Audit Technique Guide – Fraternal Beneficiary Societies exempt under Sections IRC 501(c)(8) and 501(c)(10)

Introduction

This Audit Technique Guide contains audit guidelines for an exempt organization recognized as exempt from income tax under IRC Section 501(a) as an organization in IRC Section 501(c)(8) and Section 501(c)(10), referred to as an IRC Section 501(c)(8) and IRC Section 501(c)(10) organizations.

The guide offers audit techniques in identifying and developing issues commonly found during IRC Section 501(c)(8) and IRC Section 501(c)(10) organizations’ audits.

This guide doesn’t have technical information on IRC Section 501(c)(8) or Section 501(c)(10) organizations. Review the technical information in IRM 7.25.8, Fraternal Beneficiary Societies.

Background Information

An organization under IRC Section 501(c)(8) is:
- a fraternal beneficiary society, order or association operated under the lodge system or for the exclusive benefit of the members of a fraternal beneficiary society, order or association operating under the lodge system
- which pays life, sick, accident, or other benefits to the members of such society, order or association or their dependents.

An organization under IRC Section 501(c)(10) is:
- a domestic fraternal society, order, or association operating under the lodge system
- which doesn’t offer paying life, sick, accident, or other benefits, and
- devotes its net earnings to religious, charitable, scientific, literary, educational, and fraternal purposes.

Organizational Requirements

Exemption requirements under IRC Section 501(c)(8) and IRC Section 501(c)(10) are the same except for:
- IRC Section 501(c)(10) organizations can’t provide life, sick, accident or other benefits to members.
- IRC Section 501(c)(10) organizations must be a domestic organization. A domestic organization is a corporation, order, association or society organized and operated in the United States. This restriction isn’t imposed on an IRC Section 501(c)(8) organization.
- An organization which isn’t operated under the lodge system can qualify for exemption under IRC Section 501(c)(8), if it is operated for the exclusive benefit of other IRC Section 501(c)(8) organizations operated under the lodge system.
IRC Section 501(c)(10) organizations, unlike IRC Section 501(c)(8) organizations, must be operated for religious, charitable, scientific, literary, educational and fraternal purposes. These are generally the same purposes as those traditionally pursued by IRC Section 501(c)(8) fraternal beneficiary societies. Therefore, even though there is a difference in the wording of the statute, the audit guidelines for the purposes and activities of IRC Section 501(c)(8) and IRC Section 501(c)(10) organizations are combined in this guide.

Operating Under a Lodge System

IRC Section 501(c)(8) and IRC Section 501(c)(10) organizations must be operating under a lodge system. A lodge system includes self-governed local branches, chartered and generally supervised by a parent organization. Local branches may be lodges, councils, or chapters. In this guide, we refer to all local branches as subordinate lodges.

Both the parent and the subordinate lodges must be active.

Audit Guidelines – Operating Under a Lodge System

Review the parent organization’s organizing documents to determine if it has rules governing subordinate lodges.

Inspect the subordinate lodge’s charter to verify if it’s a parent organization’s subordinate lodge.

Review the minutes, correspondence files, and reports subordinate lodges submit to the parent organization or for an audit of a parent organization, reports it received from the subordinate lodges 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 qualifies for IRC Section 501(c)(8) or IRC Section 501(c)(10) exemption.

Membership and Fraternal Activities

A fraternal society’s membership requirements and activities are interrelated, so we address their audit guidelines at the same time.

The fraternal society’s members must have a common fraternal bond. For this type of bond, the members must have adopted the same or very similar calling, avocation, profession, or be working to accomplish some objective or common cause.
Audit Guidelines- Membership and Fraternal Activities

Review the organizing documents of the parent organization and the subordinate lodge to identify the common fraternal bond.

Review membership records to determine whether the membership is primarily individuals sharing the common bond.

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, show the reasons for creating different classes and determine if creating different classes is germane to the organization’s exempt purposes.

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 aren’t fraternal or directed toward a common objective or cause, the organization may not qualify for exemption under IRC Section 501(c)(8) or IRC Section 501(c)(10).

Note: Fraternal activities include social activities that tend to promote a brotherly feeling among those who are engaged. Promoting a brotherly feeling is a fraternal purpose. The difference between IRC Section 501(c)(8) organizations and IRC Section 501(c)(7) organizations is that the latter aren’t operated under a lodge system. An IRC Section 501(c)(8) organization may also conduct social activities but it must offer benefits to members which isn’t permissible under IRC Section 501(c)(7) or IRC Section 501(c)(10).

Payment of Benefits by IRC Section 501(c)(8) Organizations

An IRC Section 501(c)(8) fraternal organization must provide life, sick, accident, or other benefits to members or their dependents.

There is no requirement that the organization provide benefits to all members.

