



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service

January 12, 2010

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Release Date: 12/19/2014

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

12/31/20XX & 12/31/20XX

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear _____

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

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

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

for Nanette M. Downing
Acting Director, EO Examinations

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

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit: Form 6018-A
Name of Taxpayer		Year/Period Ended 12/31/20XX 12/31/20XX

Issues:

1. Whether _____, doing business as “ _____”, (_____) operated exclusively for purposes listed in Treas. Reg. § 1.501(c)(19)-1(c).
2. Whether the net earnings of _____ inured to the benefit of its President.
3. Whether _____ has satisfied the recordkeeping and reporting requirements set forth in I.R.C. §§ 6001 and 6033.
4. Whether _____ exemption under I.R.C. § 501(a), as an organization described in I.R.C. § 501(c)(19), should be revoked effective date January 1, 20XX.

Facts: Background Information

_____ (hereinafter referred to as _____) is a veterans organization that holds a group exemption for veterans organizations described in I.R.C. § 501(c)(19). _____ web page states that its mission is to “”

_____ website lists several advantages to be included in its group”

”

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Formation and Purpose

(hereinafter referred to as) was purchased by () in 19XX. According to the Secretary of State Website, was established in October of 19XX as a Non-Profit Corporation.

According to the bylaws, stated purpose is “ ”. The bylaws further state that these purposes include, but are not limited, to the following:

- A.
- B.
- C.
- D.

- E.
- F.
- G.
- H.
- I.

- J.

Business Operations, Business Activities, and Members

primary activity is operation of a cash business at , . The building’s facade exhibits signs stating “ ” and “ ”. In order to sell alcohol in the area, a bar has to be recognized as an exempt organization, like , or a regular restaurant with more than \$50,000 in sales from food. The facility has a full service bar (beer, wine, and liquor), several dining tables and chairs, pool tables, television set, juke box, gaming machines, and a dining hall.

Per interview with the president , the activities for 20XX were consistent with 20XX. is open to both members and nonmembers (general public). There are no signs of private club or members only posted any where at the facility. The does not have a sign-in book for members or nonmembers. Everyone is welcome to the facility as long as the customer has met the drinking age requirement. Per initial meeting with the , has about 0 members. No membership fee was charged to individual members. The pays for the annual membership fee to which included 20 individual membership fee. Also, the pays the sales tax on all sales

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(members and nonmembers). The _____ does not have adequate records to substantiate membership and non-membership sales. The _____ reported sales after cash expenses as gross sales of inventory on Form 990 for the examination years.

_____ facilities are open 7 days a week, including holidays. _____ is open to members and nonmembers (i.e., the general public). The annual dues for the members of _____ are \$0. _____ was unable to verify the membership status of any of its other customers during the examination.

In addition to managing the day-to-day bar operations, _____, _____ President, was solely responsible for managing the organization's financial affairs and she was responsible for maintaining its books and records. _____, was responsible for filing the organization's Forms 990 for 20XX and 20XX.

The bar was open to both members and nonmembers (general public). There are no signs of private club or members only posted any where at the facility. The _____ does not have a sign-in book for members or nonmembers. Everyone is welcome to the bar as long as the customer has met the drinking age requirement. Per initial meeting with the President, _____, the _____ has about 0 members. No membership fee was charged to individual members. The _____ paid for the annual membership fee to HQ which included 20 individual membership fee. Also, the _____ paid sales tax on all sales (members and nonmembers). However, the _____ does not have adequate records to substantiate membership and non-membership sales. The _____ reported sales after cash expenses as gross sales of inventory on Form 990 for the examination years.

Per interview with the _____ President, _____, the _____ activities for 20XX were consistent with 20XX. And they were:

- A. Operating of a bar, kitchen, pool tables, gaming machines, dance hall, karaoke, and some special events for both members and nonmembers,
- B. Provide food and cook outs for the members and nonmember for a charge,
- C. Karaoke night on Friday and Saturday for both members and nonmembers,
- D. Bar and kitchen are open to public, no sign-in book, membership is not required to buy drink and food from the _____,
- E. The _____ did not charge membership fee,
- F. Facility is available to rent out to the members and general public,
- G. The _____ sell liquor and food to members and the public for consumption onsite and the _____ can sell food and liquor to members and public for consumption off the premises,
- H. The _____ also provide gaming activities with members and nonmembers,
- I. More than 80-90% of sales were from nonmembers.

Financial Information

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Per review of the expenses records, personal loan repayments were paid by the . Bar's real and personal properties own by . In 20XX, the paid mortgage interest of \$0 and auto expenses of \$0 on behalf of the President, . In 20XX, the paid mortgage interest of \$0 and auto expenses of \$0 on behalf of the President, . The auto expenses were base on estimated mileages incurred on personal vehicle.

Activities, Revenues, and Expenses

was unable to provide a complete breakdown of the hours it spent, the amount of revenue that it generated, and/or the expenses that it incurred, in connection with its activities during the years under examination.

