

D. DETECTING FRAUD IN CHARITY GAMING

by

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Contrary to popular belief, bingo cannot be categorized as a low-stakes game played by middle-aged and elderly women. It is, rather, a billion-dollar industry whose popularity permeates all aspects of American society, and the abuses of which often go undetected or unremedied.

Despite bingo's popularity as a charity fundraiser and its reputation as a harmless pastime, it has been the object of abuse by a number of sources: Illegal parlors resort to tricks to circumvent the law or openly defy it. Racketeers are thought to control bingo games- legal and illegal- in a number of urban areas. Skimming and other scams are practiced by both organized groups and shady independent operators. Some bingo players have devised elaborate cheating schemes.

Gambling in America. Final Report of the Commission on the Review of the National Policy Toward Gambling. Washington: 1976; at pages 160 and 164. Although the report was written over 20 years ago, its observations and conclusions are still essentially valid, if not possibly even a bit understated in light of the recent growth of the gambling business in the United States.

1. Introduction

The subject of exempt organizations conducting gaming activities, ostensibly to raise funds for charitable uses, has been the focus of a significant amount of interest. The April 1992 Pennsylvania Crime Commission Report entitled, Racketeering and Organized Crime in the Bingo Industry, at page iv, explains why, in its view, bingo may attract a criminal element:

Promoters have infiltrated this industry and have very little to fear from law enforcement because of their low profile and because of the benign way in which society views Bingo. However, the significant amount of monies which these scams, frauds and diversions of revenue produce, represent a multi-million dollar loss to legitimate charities with very little risk of the perpetrators being prosecuted. In a very real sense, fraudulent charitable Bingo is the perfect white-collar crime.

The purpose of this article is to educate exempt organizations examiners about abuses that have been uncovered in some gaming programs and inform them of audit techniques to detect possible diversion of funds from the charity

by the professional operator. This article will also assist examiners in accomplishing the EP/EO Examination Quality Case Standard of adequately considering and developing issues of possible fraud when examining organizations conducting gaming activities. Lastly, this updates articles on gaming activities in the 1985, 1987, 1990, and 1996 CPE Texts.

2. Factor that Causes Embezzlement in Charity Gaming

A. Inadequate Oversight by the Charity

(1) General

Members of these organizations know little about how to operate a Bingo game. Therefore they rely on the operator at the facility. This reliance eventually becomes essential to the organization continuing their games at the facility. Within a short period of time the organization finds that it has, in effect, given the Bingo hall operator/facility the organization's license to operate their Bingo game.

We find that the organizations knowingly allowed nonbonafide members to manage the intimate details of their organization's Bingo financial affairs. We are convinced often times that these organizations merely "turned their head" and allowed non-bonafide members to take advantage of the organization's apparent good name and reputation because it was an easy way to make money without any responsible supervision whatsoever.

The charitable organization is given every opportunity to raise funds through Virginia and local statutes. Yet a low percentage of their actual gross income goes to the charity. One of the main reasons this happens is that the true charitable organization who entrusts its name to an operator is charged exorbitant expense to run their Bingo operation, and then the operator takes advantage of their position and actually steals from the charity.

Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va., on September 30, 1992, December 16, 1993, at Sections 4-4, 7-3, and 4-3.

(2) Discussion

An article in the Dayton Daily News dated April 26, 1992, discussed problems with professional bingo operators. The article was headlined "Big Bucks, Big Business. No One Really Knows Where the Bingo Cash Goes." An investigative reporter had interviewed several sources and the story was the same: people outside the charities are controlling this megabucks cash business.

In the article, one minister described signing management contracts with a professional operator. The professional operator ran the bingo game in exchange for a percentage of the gross receipts. Another minister said he allowed operators to obtain bingo licenses in his church's name in exchange for \$100 per week.

The following are examples of the typical relationship between the professional operator and the charity. With control over the bookkeeping, money-counting, record-keeping, and an assortment of other duties such as bank deposits and the hiring and firing of workers, the professional operator may create a situation conducive to the diversion of funds.

