Thus,

after 1969, there was a logical inconsistency in the rules surrounding social clubs. Whereas the Code expanded the applicability of the unrelated business income tax to include the nonmember receipts of social clubs, the audit guidelines of Rev. Proc. 71-17, 1971-1 C.B. 683, continued to threaten social clubs' exemptions if nonmember receipts exceeded a small portion of gross revenues, and IRC 501(c)(7) continued to restrict exemption to clubs organized and operated "exclusively for ... nonprofitable purposes."

Congress, in Public Law 94-568 (1976), corrected the inconsistency by amending IRC 501(c)(7) by eliminating the requirement that clubs be organized and operated "exclusively" for the above social purposes and by providing a less stringent new requirement that "substantially all" of a club's activities be for pleasure, recreational, or other non-profitable purposes.

The legislative history behind the amendment, contained in Senate Report No. 94-1318 of the 94th Congress, states that the change was intended by Congress to allow organizations exempt under IRC 501(c)(7) to earn income from nonmember sources to a limited extent and to have a limited amount of investment income without threatening their tax exempt status. By enacting such amendment, Congress intended that these organizations be permitted to receive up to 35% of their gross receipts, including investment income, from sources outside of their membership without losing their tax exempt status. Congress 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 general services by the general public. The 15% limit effectively replaces the five-percent audit standard created by Rev. Proc. 71-17, 1971-1 C.B. 683. Other than the modification of the audit standard, however, the general guidelines of the above revenue procedure remain valid and helpful.

In G.C.M. 39115 (January 12, 1984), certain activities conducted by a businessmen's social club were held to be non-traditional and not to further IRC 501(c)(7) purposes. The G.C.M. included a general discussion on the Service's interpretation of the reasons for the Congressional change to IRC 501(c)(7). The Service noted that in the Committee Report, Congress was careful to point out that the liberalization was not intended to permit social clubs to have "additional income from the active conduct of businesses not traditionally carried on." In other words, there was to be a change in the permissible degree, but not the kinds of nonmember income an exempt club could have.

Advertising in public media in pursuit of nonmember business should still be viewed as prima facie evidence of an intent to operate for other than the requisite

social and recreational purpose. Regular public advertising of gambling activities, for example, should occasion careful attention of the Service.

Fraternal organizations exempt under IRC 501(c)(8) and 501(c)(10) are not subject to the IRC 501(c)(7) limitations on nonmember and investment income. Organizations exempt under IRC 501(c)(19) and 501(c)(23), like the fraternal organizations, have no statutory limitations on the amount of nonmember income and investment income they may receive. IRC 501(c)(19) veterans' organizations, however, do have certain membership requirements that mandate a certain percentage of their membership be comprised of war veterans.

13. South End Italian Independent Club, Inc.

In South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. 168 (1986), the Tax Court held that an exempt social club's charitable "donations" of beano (bingo) game proceeds were fully deductible from unrelated business income as a business expense under IRC 162 and not charitable contributions subject to 10% limitation for deductions under IRC 170. The South End Italian Independent Club, Inc. (South End) conducted weekly beano games pursuant to a license issued by the Commonwealth of Massachusetts. Under Massachusetts law, the profits earned from the sponsoring of beano games "shall be the property of the organization conducting said game, and shall be used for charitable, religious or educational purposes, and shall not be distributed to the members of such organization." The Tax Court stated that since South End's payments were made in compliance with a Massachusetts law requiring the donation of the net proceeds of South End's beano games, the donations were surrounded with a "legal compulsion" and, thus, can hardly qualify as voluntary charitable contributions. Additionally, the Tax Court found that since South End's license could be revoked if South End failed to make the donations, the expenses were "ordinary and necessary" within the meaning of IRC 162. Congress, according to the Tax Court, was concerned that income derived from activities like beano could be used by a club to reduce the members' costs below the actual cost of providing the personal facilities made available by the organization. The Tax Court concluded by stating that the result of the above case is fully consistent with Congress' purpose in imposing a tax on the income of social clubs since, to the extent South End's beano income would be available to reduce members' costs, such income is taxed.

