



# Exempt Organizations Technical Guide

## TG 8: Fraternal Beneficiary Societies and Domestic Fraternal Societies – IRC Section 501(c)(8) and IRC Section 501(c)(10)

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## I. Overview

- (1) This Technical Guide (TG) discusses the law, regulations, and federal income tax issues with respect to fraternal beneficiary societies described under Internal Revenue Code (IRC) Section 501(c)(8) and domestic fraternal societies under IRC Section 501(c)(10).

**Note:** This TG references General Counsel Memoranda (GCM). Although GCMs may not be used or cited as precedent, they do offer additional tax law analysis considerations when precedential guidance doesn't exist.

## A. Background / History

### A.1. Section 501(c)(8): Fraternal Beneficiary Societies

- (1) Fraternal societies have existed in the U.S. at least since the 19th century. They were first exempted from federal income taxation under section 38 of the Tariff Act of August 5, 1909, 36 Stat. 113 (1909). The Act exempted “fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, orders, or associations, and dependents of such members...” The language (that became the current Section 501(c)(8)) providing exemption for fraternal beneficiary societies has remained almost the same since the Act.
- (2) The Revenue Act of 1913, Pub. L. No. 63-6, Section II, G.(a), 38 Stat. 172, extended the exemption to organizations described under Section 501(c)(8) operating, “for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and providing for the payment of life, sick, accident, and other benefits to the members of such societies, order, or associations and dependents of such members...” The general purpose of the change was to allow a separately organized insurance branch of a fraternal society to qualify for exemption.
- (3) Some mutual insurance companies may claim to be fraternal beneficiary societies where state laws exempt fraternal societies from insurance regulations.
- (4) GCM 38192 (Dec. 7, 1979) discusses the historical development of personal insurance generally and indicates that the amount of life insurance written by fraternal societies grew rapidly during the 1880s and the 1890s. During this time, the amount of insurance written by fraternal societies exceeded the amount written by commercial insurers. The GCM further provides the intent of the exemption of fraternal beneficiary societies from federal income tax as follows:

Fraternal beneficiary societies were first exempted by section 38...of the Tariff, of 1909.... The 1939 Act provided, generally, for an excise tax of one percent on the net income over \$5,000 of, *inter alia*, all insurance companies, but excepted, *inter alia*,

'fraternal beneficiary societies, orders, or associations operating under the lodge system and providing for the payment of life, sick, accident and other benefits to the members of such organizations.' The intent of the exception was to exclude from the term 'all insurance companies' fraternal beneficiary societies not organized for profit that provided life, sick, accident and other benefits as 'a mere incident to the other part of their work, which is fraternal and charitable.' 44 Cong. Rec. 3937 (1909).

- (5) Nat'l Union v. Marlow, 74 F. 775 (8th Cir. 1896), described a situation in which the wife of George W. Marlow sued National Union to recover life insurance benefits following the suicide of her husband. National Union, whose geographic areas of operation included Missouri, contended that the suicide of the deceased constituted a full and complete defense to the suit. Missouri state law however, provided that "[i]n all suits upon policies of insurance on life hereafter issued by any company doing business in this state, it shall be no defense that the insured committed suicide." Nevertheless, National Union claimed that it was a "fraternal-beneficial society" rather than an insurance company and therefore wasn't subject to the insurance laws of the state.

The court provided:

We find nothing in the various sections of the Missouri statute...which justifies the conclusion that the lawmaker intended to create a class of corporations, termed 'fraternal-beneficial societies,' for the sole and only purpose of doing an insurance business...The statute...shows, as we think, very plainly, that a fraternal-beneficial society can only become a body politic and corporate by satisfying the court...that it is engaged in some work, or proposes to become so engaged, which is distinctively of a fraternal and beneficial nature.

The court concluded:

In view of the purposes of the order, as disclosed by its constitution and laws, it is obvious, we think, that [National Union] is not a fraternal-beneficial society...Or, in other words, when the defendant is stripped of all disguises, and judged by the standard of what it is engaged in doing, and what it was most likely organized to do, it is simply an insurance company which carries on an extensive business....

- (6) As demonstrated in National Union v. Marlow, some insurance companies may claim to be fraternal beneficiary societies where state laws exempt fraternal societies from insurance regulations.

## A.2. Section 501(c)(10): Domestic Fraternal Societies

- (1) Section 501(c)(10) was enacted by the Tax Reform Act of 1969, Pub. L. No. 91-172, section 121(b)(5)(A) (1969), 83 Stat. 487, 541. It added a route to exemption under 501(a) for fraternal societies that don't offer any insurance benefits to their members. Prior to this enactment, there was no exemption provided for fraternal societies operating under the lodge system that didn't, in addition to their fraternal activities, also provide for the payment of life, sick, accident, and other benefits to their members.
- (2) The Senate Committee on Finance explained the purpose of Section 501(c)(10) as follows:

[A] new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable, or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations.

See S. Rep. No. 552, 91st Cong., 1st Sess. 72 (1969).

## B. Relevant Terms

- (1) **Fraternal:** The term *fraternal* generally means having a common bond, a common tie, or a common goal. This term isn't defined in the Code or in the regulations. The term is generally used in the ordinary sense and according to its legal significance at the time the Tariff Act of 1909 was passed. See *Commercial Travelers' Life & Accident Association v. Rodway*, 235 F. 370 (N.D. Ohio 1913).
- (2) **Lodge system:** Treas. Reg. 1.501(c)(8)-1(a) provides that an organization is operating under the *lodge system* if it carries out its activities under a form of organization that comprises local branches called lodges, chapters, and other similar designations. The local branches must be chartered by a parent organization and be largely self-governing.
- (3) **Life, sick, accident, or other benefits:** Treas. Reg. 1.501(c)(8)-1(a) provides that in order to be exempt under Section 501(c)(8), it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits. However, these terms aren't clearly defined in the Code or in the regulations in the context of a fraternal beneficiary society described under Section 501(c)(8). In general, sick benefits are designed to compensate for loss of income during a period of illness. Accident benefits are designed to compensate for a loss of earning power resulting from an injury. *Other benefits* must be similar in nature to life, sick, and accident benefits and should be designed to compensate for expenses resulting

from injury or loss of earning power. See “Benefits Provided by Section 501(c)(8) Fraternal Organizations,” below for further discussion.

## C. Law / Authority

### C.1. Section 501(c)(8): Fraternal Beneficiary Societies

- (1) **Section 501(c)(8)**: Fraternal beneficiary societies, orders, or associations are exempt from federal income tax, if they are:
  - (A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and
  - (B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.
- (2) **Treas. Reg. 1.501(c)(8)-1(a)**: A fraternal beneficiary society is exempt from tax only if operated under the lodge system or for the exclusive benefit of the members so operating. Operating under the lodge system means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt, it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

### C.2. Section 501(c)(10): Domestic Fraternal Societies

- (1) **Section 501(c)(10)**: Domestic fraternal societies, orders, or associations, operating under the lodge system are exempt from federal income tax, if:
  - (A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and
  - (B) which do not provide for the payment of life, sick, accident, or other benefits.
- (2) **Treas. Reg. 1.501(c)(10)-1(a)**: For taxable years beginning after December 31, 1969, an organization qualifies for exemption under Section 501(c)(10) if it:
  - (1) Is a domestic fraternal beneficiary society order, or association, described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and
  - (2) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section.

## II. Exemption Issues

### A. Exemption Requirements Under Section 501(c)(8)

- (1) To be described in Section 501(c)(8), an organization must meet the following requirements:
  - a. it must have a fraternal purpose,
  - b. it must operate under the lodge system, and
  - c. it must provide for the payment of life, sick, accident, or other benefits.
- (2) An exception applies to separately organized insurance branches of fraternal societies. These need not operate under the lodge system but must provide permissible benefits exclusively to members of a lodge system.