Per initial meeting with the President, ,

- A. The has about 0 members. No membership fees were charged to individual members. The paid for the annual membership fee to the HQ which also included 20 individual membership fees;
- B. The paid sales tax on all sales (members and nonmembers). However, the does not have any records to substantiate membership and non-membership sales;
- C. More than 80-90% of sales were from nonmembers;
- D. The bar is open to general public. No membership is required to purchase alcohol and food or any events held by the ;
- E. The facility is available to both members and nonmembers. All events were available to general public;
- F. General membership usually do not attempt any of monthly meetings;

During examination process, provided ten copy of DD-214 and ID-Card. Minimum of ten active members was required by HQ.

LAW AND ANALYSIS

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Tax Exemption - Veterans Organizations

Prior to the enactment of I.R.C. § 501(c)(19) by Public Law 92-418, 1972-2 C.B. 675, many veterans organizations qualified for exemption from federal income tax under I.R.C. § 501(c)(4) because most of the traditional activities of these organizations were recognized by the IRS as primarily promoting social welfare. Staff of Joint Comm. on Taxation, 109th Cong., Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations, JCX-29-05 NO 8, (Comm. Print 20XX). The traditional activities of veterans organizations that were social welfare organizations included promoting patriotism, preserving the memory of those who died in war, and assisting veterans in need. *Id.* A veterans organization whose primary activity consisted of operating social facilities for its members was not able to qualify for exemption as a § 501(c)(4) social welfare organization, but it could qualify as a social club under § 501(c)(7). Rev. Rul. 66-150, 1966-1 C.B. 147; S. Rep. No. 1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713; H.R. Rep. No. 851, 92d Cong., 2d Sess. 1 (1972).

In 1972, Congress enacted I.R.C. § 501(c)(19) and I.R.C. § 512(a)(4) to address the concern that a veterans organization exempt under I.R.C. § 501(c)(4) or (7) may be subject to unrelated business income tax on the provision of insurance to its members. S. Rep. No. 1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713.¹ Section 512(a)(4) excludes amounts attributable to, or set aside by a §501(c)(19) veterans organization for the payment of life, sick, accident, or health insurance benefits for their members and their members' dependents. Public Law 92-418, 1972-2 C.B. 675.

The Section 501(c)(19) Exemption Requirements

In General

Section 501(c)(19) of the Internal Revenue Code provides for the exemption from federal income tax of a post or organization of past or present members of the United States Armed Forces if it is:

- (a) organized in the United States or any of its possessions,
- (b) at least 75 percent of its members are past or present members of the Armed Forces of the United States,

* * * *

¹ "Before the enactment of the Tax Reform Act of 1969, there was no tax on the insurance activities of the veterans' organizations since the unrelated business income did not apply to social welfare organizations and social clubs. However, the 1969 Act extended the application of the unrelated business income tax to virtually all exempt organizations including social welfare organizations and social clubs." S. Rep. No. 1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713.

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(c) substantially all of its other members are individuals who are cadets or are spouses, widows, widowers, ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets, and

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

Membership Requirements

Under I.R.C. § 501(c)(19), at least 75 percent of an organization's members must be past or present members of the Armed Forces of the United States ("veterans"). Section 501(c)(19) does not define the term "Armed Forces of the United States." The regulations under I.R.C. § 501(c)(19), likewise, do not define the term. Section 7701(a)(15) of the Code, however, defines "Armed Forces" to include all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and the Coast Guard.

In addition, I.R.C. § 501(c)(19)(B) requires that substantially all other members of an organization be cadets or spouses, widows, widowers, ancestors, or lineal descendants of veterans or cadets. According to the Senate Report accompanying the legislation, "substantially all" means 90 percent. See S. Rep. No. 1082, 92nd Cong. 2d Sess. 5 (1972), reprinted in 1972-2 C.B. 713, 715. Therefore, of the 25 percent of the members that do not have to be veterans, 90 percent must be cadets, or spouses, etc. Consequently, no more than 2.5 percent (10% x 25%) of an I.R.C. § 501(c)(19) organization's total membership may consist of individuals not mentioned in the statute.²

Neither, I.R.C. § 501(c)(19), its legislative history, nor the regulations under I.R.C. § 501(c)(19) define what it means to be a member of a veterans organization. However, whatever the organization requires for one to become a member, the organization must maintain records tracking who its members are and the proportions in the various categories of membership permitted under I.R.C. § 501(c)(19)(B) (member of armed forces, cadet, relative, etc.) to

* * * *

² Prior to 2003, ancestors and lineal descendent were not included in the statutory list of persons permitted to be members. In 2003, Congress amended I.R.C. § 501(c)(19) to include ancestors or lineal descendants of present or former members of the United States Armed Forces or cadets in the statutory list of individuals who may be members of an organization. The regulations have not been updated to reflect this change nor do they reflect the 1982 statutory change eliminating a requirement that veterans be veterans of war.

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substantiate that its members are veterans or other permitted members. See I.R.C. § 6001 and Treas. Reg. §1.6001-1(c).³

Operational Test

Section 1.501(c)(19)-1(c) of the regulations provides that an organization exempt under I.R.C. § 501(c)(19) 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 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 the dependents of their members or both, or
- 8) To provide social and recreational activities for their members.

Treas. Reg. § 1.501(c)(19).

* * * *

³ 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 proscribe. Every organization exempt from tax under § 501(a) and subject to the unrelated business income tax, including veterans organizations, must keep such records. Treas. Reg. § 1.6001-1(a). These books and records are required to be available for inspection by the Service. Treas. Reg. § 1.6001-1(a). In addition, veterans organizations are required to keep books and records to substantiate information reported on their information return. See I.R.C. § 6033 and Treas. Reg. § 1.6001-1(c). They are also required to submit additional information to the Service for the purpose of enabling the Service to inquire further into its exempt status.