Pennsylvania Bingo Law requires that bona fide members of nonprofit associations operate bingo games. However, according to the April 1992 Pennsylvania Crime Commission Report entitled, Racketeering and Organized Crime in the Bingo Industry, at pages 6 and 34, the investigation revealed that after the legalization of bingo, professional operators ran bingo games on a commercial scale using charities as "fronts." In exchange the "sponsoring" charity received either a percentage of the profits or a flat fee. The promoter utilized an established formula when distributing the bingo proceeds to the charitable organizations. Regardless of how much money was taken in from the bingo games, the charitable organizations received a specific amount based on the formula. Officers of the charities that sponsor bingo games related that they trusted the individuals that ran the bingo games. No one from the charities ever challenged the operators regarding financial matters, primarily because bingo was their biggest source of revenue, and they could not afford losing these revenues. Testimony clearly demonstrated that the promoter controlled virtually every facet of the bingo operations.

Ohio Revised Code Chapter 2915 also requires that nonprofit associations be the operators of bingo games. However, an IRS Special Agent's affidavit filed on February 9, 1996 with the United States District Court for the Southern District of Ohio provides another example of problems when the promoter controls the entire operation. During the period 1988 through 1990, a promoter and his associates operated seven bingo halls in the Cincinnati and Dayton areas ostensibly for and on behalf of certain tax-exempt organizations. In addition to the bingo games, pull-tab tickets were available for sale at these halls. The associates of the promoter worked as office manager, floor manager, and floor workers at each hall. The promoter and these associates obtained the required pull-tab ticket supplies, sold the pull-tab tickets, and operated the bingo games at the halls. The office manager's duties at each hall were to count the nightly proceeds, to pay the workers, to remove the cash to be given to the promoter, and then report the remaining proceeds to the tax-exempt organizations. The currency given to the promoter from nightly pull-tab and bingo sales

was not reported on the nightly work papers given to the exempt organization. The promoter received approximately one-half of the proceeds from the nightly instant lottery ticket and bingo game sales from each of the seven halls.

Based upon the Special Agent's examination of the records and interviews of the promoter's associates, the above affidavit described that the operator skimmed approximately the following total amounts of cash from the proceeds for the seven bingo halls: \$1,546,346 for the year 1990; \$1,017,848 for the year 1989; and \$703,382 for the year 1988.

(3) Audit Procedures to Determine Adequate Oversight by the Charity

Conduct a detailed interview with the officers of the organization to determine its corporate structure and history. The interview should also discuss whether and, if so, how the Board monitors the bingo game to ensure that all funds are collected from the bingo operator and workers.

The examiner should determine if the bingo operation has a system of internal controls to safeguard adequately the revenue generated from the game. The internal control system should be structured so that various parts of the bingo activity are handled by different members of the charity, each of whom serves as a check on the others. The following is an example of various positions and responsibilities when an internal control system is functioning properly. This example is not a mandatory internal control system; it is merely illustrative.

1. The bingo operator has control over the execution of the game and records the transactions of the game on the daily sheet.
2. The cash controller independently counts the cash receipts and compares the cash on-hand to the inventory/paid out reports.
3. The inventory controller reviews the daily sheets received from the operator to determine the inventory usage and profit achieved.
4. The check writer is responsible for making all payments related to the bingo game and for ensuring that all deposits stated on the daily sheet actually appear on the bank statement.
5. The Board of Directors or Trustees reviews and compares the bingo reports or daily sheets with the previous reports for consistency. The board should monitor the bingo game to ensure the internal controls, as described above, are functioning properly.

3. Ways Funds are Embezzled in Charity Gaming

A. Pull-tab Embezzlement Schemes

(1) General

"Pull-tabs" are defined as the gaming pieces used in a game of chance which are made completely of paper or paper products with concealed numbers or symbols that must be exposed by the player to determine wins or losses.

Pull-tabs are known in various jurisdictions as charitable gaming tickets, break-opens, hard cards, banded tickets, jar tickets, pickle cards, Lucky Seven cards, Nevada Club tickets, instant bingo tickets, and other such names and include the tickets used with tip boards, seal cards and club special games. See North American Gaming Regulators Association, Standards on Pull-tabs, October 12, 1991, at page 1. See also Julius M. Israel Lodge of B'nai Brith No. 2113, 1995 RIA TCM 95,439 for distinction between bingo and "instant bingo" (pull-tabs).