#### A.1. Fraternal Purposes and Activities

- (1) The Code and the regulations don't define a *fraternal beneficiary society*. The court in *Nat'l Union v. Marlow* summed up the nature of a fraternal beneficiary society as follows:

[A] fraternal-beneficial society...would be one whose members have adopted the same, or a very similar, calling, avocation, or profession, or who are working in unison to accomplish some worthy object, and who for that reason have banded themselves together as an association or society to aid and assist one another, and to promote the common cause. The term 'fraternal' can properly be applied to such an association, for the reason that the pursuit of a common object, calling, or profession usually has a tendency to create a brotherly feeling among those who are thus... engaged. It is a well-known fact that there are at the present time many voluntary or incorporated societies which are made up exclusively of persons who are engaged in the same avocation. As a general rule such associations have been formed for the purpose of promoting the social, moral, and intellectual welfare of the members of such associations, and their families, as well as for advancing their interests in other ways and in other respects.... Many of these associations make a practice of assisting their sick and disabled members, and of extending substantial aid to the families of deceased members. Their work is at the same time of a beneficial and fraternal character, because they aim to improve the condition of a class of persons who are engaged in a common pursuit, and to unite them by a stronger bond of sympathy and interest.
- (2) A Section 501(c)(8) organization must have a fraternal element, sometimes referenced as a common bond in guidance and caselaw, among its members. The requirement of a fraternal element was set forth in *Appeal of Philadelphia & Reading Relief Ass'n*, 4 B.T.A. 713 (1926). The court held that the organization



of railroad company employees that made payments to members who became disabled because of accident or sickness wasn't entitled to exemption as a fraternal beneficiary association because it wasn't organized for any fraternal purpose. The court provided that there was no fraternal element present where the sole motive in joining an organization was to receive insurance benefits. The court stated:

In dealing with cases coming under section 231 of the Revenue Act of 1918, the character of the organization must be judged by its articles of incorporation, constitution, and by-laws, or by what other instrument it is governed.... Search the petitioner's governing regulations as we may...we are unable to discover, even in a remote degree, a single fraternalistic feature in its organization. It is entirely without any social features. Its membership is made up of individuals whose vocations are as [numerous] and diverse as the classifications of employment of a great railway system.... There is no fraternal object which moves them to seek membership in the Association, but rather the motive is mercenary. The petitioner has neither lodges, rituals, ceremonial, or regalia; and it owes no allegiance to any other authority or jurisdiction. It is not a 'fraternal beneficiary association' operating under the lodge system, within the meaning of section 231(3) of the Revenue Act of 1918, and, therefore, is not entitled to exemption under the provisions of that section.

- (3) Neither the Code nor the regulations under Section 501(c)(8) specify the kind of activities an organization must engage in to be operated under the lodge system, nor do they require a fraternal beneficial society to hold regular meetings in order to satisfy the requirements for tax exemption. The court in *W. Funeral Ben. Ass'n v. Hellmich*, 2 F.2d 367 (E.D. Mo. 1924), stated "the 'lodge system' is generally understood as an organization which holds regular meetings at a designated place, adopts a representative form of government, and performs its work according to ritual." Thus, an organization that provides insurance to members of 80 to 100 lodges or organizations isn't, for that reason, itself operated under the lodge system, though the organization may qualify for exemption under Section 501(c)(8) if it establishes it, in fact, is operated exclusively for the benefit of the members of fraternal societies themselves operating under the lodge system. See "Operate for the Exclusive Benefit of Members of a Fraternity Itself Operating Under the Lodge System" in this TG for more information.
- (4) A former regulation, Article 89 of Regulations 33, dealing with section 2 of the Income Tax Act of 1913, defining a fraternal beneficiary society as having "an adopted ritual or ceremonial, holding meetings at stated intervals," is no longer strictly in force. The conduct of regular localized meetings on an annual schedule or at more frequent periodic intervals, with or without the observance

of ritualistic ceremonies, is but one possible means of achieving the fraternal objectives of a membership organization. A fraternal beneficiary society's performance of civic, benevolent, or charitable functions may also serve to establish a fraternal purpose in lieu of regular meetings or rituals. Other kinds of fraternally-oriented functions, such as the conduct of civic, benevolent, or charitable functions, may be acceptable substitutes for local lodge meetings or the regular use of ritualistic ceremonies. However, an organization whose fraternal features are so insubstantial as to make it indistinguishable from an ordinary insurance company doesn't qualify for tax exemption under Section 501(c)(8). See GCM 34607 (Sept. 13, 1971).

- (5) While social activities often play a significant role in a fraternal society, the requirement of a common "calling, avocation, or profession," or "pursuit of a common object" as described above in Appeal of Philadelphia & Reading Relief Ass'n, isn't satisfied by the presence of social activities alone. The court, in *Polish Army Veterans Post 147 v. Comm'r*, 24 T.C. 891 (1955), vacated on other grounds sub nom. *Polish Army Veterans v. Comm'r*, 236 F.2d 509 (3d Cir. 1956), concluded that the organization didn't establish its exemption as a fraternal beneficiary society because its members lacked a common bond:

To qualify for the exemption an organization must be fraternal.... Here only the active members, comprising less than 10 percent of the total membership of the Post, had a common tie. They, of course had the bond of having formerly served in the Polish Army. But approximately 90 percent of the total membership of the Post were social members who were not ex-members of the Polish Armed Forces and who...had nothing in common with the active members or with each other. An organization cannot be classes [sic] as fraternal where the only common bond between the majority of the members is their membership in that organization.

- (6) A mere recitation of common bond in the governing instrument isn't enough; there must be a common bond in fact among the members. The court in *Fraternal Ord. of Civitans of Am. v. Comm'r*, 19 T.C. 240 (1952) stated:

The members of the [organization] had nothing in common, so far as this record shows, except that they were members of the [organization] and it is difficult to detect the fraternal bond required by the statute. It does not appear what, if anything, was ever done by the [organization] to accomplish any of the purposes set forth in its constitutions and by-laws.

- (7) In *Hip Sing Ass'n Inc. v. Comm'r*, 43 T.C.M. 1092 (T.C. 1982), the Tax Court found a common tie among members of an association based on their common ethnic background. It also found that members had a common goal to improve their social, moral, and intellectual welfare.

- (8) Likewise, persons who join together to promote a common interest, such as a particular method of fortune telling, can be said to have a common bond. Revenue Ruling 77-258, 1977-2 C.B. 195, describes an organization formed to provide a fraternal framework for social contact among its members who are interested in the use of and the philosophy behind a method used in fortune telling. In furtherance of its purpose, the organization conducts monthly meetings and provides instructions on the use of the method to its members. In addition, the organization provides instruction on the use of the method, maintains a reference library, and supplies information on the method to the general public. By carrying on the fraternal and educational activities, the organization is operating as a fraternal society. Accordingly, because the organization operates under the lodge system, doesn't provide for the payment of life, sick, accident, and other benefits, and devotes its income exclusively to educational and fraternal purposes, it is exempt from federal income tax under Section 501(c)(10).

## A.2. Operating Under the Lodge System

- (1) Treas. Reg. 1.501(c)(8)-1(a) provides that a fraternal beneficiary society is exempt from tax "only if operated under the lodge system or for the exclusive benefit of the members so operating. Operating under the lodge system means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like."
- (2) In addition to organizations operating under the lodge system, the Code provides exemption under Section 501(c)(8) for entities that "operate...for the exclusive benefit of members of a fraternity itself operating under the lodge system." See "Operate for the Exclusive Benefit of Members of a Fraternity Itself Operating Under the Lodge System" in this TG for further discussion.
- (3) The term *operating under the lodge system* implies, at a minimum, two active entities: a parent and a subordinate (referred to as a *lodge*). In general, an organization is operating under the lodge system when the parent and local organizations exist and are active. Additionally, there are no clear rules setting forth any minimum requirements regarding the regularity or frequency of membership meetings at the local level as long as the lodge system is effectively used as a means of maintaining a representative form of government. Furthermore, there are no specifications as to the kinds of activities an organization must engage in to be operated under the lodge system.
- (4) Rev. Rul. 55-495, 1955-2 C.B. 259, holds that an organization which doesn't have a parent organization or subordinate branches doesn't qualify for tax exemption under Section 501(c)(8) because it doesn't operate under the lodge system. In addition, Rev. Rul. 55-495 holds that such an organization may qualify for tax exemption as a social welfare organization under Section 501(c)(4). Rev. Rul. 75-199, 1975-1 C.B. 160, modified Rev. Rul. 55-495 to

remove from the conclusion that an otherwise fraternal organization not operating under the lodge system may qualify for tax exemption under Section 501(c)(4), however, it affirms the holding in Rev. Rul. 55-495 that such an organization is not tax-exempt under Section 501(c)(8).