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Social and Recreational Activities for Members

While Treas. Reg. §1.501(c)(19)-1(c)(8) does not address what it means to “exclusively” provide social and recreational activities for members it is similar to the exempt purpose contained in I.R.C. § 501(c)(7), as both provisions permit an exempt organization to operate social and recreational facilities for its members. In fact, prior to the enactment of I.R.C. § 501(c)(19), a veterans organization whose primary activity consisted of operating a bar or restaurant for the benefit of its members would have to qualify as §501(c)(7) social club to be tax-exempt. See Rev. Rul. 60-324 and Rev. Rul. 69-219.⁴ These organizations, prior to 1976, were required to operate “exclusively” for the pleasure and recreation of its members. See I.R.C. § 501(c)(7) (1975). Thus, the rulings and case law under I.R.C. § 501(c)(7) are useful for purposes of determining whether an I.R.C. § 501(c)(19) veterans organization is providing social and recreational activities exclusively for its members.

Treas. Reg. § 1.501(c)(7)-1(b) provides that a club that engages in business, such as making its social and recreational facilities available to the general public is not organized and operated exclusively for pleasure, recreation, and other nonprofit purposes, and is not exempt under I.R.C. § 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes.

In West Side Tennis Club v. Commissioner, 111 F.2d 6 (2nd Cir. 1940), cert. denied, 311 U.S. 674 (1940), the Second Circuit upheld the board of tax appeals determination that a social club was not exempt because a substantial amount of its income was received from the general public. West Side Tennis Club was organized to provide tennis facilities for the use and enjoyment of its members. The facilities were only available to members for most of the year; the club hosted annual national championship tennis matches, however, that were open to the general public. The club shared in the ticket proceeds from these matches. The Second Circuit upheld the board of tax appeals determination that the national championship matches were a substantial and profitable business which jeopardized the club’s exemption. West Side Tennis Club, 111 F.2d at p. 7.⁵

* * * *

⁴ In 1976, Congress amended § 501(c)(7) replacing “exclusively” with “substantially all.” This change was effected to establish that social clubs will not jeopardize their exempt status if they receive 35% of their gross receipts from non-membership sources. Only 15% of their gross receipts, however, may be derived from nonmembers’ use of club facilities or services. Pub. L. No. 92-568, S. Rep. 1318, 94 Cong., 2d Sess. (1976).

⁵ In 1976, Congress amended § 501(c)(7) replacing “exclusively” with “substantially all.” This change was effected to establish that social clubs will not jeopardize their exempt status if they receive 35% of their gross receipts from non-membership sources. Only 15% of their gross receipts, however, may be derived from nonmembers’ use of club facilities or services. Pub. L. No. 92-568, S. Rep. 1318, 94 Cong., 2d Sess. (1976).

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In Rev. Rul. 60-324, 1960-2 C.B. 173 and Rev. Rul. 69-219, 1969-1 C.B. 153, the Service held that a § 501(c)(7) social club is not operated exclusively for the pleasure or recreation of its members if it makes its facilities available to the general public to a substantial degree. Id. However, this does not mean that all dealings with the general public are necessarily inconsistent with the club's exempt purposes. For instance, in Rev. Rul. 60-324, 1960-2 C.B. 173, the Service stated that:

[w]hile [the] regulations indicate that a club may lose its exempt status if it makes its facilities available to the general public, [it] does not mean that any dealings with outsiders will automatically cause a club to lose its exemption. A club will not lose its exemption merely because it receives some income from the general public, that is, persons other than members and their bona fide guests, or because the general public may occasionally be permitted to participate in its affairs, provided such participation is incidental to and in furtherance of its general club purposes and the income therefrom does not inure to members.

In 1971, the Service issued Revenue Procedure 71-17, 1971-1 C.B. 683, which contains guidelines for determining the impact of an organization's nonmember gross receipts on its exempt status under I.R.C. § 501(c)(7). The revenue procedure provides that "[a] significant factor reflecting the existence of a nonexempt purpose is the amount of gross receipts derived from use of a club's facilities by the general public." The revenue procedure went on to provide a safe harbor for organizations serving the general public:

As an audit standard, [the gross receipts derived from the general public] alone will not be relied upon by the Service if annual gross receipts from the general public for [use of the club's facility] is \$2,500 or less or, if more than \$2,500, where gross receipts from the general public for use is five percent or less of total gross receipts of the organization.

Rev. Proc. 71-17, 1971-1 C.B. 683 at § 3.01.

The term "general public" is defined as persons other than members or their dependents or guests. Id. at § 2.01. Section 3.03 of Rev. Proc. 71-17 provides four instances in which nonmembers are assumed to be the guests of the members. The assumptions include:

Where a group of eight or fewer individuals, at least one of whom is a member, uses club facilities, it will be assumed for audit purposes that the nonmembers are the guests of the member, provided payment for such use is received by the club directly from the member or the member's employer.

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Where 75 percent or more of a group using club facilities are members, it will likewise be assumed for audit purposes that the nonmembers in the group are guests of members, provided payment for such use is received by the club directly from one or more of the members or the member's employer.