At most bingo games, the majority of profits is generated through the sale of pull-tabs. There are approximately ten major manufacturers of pull-tab tickets in the United States. Each state has numerous suppliers who obtain the pull-tabs from the manufacturer and sell the tickets to the local charities conducting the gaming activity. Suppliers provide pull-tab tickets to the charities in the form of packaged boxes known as "deals." Each deal of pull-tabs sold by the charities to players is supposed to generate a specified net profit as indicated by the manufacturer. For example, charities may purchase a pull-tab game called "Form 860" or "C-Note." Each box contains 2400 tickets that sell for \$1.00 each. The box's winning tickets pay out a total of \$1,992. This results in a net proceeds of \$408 (2,400 tickets at \$1.00 less \$1,992) for each box of tickets sold.

(2) Discussion

Recent IRS examinations in the State of Ohio revealed skimming of the pull-tab receipts by the bingo operator. During the examinations, individuals have admitted during interviews with IRS agents to skimming cash from the nightly proceeds. In some instances, the amount skimmed was as much as \$250,000 annually on \$500,000 of profits. The IRS also found that some bingo game operators are buying their pull-tab supplies with cash. When this happens, the supply company does not provide an invoice to the charity, and the profits from the pull-tabs are easily skimmed by the operator.

The December 16, 1993 report entitled Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va. on September 30, 1992, at Section 6-5, documented similar pull-tab embezzlement schemes:

This investigation has also revealed that boxes of instant bingo [pull-tabs] can be purchased in cash either from local suppliers or from out of state suppliers where supply records would not necessarily document the purchase. The many boxes that are purchased in this manner can easily be sold at a bingo game where the entire profit of each box (anywhere from \$160 to \$650) could be skimmed or embezzled with absolutely no trace that the sale had occurred.

For the ten charitable organizations noted in the above report compiled by the Special Grand Jury in Henrico County, Virginia, nearly a million dollars was shown to be missing from the pull-tab operations. (The report does not specify the duration of time involved.)

(3) Audit Procedures for Examination of Pull-tab Operations

The examiner should review the inventory of pull-tab supplies by comparing boxes of pull-tabs in the inventory to the supplier invoices described in the books and records. Where an organization's records do not reflect all pull-tab purchases, secure information from pull-tab manufacturers and suppliers to aid in reconstructing purchases. State laws generally require manufacturers and suppliers to have internal control procedures that enable them to track pull-tab deals by serial number. For those pull-tab deals that are not reflected in the organization's supplier invoices, the examiner could contact the manufacturer to identify the supplier of pull-tabs purchased for cash by describing the serial number and form number of the applicable boxes. Once the supplier is identified, the agent should interview the supplier's salesperson to determine the frequency of currency purchases by the organization. This will help in verifying that the supplier provided copies of all the organization's pull-tab purchases when requested by the Service.

The examiner should analyze the pull-tab income to determine if there was any unreported profit. Gaming regulators have reconstructed pull-tab operations and determined that for every dollar spent on pull-tab supplies, between ten to thirteen dollars in pull-tab profits is generated. If the examiner determines that the pull-tab operation consistently reports ten dollars or less of pull-tab profits for every dollar spent on pull-tab supplies, the gaming operation may be consistently under-reporting profits from the pull-tab operation.

In cases where the examiner suspects that the organization is under-reporting pull-tab profits, he or she should consider completing the following analysis.

- Construct a schedule of the type of pull-tabs and the guaranteed profit for each deal purchased by the organization. Catalogues listing pull-tab profits for various deals may be obtained from suppliers.
- Compare the total amount of pull-tab profits for all deals purchased by the organization for the year to the pull-tab profits described per the general ledger.
- Reconcile and obtain detailed documentation for any differences.