- (5) Similarly, Rev. Rul. 63-190, 1963-2 C.B. 212, describes an organization (not operating under the lodge system), which maintains a social club for members and also provides sick and death benefits for members and their beneficiaries. Citing Treas. Reg. 1.501(c)(8)-1(a), Rev. Rul. 63-190 provides that *operating under the lodge system* means carrying on activities under a form of organization that comprises local branches chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. As the organization described in Rev. Rul. 63-190 doesn't operate under the lodge system, it doesn't qualify for tax exemption under Section 501(c)(8).
- (6) The court in *Fraternal Order of Civitans of America v. Commissioner* held that an organization, incorporated in 1937, whose members voted in 1946 to separate the "National Lodge" from the parent lodge and elected from their own membership national officers, wasn't *operating under the lodge system* prior to 1946 "in that the petitioner was the only organization of its kind in existence and the record does not show that there was any 'parent organization' separate from the petitioner." The organization failed to show that it was a fraternal beneficiary society operating under the lodge system under Section 501(c)(8).

**Note:** An organization may be exempt under Section 501(c)(8) even if it's not operated under the lodge system itself as long as it's operated for the exclusive benefit of the members of a Section 501(c)(8) organization that is so operated. See "Operate for the Exclusive Benefit of Members of a Fraternity Itself Operating Under the Lodge System" in this TG for further discussion.

- (7) Each lodge operating under the lodge system must be recognized as a subordinate by a parent. But that doesn't mean that a new lodge must be created by the parent. The court case, *Hip Sing Association, Inc. v. Commissioner*, illustrated that existing autonomous organizations can choose to operate under the lodge system by banding together and creating their own parent. The Tax Court in *Hip Sing Association, Inc. v. Commissioner* stated:

...[T]here is nothing explicit in either the statute or the language of this regulation which requires that the parent organization be created first and then for the parent to create the subordinate organizations. Logic would dictate that qualification under the statute should not be affected by whether the subordinate organizations form the national or the converse.... When the various local associations banded together formally to create a national organization, they created their own parent in the sense that a central organization must be considered to be in a position to support and give direction to its constituents. The regulation recognizes that, as here, the constituent organizations may be

'largely self-governing.' With the creation of the national or central Hip Sing entity, each of the then existing local associations, including petitioner, must be deemed to have been simultaneously "chartered by the parent they created." Certainly, they were the "charter members" of the national. We conclude, therefore, that petitioner is 'operating under the lodge system' within the meaning of the Code and the applicable regulations. In all respects during these years, it qualifies as a domestic fraternal association as described in section 501(c)(10), and it is, therefore, exempt from tax.

- (8) It is possible for existing lodges to create additional lodges. In Rev. Rul. 73-370, 1973-2 C.B. 184, a lodge of a fraternal beneficiary society forms a subordinate lodge to carry out the activities of the society within a particular geographic area. The parent authorizes the local lodges to create subordinate organizations to carry its fraternal and charitable activities into additional geographical areas to facilitate the growth of the society and to increase participation in its activities. The new organization operated under a charter from the local lodge, and its members must adhere to the rules and regulations of the local lodge and the laws and edicts of the parent. This ruling holds that the new organization functions as part of the lodge system of a fraternal society. Because its net earnings are devoted exclusively to charitable and fraternal purposes, and it doesn't provide for the payment of life, sick, accident, or other benefits to its members, it is exempt under Section 501(c)(10).

### **A.3. Benefits Provided by Section 501(c)(8) Fraternal Organizations**

- (1) To qualify for exemption under Section 501(c)(8), a fraternal beneficial society must provide for the payment of life, sick, accident, or other benefits. There are two issues that must be considered to determine if the benefits comply with exemption requirements under Section 501(c)(8):
- Whether most of the fraternal members are provided benefits
  - Whether the type of benefit is permissible
- (2) The first issue is whether most of the fraternal members are provided benefits. The issue of whether most of the fraternal members are provided benefits has two components.
- a. The first component focuses on the word *most* when considering whether most of the members are provided benefits. See Rev. Rul. 64-194, 1964-2 C.B. 149. The court case, *Polish Army Veterans Post 147 v. Comm'r*, 24 T.C. 891 (1955), vacated on other grounds sub nom., *Polish Army Veterans v. Comm'r*, 236 F.2d 509 (3d Cir. 1956), demonstrated this requirement by concluding that an organization didn't qualify as a fraternal organization where most of its members weren't entitled to receive any benefits. In this case, approximately 90% of the total membership was not entitled to receive benefits from the organization.

- b. However, *most* doesn't have to be *all*, as explained in Rev. Rul. 64-194. The ruling holds that exemption under Section 501(c)(8) isn't precluded where most of the members of the organization are eligible to receive the benefits provided by the organization.
- c. In Rev. Rul. 64-194, the organization had two classes of membership: beneficial and social. Beneficial membership was available only to a member who joined the organization prior to their 50th birthday and the member was then entitled to sick, accident, and death benefits. Social membership was available to a member who joined the organization on or after the member's 50th birthday. Social membership carried all club privileges, but did not confer any sick, accident, or death benefits. Substantially all of the members were beneficial members. The fund from which benefits were paid to beneficial members was contributed to solely by beneficial members and was kept separate from the general funds of the organization. Rev. Rul. 64-194 found that the age restriction on beneficial membership was a reasonable means to discourage membership by those interested more in obtaining benefits than in furthering the fraternal purposes of the organization.
- d. In addition, tax exemption won't be jeopardized where benefits to others outside the organization are incidental to the accomplishment of the society's exempt purpose. Rev. Rul. 78-87, 1978-1 C.B. 160, described an organization that participates in the reinsurance pool and makes the agreed payments into it for protection against excessive losses on major medical health and accident insurance. Although other insurers also participated in the pool and may have derived a similar benefit from it, the purpose of the fraternal beneficiary society was to promote its own financial stability by participating in spreading the risk of loss in this manner. It undertook participation, therefore, in the best interest of its members, and any benefit derived by other insurers from participation in the pooling arrangement was incidental to the accomplishment of the organization's exempt purpose and did not detract from the conclusion that it was operated for the exclusive benefit of its members. Therefore, the participation of the organization in a state-sponsored reinsurance pool furthered its exempt purposes and wouldn't cause the organization to lose its tax-exempt status under Section 501(c)(8).
- e. The second component of whether a substantial number of the fraternal members are provided benefits focuses on the word *provided*. As explained in Rev. Rul. 76-457, 1976-2 C.B. 155, the benefits must automatically accrue to the member as part of the dues paid. In Rev. Rul. 76-457, the organization was involved in an arrangement with independent insurers whereby members, on an individual application to the insurers and not automatically by virtue of membership in the organization, could obtain insurance at a reduced cost. The organization

didn't qualify for exemption under Section 501(c)(8) because it didn't provide an insurance benefit. Instead, members had the option to purchase insurance directly from an insurance company using their personal funds.

- (3) The second issue that must be considered to determine if the benefits comply with exemption requirements under Section 501(c)(8) is whether the type of benefit is permissible. Life, sick, and accident benefits are specifically enumerated in Section 501(c)(8). Rev. Rul. 86-75, 1986-1 C.B. 245, holds that whole life insurance constitutes a *life benefit* under Section 501(c)(8) even though the member may borrow against the cash surrender value of the contract or withdraw the cash surrender value and terminate the contract. Sick benefits are designed to compensate for loss of income during a period of illness, and accident benefits are designed to compensate for a loss of earning power resulting from an injury.
- (4) Section 501(c)(8) also lists *other benefits* as permissible benefits. GCM 38192 (Dec. 7, 1979) discussed the historical development of Section 501(c)(8) benefits and concluded that in order for a benefit to be included within the term *other benefits*, it must be similar in nature to protection designed to compensate for expenses resulting from injury or loss of earning power.
- (5) Rev. Rul. 84-48, 1984-1 C.B. 133, provides guidance explaining what *other benefits* means. It concludes that *other benefits* must be similar in nature to life, sick, and accident benefits and that they should be designed to compensate for expenses resulting from bodily injury or loss of earning power. In Rev. Rul. 84-48, the organization maintained a legal defense fund to defend members against criminal, civil, and administrative misconduct charges to protect against financial loss directly related the loss of earning power. As such, the legal defense fund benefit was considered *other benefits* within the meaning of Section 501(c)(8). The ruling states:

Historically, sick benefits have been understood to include benefits designed to compensate for loss of income during a period of illness, and accident benefits have been understood to encompass benefits payable due to a loss of earning power resulting from an injury.... For a benefit to be of a like kind and nature to sick or accident benefits and, therefore, to be included within the term 'other benefits' under section 501(c)(8) of the Code, the benefit must be similar in nature to protection designed to compensate for expenses resulting from bodily injury or loss of earning power.

Thus, payments from a legal defense fund maintained by a fraternal beneficiary society are *other benefits* if the payments protected against the risk of loss of earning power.