Rev. Proc. 71-17, Section 3.03.

In Pittsburgh Press Club v. United States, 615 F.2d 600 (3rd Cir. 1980), the Third Circuit upheld the Commissioner's determination that a social club failed to qualify for exemption from income tax as a §501(c)(7) organization because it was operated for business and not for the pleasure and recreation of its members. The Pittsburgh Press Club was organized for the purpose of providing a professional and social meeting place for its members. During the years under exam, however, the Pittsburgh Press Club hosted several functions for nonmember outside groups, although each such group had been member sponsored. Based on the amount of nonmember revenues (\$281,000 of nonmember receipts), as well as the percentage of those revenues (11 to 17 percent of gross receipts), the Third Circuit upheld the revocation stating that the exemption from Federal income tax for §501(c)(7) organizations "is to be strictly construed." Pittsburgh Press Club, 615 F.2d at 606. The Court stated that such strict construction cannot be reconciled with the fact that a substantial amount of the Club's activities and income consisted of nonmember functions and nonmember income. Therefore, the Court held "revocation of its exemption was proper." Id.

Inurement

An organization fails to qualify for exemption under I.R.C. § 501(c)(19) if there is inurement. Section 501(c)(19) of the Code prohibits inurement "to the benefit of any private shareholder or individual." The regulations contain corresponding language. See Treas. Reg. §1.501(c)(19)-1(a)(1).

There are no cases or rulings interpreting this statutory or regulatory language under I.R.C. § 501(c)(19). The inurement prohibition set forth in I.R.C. § 501(c)(19), however, parallels exactly the language found in I.R.C. § 501(c)(3). Thus, it is the government's position that the case law, as well as the regulatory and other guidance, on inurement under I.R.C. § 501(c)(3) may be used by analogy in interpreting prohibited inurement under I.R.C. § 501(c)(19).

An organization will not qualify for exempt status under I.R.C. § 501(c)(3) if it is organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). Inurement refers to the non-incidental diversion of assets, which are supposed to be dedicated to charitable purposes, to an insider of the organization. See Treas. Reg. § 1.501(a)-1(c); Ginsburg v. Commissioner, 46 T.C. 47 (1966).

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Inurement may take many forms and an organization's earnings may inure to the benefit of private individuals in ways other than by the actual distribution of dividends or payment of excessive salaries. See Founding Church of Scientology v. United States, 412 F.2d 1197, 1200 (1969), cert. denied, 397 U.S. 1009 (1970) (excessive compensation paid to insiders); Founding Church of Scientology, 412 F.2d 1197, 1200 (1969), cert. denied, 397 U.S. 1009 (1970) (excessive rents paid to insiders as landlords); Easter House v. U.S., 12 Cl. Ct. 476 (1987) (loans to insiders on advantageous terms); Rev. Rul. 56-138, 1956-1 C.B. 202 (excessive employee benefits provided to insiders); Anclote Psychiatric Center, Inc. v. Commissioner, T.C. Memo 19XX-273 (purchase of assets from insiders for more than fair market value or sale of assets to insiders for less than fair market value). Moreover, the unaccounted for diversions of a charitable organization's resources by one who has complete and unfettered control can constitute inurement. Founding Church of Scientology of California v. United States, 823 F.2d 1310, 1316. See also, Parker v. Commissioner, 365 F.2d 792, 799 (8th Cir. 1966), cert. denied, 385 U.S. 1026 (1967); Kenner v. Commissioner, 318 F.2d 632 (7th Cir. 1963).

In People of God Community v. Commissioner, 75 T.C. 127 (1980), a newly formed Christian religious organization, which was founded by one of its ministers, paid its founder and its other ministers a predetermined percentage of the gross tithes and offerings that were received by the organization. After determining that part of the organization's net earnings inured to the benefit of private shareholders or individuals (i.e., the ministers), the Tax Court held that the organization was not exempt as an organization described in I.R.C. § 501(c)(3).

In Spokane Motorcycle Club v. United States, 222 F. Supp. 151 (E.D. Wash. 1963), the plaintiff, a motorcycle club, claimed it was a non-profit, charitable corporation, and asserted that it was except from Federal income tax under I.R.C. § 501(c)(7) and entitled to a refund. The District Court disagreed with the plaintiff's assertions, held that part of the motorcycle club's net earnings inured to its members, even though the amount involved was de minimus, and concluded that the plaintiff was not exempt from Federal income tax.

In Mabee Petroleum Corp. v. United States, 203 F. 2d 872, 875 (5th Cir. 1953), a corporation filed suit to recover overpayments of income taxes on grounds that it was entitled to charitable exemption. The United States District Court for the Northern District of Texas entered judgment against the plaintiff and the plaintiff appealed. The Court of Appeals affirmed the District Court's judgment and concluded that the District Court's finding that the salary that was paid to the founder of the charitable foundation, to which all of the founder's stock in the corporation was transferred, was excessive and constituted inurement of net earnings to the benefit of a private individual, was not clearly erroneous.