Audit Guidelines – Payment of Benefits by IRC Section 501(c)(8) Organizations

Review the organizing documents, contracts, publications, and disbursement records to determine:

- The type of benefits
- Eligibility requirements for the benefits,
- If non-beneficial membership classes exist
- The non-beneficial membership classes’ purpose
- The ratio of beneficial members to non-beneficial members

The organization may not offer all types of benefits to members. If benefits not similar to life, sick or accident benefits are offered, review IRM 7.25.8 and research in-depth to determine the IRS’s current position on “other” benefits. If the benefits involve insuring members against property loss, coordinate with Rulings and Agreements to develop the case.
If the number of non-beneficial members is large when compared to the beneficial members, the organization may not be exempt per IRC Section 501(c)(8). See *Polish Army Veterans Post 147 v. Commissioner* 24 T.C. 891 (1955) in which the court ruled that when only 10 percent of the members were qualified to receive benefits, it wasn’t enough to qualify the organization as a “beneficiary” society.

**Unrelated Business Income (UBI)**

Frequently, fraternal organizations have unrelated business income from:

- Bar and restaurant sales to the general public
- Rental income from debt financed property rented to non-member groups
- Income from the rental of its facilities which include services such as food and beverage sales
- Gaming activities open to the public
- Advertising in its publications

If the unrelated business activities are large, consider revoking the fraternal organization’s exempt status.

**Audit Guidelines – Unrelated Business Income (UBI)**

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:

- Renting the organization’s facilities to non-member groups
- Using non-member groups’ facilities
- A non-member participating in its social and gaming activities
- Advertising in its publications

If the fraternal organization conducts gaming activities, follow the audit guidelines in the Audit Technique Guide, Organizations Conducting Gaming Activities.

If the fraternal organization’s restaurant, bar or social activities are open to non-members, follow the audit guidelines in the Audit Technique Guide, *Social and Recreational Clubs – IRC Section 501(c)(7)*, to determine non-member use and acceptable methods for allocating expenses to the non-member receipts.

**Note:** You can use most of the audit techniques for determining non-member receipts of an IRC Section 501(c)(7) social club to determine the non-member receipts of fraternal organizations. However, 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 (Senate Report No. 94-1318 2d Session, 1976-2 C.B. 597).
Employment Taxes and Information Returns

The most frequently found 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:

- Bartending
- Maintenance
- Bookkeeping
- Facility improvements
- Security

Fraternal organizations frequently don’t offer Forms 1099-MISC to bands and other entertainers who perform at social events.

Audit Guidelines – Employment Taxes and Information Returns

During the initial interview, ask:

- Who provides the services necessary to operate and maintain the facilities? Address services such as managing the facilities, bartending, cooking and maintenance.
- Who keeps the books and records?
- Does the organization have live entertainment at its meetings and social functions?
- Does the organization pay cash or by check for the services?
- If the payments are in cash, how are they initially recorded?
- If volunteers provide the services, are they reimbursed for expenses incurred?
- Are the payments reported on Forms:
  - 940, Employer's Annual Federal Unemployment (FUTA) Tax Return;
  - 941, Employer's Quarterly Federal Tax Return;
  - W-2, Wage and Tax Statement; or
  - 1099 MISC, Miscellaneous Income?

Review the minutes, newsletters, flyers, advertisements, activity calendars, reservation books and contracts. Pay attention to special events needing additional employees or involving independent contractors.

Review the disbursements records for payments to individuals or for cash expenses.

For additional guidance, refer to IRM 4.23.4, Employment Tax, Workpapers - Employment Tax Examinations and IRM 4.23.8, Employment Tax, Determining Employment Tax Liability.

Related Entities

Subordinate lodges frequently have related entities such as:

- Title Holding Companies
- Auxiliaries, usually women’s auxiliaries affiliated with a subordinate lodge
• Corporations organized and operated to carry on the fraternal organization’s social activities

Audit Guidelines – Related Entities

• During the initial contact with the fraternal organization, determine if any related entities exist.
• Determine the exempt status of the related entities.
• Determine if the related entities must file information or tax returns.
• 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 RICS return for inspection.
• When inspecting a related title holding company’s return exempt under IRC Section 501(c)(2), be alert for social activities, food and beverage sales and similar activities being conducted by the title holding company rather than the fraternal organization. If the title holding company carries on these activities, pick up the returns for examination and consider revocation.
• Most women’s auxiliaries are separate entities exempt as organizations under IRC Section 501(c)(8) or IRC 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 IRC 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. In this case, include the books and records of the auxiliary in the subordinate lodge’s audit.

Separate Segregated Funds for Charitable Purposes

IRC Section 170(c)(4) lets an individual 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.

Audit Guidelines – Separate Segregated Funds for Charitable Purposes

In the initial interview, ask if the organization has a separate charitable fund.

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 charitable purposes.