B. Bingo Embezzlement Schemes

(1) General

"Bingo" means a game of chance played for prizes with cards containing five rows of five squares bearing numbers, except for the center square which is a free space. Traditional bingo also requires that the letters "B - I - N - G - O" appear in order over each column and that no more than 75 numbers may be used. The holder of a card ("player") covers such numbers when objects similarly numbered are randomly drawn. The game is won by the first person covering a previously designated arrangement of numbers on such cards. A game of bingo begins with the first number called and ends when an individual covers the previously designated arrangement, declares bingo and the winning card is verified. Beano as it is played in Massachusetts, is the same as bingo. See North American Gaming Regulators Association, Standards on Bingo, October 22, 1992, at page 2.

(2) Discussion

Skimming, the practice of underreporting income [receipts] from games and pocketing the difference, is thought to be the biggest problem regulatory agencies and law enforcement officials have with bingo. Skimmed money is tax free: Federal, State, and local governments do not receive their share of taxes from that income.

Most bingo scams are simple. Not all of the games are reported to the regulatory authority, and the bingo operator merely pockets the money from the unreported ones. Skimming is even easier if the floor workers are involved. For example, after a collector turns over the money picked up from the tables, the counter (who tabulates each game's income) records a figure lower than the amount collected and keeps the difference.

Gambling in America. Final Report of the Commission on the Review of the National Policy Toward Gambling. Washington: 1976; at page 160.

Illegitimately run bingo games derive much of their unreported income by underreporting the attendance and the number of bingo packages sold. An IRS Special Agent's affidavit filed on February 8, 1992 with the United States District Court of Western Kentucky provides an example of this type of bingo embezzlement scheme. The affidavit describes a professional operator who failed to report the actual number of players attending each bingo session on quarterly reports filed with the local authorities, sometimes reporting less than half the actual players. Former workers stated that the charity's bingo game averaged 650 players per session during the week, and 1,000 players per session on weekends. The records for the charity reflected an average of 350 players per session. If, for argument's sake, we assume in this case that the average spent for bingo packages by players attending the game was \$15, the professional operator had the opportunity to skim between \$4,500 to \$9,750 each night by underreporting the attendance.

According to the 1976 Commission on the Review of the National Policy Toward Gambling, "...to avoid paying out large jackpots advertised to lure players, some operators hire a player who works from a card recorded earlier with the announcer. The announcer calls the numbers from that card to insure that the "plant" wins the jackpot, which remains with the house."

The above IRS Special Agent's report also describes a variation on this scheme. As a promotion for a charity bingo operation, the promoter announced that the organization would give away a new pickup truck. On the night of the drawing, the promoter's neighbor won the truck. The winner later bragged that the truck game was fixed, that the promoter slipped him the winning key. The promoter retained actual possession of the truck. The phony winner received a kickback from the promoter.

(3) Audit Procedures for Examination of Bingo Operations

The examiner should review the information reported periodically on the application for a gaming license filed with the gaming regulators. The amounts reported from the game under examination should be compared with games similar in size within its respective county. If the game under examination reports significantly less revenue and a smaller profit margin when compared to similar operations in its locality, that could indicate "skimming" or private purposes being served. Information on gaming regulators may be obtained from

the EO Gaming Focus Group or the North American Gaming Regulators Association, which were discussed in the 1996 CPE text, at page 92.

With approval from his or her supervisor, the agent can gain much insight into the gaming activity by monitoring the bingo game while it is in operation. The examiner should determine the type of packages and or specials purchased by the bingo players at the beginning of a bingo occasion. The cash received at the door from the bingo players should be compared to the door receipts reported previously by the bingo operation. While the on site observation does not establish or disprove the accuracy of reported receipts, it may help the examiner determine the appropriate scope of the audit.

The examiner should reconcile the bingo operations' gross receipts reported on the Form 990 to the gross receipts reported on the summary of the daily bingo sheets. Trace the gross income from the bingo occasions to the bank deposit slip for each occasion. The bingo operation should be closely scrutinized if currency deposits are not made soon after each bingo occasion.