In The Founding Church of Scientology v. United States, 412 F.2d 1197, 1201 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970), in addition to receiving salary, commission, and royalty payments, the founder of the church, and several members of his family, received unexplained

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payments in the nature of loans and reimbursements for expenditures made in plaintiff's behalf, for expenses and other purposes. The Court of Claims held that the plaintiff was not entitled to exemption from Federal income tax because it failed to prove that no part of the corporate net earnings benefited private individuals. Thus, the plaintiff's claim was denied and the petition was dismissed.

In Parker v. Commissioner, 365 F.2d 792 (8th Cir. 1966), after the Court of Appeals concluded that the Tax Court was justified in ruling that the corporate petitioner was not entitled to tax exemption as a religious organization under I.R.C. § 501, it turned its attention to the unaccounted-for and unexplained withdrawals from the corporation's bank accounts and the checks, which were made payable to the founder, that were drawn on the organization's account. The Commissioner credited the unidentified withdrawals to the founder's income. The Tax Court sustained such action, and the Court of Appeals affirmed the Tax Court's determination, noting that [d]ue to the extremely close relationship between [the founder] and the day-to-day financial activities of [organization] and due to [the founder's] complete and unfettered control over [the organization], [the founder] has the burden of explaining unidentified withdrawals from the [organization's] accounts." Id. at 799, citing Reinecke v. Spalding, 280 U.S. 227 (1930); Arc Realty Company v. Commissioner, 295 F.2d 98 (8th Cir. 1961). "If he is unable to do so the Commissioner may validly assume that the withdrawals were income to the [founder]." Parker v. Commissioner, 365 F.2d 792, 799 (8th Cir. 1966). No evidence of any kind was produced explaining the withdrawals or indicating that the founder did not receive the benefit from them. Thus, the Court of Appeals concluded that the assessments were proper. Id.

In Church of Scientology of California v. Commissioner, 823 F.2d 1310 (9th Cir. 1987), cert. denied, 486 U.S. 1015 (1988), the Court of Appeals affirmed the Tax Court's judgment which upheld the Commissioner's assessment of tax deficiencies and penalties against the church, following the revocation of the church's tax exempt status.

The Court of Appeal reviewed the Tax Court's factual finding that a portion of the church's net earnings inured to the benefit of L. Ron Hubbard, and his family, and OTC, a private for-profit corporation, for clear error. In finding that a portion of the church's net earnings inured to the benefit of L. Ron Hubbard, his family and OTC, the Tax Court isolated two indicia of inurement, overt and covert inurement. The overt indicia included salaries, living expenses, and royalties, and the covert indicia included "debt repayments" and L. Ron Hubbard's unfettered control over millions of dollars of church assets. The Tax Court concluded that these indicia, when viewed in light of the self-dealing associated with them, coupled with the church's failure to carry its burden of proof and to disclose the facts candidly, proved conclusively that the church was operated for the benefit of L. Ron Hubbard and his family. Id. at p. 1317. In addition to Hubbard's salary, the church paid for all of the Hubbards' living and medical expenses aboard the cruise ship Apollo. The church paid substantial royalties to L. Ron Hubbard for his books, recordings and E-meters. The record revealed that L. Ron Hubbard had unfettered control over millions of dollars in church assets, and supported the Tax Court's conclusion that L. Ron Hubbard had unfettered control over Church of Scientology Trust Fund assets. Additionally, the

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Tax Court found that church income incurred to the benefit of L. Ron Hubbard in a "grand scale" in the form of "debt repayments." *Id.* at p. 1319. In sum, the Tax Court held that "significant sums of money inured to the benefit of L. Ron Hubbard and his family" during the years at issue. The Court of Appeals found no clear error and noted that "[a]lthough neither the salaries nor the living expenses necessarily constituted evidence of inurement, the cumulative effect of Hubbard's use of the Church to promote royalty income, Hubbard's unfettered control over millions of dollars of church assets, and his receipt of untold thousands of dollars worth of "debt repayments" strongly demonstrative inurement." *Id.*

Recordkeeping and Reporting Requirements

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. See I.R.C. § 6001. Every organization exempt from tax under I.R.C. § 501(a), and subject to the tax imposed by I.R.C. § 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. Such organization shall also keep such books and records as are required to substantiate the information required by §6033. See Treas. Reg. §§ 1.6001-1(a) and 1.6001-1(c). The books or records required by section 1.6001-1 shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law. See Treas. Reg. §1.6001-1(e).

Except as provided, every organization exempt from tax under I.R.C. § 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.

See I.R.C. § 6033(a)(1).

Every organization which is exempt from tax, whether or not it is required to file an annual information return, shall submit such additional information as may be required by the Service for the purpose of inquiring into its exempt status and administering the provisions of subchapter F (i.e., I.R.C. § 501 and following), chapter 1 of subtitle A of the Code, I.R.C. § 6033, and chapter 42 of subtitle D of the Code. See Treas. Reg. §1.6033-2(i)(2). See also, I.R.C. § 6001, Treas. Reg. §1.6001-1.

An organization's failure or inability to file required information returns or otherwise to comply with the provisions of I.R.C. § 6033 and the regulations which implement it, may result in the termination of the organization's exempt status based on the grounds that the organization has not established that it is observing the conditions that are required for the continuation of its

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exempt status. See Rev. Rul. 59-95. These conditions require 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 the organization is operated for the purposes for which it was granted tax-exempt status and to determine its liability for any unrelated business income tax. Id.