14. Wagering Tax

In addition to the application of the tax on unrelated business income to the proceeds of gambling activities, the specialist should also be aware that the

sponsorship of gambling activities by an exempt organization may lead to the imposition of a wagering tax under IRC 4401.

15. Conclusion

The conduct of illegal activities by an exempt organization is a developing area of concern to the Service and warrants careful attention by the specialist. Beyond the illegality issue, the next determination to be made by the specialist is whether or not the income generated from such activities will be subject to the tax on unrelated business income. Stated briefly, an organization will be subject to the unrelated business income tax on the income derived from the conduct of such activities, unless the organization can satisfy one of the enumerated exceptions to such tax.

If an organization can establish that (1) the conduct of gambling activities is "substantially related" to the exempt purposes of the organization or (2) that the gambling activities are not regularly carried on by the organization, the income derived from such activities will not be subject to the tax on unrelated business income. Alternatively, if an organization can establish that substantially all of the work in carrying on the gambling activities is performed for the organization without compensation, the income from such activities will not be subject to tax. More specific exceptions to the unrelated business income tax include qualified public entertainment activities, described in IRC 513(d)(2), and certain bingo games, described in IRC 513(f).

Regardless of whether or not the income derived from gambling activities constitutes unrelated business income, a determination must also be made as to whether or not the net earnings of the sponsoring organizations inure to the benefit of private individuals. If inurement exists, exemption should be denied or revoked, unless the specialist determines that the actual amount of income inuring to the benefit of the private individuals is de minimis.

Finally, when confronted with gambling activities sponsored by IRC 501(c)(7) social clubs, the specialist must determine the extent to which the club is supported by nonmember income. If the club is receiving more than 15% of its gross receipts from nonmember support, or if the kind of business being conducted is not of a type traditionally carried on by clubs, the club's exemption must be called into question.

****

1990 UPDATE

Editor's Note: In late 1990 the IRS updated each topic that came out in early 1990 in its Exempt Organizations Continuing Professional Education Technical Instruction Program textbook for 1990. As a result, what you have already read contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

M. GAMBLING ACTIVITIES OF EXEMPT ORGANIZATIONS

Since publication of the 1990 CPE text, the subject of gambling activities by EOs, always controversial, has become a "hot topic" which, roughly defined, means an area that is subject to considerable internal debate, and attention by the public, the media, and the legislature. Gambling by EOs has recently witnessed all of the above, and more. Sometimes debate begets action, sometimes stalemate and paralysis. For the moment, at least, there is more heat than light, and more stiffness in the joints than solid accomplishment. As a result there is nothing to report in the way of new court decisions, federal enactments, GCMs, AODs, etc. What follows, therefore, is a discussion of the origins of the latest flap concerning exempt gambling and, to the extent disclosable, some insight into the current legislative and administrative ruminations on the subject.

1. Happy New Year

The current flurry of activity in a number of circles over the Service's treatment of gambling activities by exempt organizations is traceable to the actions of the Internal Revenue Service at the very beginning of this year. In early January, the Service revoked the tax-exempt status of 12 Minnesota exempt organizations that conducted gaming activities. News of the revocations was reported by the major wire services.

In addition to the above revocations, numerous other exempt organizations received letters from the Service informing them that substantial back taxes were owed due to the organizations' failure to report the UBI derived from their gaming activities. According to a UPI story, the majority of the organizations that received such letters were unaware of the provision included in the 1986 Tax Reform Act that clarified that certain gambling activities became subject to UBIT after 1986. UPI quotes Rep. Peter Hoagland (D-Neb.) as stating that the new Code provision went largely unnoticed by exempt organizations until April 1989, when the Service issued letters to affected organizations. According to an article in The Wall Street Journal,

about 200 exempt organizations in Nebraska are in a panic about the implications of such taxes. An IRS official in Omaha was quoted as saying that about a dozen organizations in Nebraska are looking at potentially six-figure bills for back taxes.

The public outcry at the Service's actions has caused a stir both on Capitol Hill and at the National Office. Current Service position, although essentially dictated by black letter law and court decisions, has even prompted the rather comical charge by one Senatorial aide that the Service's acquiescence in the case of the Massachusetts based South End Italian Independent Club (see below) was prompted by favoritism for East Coast institutions!

2. The World's Greatest Deliberative Bodies

Congressional reaction to the Service's taxation of gambling income has been swift and to the point, but remains only preliminary at this writing. Sens. J. James Exon (D-Neb.) and Bob Kerrey (D-Neb.) have introduced S.2308. The bill would retroactively repeal the tax imposed on exempt organization's income derived from gambling activities. Additionally, Senate Finance Committee member William L Armstrong (R-Colo.) has introduced S.2867, which would exempt charitable organizations from (1) collecting the $50 occupational stamp tax which is imposed on each and every volunteer who helps with the gambling activities and (2) would exempt charitable organizations from the wagering excise tax imposed by IRC 4401.

On the House side, Rep. Hoagland has introduced H.R. 4320, an identical bill to the one introduced by Sens. Exon and Kerrey. Likelihood of passage of any of these bills is quite uncertain at this time (8/90).

3. Service Positions

A. South End Italian Independent Club, Inc. v. Commissioner

The Service continues to grapple with the decision of the Tax Court in South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. 168 (1986), acq. in result. In South End, the Tax Court held that an exempt social club's payment to charity of beano game proceeds as required by Massachusetts law was fully deductible from unrelated business income as a business expense under IRC 162 and, thus, not subject to the 10% limitations for charitable deductions from UBI found in IRC 513(b)(10). Although the Service has acquiesced in result only, the treatment to be accorded the holding is currently undetermined. At this time, the National Office is considering a wide spectrum of responses to the decision in the South End case,

including the possibility of withdrawing the acquiescence and relitigating the issue. For now, however, it remains the Service position that the proceeds of charitable gambling that are donated to other organizations pursuant to state law are generally fully deductible from UBI as business expenses under IRC 162.

Theoretically, this result depends on a case-by-case showing that the organization expected an economic benefit (such as South End's retention of its license to operate) in return for the expenditures. Compare, for example, Rev. Rul. 77-124, 1977-1 C.B. 39, which holds that a pari-mutuel race track corporation that agrees to promote, and absorb any losses from, extra racing days each year for the benefit of local charities to obtain and ensure retention of its license must include revenues from the extra days in its gross income and may deduct as a business expense under IRC 162 the profits turned over to charities. See GCM 39474, January 23, 1986. See also a 1990 letter ruling, PLR 9011025, which allows a section 162 deduction to a nonprofit corporation, formed as an "organization licensee" to conduct the parimutuel operations for a dog and horse racing facility, because the organization is required by state law to pay over all its net earnings to IRC 501(c)(3) organization.

B. Inurement and the Wagering Taxes

IRC 4401, in part, imposes an excise tax of 0.25% on the amount of state authorized wagers, and IRC 4411 provides for a special occupational tax on persons with whom the wagers are placed. The term "wager" is defined in IRC 4421 to include most types of gambling activities that exempt organizations are involved in. However, IRC 4421(2)(B) provides, in part, that the term "wager" does not include drawings conducted by organizations exempt from tax under IRC 501 so long as no part of the net proceeds derived from such drawing inures to the benefit of any private shareholder or individual.

Thus, in order to assert the wagering tax on EOs, the Service must take the position that there is inurement of income that arises from their gaming activity. A "Catch 22" results. If inurement exists, the organization cannot retain its exemption. If it loses its federal exempt status, in many cases it may also lose its right to conduct gaming activity under state law. No gaming activity, no wagering tax. Moreover, the Exempt Organizations Technical Division has long recognized that the legislative and administrative history of Subchapter F reveals a pervasive recognition that the mere conduct or sponsorship of a limited amount of legal gambling by tax exempt membership organizations does not, ipso facto and without more, give rise to impermissible inurement of income to members. Church bingos, union raffles, club casino nights, Calcuttas, etc., are classic examples of traditionally accepted gambling

activities that, without more, have not endangered exempt status on the grounds of impermissible inurement. It may eventually be concluded that inurement has different meanings for purposes of the two different provisions.

4. Conclusion

The conduct of gambling activities by exempt organizations continues to be a source of confusion and frustration for field agents, an election-year soap box for politicians, and no end of headaches for National Office personnel. As a result, the likeliest bet for the future of charitable gambling is the expectation of more changes in both the statutory law and Service positions regarding such activities.