Lastly, the examiner should analyze the gross receipts from the bingo occasion to determine the potential for unreported revenue. The daily sheet for each bingo occasion usually reflects the bingo gross receipts from package sales, prizes paid, and the number of players in attendance. The average spent per player is computed by dividing the bingo gross receipts by the number of players in attendance. The average spent per player should be compared to the prices for bingo packages sold during the bingo occasion.

4. Additional Ways Funds are Diverted in Charity Gaming

A. Diverting Charity Gaming Profits by Use of Management, Supply & Real Estate Companies

(1) General

According to the April 1992 Pennsylvania Crime Commission Report entitled Racketeering and Organized Crime in the Bingo Industry, at pages 7 and 16, gaming operations employed related management, supply, and real estate companies to oversee and run the bingo games. These companies were determined to receive unreasonable compensation for their services rendered:

Organized crime obtained an interest in the bingo operations through the use of management companies which are employed by the charity or Indian tribes to oversee and run the bingo games. These management companies control the entire bingo operation,

including record-keeping and accounting. Once organized crime controls the bingo operation, they siphon the proceeds using several methods, such as skimming the profits before they are dispersed (sic) to the charity or Indian tribes and rigging the jackpot games.

Organized crime also receives the profits from bingo halls through the use of companies which provide supplies and equipment to the halls. By requiring bingo operations to purchase supplies from their businesses, organized crime can charge inflated prices for merchandise or equipment. The halls can also be billed for non-existent supplies.

A sub-lease is also utilized as a means of diverting money from a charity. The commercial operators become the landlords to the charities, and siphon off the profits of the bingo game from the charitable associations. Rents charged for the halls are in excess of the fair market value of the properties, thus obtaining for themselves the great bulk of the profits of the bingo games from the charitable associations and giving the landlord corporations a direct pecuniary interest in the profitability of the Bingo games.

The December 16, 1993 report entitled Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va. on September 30, 1992, at Section 10-1, also provided an example of sub-leases and unreasonable compensation:

Our investigation reveals that the same practice is prevalent in Henrico County. Four Bingo permittees sponsored eight games per week for years prior to October, 1992, resulting in a weekly rental from Bingo alone of \$8,200.00, and an annual rent of \$426,400.00. Given the current assessed value of the property is \$490,700.00, the question arises whether the rental charged was in excess of a fair market rental for the property.

(2) Audit Procedures for Reviewing Management, Real Estate, & Supply Companies

Bingo and pull-tab operations may consist of more than one established legal entity. Related entities should be identified as early as possible in the examination. The examiner should ascertain that any management, real estate, supply, or equipment companies are receiving reasonable and true compensation as would ordinarily be paid for like services by like enterprises under like circumstances, as described in Reg. 1.162-7(b)(3).

The examiner should review any management, supply, or rental agreements from the bingo operation. He or she should closely scrutinize any of the above agreements where the charity pays for its management, rental, supplies, or equipment based on its gross sales or net profits from the bingo or pull-tab operation.

The following factors in a management or operating agreement may indicate private benefit or inurement:

1. The contract is lengthy in duration.
2. The contract provides severe penalties if the exempt organization terminates the agreement.
3. The gaming operator was not selected through open bidding, or the organization lacks documentation to support such a claim.

B. Diverting Charity Gaming Profits by Use of Grantee Agreements or by Creating Fraudulent Charities

(1) General

For charitable organizations whose primary purpose is to raise funds from the operation of bingo and pay the proceeds to other charities, the examiner should review any large grants or contributions to other charities. The grantee may be required to make kickbacks to the for-profit fund-raising companies owned and operated by persons who are related to officers of the grantor. Contributions may also be linked to the grantee's participation in supply or service agreements with the grantor officer's for-profit companies. (For the effects of the "feeder organization" provision, section 502 of the Internal Revenue Code, see 1983 CPE at page 83.)

For example, in one recent examination, the bingo operator offered an educational organization a million dollar grant. The educational organization was instructed that it would receive only 50% of the funds, and the remaining funds were to be distributed back to the bingo operator in monthly installments.