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. Its records were so incomplete, however, that the organization was unable to furnish such statements. The Internal Revenue Service held that the organization's failure or inability to file the required information return or otherwise to comply with the provision 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 its exempt status.

Unrelated Business Income Tax

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

Section 512(a)(1) defines unrelated business taxable income as the gross income from any unrelated trade or business regularly carried on by the organization.

Section 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income of funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Section 513(c) provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods. An activity does not lose its identity as trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may not be related to the exempt purposes of the organization.

Treas. Reg. § 1.513-1(d)(2) provides that a trade or business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). It is substantially related, for purposes of section 513 of the Code, only if the causal relationship is a substantial one. For this relationship to exist, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute

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importantly to the accomplishment of any purpose for which an organization is granted exemption depends on each case upon the facts and circumstances involved.

In Rev. Rul. 68-46, 1968-1 C.B. 260 a war veterans' organization did not qualify for exemption from Federal income tax under I.R.C. § 501(c)(4) because it was primarily engaged in renting a commercial building and operating a public banquet and meeting hall having bar and dining facilities.

Government's Position and Conclusions

Taxpayer's Position 1:

The corporation was dissolved in 20XX

Issue 1. has not established that it operates exclusively for exempt purposes listed in Treas. Reg. § 1.501(c)(19)-1(c).

As is discussed more fully above, an organization described in I.R.C. § 501(c)(19) carries out activities in furtherance of its exempt purposes only when such activities are carried out exclusively in furtherance of the purposes listed in Treas. Reg. § 1.501(c)(19)-1(c). Among these purposes is the provision of social and recreational activities for its members. Accordingly, when a veterans organization described in I.R.C. § 501(c)(19) provides social and recreational activities for its members, or for guests whose expenses are paid by members, the organization is engaged in activities in furtherance of its exempt purposes. If such an organization makes its facilities available to the general public to a substantial degree, and/or a significant amount of the organization's income is received from the general public, the organization may lose its tax exemption.

A veterans' organization must be operated for one or more of the purposes listed in Treas. Regs. Section 1.501(c)(19)-1(c). The organization is not required to include all of the listed purposes or activities in its organizing instrument. However, the organization cannot have purposes of a substantial nature that are not listed and retain exempt status under IRC 501(c)(19). The exempt purposes are:

- A. Promoting the social welfare of the community as defined in Treas. Regs. section 1.501(c)(4)-1(a)(2);
- B. Assisting disabled and needy war veterans and members of the U.S. Armed Forces and their dependents and the widows and orphans of deceased veterans;
- C. Providing entertainment, care, and assistance to hospitalized veterans or members of the U.S. Armed Forces;

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- D. Carrying on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors;
- E. Conducting programs for religious, charitable, scientific, literary, or educational purposes (as set out in IRC 170(c)(4));
- F. Sponsoring or participating in activities of a patriotic nature;
- G. Providing insurance benefits for their members or dependents of their members (or both); and
- H. Providing social and recreational activities for their members.

The primary activity of _____ is operating a bar and to serve the general public and the members. Per initial meeting with the _____ President, _____, she is certain that more than 80-90% of sales were from the general public.

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. 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 or not the organization is primarily engaged in section 501(c)(19) activities.

The level of activity with the general public engaged in by the organization overshadows the organization's exempt activities, particularly in view of the absence of adequate books and records pertaining to the year in question, which is required by sections 6001 and 6033 of the Code, Sections 1.6001-1 and 1.6033-2 of the regulations, and Rev. Rul. 59-95, 1959-1 C.B. 627.

Substantial unrelated activities may adversely effect exempt status. Such activities include:

- Renting out facilities to the general public;
- Opening bar and dining facilities to the general public;
- Selling liquor and/or food to members and/or the public for consumption off the premises;
- and
- Gaming activities with nonmembers.

During initial meeting with the _____, President, _____, stated that:
 the _____ facility is available for rent to general public,
 the _____ operating a bar and dining facility to the general public;
 the _____ sell liquor and food to members and general public for consumption on premises and can sell food and liquor to members and general public off premises
 the _____ operate gaming machines and poker games with nonmembers

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It is government's position that providing social and recreational activities to the public is not an exempt activity under IRC 501(c)(19). Although the _____ carries on veterans' programs and other benevolent, welfare, patriotic, and civic activities, it has been determined that the _____ business activities relating to the operation of commercial bar for the general public exceeds all other activities.

Government's Position 2:

According to the _____ Secretary of State Website, _____ was established in October of 19XX as a Non-Profit Corporation. _____, president for the examination year 20XX and 20XX is _____.

_____, President _____ purchased the bar from a previous _____ owner in 19XX. _____ purchased bar, inventories, and the building from prior bar owners. _____ is the legal owner of the bar real property and most of bar properties. _____ financed a personal loan with bank when she bought the business and the properties from prior owner.

Per review of the _____ expenses records, _____ personal loan repayments were paid by the _____. Bar's real and personal properties own by _____. In 20XX, the _____ paid mortgage interest of \$0 and auto expenses of \$0 on behalf of the _____ President _____. In 20XX, the _____ paid mortgage interest of \$0 and auto expenses of \$0 on behalf of the _____ President, _____. The auto expenses were base on estimated mileages incurred on _____ personal vehicle. It is clear the president of the _____ has inured the earning from the _____.