- (6) Rev. Rul. 84-49, 1984-1 C.B. 134, illustrates another example of *other benefits* providing financial security after loss of earning power. In the ruling, an

organization that operated an orphanage open to surviving dependent children of any deceased member was granted exemption under Section 501(c)(8). The expenses of the orphanages were paid from a separate fund supported by members' dues. The ruling notes that although it differs from life insurance benefits because it's a non-cash benefit, the organization's orphanage serves the same purpose that life insurance serves. Life insurance provides a measure of financial security to the insured's survivors if the insured dies. Similarly, the organization's orphanage provided its members' children security against becoming wards of the state if their parents died.

- (7) GCM 39575 (1986) indicates that an annuity is a permissible *other benefit* because it protects against a "risk of loss of earning power" affecting the financial stability of its members. In addition, an annuity may also be considered a *life benefit* to permit the provision of life insurance among the benefits provided by fraternal beneficiary societies. GCM 39575 states:

Life insurance protects against the absence of income in the event of premature death or disability, whereas the annuity protects (insures) against the absence of income on the part of those 'afflicted' with undue longevity. Both means dependable protection to two unfortunate groups, the one dying too soon and the other living too long. They are both insurance arrangements, the one pertaining to the years of ascendancy, and the other to the years of decline. When coupled together, the two forms of insurance complete the economic program from start to finish on a basis of financial dependability....

...It is our opinion that the risk of outliving one's savings is a 'risk of loss,' i.e. of outliving savings intended to provide financial security later in life by living longer than expected. This risk of loss involves the risk of loss of earning power, i.e., of one's livelihood intended to provide financial security during one's working life, that may occur as a result of the loss of employment as described in Rev. Rul. 84-48.... In this sense, an annuity is a permissible 'other benefit' within the meaning of section 501(c)(8).... Furthermore, based upon the technical explanation of annuities and their function within the realm of life insurance..., it appears that an annuity may also be considered a 'life benefit,' as that term is used within the meaning of section 501(c)(8), to permit the provision of life insurance among the benefits provided by fraternal beneficiary societies.

- (8) However, an organization may not qualify under Section 501(c)(8) if it doesn't provide traditional types of insurance benefits listed in Section 501(c)(8) in addition to providing annuities. See GCM 39575 (1986).
- (9) In *Grange Ins. Ass'n of Cal. v. Comm'r*, 317 F.2d 222 (9th Cir. 1963), the Ninth Circuit disagreed with the Tax Court's position that *accident insurance* refers



only to bodily injury to the person. Instead, the Ninth Circuit concluded that, “‘accident’ benefits include payment for damage to property quite as naturally as payment for injury to the person” and, therefore, “the statutory phrase ‘accident or other benefits’ is sufficiently broad to include payments for injuries to property as well as to the person.” In considering the purpose of the exemption, the Ninth Circuit stated, “the moving consideration was the character and purpose of the organization. Nowhere have we found any indication that Congress intended the exemption to depend upon the type of benefits paid.”

- (10) However, in footnote 1 to GCM 38192 (Dec. 7, 1979), Associate Chief Counsel indicated that “...the Service will not follow the decision in *Grange Insurance Assn. of California v. Commissioner*, 317 F.2d 222 (9<sup>th</sup> Cir. 1963),” and instead provided that *accident and other benefits* don’t include payments for injury to property. Life, sick, and accident benefits are payable with respect to an individual, while property insurance protects against property loss. The footnote in GCM 38192 states that “This division between ‘personal insurance’ and ‘property insurance’ is long recognized. See G.C.M. 35639, (January 28, 1974).” In GCM 35639, the Service showed an intent not to follow *Grange Ins. Ass’n of Cal. v. Comm’r* outside of the Ninth Circuit in its holding that property insurance benefits are “accident or other benefits.” GCM 35639 notes, “The term ‘accident or other benefits’ as used in section 501(c)(8) of the Code includes payments for injuries to a member’s person but not payments for loss or damage to a member’s property.”
- (11) The phrase “life, sick, accident, or other benefits” also appears in Section 501(c)(9) to describe permissible benefits provided by voluntary employees’ beneficiary associations. In GCM 35639, the Service decided that Section 501(c)(8) interpretations of the phrase “life, sick, accident, or other benefits” need not be construed consistently with Section 501(c)(9) interpretations. GCM 35639 notes that “Not only did the earliest predecessor of Code § 501(c)(8) antedate enactment of the predecessor of Code § 501(c)(9) by some 19 years, but...the history and development of the organizations covered by the respective sections is sufficiently different to justify different interpretations, particularly of the scope of the phrase ‘other benefits,’ under the two sections.” For instance, voluntary employees’ beneficiary associations, whose members are bound together by their common employment, have a relationship to labor organizations that few, if any, fraternal beneficiary societies share. Thus, interpretations of the statutory language for purposes of either Section aren’t required to be identical in all respects. Additionally, GCM 39212 (April 13, 1984), indicates that, “[d]espite the similar wording in both sections, it is not intended that the scope of section 501(c)(9), or section 1.501(c)(9)-3(d) defining ‘other benefits,’ control with respect to the same question under section 501(c)(8).”

#### A.4. Operate for the Exclusive Benefit of Members of a Fraternity

- (1) In addition to organizations operating under the lodge system (i.e., parents and their subordinate lodges), the Code provides exemption under Section 501(c)(8) for entities “operating...for the exclusive benefit of members of a fraternity itself operating under the lodge system, and...providing for the payment of life, sick, accident, or other benefits to the members of such society...or their dependents.” Such organizations are understood to be separately organized insurance branches of fraternal societies.
- (2) An organization may be exempt under Section 501(c)(8), even if it’s not operated under the lodge system itself, as long as it’s operated for the exclusive benefit of the members of a Section 501(c)(8) organization that is so operated. A separately organized insurance branch of a fraternal society need not benefit all the members of a lodge system. It may serve the members of a single lodge. Rev. Rul. 73-192, 1973-1 C.B.225, concerns an organization composed of members of a lodge of a fraternal beneficiary society operating under the lodge system. Its charter limits its membership to members of this lodge. Its sole purpose and activity are to provide for the payment of life, sick, and accident benefits exclusively for members of the lodge or their dependents. Thus, even though the organization doesn’t operate under the lodge system, it operates exclusively for the benefit of the members of a fraternal beneficiary society itself operating under the lodge system, and it provides life, sick, and accident benefits to the members of that society. Accordingly, the ruling holds that the organization is exempt under Section 501(c)(8).
- (3) The organization in *W. Funeral Ben. Ass’n v. Hellmich* asserted that it was carrying on its activities for the exclusive benefit of the members of many fraternities operating under the lodge system. However, the court held that the organization was not operating for the exclusive benefit of the members of a fraternity itself operating under the lodge system. The court stated:

...It seems to have been fairly well disclosed that plaintiff accepted business from organizations who chose to adopt its plan without any particular inquiry into the nature of the organizations or the manner in which they carried on their business. It is contended that the policy holders of plaintiff, who are not members of duly constituted lodges, are so insignificant that that fact ought not to affect the situation in view of the general nature of plaintiff’s business. This probably is true, but the plaintiff is claiming an exemption from taxation and in doing so asserts that it comes within the exemption clause of a certain statute. It does not seem to be asking too much of it that it fairly, if not strictly, bring itself within the terms of the statute. The rule by which we are to be governed, as above stated, required of the plaintiff a strict degree of proof in order to establish its exemption. It seems that it has not brought itself within the

statute even if we only require a reasonably and fairly exact degree of proof.

**Note:** The requirement that separately organized insurance branches operate exclusively for the benefit of members of a fraternity operating under the lodge system may be regarded as an exception to the “primary activities” test set forth in GCM 38312, (March 20, 1980). See “Fraternal Activities and Benefits Must be Primary” below for further discussion. Such insurance branches shouldn’t be authorized to provide benefits to persons that aren’t members of a fraternity operating under the lodge system. See GCM 35639.