(2) Discussion

Recent IRS examinations revealed that some organizations obtaining gaming permits were nothing more than a subterfuge to support the personal living expenses of the family members that controlled the charity. A review of

the general fund of these charities revealed the following transactions that indicated inurement or private benefit:

1. Salaries and loans provided to family members with no substantiation of services being performed.
2. The purchase of vehicles and boats for officers with no substantiation of business purposes.
3. Equipment purchases for a sole proprietorship operated by family members.

(3) Audit Procedures

Review in detail the transactions within the general fund of the charity for expenditures that indicate inurement or private benefit. A discussion of inurement or private benefit for organizations conducting gaming activities is provided in the 1996 CPE text, at page 101.

Determine if the section 501(c)(3) organization operating gaming activities conducts a charitable program commensurate in scope with its financial resources. The charity may fail to operate a real and substantial charitable program. See the discussion in the 1996 CPE text, at page 100.

Review minutes of meetings of the governing board, committees and other groups to determine whether the officers of the charity approved the grant. Grants should be closely scrutinized if large contributions are not approved by officers of the charity and do not appear to further the charity's mission statement.

Compare the date the grants are made by the grantor and the date of any management and supply agreements signed by the grantee. This may provide evidence that the contributions may be linked to the grantee's participation in supply or service agreements with the grantor officer's related companies.

C. Diverting Charity Gaming Profits by Payment of Money to Volunteer Bingo Workers

(1) General

In many states allowing gaming activities, the bingo workers must volunteer their services. The worker may not be paid, or compensated in any manner, directly or indirectly. Recent IRS examinations have revealed that although

persons working the bingo game were referred to as "volunteers," they were actually paid for their work and were legally employees of the bingo operator.

(2) Discussion

The IRS Special Agent's affidavit filed on February 9, 1996 with the United States District Court for the Southern District of Ohio described an example of the diversion of bingo receipts to pay bingo workers in violation of State law. As previously noted, one of the office manager's duties at each hall was to pay the workers with the funds skimmed from the bingo receipts. See Section 2A(2) of this article.

The December 16, 1993 report entitled Special Grand Jury Impaneled to Investigate Bingo Operations in Henrico County, Va. on September 30, 1992, at Section 6-8, also provided an example of payment of money to "volunteer" bingo workers:

Clear evidence and testimony has revealed that the "volunteer" workers are paid \$30.00 per Bingo event "under the table." Bingo members and family members of the landlord have been paid \$40.00 to \$50.00 per Bingo event. Payment is usually put under an ashtray or under a cigar box close to the caller's stand and available for the workers to pickup at intermission. Also, sometimes "volunteers" have been paid by not returning their "\$30.00 bank" handed to each floor worker at the beginning of the games which they use to make change for sales on the floor. These payments mean that the charity organization is duped out of anywhere from \$120.00 to \$160.00 per bingo event.

(3) Audit Procedures

Talk to current and, if possible, former workers. If the organization will not divulge the names of former workers, consideration should be given to issuing a summons for such information. Regarding summons procedures, see IRM 7(10)22.2(1).

The payment of workers in violation of State law may cause exemption or unrelated business income tax issues, excise and employment tax issues. The effect of illegal gaming activities on exempt status is discussed in the 1996 CPE text, at page 99. The unrelated business income tax issues for gaming activities are also discussed in the 1996 CPE text, at page 93. Lastly, Federal excise taxes on wagering are discussed in the 1996 CPE text, at page 105 and Topic E, Excise Tax and Occupational Tax on Wagering, of this text.

5. Conclusion

Since the federal and state governments have cut back on the amount of money they contribute to charitable programs, some organizations have focused more intensely on fundraising options such as charity gaming. Proper control of the bingo games by the officers of the charitable organizations is essential if the charities are to realize their appropriate profit. The officers of the charity should monitor their games as closely as possible to keep instances of embezzlement to a minimum. Instead of just assuming that the volunteers are doing an adequate job, the officers should determine how much money is being realized from the gaming activity. A detailed system of internal controls should be established to safeguard the revenues from the games. Charities and purported charities that lend their names indiscriminately to unscrupulous bingo operators usually have little or no control over their own bingo operations, and may be mere fronts (witting or unwitting) for tax dodges, criminal activities, and scams.