The Service does not have to establish that payments for goods or services are unreasonable or exceed fair market value to substantiate the existence of private benefit. In Hawaii v. Commissioner, 71 T.C. 1067 (1979), the Tax Court stated: Nor can we agree petitioner that the critical inquiry is whether the payments made to International were reasonable or excessive. Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner.

Taxpayer's Position 3:

The corporation was dissolved in 20XX

Government's Position 3:

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An organization must satisfy two requirements to be described in Section 501(c)(19) of the Code. First, the organization must satisfy a membership test, and second, its activities must further the purposes listed in Section 1.501(c)(19)-1(c) of the regulations. If the membership requirements are not satisfied, then the organization will not qualify for exemption under section 501(c)(19).

The membership test under section 501(c)(19) of the Code provides that an organization's membership must be composed of the following:

- A. 75% of the membership must consist of past or present members of the Armed Forces;
- B. Substantially all of its other members need to be individuals who are cadets or are spouses, widows, or widowers of past or present members of the United States Armed Forces or cadets. "Substantially all" has been defined to mean 90% of the remaining 25% of the membership. Therefore, 22.5% of the organization's membership can consist of cadets, spouses, widows and widowers of cadets or members of the Armed Forces; and
- C. The remaining 2.5% of the membership can be anyone.

Per initial meeting with the President, , the has about 0 members. The did not charge membership fee to any members. The general membership has little to do with the operations and financial matters. The general membership is not required to attend any membership meetings. officers were named by rather than voted for. has been the president of the since he bought the business from prior owner. For the years under examination, the provided ten copies of DD-214 and other alternative military forms. The is open to general public. The membership is not required to purchase food and drink from the for consumption on-site or off site. The does not have adequate records to represent membership sales. It is certain that over 80-90% of sales were from nonmembers.

Section 501(c)(19) of the Code does not define the meaning of member as being an individual who has the right to control the day-to-day operations of the organization, such as having the right to vote. Membership in a section 501(c)(19) organization is based upon analyzing the organization's organizing document, which defines the rights and obligations of membership.

In determining whether an individual is a member of a veterans' organization for purposes of section 501(c)(19) of the Code, such an individual must be involved in the organization in such a manner as to further the organization's exempt purposes, rather than joining to receive a personal benefit, such as the right to receive free food while being a patron at the bar.

Based on the facts available of this case, it appears that Membership are not bona fide members and should not be part of the membership calculation for purposes of section 501(c)(19) of the Code. The organization is run like a sole proprietorship bar and members do

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not have a say in its operations. Therefore, since the organization failed to provide adequate records to substantiate the bona fide members, therefore, failed to meet the membership test under 501(c)(19) because it has no bona fide members. See National Association of Life Underwriters, Inc. v. Commissioner, supra and Section 501(c)(19) of the Code.

Taxpayer's Position 4:

The corporation was dissolved in 20XX

Government's Position 4:

Unless specifically excepted under IRC 6033, every organization exempt from taxation under section 501(a) must file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and shall 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.

Regardless of the organization's requirement to file an information return, it is required to maintain adequate books and records to substantiate its claims regarding its level of income and the expenditures and to provide such additional information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status.

Under Section 1.6033-2(i)(2) of the Regulations, every organization exempt from tax, whether or not it is required to file an annual information return, shall submit additional information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status. During the examination, several requests for information were made, but failed to supply the requested information. The organization has clearly failed to provide the requested information despite adequate notice as required by Section 1.6033-2(i)(2) of the Regulations.

Revenue Ruling 59-95 states if an exempt organization fails to comply with the requirements of Section 6033 of the Code and its corresponding Regulations, the organization will no longer qualify for exempt status. As described in the previous paragraph, has not complied with Section 1.6033-2(i)(2) of the Regulations since no reply to information document requests have been received. Per Revenue Ruling 59-95, you do not qualify for exempt status under Section 501(c)(3) of the Code

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since your organization has failed to provide the required information as prescribed by Regulations of Section 6033 of the Code.

Generally, the income an organization receives from nonmembers for the purchase of goods or services or for the use of its facilities is considered unrelated business taxable income. For purposes of differentiating unrelated business income and income from exempt activities, an organization must maintain adequate records to distinguish between members and nonmembers who participate in its activities and to determine the amount of income received from each.

IRC 6001 and Treas. Regs. Section 1.6001-1(a) and (c) discuss recordkeeping requirements for exempt organizations. In addition, Publication 3386 provides recordkeeping requirements for Veterans' Organizations exempt under IRC 501(c)(19) and provides the following guidance in determining member and non-member participation:

- A. A guest, for IRC 501(c)(19) purposes, is an individual who is accompanied by a member who pays for goods or services provided to the guest without being reimbursed by the guest;
- B. A nonmember is a person from the general public, who pays the organization for recreational and social services provided;
- C. A paying nonmember is a purchaser of the goods or services provided by the organization and are a direct recipient of those goods or services from the organization. Such a nonmember is not considered to be entertained by a member even when accompanied by a member, but is instead considered to be a principal in a business transaction with the organization; and
- D. A "social member" is generally considered a member of the general public and a nonmember for IRC 501(c)(19) purposes unless the membership category is established in the bylaws and/or articles of incorporation. Such social members must be limited to no more than 2.5% of a veterans' organization total membership.