## **A.5. Fraternal Activities and Benefits Must Be Primary**

- (1) A fraternal beneficiary society that is described in Section 501(c)(8) by virtue of engaging in fraternal activities and providing for the payment of life, sick, or accident benefits to its members may not then engage in unlimited non-fraternal activities or provide unlimited non-fraternal benefits and still maintain its exempt status. The non-fraternal activities and non-fraternal benefits of a fraternal beneficiary society will result in the organization’s loss of exempt status unless the organization remains primarily engaged in fraternal activities and its benefits are primarily fraternal benefits. Note that income from such non-fraternal activities and benefits may produce unrelated business taxable income. See “Unrelated Business Taxable Income and Social Activities” below. GCM 38312 indicates the following:

...A fraternal beneficiary society that is described in section 501(c)(8) by virtue of engaging in fraternal activities and providing death benefits may not then engage in unlimited non-fraternal activities or provide unlimited non-fraternal benefits and still maintain its exempt status. We conclude that the non-fraternal activities and non-fraternal benefits of a fraternal beneficiary society will result in the organization’s loss of exempt status unless the organization remains primarily engaged in fraternal activities and its benefits are primarily fraternal benefits...

...We believe that the exempt status of a fraternal beneficiary society that has fraternal features and provides a death benefit will be jeopardized if the organization engages primarily in non-fraternal activities and provides primarily benefits other than fraternal benefits....

...In G.C.M. 34985, we concluded that an organization may engage in some non-fraternal (in that case, political) activities without losing its exempt status. We declined to state exactly how much political activity a section 501(c)(8) fraternal beneficiary society may engage in without jeopardy to its exemption. We suggested that a fraternal beneficiary society could retain its exempt status ‘so long as it is primarily engaged

in fraternal activities....' We believe that such a standard is the correct one. Accordingly, we believe that so long as the Lodge's activities are primarily fraternal, it should not be denied exempt status under section 501(c)(8) on account of its non-fraternal activities.

With respect to the payment of non-fraternal benefits by the Lodge, we have never addressed the issue of whether an otherwise qualified organization that provides both fraternal benefits and benefits that are not fraternal benefits can qualify under section 501(c)(8).... We believe, however, that the standard suggested in G.C.M. 34985 with regard to activities is also an appropriate standard for benefits. Thus, we believe that a fraternal beneficiary society that provides both fraternal and non-fraternal benefits may retain its exempt status so long as its benefits are primarily fraternal benefits. We believe that applying the standard suggested in G.C.M. 34985 to both an organization's activities and to the benefits it provides its members will assure that the organization is one properly described in section 501(c)(8)....

- (2) Rev. Rul. 73-165, 1973-1 C.B. 224, discusses the necessary ratio of fraternal activity to beneficial activity required of a Section 501(c)(8) organization, and states that there is no requirement that either feature predominate so long as both are present. However, an association whose fraternal features are so insubstantial as to make it indistinguishable from an ordinary life insurance company doesn't qualify for exemption under Section 501(c)(8).
- (3) Political activity isn't considered a fraternal activity within the meaning of Section 501(c)(8). But engaging in political activity doesn't, in and of itself, give rise to revocation of exemption. Therefore, a fraternal beneficiary society, so long as it's primarily engaged in fraternal activities and the provision of benefits to its members and their dependents within the meaning of Section 501(c)(8), may engage in some political activities, including intervention in political campaigns on behalf of, or in opposition to, candidates for public office, without jeopardizing its exempt status. See GCM 34985 (Aug. 10, 1972). Nevertheless, the organization would be subject to tax on its political expenditures under Section 527(f).
- (4) Similarly, "union-like" activities that relate to the members' working conditions aren't fraternal activities. See GCM 38312.
- (5) *McGlotten v. Connally*, 338 F. Supp. 448 (D.D.C. 1972) involved a suit to enjoin the Secretary of Treasury from granting tax benefits to fraternal and nonprofit organizations which engaged in racially discriminatory membership practices. The District Court, among other things, concluded that exemption from income tax given to fraternal organizations, some of which exclude minorities from membership, was sufficient government involvement to invoke the Fifth

Amendment. The court stated that by providing differential treatment to only selected organizations, the government indicated approval of the organizations and hence their discriminatory practice and aided that discrimination by provision of federal tax benefits. The court further held that provision of a tax deduction for charitable contributions was a grant of federal financial assistance within the scope of the 1964 Civil Rights Act. Moreover, the court provided that exemption from income tax for fraternal orders, which shielded from taxation not only member-generated funds but passive investment income as well and which was available only to particular groups, operated in fact as a subsidy in favor of particular activities these groups were pursuing. As a result, the court determined this fell within the 1964 Civil Rights Act.

- (6) Footnote 7 to *Stearns v. Veterans of Foreign Wars*, 394 F. Supp. 138, 146 (D.D.C. 1975), *aff'd*, 527 F.2d 1387 (D.C. Cir. 1976) states, "Plaintiff relies on *McGlotten v. Connally*, 338 F.Supp. 448 (D.D.C.1972) (three-judge court). *McGlotten* is distinguishable because, *inter alia*, government involvement with racial discrimination, as alleged in *McGlotten*, has apparently been treated more strictly than other types of discriminations, see *McGlotten*, 338 F.Supp. at 459 n. 58; *Spark v. Catholic University of America*, 510 F.2d 1277 at 1282-1283 (D.C.Cir. 1975)."

## **B. Exemption Requirements Under Section 501(c)(10)**

- (1) Section 501(c)(10) was added to the Internal Revenue Code by the Tax Reform Act of 1969, Pub. L. No. 91-172, section 121(b)(5)(A) (1969), 83 Stat. 487, 541. Prior to that, there was no exemption provided for fraternal societies operating under the lodge system that didn't, in addition to their fraternal activities, also provide for the payment of life, sick, accident and other benefits to their members.
- (2) The Senate Committee on Finance explained the purpose of Section 501(c)(10) as follows:

[A] new category of exemption for fraternal beneficiary associations is set forth which applies to fraternal organizations operating under the lodge system where the fraternal activities are exclusively religious, charitable, or educational in nature and no insurance is provided for the members. The committee believes that it is appropriate to provide a separate exempt category for those fraternal beneficiary associations (such as the Masons) which do not provide insurance for their members. This more properly describes the different types of fraternal associations.

See S. Rep. 91-552, S. Rep. No. 552, 91st Cong., 1st Sess. (1969).

- (3) In its current form, Section 501(c)(10) describes domestic fraternal societies, orders, or associations that:
  - a. Operate under the lodge system;
  - b. Devote their net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes; and;
  - c. Do not provide for the payment of life, sick, accident, or other benefits.

### **C. Comparison Between Organizations Exempt Under Section 501(c)(10) and Section 501(c)(8)**

- (1) Like the organizations described in Section 501(c)(8), organizations described in Section 501(c)(10) are fraternal societies, orders, or associations operating under the lodge system. The terms *fraternal* and *operating under the lodge system* mean the same under Section 501(c)(10) as under Section 501(c)(8).
- (2) Unlike organizations exempt under Section 501(c)(8), organizations exempt under Section 501(c)(10) aren't "beneficiary" societies; that is, they may not provide for the payment of life, sick, accident, or other benefits to their members.
- (3) Any organization purporting to operate for the exclusive benefit of the members of a Section 501(c)(10) organization, but that doesn't itself conduct fraternal activities or operate under the lodge system, wouldn't qualify for exemption under Section 501(c)(10). The Code provides exemption under Section 501(c)(8) for entities "operating...for the exclusive benefit of members of a fraternity itself operating under the lodge system, and...providing for the payment of life, sick, accident, or other benefits to the members of such society...or their dependents." Such organizations are understood to be separately organized insurance branches of fraternal societies. Because Section 501(c)(10) organizations are prohibited from providing insurance benefits to their members, there's no counterpart under Section 501(c)(10) for the separately organized insurance branches found under Section 501(c)(8). Section 501(c)(10) itself, however, doesn't refer to organizations operated for the exclusive benefit of other Section 501(c)(10) organizations.
- (4) Rev. Rul. 81-117, 1981-1 C.B. 346, describes an organization operated for the purpose of holding real estate and other property of all kinds for the use and benefit of certain related fraternal societies. Each of the related societies is described in Section 501(c)(10) and has representation on the corporation's board of trustees. The organization's charter limits its membership to members of the related fraternal societies. The organization doesn't operate under the lodge system. The ruling provides an organization that doesn't conduct any fraternal activities or operate under the lodge system but does operate exclusively for the benefit of the members of certain related domestic fraternal societies themselves operating under the lodge system, doesn't qualify for exemption from federal income tax under Section 501(c)(10).

- (5) There are two additional requirements under Section 501(c)(10) not found under Section 501(c)(8):
  - a. First, a Section 501(c)(10) organization must be “domestic”; that is, it must be organized in the United States. See Section 7701(a)(4).
  - b. Second, the net earnings of a Section 501(c)(10) organization must be devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

#### **D. Comparison Between Organizations Exempt Under Section 501(c)(10) and Section 501(c)(7)**

- (1) Section 501(c)(7) describes clubs organized for pleasure, recreation, and other nonprofitable purposes. Such “social clubs” offer activities that are often similar to the social activities conducted by fraternal beneficiary organizations. Social clubs are distinguishable from Section 501(c)(10) organizations, however, because they generally aren’t operated under the lodge system. Treas. Reg. 1.501(c)(10)-1 specifically excludes social clubs from exemption under Section 501(c)(10).
- (2) Exemption under Section 501(c)(10) is considered more desirable than exemption under Section 501(c)(7). For one reason, a Section 501(c)(10) organization isn’t subject to the Section 501(c)(7) percentage limitations on nonmember income and investment income. Another reason is that a Section 501(c)(10) organization isn’t subject to Section 512(a)(3) which applies special rules on unrelated business taxable income for Section 501(c)(7) organizations.
- (3) Although college fraternities often are operated under a lodge system, they are specifically excluded by Treas. Reg. 1.501(c)(10)-1 from qualifying for exemption under Section 501(c)(10). In *Zeta Beta Tau Fraternity, Inc. v. Commissioner*, 87 T.C. 421 (1986), a Section 501(c)(7) local chapter of a national fraternity sought exemption from tax on its investment income by changing its classification to a fraternal society under Section 501(c)(10). The predominant purpose of Zeta Beta Tau and its local chapters was to provide housing, board, and social activities for its undergraduate student members. The court provided that the possibility of using tax-free investment income for recreational purposes would violate the congressional intention in framing Section 501(c)(10) and that the regulation was a reasonable interpretation of the statute. The court held that the organization, described under Section 501(c)(7), didn’t also qualify as a domestic fraternal organization under Section 501(c)(10). Therefore, the organization’s unrelated business taxable income included income from investments under Section 512(a)(3)(A). See also GCM 37179 (June 24, 1977) and GCM 39378 (June 26, 1985).



### III. Unrelated Business Taxable Income

- (1) Fraternal organizations have traditionally engaged in social and recreational activities in addition to their fraternal activities.
- (2) Organizations described in Section 501(c)(8) and Section 501(c)(10) are subject to tax on their unrelated business taxable income (UBTI) under Section 511.
  - a. Section 511 imposes a tax on unrelated business taxable income earned by organizations described in Section 501(c).
  - b. Section 512 defines ways that unrelated business income is computed and explains the exclusions and modifications that apply in determining correct unrelated business taxable income.
  - c. Section 513(a) provides for specific exclusions when a trade or business won't be considered an unrelated business activity. These exclusions are:
    - (1) a trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation;
    - (2) the trade or business is conducted primarily for the convenience of members;
    - (3) the trade or business involving selling merchandise, substantially all of which was received by the organization through gift or contribution.
  - d. Section 513(f) excepts certain bingo games from unrelated trade or business treatment so long as the games aren't carried out on a commercial basis and don't violate any state or local law.
- (3) Treas. Reg. 1.513-1(a) states that, unless one of the specific exceptions of Section 512 or 513 is applicable, gross income is includible in the computation of unrelated business taxable income if:
  - (1) the income is from a trade or business;
  - (2) such trade or business is regularly carried on; and
  - (3) the conduct of such trade or business isn't substantially related to the organization's performance of its exempt function.

#### A. Sale of Alcoholic Beverages

- (1) The operation of a bar, restaurant, or general meeting hall is an accepted social and recreational activity in which fraternal organizations may engage in. The sale of alcoholic beverages to members for consumption on the premises is considered to be related to the purposes of a fraternal organization. On the other hand, the sale of alcoholic beverages to members for consumption off the premises is generally considered to be unrelated trade or business activity within the meaning of Section 513. See TAM 8641001 (June 5, 1986).



## B. Participation of Nonmembers in Activities

- (1) A fraternal organization may provide social and recreational activities to its members. Guests of members may also participate in the organization's activities or make use of its facilities so long as the guest is being entertained by the member. However, a nonmember isn't being "entertained" merely because he or she accompanies a member.
- (2) When nonmember "guests" spend their own funds to participate in social and recreational activities operated by fraternal organizations, they aren't being entertained by the member. If a nonmember incurs a charge to participate in a social or recreational event or to make use of a social or recreational facility, the nonmember is considered to be entertained by a member only if the member pays the charge.
- (3) When a fraternal organization allows or solicits nonmembers to make use of its social and recreational facilities such as the operation of a bar and restaurant open to the general public on a regular and continuous basis and the nonmember pays for the costs of such recreation, the activity may result in unrelated business taxable income. Providing recreational activities such as the operation of a bar or restaurant to nonmembers directly where the nonmember pays for the cost of the recreation doesn't have a substantial causal relationship to the exempt purpose of providing social and recreational activities to members and may be considered unrelated trade or business if it's a business regularly carried on and no other exceptions to Sections 511 and 512 apply.

## C. Gambling Activities

- (1) Gambling, to the extent that fraternal members participate, is considered a traditional exempt function of fraternal organizations. Rev. Rul. 69-68, 1969-1 C.B. 153, holds that gambling open only to members and their guests (even if illegal) is a proper activity for social clubs exempt under Section 501(c)(7) because it supplies pleasure and recreation to members and guests, even if it has an additional purpose of raising money.
- (2) However, when a nonmember gambles with their own money, the fraternal organization is providing recreational activities directly to a nonmember rather than as a service to members. When a fraternal organization provides recreational activities, such as gambling, to nonmembers directly, those activities don't have a substantial causal relationship to the organization's exempt purpose of providing social and recreational activities to members. As a result, the activity may be considered unrelated trade or business if it's a business regularly carried on and no other exceptions to Sections 511 and 512 apply.
- (3) The Tax Court in *Waco Lodge No. 166, Benev. & Protective Ord. of Elks v. Comm'r*, 42 T.C.M. (CCH) 1202 (T.C. 1981), *aff'd*, 696 F.2d 372 (5th Cir. 1983), held that a Section 501(c)(8) organization's income from operation of a weekly bingo game constituted unrelated business taxable income under Section 511

and Section 513. The Service asserted that the gambling activities were open to the public. The Tax Court provided that the organization's bingo games were illegal in Texas at the time the organization conducted bingo nights because they fell within the definition of *lottery* as defined in 4 Tex. Penal Code Ann. tit. 10, sec. 47.01(6) (Vernon 1974). As the organization's bingo games were illegal under Texas law, the bingo games didn't meet the "bingo exception" from unrelated trade or business treatment under Section 513(f) and so, the bingo games weren't excluded from the Section 513(a) definition of unrelated trade or business. The Tax Court also concluded that the bingo games didn't meet the exception from the definition of *unrelated trade or business* under Section 513(a)(1) because substantially all of the work performed in carrying on the bingo games was compensated.

(4) GCM 39061 (Nov. 21, 1983) indicates the following:

... When guests spend their own funds to participate in gambling activities operated by these organizations, they are not being entertained by the members. A guest is only being entertained by a member at a social or recreational activity or facility of the organization for which there is a charge for such participation in the activity or use by the guest if the member pays that charge. When guests gamble with their own money, the organizations are providing recreational activities in the form of gambling directly to nonmembers rather than as a service to members. Providing recreational activities such as gambling to nonmembers directly rather than as a service to members does not have a substantial causal relationship to the exempt purpose of providing social and recreational activities to members and must as a result be considered unrelated trade or business, as long as it is a business regularly carried on and no other exceptions to sections 511 and 512 apply....

...Further, under the facts and circumstances of a particular case, a certain gambling activity may essentially be a predominantly public activity and only incidentally a member activity. For example, a veterans organization...has a punchboard in a public tavern and 80 percent of the receipts from the punchboard come from payments by nonmembers for gambling by nonmembers who are not even participating as guests of members but are simply members of the public. In that case, the entire activity including participation by members would be considered unrelated trade or business because the gambling is not being conducted primarily as recreation for members.

**Note:** GCM 39061 mentions that under certain facts and circumstances of a case, such as where 80% of the gaming receipts came from payments by nonmembers (who aren't guests of members), a gambling activity may be a predominantly public activity and only incidentally a member activity. In that

situation, the entire activity, including participation by members, is considered unrelated trade or business because the gambling isn't being conducted primarily as recreation for members. See also "Fraternal Activities and Benefits Must Be Primary" above for a discussion on the potential impact of non-fraternal activities on the tax-exempt status of a fraternal organization.

## D. Rents from Real Property

- (1) As a general rule, Section 512(b)(3)(A)(i) provides that all rents from real property are excluded from unrelated trade or business. For example, Rev. Rul. 69-178, 1969-1 C.B. 158, provides that income derived by an exempt organization for the occasional use of its meeting hall constitutes rents from real property within the meaning of Section 512(b)(3) and, therefore, the rents are excluded in determining unrelated business taxable income.
- (2) However, Section 514 expands unrelated business income to include *unrelated debt-financed income* from property in proportion to the debt acquired in purchasing it. Property purchased with borrowed money and held to produce income generally is called *debt-financed property*.
- (3) In general, due to the provisions of Section 512(b)(4), Section 514 taxes income that would otherwise be excluded from taxation under Sections 512(b)(1), (b)(2), (b)(3), and (b)(5) (for example, dividends, interest, royalties, rents, and certain gains or losses from the sale of property), but only if two conditions are met:
  - (1) the income arises from property that's acquired subject to a mortgage or other similar lien (unless an exception to treatment as acquisition indebtedness is met under Section 514(c)(2)(B)), and
  - (2) the production of income is unrelated to the purpose constituting the basis of the organization's tax exemption.
- (4) Based on Section 514(b), rent from property acquired with acquisition indebtedness as defined in Section 514(c) isn't subject to unrelated business income tax if substantially all of the use of the property is substantially related to the organization's exempt purposes.
- (5) Specifically, Treas. Reg. 1.514(b)-1(b)(1)(i) provides that to the extent that the use of any property is substantially related to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under Section 501, such property shall not be treated as *debt-financed property*.
- (6) Additionally, Treas. Reg. 1.514(b)-1(b)(1)(ii) provides that if substantially all of any property is used in a manner described in Treas. Reg. 1.514(b)-1(b)(1)(i), such property shall not be treated as *debt-financed property*. In general, the preceding sentence will apply if 85% or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is

used for a particular purpose will be determined on the basis of all the facts and circumstances. These may include (where appropriate):

- a. A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,
- b. A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or
- c. Both the comparisons described in (a) and (b).

## **D.1. Hall Rental and Catering**

- (1) Fraternal organizations commonly raise funds through hall rental and catering. Although hall rental income received by exempt organizations is generally excluded from unrelated business income tax by Section 512(b)(3), there are a few exceptions.

When rents are derived from unrelated debt-financed property, a portion of such rents, in an amount determined under Section 514(a), may be included under Section 512(b)(4) as an item of gross income derived from an unrelated trade or business.

In addition, payments for the use of rooms or other space are not rents from real property, when services are also rendered to the occupant if the services are primarily for the occupant's convenience and aren't usually rendered in connection with the rental of rooms for occupancy only.

- a. Treas. Reg. 1.512(b)-1(c)(5) states that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant doesn't constitute rents from real property. Generally, services are considered rendered to the occupant if they are primarily for their convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service, however, the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., aren't considered services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.
- b. Rev. Rul. 69-69, 1969-1 C.B. 159, describes an organization created for the stimulation and fostering of public interest in the fine arts by promoting art exhibits, sponsoring cultural events, conducting educational programs, and disseminating information relative to the fine arts. Its activities are carried on in a building that contains offices, galleries, music rooms, a library, a dining hall, and studio apartments where artists may live and work. The studio apartments are leased only to artists, a few of whom are members of the organization. However, the apartments aren't made

available to the tenants on the basis of membership in the club or any criteria that would further the exempt purpose of the organization. The organization provides maid and switchboard services for the tenants similar to those provided to the occupants of rooms in hotels.

Rev. Rul. 69-69 holds that neither the leasing of the studio apartments nor the operation of the dining hall by the organization has a substantial causal relationship to the achievement of its exempt purposes. Because substantial services are rendered to the tenants, the payments by the tenants are not *rents* within the meaning of Treas. Reg. 1.512(b)-1(c)(2). Thus, the leasing of the studio apartments and the operation of the dining hall are unrelated trades or businesses under Section 513, and the income from these activities is unrelated business taxable income under Section 512.

- c. Catering is a service primarily for the occupant's convenience and not usually rendered in connection with the rental of rooms for occupancy only and, thus, is generally considered to be an unrelated trade or business activity. However, the catering may be analyzed separately from the rental of space if there is a separate charge paid in accordance with a separate agreement between the parties. In addition, income from catering incidental to the hall rental would be taxable as unrelated trade or business income if substantially all the work in providing the catering services is performed by compensated individuals and the catering is regularly carried on. See TAM 9605001 (Oct. 9, 1995).

## IV. Deductibility of Contributions

- (1) Section 170(c)(4) provides that, in the case of a contribution or gift by any individual, the term *charitable contribution* includes a contribution or gift to or for the use of a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.
- (2) However, contributions for fraternal or social purposes are not deductible.

## V. Filing Requirements

### A. Annual Return or Notice

- (1) Organizations that are tax-exempt under Section 501(c)(8) or Section 501(c)(10) are generally required to electronically file an annual Form 990-series return or notice (that is, Form 990, Return of Organization Exempt From Income Tax; Form 990-EZ, Short Form Return of Organization Exempt From Income Tax; or 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or Form 990EZ) to report certain information required by Section 6033.

The organization's gross receipts and its total assets determine which Form 990-series return it must file. See IRS.gov page "Form 990 Series - Which Forms Do Exempt Organizations File - Filing Phase In" for a chart on gross receipts and asset levels.

In general, Section 6033(a)(1) requires organizations exempt from taxation under Section 501(a), which includes Section 501(c)(8) and Section 501(c)(10) organizations, to file an annual return. Section 6033(a)(1) provides that every organization (except for certain exceptions) exempt from tax under Section 501(a) will file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information.

- (2) In determining whether the gross receipts of an organization reached the threshold provided in Treas. Reg. 1.6033-2(g)(1)(iii) and Treas. Reg. 1.6033-2(g)(1)(viii), a local lodge may disregard insurance premiums received from members in certain instances. Rev. Rul. 73-364, 1973-2 C.B. 393, holds that the insurance premiums aren't gross receipts of the local lodge where the parent organization operates the insurance program, issues policies to the individual members, and is required to report the collection of these premiums. The local lodge merely collects the premiums and forwards the premiums to the parent, without asserting any right to use them or otherwise deriving benefit from their collection.
- (3) Organizations with group rulings must follow certain return filing procedures. For more information, visit IRS.gov page "Group Exemption Resources."

### **A.1. Automatic Revocation**

- (1) Section 6033(j)(1) provides for the automatic revocation of exemption of any organization that is required to file an annual return (Section 6033(a)(1)) or notice (Section 6033(i)), but which fails to file an annual return or notice for three consecutive years.

### **B. Unrelated Business Taxable Income**

- (1) Organizations with UBTI must electronically file Form 990-T, Exempt Organization Business Income Tax Return, and electronically pay any required periodic estimated tax payments.

### **C. Employment and Unemployment Tax**

- (1) Organizations with employees must file employment tax returns and unemployment tax returns and electronically pay any required periodic tax deposits. See Publication 15 (Circular E), Employer's Tax Guide, for more information.

## VI. Application for Recognition of Exemption

- (1) Organizations seeking recognition of tax exemption under Section 501(c)(8) and Section 501(c)(10) are required to electronically submit the Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521, including its Schedule E, with the correct user fee and all required supplemental documents through Pay.gov. See Rev. Proc. 2023-5, updated annually.
- (2) Proposed denials involving organizations seeking recognition of tax exemption under Section 501(c)(8) and Section 501(c)(10) may be appealed. Organizations described in Section 501(c)(8) and Section 501(c)(10) may also institute a declaratory judgment proceeding in court in response to a denial under the rules of Section 7428. See Sections 9 and 10 of Rev. Proc. 2023-5, updated annually, and Publication 892, How to Appeal an IRS Determination on Tax-Exempt Status.

## VII. Examination Techniques

- (1) The following sections provide examination techniques to assist in identifying and developing issues commonly encountered during the examination of a Section 501(c)(8) or Section 501(c)(10) organization. These guidelines aren't all-inclusive, and the intent isn't to restrict the examiner in identifying issues or using examination techniques not included herein.

### A. Operating Under the Lodge System

- (1) Review the parent organization's organizing documents to determine if it has rules governing subordinate lodges.
- (2) Inspect the subordinate lodge's charter to verify if it's a parent organization's subordinate lodge.
- (3) Review the minutes, correspondence files, and reports subordinate lodges submit to the parent organization to verify that an active parent and subordinate lodges exist.

**Note:** If the subordinate lodges aren't required to submit activity and financial reports to the parent organization, this may indicate the parent organization and subordinate lodges aren't operating under the lodge system. If the parent organization and the subordinate lodges aren't operated under the lodge system, neither the parent organization nor the subordinate lodges may continue to qualify for Section 501(c)(8) or Section 501(c)(10) exemption. Consideration of potential revocation may be appropriate in such instances.

### B. Membership and Fraternal Activities

- (1) Review the organizing documents of the parent organization and the subordinate lodge to identify the common fraternal bond.
- (2) Review membership records to determine whether the membership is primarily individuals sharing the common bond.



- (3) Analyze the membership records and the initiation and dues ledger accounts to determine if more than one class of members exists. If more than one class of members exists, identify the reasons for creating different classes, and determine if creating different classes is germane to the organization's exempt purposes.
- (4) Review the minutes, correspondence, newsletters, flyers, advertisements, activity calendars, reservation book, and house rules to identify the types and purposes of the organization's activities. If the activities are primarily non-fraternal in nature or there is no common bond among the members, the organization may no longer continue to qualify for exemption under Section 501(c)(8) or Section 501(c)(10). Consideration of potential revocation may be appropriate in such situations.

### **C. Payment of Benefits by Section 501(c)(8) Organizations**

- (1) Review the organizing documents, contracts, publications, and disbursement records to determine:
  - a. The type of benefits
  - b. Eligibility requirements for the benefits
  - c. If non-beneficial membership classes exist
  - d. The non-beneficial membership classes' purpose
  - e. The ratio of beneficial members to non-beneficial members
- (2) The organization must offer benefits that are permissible under Section 501(c)(8) to members. If benefits not similar to life, sick or accident benefits are offered, conduct in-depth research to determine the Service's current position on *other* benefits. If the number of non-beneficial members is large compared to the number of beneficial members such that most of the members aren't entitled to receive benefits, the organization may not be exempt under Section 501(c)(8). See *Polish Army Veterans Post 147 v. Comm'r*, 24 T.C. 891 (1955), vacated on other grounds sub nom. *Polish Army Veterans v. Comm'r*, 236 F.2d 509 (3d Cir. 1956), in which the Tax Court concluded that an organization didn't qualify for exemption under Section 501(c)(8) when approximately 90% of the total membership of the organization wasn't entitled to receive benefits from the organization.

### **D. Unrelated Business Income**

- (1) Review sources of income reported on income statements or accounts receivable files for sources of potential unrelated business income (UBI). Frequently, fraternal organizations have UBI from:
  - a. Bar and restaurant sales to the general public
  - b. Rental income from debt-financed real property rented to nonmember groups



- c. Income from the rental of real property where services are rendered for the occupants' convenience
  - d. Gaming activities open to the public
  - e. Advertising in its publications
- (2) If the unrelated business activities (those regularly carried on and no other exceptions to Sections 511 and 512 apply) are the fraternal organization's primary activities, revocation of tax-exempt status may be appropriate.
- (3) During the initial interview, in addition to asking general questions about the organization's sources of income and its books and records per IRM 4.75.11, On-Site Audit Guidelines, ask questions about:
- a. Renting the organization's facilities to nonmember groups
  - b. Using nonmember groups' facilities
  - c. Nonmembers participating in its social and gaming activities
  - d. Advertising in its publications
- (4) If the fraternal organization's restaurant, bar, or social activities are open to nonmembers, follow the Audit Technique Guide (ATG) or (if available) the TG covering social and recreational clubs under Section 501(c)(7) to determine nonmember use and acceptable methods for allocating expenses to the nonmember receipts.

**Note:** The ATG or (if available) the TG on social and recreational clubs under Section 501(c)(7) used for determining nonmember receipts of a Section 501(c)(7) social club, for the most part, can also be used to determine the nonmember receipts of fraternal organizations. However, keep in mind that fraternal organizations aren't subject to the record keeping requirements or percentage limitations of Rev. Proc. 71-17, 1971-1 C.B. 683 (as changed by Public Law 94-568 (S. Rep. No. 94-1318 2d Session, 1976-2 C.B. 597)).

## E. Employment Taxes and Information Returns

- (1) The most frequently encountered employment tax issues in a fraternal organization audit involve wages paid to members who offer services to the fraternal organization on a part-time, irregular basis. Some of the more common services are:
- a. Bartending
  - b. Maintenance
  - c. Bookkeeping
  - d. Facility improvements
  - e. Security

- (2) During the initial interview, ask:
  - a. Who provides the services necessary to operate and maintain the facilities? Address services such as managing the facilities, bartending, cooking and maintenance.
  - b. Who keeps the books and records?
  - c. Does the organization have live entertainment at its meetings and social functions? If so, have information returns, such as Forms 1099-MISC, been filed and furnished for payments in excess of \$600?
  - d. Does the organization pay cash or by check for the services?
  - e. If payments are in cash, how are they initially recorded?
  - f. If volunteers provide services, are they reimbursed for expenses incurred?
  - g. Are all payments for services properly reported on forms, such as:
    - Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return
    - Form 941, Employer's Quarterly Federal Tax Return
    - Form 944, Employer's Annual Federal Tax Return
    - Form W-2, Wage and Tax Statement
    - Form 1099-MISC, Miscellaneous Income?
- (3) Review the minutes, newsletters, flyers, advertisements, activity calendars, reservation books, and contracts. Pay attention to special events that require additional employees or independent contractors.
- (4) Review the disbursements records and accounts payable files for payments to individuals or for cash expenses.
- (5) For additional guidance, refer to IRM 4.23.4, Employment Tax - General Procedures and Workpapers, and IRM 4.23.8, Determining Employment Tax Liability.

## **F. Related Entities**

- (1) Subordinate lodges frequently have related entities such as:
  - a. Title Holding Companies
  - b. Auxiliaries, usually women's auxiliaries affiliated with a subordinate lodge
  - c. Corporations organized and operated to carry on the fraternal organization's social activities
- (2) During the initial contact with the fraternal organization, determine if any related entities exist. Determine the exempt status of the related entities.
  - a. Determine if the related entities must file information or tax returns independently.

- b. Inspect copies of any returns the related entities filed and determine whether they warrant examination. If the fraternal organization doesn't have copies of the related entity's return and the related entity is exempt, ask for a Return Integrity & Compliance Services (RICS) return for inspection.
- c. When inspecting a related Section 501(c)(2) or Section 501(c)(25) title-holding organization's return, be alert for social activities, food and beverage sales, and similar activities being conducted by the title-holding organization rather than the fraternal organization. If the title-holding organization carries on the fraternal activities and the fraternal organization doesn't, pick up the title-holding organization's returns for examination, and consider revocation.
- d. Most auxiliaries are separate entities exempt as organizations under Section 501(c)(8) or Section 501(c)(10). In this case, determine whether the auxiliary is fulfilling its filing requirements, and inspect its information return. Occasionally an auxiliary is:
  - Separately organized, but not exempt under Section 501(a) and not filing the required tax returns. In this case, secure the delinquent return.
  - Not separately organized and an integral part of the subordinate lodge, but its receipts aren't being included on the subordinate lodge's Form 990-series. In this case, include the books and records of the auxiliary in the subordinate lodge's examination.

## **G. Separate Segregated Funds for Charitable Purposes**

- (1) Section 170(c)(4) allows an individual to deduct a contribution or gift to a domestic fraternal organization if that contribution or gift is used for religious, charitable, scientific, literary, or educational purposes or for preventing cruelty to children or animals.
- (2) In the initial interview, ask if the organization has a separate charitable fund.
- (3) Review the organizational documents, minutes, correspondence, newsletters, flyers, and receipts records to determine if the organization receives contributions for charitable purposes. If the fraternal organization does receive charitable contributions, verify that the receipts are kept in a separate fund and disbursed only for religious, charitable, scientific, literary, or educational purposes, or for preventing cruelty to children or animals.

## VIII. References

### A. EO CPE Texts

- (1) 1980 EO CPE Topic H: Fraternal Beneficiary Societies and Fraternal Societies
- (2) 1990 EO CPE Topic H: Nonmember Income of Social, Fraternal, Veterans, and Social Welfare Organizations
- (3) 2004 EO CPE Topic F: IRC 501(c)(8) Fraternal Beneficiary Societies and IRC 501(c)(10) Domestic Fraternal Societies

**Note:** Although the precedent cited in these CPE texts was current at the time they were published, some of the references may now be outdated.