For the years under the examination, there was no permanent mechanism in place to maintain records to distinguish between income from bona fide members, members' families, bona fide guests, auxiliary members, and non-member's income, with respect to the organization's operation.

While the operation of a bar may further an exempt purpose under section 501(c)(19), such activities are not engaged in for the members' social and recreational benefit when the facility is open to the public. No accurate records were maintained indicating use by members and nonmembers. Based upon the available information, the operation of the bar is a public activity that primarily serves to non bona fide members and general public.

Based upon an analysis of the whole operation and in view of the unavailability of adequate records, we believe that the business activities relating to the operation of the bar, all of which were available to the public, predominate over the inadequately documented exempt activities.

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Based upon the information available, the organization has not met its burden of proof by furnishing sufficient records to show that it is not operating a business for profit by operating a bar open to the general public. Operation of an establishment open to the public neither accomplishes social welfare or any other section 501(c)(19) purposes. See Rev. Rul. 68-46 1968-1 C.B. 260, Rev. Rul. 61-158, 1961-2 C.B. 115, and Section 1.501(c)(19)-1(c) of the Regulations. These activities establish that the organization is not operated exclusively for exempt purposes under section 501(c)(19) of the Code.

When Congress enacted IRC 501(c)(19), which provides a specific exemption for veterans' organizations, social and recreational activities for the members was one of the purposes permitted. The only way a nonmember may gain admission to the bar or restaurant is if he or she is a bona fide guest of a member. Per the interview with the President, , the bar primarily serves to the general public (more than 80-90% sales were from nonmembers). The membership is not required to purchase food and drink from the bar. In addition, the did not keep the required records to delineate between member and non member income as required by Section 1.6001-(c) of the Regulations.

Since the has not complied with the record keeping requirement and the organization is open to the public, the burden of proof is on the to prove that a portion of its income wasn't from an unrelated trade or business. Unless additional records are submitted to substantiate the amount of non member income, it is presumed that 100% of the organization's income is considered from an unrelated trade or business and is subject to corporate tax under Section 11 of the Code.

Conclusions

1. During the examination process, the did not provide adequate information to show the devoted at least 50% of their time to activities in furtherance of the organization's exempt function. Based on the available information, it appears that the organization primarily operates a bar open to the public. Since operating a bar open to the public does not further Section 501(c)(19) purposes, it does not qualify for exemption under Section 501(c)(19) of the Code. Accordingly, the exempt status is revoked effective January 1, 20XX. Form 1120 returns should be filed for the tax periods ending on or after December 31, 20XX and beyond. Since the corporation was dissolved in tax year

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20XX, we will convert the 990 returns for tax years 20XX and 20XX to Form 1120. You are required to file 20XX Form 1120 for the remaining period from January 1, 20XX to June 30, 20XX.

2. Since net earnings of _____, inured to the benefit of the President, _____, exemption under IRC section 501(a) as an organization described in section 501(c)(19) should be revoked, effective January 1, 20XX.
3. During the examination process, it was shown that _____ did not have a Bona Fide membership. Therefore, it does not meet the membership test and/or qualify for exemption under Section 501(c)(19) of the Code. Accordingly, the organization's exempt status is revoked effective January 1, 20XX.
4. Since the _____ has failed to provide the required information that has been requested, concerning the organization's exempt status per Section 6033 of the Code, we have determined that the organization has failed to satisfy the conditions required for the continuation of its exempt status as required under section 6033 of the Internal Revenue Code and Revenue Ruling 59-95, Cumulative Bulletin 1959-1, page 627.

In this case, _____ was actively engaged in the operation of a bar, which was open to the general public. _____ bar was open 7 days a week, and the bar was operated by the organization in direct competition with similar non-exempt commercial enterprises. Thus, _____ bar activities constituted a regularly carried on trade or business. _____ has failed to demonstrate that its bar activities were conducted in a non-commercial manner or that the frequency of its operations were irregular compared with similar non-exempt enterprises. _____ did not maintain any records, which specify the amounts of income that the bar generated from members and non members, and it failed to provide any basis for determining how much of its income came from members and non members. Since no reasonable method exists for determining which part of the organization's bar income was derived from the general public as opposed to the organization's members, it is the government's position that all of the income that was generated by the bar including, but not limited, to the bar operations, vending machines, Keno and gaming activities should be treated as unrelated business income.

Since the organization's bar income that was derived from the general public is unrelated to the organization's exempt purposes, and the organization failed to maintain records that delineated between the income that it derived from members and non members, and because it was unable to establish which part of the income was related to and/or generated by members of the organization as opposed to nonmembers, such income should be considered to be unrelated trade or business income and it is therefore subject to income tax. No reasonable basis was provided to explain how such income was determined.

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Due to _____ not keeping proper records related to nonmember income and the _____ is open to the general public, the burden of proof to prove that the organization had member income is on the _____. Therefore, unless additional records are provided to prove the organizations member income, 100% of the bar income will be considered non member income subject to tax. 100% of the _____ income is considered from an unrelated trade or business and is subject to corporate tax under Section 11 of the Code.

If you accept our findings, please sign the enclosed Form 6018-A, Consent to Proposed Action-Non Declaratory Judgment. Please return it to the following address within 30 days of the date of this letter: