



DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

Attn: Mandatory Review, MC 4920 DAL  
1100 Commerce Street  
Dallas, TX 75242

501.19-00

**Date: 4/30/2010**

Release Number: 201037035

Release Date: 9/17/10

LEGEND

ORG = Organization name      XX = Date      Address = address

ORG  
ADDRESS

**Person to Contact/ID Number:**  
**Contact Numbers:**  
**Voice:**  
**Fax:**

**CERTIFIED MAIL – RETURN RECEIPT REQUESTED**

Dear

In a determination letter dated November 19XX, you were held to be exempt from Federal income tax under section 501(c)(19) of the Internal Revenue Code.

Based on recent information received, we have determined you have not operated in accordance with the provisions of section 501(c)(19) of the Code. Accordingly, your exemption from Federal income tax is revoked effective January 1, 20XX. This is a final adverse determination letter with regard to your status under section 501(c)(19) of the code.

We previously provided you a report of examination explaining why we believe revocation of your exempt status is necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights.

You are therefore required to file Form 1120, *U.S. Corporation Income Tax Return*, for the years ended December 31, 20XX and 20XX with the Ogden Service Center. For future periods, you are required to file Form 1120 with the appropriate service center indicated in the instructions for the return.

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

If you have any questions, please contact the person whose name and telephone number are shown at the beginning of this letter.

Sincerely,

Nanette M. Downing  
Director, EO Examinations



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service  
TEGE EO Examinations  
3730 South Elizabeth Street  
Independence, MO 64057

January 6, 2010

ORG  
ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear

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

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

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

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

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

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

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

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

Thank you for your cooperation.

Sincerely,

Nanette M. Downing  
Acting Director, EO Examinations

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

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

**LEGEND**

ORG = Organization name      XX = Date      Address = address      City = city  
 State = state      BM-1, BM-2 & BM-3 = 1<sup>ST</sup>, 2<sup>ND</sup> & 3<sup>RD</sup> BM      RA-1, RA-2, RA-3 &  
 RA-4 = 1<sup>ST</sup>, 2<sup>ND</sup>, 3<sup>RD</sup> & 4<sup>TH</sup> RA      CO-1, CO-2, CO-3, CO-4, CO-5 & CO-6 = 1<sup>ST</sup>, 2<sup>ND</sup>,  
 3<sup>RD</sup>, 4<sup>TH</sup>, 5<sup>TH</sup> & 6<sup>TH</sup> COMPANIES

**Issue:**

- (1) Whether ORG, doing business as “ORG”, has failed the IRC 501(c)(19)(B) requirements to have “at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, widowers, ancestors or lineal descendants of past or present member of the Armed Forces.” If so, should ORG’s exemption under IRC section 501(a), as a organization described in section 501(c)(19) be revoked, effective January 1, 20XX.
- (2) Whether the primary activity of ORG, doing business as “ORG”, is the operation of a commercial bar open to the general public. If so, should CO-1 exemption under IRC section 501(a) as a organization described in section 501(c)(19) should be revoked, effective January 1, 20XX.
- (3) Whether ORG, doing business as “ORG”, records are inadequate under Section 6033. If so, should ORG’s exemption under IRC Section 501(a), as an organization described in Section 501(c)(19) be revoked, effective January 1, 20XX?

**Facts for issues 1, 2, and 3:**

According to the State of State’s Secretary of State, ORG, doing business as “ORG” was incorporated February 4<sup>th</sup>, 20XX by BM-1. On July 5<sup>th</sup>, 20XX, the annual report filed with the State of State shows BM-1 as the Chairman and Secretary, and the Board of Director members being BM-1, BM-2 and BM-3. The 20XX annual report filed with the State of State shows BM-1 as the owner. See attachment one for the state filings.

The rest of the informational attachments were provided, and sent, in the revocation letter dated August 6<sup>th</sup>, 20XX and are included in the body of these facts as they were presented in the original revocation letter of that date. The Attachment One of that revocation letter shows that BM-1 is the 100% owner of ORG.

A review of the Form 990 for the years ended December 31, 20XX and 20XX shows that the returns do not have a year beginning date on the Form 990s. The organization operates using the cash method. Under program service accomplishments for 20XX there are three exempt purpose achievements: (1) Gathering together fraternally of veterans and families, (2) Participating in things of a platonic nature and (3) Helping needy veterans families. For 20XX, the total reported sales were \$ with a reported cost of goods sold being \$. Total reported revenue reported is \$ and

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total reported expenses of \$. The Form 990 for the year ended December 31, 20XX was signed by BM-1 on May 8, 20XX.

The Form 990 for the year ended December 31, 20XX had the same three exempt purpose achievements as was stated on the Form 990 for the year ended December 31, 20XX. The total reported sales were \$ with a reported cost of goods sold being \$. Total revenue reported is \$ and total reported expenses of \$. The Form 990 for the year ended December 31, 20XX was signed by BM-1 (who identified herself as the owner) on June 30, 20XX.

According to the State of State's Division of Alcohol and Tobacco Control, the original mailing address for ORG was Address, City, State. The organization notified the State of State that they moved their location to Address on March 30, 20XX. The managing officer is BM-1 (see attachment two).

According to the City Tip of the Day dated January 16, 20XX by description is the statement, "School is back in session, and by Wednesday night of the first week, you probably needing to let off a little steam. Not to many places are 18 and up anymore (especially for the guys), but ORG is one of them on Wednesday night (ladies 18 and older are always admitted). With a college ID, you'll get a discount admission. Its also industry night, so if you're a waitress who also goes to college, you're home free." See attachment three.

According to the Night Life Guide (see attachment four), ORG located at Address is the following statement: "A crazy bright sign is now up at this club near the corner of Address and State. Its 18-and-up which makes for a diverse crowd even in its farwestern location."

According to CO-2 ORG, located at Address, City, State is a bar / tavern. See attachment five.

According to a CO-3 RA-2 dated October 27, 20XX (see attachment six) "City Attorney: ORG is now Problem Property." The RA-2 goes on with, "After several shooting incidents, assaults and a stabbing, City's city attorney says one night club is now considered a problem property. Someone called police to ORG parking lot 34 times this year. That means police were at the club at least once every ten days. The most recent call was for a shooting early Sunday that sent one man to the hospital. Police, city staff and nearby businesses say the violence isn't uncommon and something may be done to change that.

RA-1 is the education leader for The System: Co-4 on south State Expressway. RA-1 says, "I have had the experience of walking into work with glass shattered." RA-1 says her main concern is for the safety of the nearly 80 people learning their trade at the school. "We've had employees' cars vandalized." RA-1 said, "We've also had a couple of break-ins within the year ORG has been here."

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

However it's the violence in the parking lot that has police and nearby businesses concerned. RA-1 says, "The violence is hard to coexist with as a daytime business trying to protect your customers." City Police Officer RA-2 says, "We've had a lot of calls from assaults, to disturbances, to leaving the scene of an accident to noise complaints."

Thirty-four police calls, complaints and concerns could cause the city to step in. City Attorney RA-3 says if problems persist the city could enforce the nuisance ordinance against the club. RA-3 says, "We've had contact with the owner I won't say what the response was but I will say our goal is to reestablish contact with the owner and express our continued concern."

CO-3 called the owner, BM-3, whose number was listed on ORG front door. BM-1 told CO-3 he did not want to comment. Police and city staff say only certain clubs require strict action. RA-2 says, "We certainly do have fights at other bars but shootings are particularly a concern for us because innocent bystanders can easily be pulled into those." RA-3 says, "When you have a property that despite problems and serious criminal activity shows no response to your advice, then we step in." Without someone stepping nearby businesses are taking their own precautions. RA-1 says, "We will never leave the parking lot until everyone is picked up and gone." The city attorney says he will likely decide if the city will take any action sometime within the next week or so. Punishment could range from a warning up to closing the business for one year. The victim and witnesses in Sunday's shooting are not cooperating with police."

Certified letters were sent to several addresses in an effort to contact the organization and determine if the organization is an exempt organization described under Internal Revenue Code Section 501(c)(19). The letters were sent to: Address, City, State; Address, City, State; and Address, City, State; and the owner's address which, according to Internal Revenue Service records, is Address, City, State. All the certified letters were returned from the post office with the notation, "Return to Sender, Attempted – not known, unable to forward."

A postal tracer was sent on April 23, 20XX and the Post Office responded on May 4, 20XX in order to obtain the address for the organization from the U.S. Post office. According to the U.S. Post Office, the organization receives their mail at Address, City, State and is physically located at Address, City, State. Because this is where the organization receives their mail, and this is the owner's address, that is where mail was sent.

The CO-5 was contacted for more information, but the national organization had no records of any kind on any subsidiary, so no information of any kind could be obtained from CO-5.

In a letter dated June 5, 20XX from State's Division of Alcohol and Tobacco Control ORG D/B/A ORG the organization notified the Division of Alcohol and Tobacco Control that they were placed in Out of Business Status effective December 31, 20XX. See Attachment Seven.



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<b>Name of Taxpayer</b> ORG		<b>Year/Period Ended</b> 12/31/20XX, 12/31/20XX

However, the State of State's Secretary of State still shows that the organization is an active organization. In all the information reviewed, there is no reference to the organization being a veteran's organization and there is no reference to the organization not being open to the public. In fact, everything shows that the organization was open to the public.

The organization was asked to supply documentation and substantiation of expenses. All efforts to obtain those documents failed. Internal Revenue Service records were reviewed in an effort to identify substantiated expenses. According to those records, the organization spent, in 20XX, \$ for wages and \$ for employment taxes. In 20XX, the organization spent \$ for wages and \$ for employment taxes. The organization issued 1099s to RA-4 and BM-1 Rentals in 20XX for \$ and \$ respectively. The organization issued 1099s to RA-4 and BM-1 Rentals in 20XX for \$ and \$ respectively. See attachment Eight.

According to the State Secretary of State, BM-1 CO-6 is a partnership equally owned by BM-3 and BM-2. The address listed on the Articles of Organization is listed as being: Address, City, State. See Attachment Nine.

In order to locate the Form 1099s filed, a search was made using Internal Revenue Service records. According to the Form 1099s filed, the address for BM-1 CO-6 in 20XX was Address, City, State. The same address as ORG. In 20XX, BM-1 CO-6's address was the same as it was for 20XX.

BM-1, the 100% owner of ORG, and the information from State's Division of Alcohol and Tobacco Control showing that BM-1 is the managing officer. So, BM-1 appears to be the person responsible for the organization. According to BM-1's 20XX and 20XX Form 1040, BM-2 is BM-1's husband. From claimed Form 1040 information, BM-1 and BM-2 do not appear to have been paid either directly, or indirectly, by ORG.

#### Law Background

Prior to the enactment of §501(c)(19) by Public Law 92-418, 1972-2 C.B. 675, many veterans organizations qualified for exemption from federal income tax under §501(c)(4) because most of the traditional activities of these organizations were recognized by the Internal Revenue Service ("IRS") as primarily promoting social welfare. Staff of Joint Comm. on Taxation, 109<sup>th</sup> Cong., Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations, JCX-29-05 NO 8, (Comm. Print 20XX).

The traditional activities of veterans organizations that were social welfare organizations included promoting patriotism, preserving the memory of those who died in war, and assisting veterans in need. Id. A veterans organization whose primary activity consisted of operating social facilities for its members was not able to qualify for exemption as a §501(c)(4) social welfare organization, but it could qualify as a social club under §501(c)(7). Rev. Rul. 66-150,

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Name of Taxpayer ORG		Year/Period Ended 12/31/20XX, 12/31/20XX

1966-1 C.B. 147; S. Rep. No. 1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713; H.R. Rep. No. 851, 92d Cong., 2d Sess. 1 (1972).

In 1972, Congress enacted §501(c)(19) and §512(a)(4) to address the concern that a veterans organization exempt under §501(c)(4) or (7) may be subject to unrelated business income tax on the provision of insurance to its members. S. Rep. No. 1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713.<sup>1</sup> Section 512(a)(4) excludes amounts attributable to, or set aside by a §501(c)(19) veterans organization for the payment of life, sick, accident, or health insurance benefits for their members and their members' dependents. Public Law 92-418, 1972-2 C.B. 675.

### Section 501(c)(19) Exemption Requirements

General Requirements of a 501(c)(19) organization:

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

- (a) Organized in the United States or any of its possessions,
- (b) At least 75 percent of its members are past or present members of the Armed Forces of the United States,
- (c) substantially all of its other members are individuals who are cadets or are spouses, widows, widowers, ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets, and
- (d) No part of the net earnings of which inures to the benefit of any private shareholder or individual.

### **(1) Can ORG be considered to be a veterans organization as described in Internal Revenue Code Section 501(c)(19)?**

#### **Issue One Law:**

\* \* \* \*

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

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

Internal Revenue Code Section 501(c)(19) A post or organization of past or present members of the Armed Forces of the United States, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization organized in the United States or any of its possessions, at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, widowers, ancestors, or lineal descendants of past or present members of the Armed Forces of the United States or of cadets, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Tax Regulation, §1.501(c)(19)-1(b) states that a war veteran organization there are two requirements that must be met under this paragraph. The first requirement is that at least 75 percent of the members of the organization must be war veterans. For purposes of this section the term "war veterans" means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts). The second requirement of this paragraph is that at least 97.5 percent of all members of the organization must be described in one or more of the following categories: (i) War veterans, (ii) Present or former members of the United States Armed Forces, (iii) Cadets (including only students in college or university ROTC programs or at Armed Services academies), or (iv) Spouses, widows, or widowers of individuals referred to in paragraph (b)(2)(i), (ii) or (iii) of this section.

Tax Regulation, §1.501(c)(19)-1 (c) states that in addition to having the proper members, an organization must be operated exclusively for one or more of the following purposes: (1) To promote the social welfare of the community as defined, (2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans, (3) to provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States, (4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors, (5) To conduct programs for religious, charitable, scientific, literary, or educational purposes, (6) To sponsor or participate in activities of a patriotic nature, (7) To provide insurance benefits for their members or dependents of their members or both, or (8) To provide social and recreational activities for their members.

Tax Regulation, §1.501(c)(19)-1 (d) states that Auxiliary units or societies for war veterans organizations may be exempt as an organization described in section 501(c)(19)(a)(2) if it is an auxiliary unit or society of a post or organization of war veterans described in paragraph 501(c)(19)(a)(1) of this section. A unit or society is an auxiliary unit or society of such a post or organization if it meets the following requirements: (1) It is affiliated with, and organized in accordance with, the bylaws and regulations formulated by an organization described in paragraph (a)(1) of this section, (2) At least 75 percent of its members are either war veterans, or spouses of war veterans, or are related to a war veteran within two degrees of consanguinity (i.e., grandparent, brother, sister, grandchild represent the most distant allowable relationships), (3) All

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<b>Name of Taxpayer</b> ORG		<b>Year/Period Ended</b> 12/31/20XX, 12/31/20XX

of its members are either members of an organization described in paragraph (a)(1) of this section, or spouses of a member of such an organization or are related to a member of such an organization, within two degrees of consanguinity, and (4) No part of its net earnings inures to the benefit of any private shareholder or individual.

Internal Revenue Code Section 501(c)(19) defines a veteran as being a past or present member of the United States armed forces.

Internal Revenue Code Section 7701(a)(15) defines the term “military or naval forces of the United States” and the term “Armed Forces of the United States” each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each term also includes the Coast Guard. The members of such forces include commissioned officers and personnel below the grade of commissioned officers in such forces.

**Government Position:**

Due to the lack of response by the organization, and the information that was found, it appears that ORG is an open bar that allows anyone to use the facilities. Since nothing could be found to show that the organization is a veteran’s organization, there is no substantiation of the composition of the membership.

Absent verification of the membership, none of the membership is presumed to be veterans. For that reason, the ORG has failed the membership test and should have its exempt status revoked effective January 1, 20XX.

**Organization Position:**

Not known at the time of this Revenue Agent Report.

**Conclusion:**

The organization made no response. The governmental position will be accepted as the correct and final position.

**(2) Can ORG retain its exempt status when it is operating in a commercial fashion?**

**Law:**

Internal Revenue Code Section 513(a) defines the term “unrelated trade or business” as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or

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<b>Name of Taxpayer</b> ORG		<b>Year/Period Ended</b> 12/31/20XX, 12/31/20XX

performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Internal Revenue Code Section 501. That term does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or which is carried on, in the case of an organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

Treasury Regulations, §1.501(c)(19)-1(c) states that in addition to the requirements of paragraphs (a)(1) and (b) of this section, in order to be described in section 501(c)(19) under paragraph (a)(1) of this section an organization must be operated exclusively for one or more of the following purposes:(1) To promote the social welfare of the community as defined in §1.501(c)(4)-1(a)(2), (2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans, (3) to provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States, (4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors, (5) To conduct programs for religious, charitable, scientific, literary, or educational purposes, (6) To sponsor or participate in activities of a patriotic nature, (7) To provide insurance benefits for their members or dependents of their members or both, or (8) To provide social and recreational activities for their members.

Treas. Reg. §1.501(c)(19), does not address what it means to “exclusively” provide social and recreational activities for members. There are no cases or revenue rulings regarding the operation of veterans organizations for the social and recreational activities of their members under §501(c)(19).

However, the permitted purpose reflected in Treas. Reg. §1.501(c)(19)-1(c)(8) is similar to the exempt purpose contained in §501(c)(7) as both provisions permit an exempt organization to operate social and recreational facilities for its members. In fact, prior to the enactment of §501(c)(19), a veterans organization whose primary activity consisted of operating a bar or restaurant for the benefit of its members would have to qualify as §501(c)(7) social club to be tax-exempt. See Rev. Rul. 60-324 and Rev. Rul. 69-219.<sup>2</sup>

\* \* \* \*

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

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<b>Name of Taxpayer</b> ORG		<b>Year/Period Ended</b> 12/31/20XX, 12/31/20XX

These organizations, prior to 1976, were required to operate “exclusively” for the pleasure and recreation of its members. See §501(c)(7) (1975). Thus, the rulings and case law under §501(c)(7) may be useful for determining whether a §501(c)(19) veterans organization is providing social and recreational activities exclusively for its members.

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

In West Side Tennis Club v. Commissioner, 111 F.2d 6 (2<sup>nd</sup> Cir. 1940), the Second Circuit upheld the board of tax appeals determination that a social club was not exempt because a substantial amount of its income was received from the general public. In that case, the West Side Tennis Club was organized to provide tennis facilities for the use and enjoyment of its members. The facilities were only available to members for most of the year; however, the club hosted annual national championship tennis matches that were open to the general public. The club shared in the ticket proceeds from these matches. The Second Circuit upheld the board of tax appeals determination that the national championship matches were a substantial and profitable business which jeopardized the club’s exemption. West Side Tennis Club, 111 F.2d at 7.<sup>3</sup>

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

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

\* \* \* \*

<sup>3</sup> In The Minnequa University Club v. Commissioner, T.C. Memo 1971-305 (1971), the Tax Court upheld the Service’s determination that a § 501(c)(7) organization was no longer exempt from Federal income tax because at least 30 percent of its income over a 5 year period was derived from the general public.

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

participation is incidental to and in furtherance of its general club purposes and the income therefrom does not inure to members.

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

As an audit standard, [the gross receipts derived from general public] alone will not be relied upon by the Service if annual gross receipts from the general public for [use of the club's facility] is \$2,500 or less or, if more than \$2,500, where gross receipts from the general public for use is five percent or less of total gross receipts of the organization. *Id.* at §3.01.

The term "general public" is defined as persons other than members or their dependents or guests. *Id.* at §2.01. Section 3.03 of Rev. Proc. 71-17 provides four instances in which nonmembers are assumed to be the guests of the members. The assumptions include: Where a group of eight or fewer individuals, at least one of whom is a member, uses club facilities, it will be assumed for audit purposes that the nonmembers are the guests of the member, provided payment for such use is received by the club directly from the member or the member's employer:

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

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

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

functions and nonmember income. Therefore, the Court held “revocation of its exemption was proper.” *Id.*

Treasury Regulation §1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated for the purpose of bringing about civic betterments and social improvements.

Treasury Regulation §1.501(c)(4)-1(a)(2)(ii) states that promotion of social welfare does not include any of the following: A. Direct or indirect participation or intervention in a political campaign on behalf of or in opposition to any candidate for public office, B. Operating a social club for the pleasure, benefit or recreation of its members, C. Carrying on a business with the general public in a manner similar to organizations operated for profit.

Tax Regulations, §1.501(c)(19)-1(c) limits the organizations social and recreational activities to its members. The sponsorship of gaming activities, to the extent of the members’ participation, is an activity related to the exempt purposes of an IRC 501(c)(19) organization. Thus, to the extent of member participation, income derived from the gaming activities is not subject to the tax on unrelated business income, provided such participation is documented. If the organization is unable to support the conclusion that such income was received from members, based on the facts and circumstances, the examiner may presume income to be from nonmembers.

Participation by nonmembers in the sponsored gaming activities may be deemed unrelated to the sponsoring organization’s exempt purposes, and may jeopardize the organization’s exemption or result in the imposition of unrelated business income tax. Analyze revenue from gaming activities, such as pull-tabs, to determine whether it is considered unrelated income. Gaming activities involving nonmembers are generally not considered substantially related to the organization’s exempt purpose(s).

In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945), the Supreme Court held that “the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly. . . [exempt] purposes.”

**Government Position:**

The operations of the organization can not be distinguished from the commercial operations of a for-profit bar. The primary activity is the operation of a club that is available for everyone for the purpose of pleasure, or recreation, that benefits those who come to participate in its activities.



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

The principle activity of the bar and organization is for non-members. The principle activity appears to be the same as seen in for-profit bars and so there is a commercial hue and tone to the operations of the organization.

While the organization has refused to accept mail from the Internal Revenue Service, according to the U. S. Post Office, they appear to accept other mail at two of the addresses that examiner mailed certified mail to.

Therefore, examiner will arrive at a conclusion based on the facts available. Because there is a taxable effect, examiner will not terminate the status of the organization when it appears that the organization is still operating. ORG is substantially operating for non-veterans and so has a substantial non-exempt purpose. For that reason, the organization should have its exempt status revoked effective January 1, 20XX.

**Organization Position:**

Not known at the time of this Revenue Agent Report.

**Conclusion:**

The organization did not respond. Therefore, the governmental position is accepted as the correct and final position.

**(3) Whether ORG, doing business as “ORG”, records are inadequate under Section 6033.**

**Law:**

Treas. Reg. § 1.6001-1(a) in conjunction with Section 1.6001-1(c) provides that every organization exempt from tax under Section 501(a) of the Code and subject to the tax imposed by Section 511 on its unrelated business income must keep such permanent books or accounts or records, including inventories, as are sufficient to establish the amount of gross income, deduction, credits, or other matters required to be shown by such person in any return of such tax. Such organization shall also keep such books and records as are required to substantiate the information required by Section 6033.

Treas. Reg. § 1.6001-1(e) provides that the books or records required by this Section shall be kept at all times available for inspection by authorized internal revenue officer or employees, and shall be retained as long as the contents thereof may be material in the administration of any internal revenue law.

Treas. Reg. § 1.6033-2(a)(1) states in part that every organization exempt from taxation under Section 501(a) shall file an annual information return specifically setting forth its items of gross

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

income, gross receipts and disbursements, and such Tax Regulation §1.6033-2(a)(2)(i) states in pertinent part that every organization exempt from taxation under Section 501(a), and required to file a return under Section 6033 and this Section (including, for taxable years ending before December 31, 1972, private foundations, as defined in Section 509(a), other than an organization described in Section 401(a) or 501(d), shall file its annual return on Form 990.

Treas. Reg. § 1.6033-2(i)(1) states that an organization which is exempt from taxation under Section 501(a) and is not required to file annually an information return required by this Section shall immediately notify in writing the district director for the internal revenue district in which its principal office is located of any changes in its character, operations, or purpose for which it was originally created.

Treas. Reg. § 1.6033-2(i)(2) states that every organization which is exempt from tax, whether or not it is required to file an annual information return, shall submit such additional information as may be required by the Internal Revenue Service for the purpose of inquiring into its exempt status and administering the provisions of subchapter F (Section 501 and following), chapter 1 of subtitle A of the Code, Section 6033, and chapter 42 of subtitle D of the Code. See Section 6001 and §1.6001-1 with respect to the authority of the district directors or directors of service centers to require such additional information and with respect to the books of accounts or records to be kept by such organizations.

Rev. Rul. 59-95, 1959-1 C.B. 627, concerns an exempt organization that was requested to produce a financial statement and statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provision of Section 6033 of the Code and the Regulations which implement it, may result in the termination of the exempt status of an organization previously held exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of its exempt status.

**Government Position:**

In order to qualify for exemption under Section 501(c)(19) of the Code, an organization must keep accurate books and records to determine the nature of the organization’s income and records of its exempt and non exempt activities.

The organization did not accept the mail even though the U. S. Post Office states that the organization received their mail at the locations mail was sent to. For that reason, the examiner will not accept any expenses that are not substantiated. Further, as covered in the facts section, the organization appears to have been open to the general public.

Based on the information available, the organization’s December 31, 20XX and December 31, 20XX form 990’s do not accurately reflect the organizations activities, nature of income &

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

expenses, and amount of income & expenses as required by Section 6001 and 6033 of the Code and its Regulations. Therefore, since the organization's records were not sufficient to accurately reflect the nature of their income & expenses, amount of income & expenses, and its exempt vs. non exempt activities, such failures have risen to a level that would support revocation of exemption under Section 501(c)(19) and Section 501(c)(7) of the Code as described in Rev. Rul. 59-95, 1959-1 C.B. 627.

The exempt status of ORG Doing Business As "ORG" should be revoked effective January 1, 20XX. All non-substantiated expenses will be disallowed as expenses.

**Organizational Position:**

Not known at the time of this Revenue Agent Report.

**Conclusion:**

The organization did not respond. Therefore, the governmental position is accepted as the correct and final position.

**Conversion of Form 990 to form 1120:**

In the absence of a lease contract, and considering the close relationship between the owners of the ORG and BM-1 CO-6, the expense represented by the Form 1099s to BM-1 Rentals is not considered to be substantiated and so is not accepted as an expense of ORG.

The organization was asked to supply documentation and substantiation of expenses. All efforts to obtain those documents failed. Internal Revenue Service records were reviewed in an effort to identify substantiated expenses. According to those records, the organization spent, in 20XX, \$ for wages and \$ for employment taxes. In 20XX, the organization spent \$ for wages and \$ for employment taxes. The organization issued 1099s to RA-4 and BM-1 Rentals in 20XX for \$ and \$ respectively. The organization issued 1099s to RA-4 and BM-1 Rentals in 20XX for \$ and \$ respectively. See attachment Eight.

According to the State Secretary of State, BM-1 CO-6 is a partnership equally owned by BM-3 and BM-2. The address listed on the Articles of Organization is listed as being: Address, City, State. See Attachment Nine.

In order to locate the Form 1099s filed, a search was made using Internal Revenue Service records. According to the Form 1099s filed, the address for BM-1 CO-6 in 20XX was Address, City, State. The same address as ORG. In 20XX, BM-1 CO-6's address was the same as it was for 20XX.

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

BM-1, the 100% owner of ORG, and per the information from State's Division of Alcohol and Tobacco Control shows that BM-1 is the managing officer. So, BM-1 appears to be the person responsible for the organization. According to BM-1's 20XX and 20XX Form 1040, BM-2 is BM-1's husband. From claimed Form 1040 information, BM-1 and BM-2 do not appear to have been paid either directly, or indirectly, by ORG.

BM-1 Rental did file a partnership return but no revenue was claimed as a result of that partnership on the BM-1's joint return. Because of the close relationship of the individuals involved, and the absence of substantiation, the Form 1099 amounts are treated as a sham transaction and considered to be the discrepancy adjustment amount for the owner's Form 1040.

There does not appear to be a business purpose for the BM-1 Rental, or the issuance of the Form 1099 to BM-1 Rental when ORG and / or its owner BM-1 could just as easily have entered into the rental contract with the owner of the building.

Because the certified mail was returned as undeliverable, then it appears that BM-1 Rentals is not the building owner. If they were, then the partnership owners who were ORG Board of Director members in 20XX would have known to accept the certified letters, or they would have known what the correct address for the organization was.

According to the documents cited above BM-1 is the sole officer and 100% owner of the organization. As an officer of the organization she is a common law employee of the Exempt Organization (EO) unless, under IRC 414(n) there is a leased employment agreement. Since the organization did not respond, no substantiation was provided to demonstrate that BM-1 is under a lease agreement, so BM-1 is a common law employee.

A review of the Form 990s filed for 20XX and 20XX do not show ORG as owning any property. The Form 990s filed show BM-3 as the organizational manager.

As the 100% owner, BM-1 was entitled to receive 100% of the net income. Because the Form 1099 does not appear to have a business purpose, but does appear to be for a sham activity and appears to have been made solely for the purpose of tax avoidance.

Because BM-1 is the 100% owner of the organization, was its president (or chairman depending on which State Annual Report you are looking at) and had unlimited control of the organization's activities, there is no reason to allocate the sham activity represented by the 20XX and 20XX Form 1099s issued to BM-1 Rentals to anyone other than BM-1. She bears sole responsibility for this activity as she represents herself as being the 100% owner of ORG Doing Business As "ORG."

In **Higgins v Smith** (308 U.S. 473, 60 S. Ct. 355), the court stated that, "...The government may not be required to acquiesce in a taxpayer's election of that form for doing business which is most advantageous to him, but the government may look at actualities and upon determination that the

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

form employed for doing business or carrying out a challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.”

**Internal Revenue Code Section 61(a)** states that except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

In **Revenue Ruling 79-9**, 1979-1 CB 125 stated that property or an economic benefit received by the controlling shareholders or their families as a result of the corporations charitable contribution is a constructive dividend.

**Revenue Ruling 73-605**, 1973-2 CB 109, (Jan. 01, 1973) states that, “Section 316 of the Code defines a dividend as a distribution of property by a corporation to its shareholders out of its earnings and profits of the taxable year or earnings and profits accumulated after February 28, 1913. This definition has been considered by the courts to be broad enough to cover an amount paid by a corporation under an agreement or contract in excess of its allocable share of the consolidated tax liability. See *Beneficial Corporation*, 18 T.C. 396 (1952), *aff’d per curiam*, 202 F.2d 150 (3rd Cir. 1953); *Dynamics Corporation v. United States*, 392 F.2d 241 (Ct. Cl. 1968). See also section 1.1552-1(b)(2) of the Income Tax Regulations. It is not necessary that the dividend distribution be made directly by a corporation to its shareholders. A distribution by a corporation to a third party for the benefit of a shareholder is a constructive dividend, which will be taxed as a dividend to the shareholder for whose benefit the distribution is made...”

In **Baumer v United States** (580 F 2d 863) stated that for federal taxation purposes, transactions between closely held corporations and its shareholders or relatives of shareholders are not entitled to the presumption that they are conducted at arms length. The court further stated that the crucial determinate of whether or not there is a dividend or not is whether or not the distribution served a business purpose or not, and Where corporation consummates transaction with favorable consequences for controlling shareholder's immediate family, only in most extraordinary circumstances would it be possible to conclude that shareholder had not exercised substantial influence in causing diversion of corporate assets, thereby justifying constructive dividend treatment..

**Internal Revenue Code Section 162(k)(2)(A)** disallows, as a corporate business expense, the payment of dividends.

The money represented by the Form 1099s is considered to be a constructive Dividend received by BM-1. For that reason, the dividend amount is not considered to be a valid business expense of ORG.

In the absence of substantive documentation, no liabilities will be considered as substantiated. In the absence of substantive documentation, no members will be considered to be veterans. In the

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

absence of documentation to the contrary, the organization will be treated as an organization that is not seperable from BM-1.

The below information summarizes the Form 990 information per return and per examination:

Year:		Per Return	Per Exam	Change
Part one:		December-	December-	
Line:		XX	XX	
1a	Direct public support			
1b	Indirect Public support			
1c	Government Contr	\$ -	\$ -	
1d	Total	\$ -	\$ -	
2	Program Rev	\$ -	\$ -	
3	Membership Dues	\$ -	\$ -	
4	Interest on Savings	\$ -	\$ -	
5	Dividends			
6a	Gross Rents			
6b	Less: Rental Exp			
6c	Net Rental Income	\$ -	\$ -	
7	Other Inv Income			
8a	Gross Sales			
8b	Less: COGS			
8c	Gain (or Loss)	\$ -	\$ -	
8d	Net Gain			
9a	Special Events			
9b	Less: Direct Exp			
9c	Net Income	\$ -	\$ -	
10a	Gross Inv Sale			
10b	Less: COGS			
10c	Gross Profit			
11	other revenue			
12	Total Revenue			
13	Program Services			
14	Management & General			
15	Fundraising			
16	Payments to affiliates			
17	Total Expenses			
18	Excess or deficit			
19	Net BOY fund balance			
	Other Changes in net assets			
20				
21	Net EOY fund balance			
Part two:				
22	Grants	\$ -	\$ -	

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

23	Specific Assistance		
24	Benefits Paid to mbr		
25	Officer Comp	\$	-
26	Other Salaries		
27	Pension Plan		
28	Other Emp Benefits		
29	payroll taxes		
30	prof fundraising fees		
31	accounting fees		
32	legal fees		
33	supplies		
34	telephone		
35	postage & shipping		
36	occupancy		
37	equip rental & maint		
38	printing & Pubs		
39	travel		
40	conf, conv		
41	interest		
42	Depreciation		
43a	Misc		
43b	Insurance		
43c	Taxes, Fees		
43d	Donations	\$	-
43e	Bank Charges	\$	-
44	Total		

For 20XX, the Form 990 information per return and per examination is summarized below:

Year:		Per Return	Per Exam	Change
Part one:		December-	December-	
Line:		XX	XX	
1a	Direct public support			
1b	Indirect Public support			
1c	Government Contr	\$	\$	-
1d	Total	\$	\$	-
2	Program Rev	\$	\$	-
3	Membership Dues	\$		-
4	Interest on Savings	\$	\$	-
5	Dividends			
6a	Gross Rents			
6b	Less: Rental Exp			
6c	Net Rental Income	\$	\$	-

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

7	Other Inv Income	
8a	Gross Sales	
8b	Less: COGS	
8c	Gain (or Loss)	\$ - \$ -
8d	Net Gain	
9a	Special Events	
9b	Less: Direct Exp	
9c	Net Income	
10a	Gross Inv Sale	
10b	Less: COGS	
10c	Gross Profit	
11	other revenue	
12	Total Revenue	
13	Program Services	
14	Management & General	
15	Fundraising	
16	Payments to affiliates	
17	Total Expenses	
18	Excess or deficit	
19	Net BOY fund balance	
20	Other Changes in net assets	
21	Net EOY fund balance	
Part two:		
22	Grants	
23	Specific Assistance	
24	Benefits Paid to mbr	
25	Officer Comp	
26	Other Salaries	
27	Pension Plan	
28	Other Emp Benefits	
29	payroll taxes	
30	prof fundraising fees	
31	accounting fees	
32	legal fees	
33	supplies	
34	telephone	
35	postage & shipping	
36	occupancy	
37	equip rental & maint	
38	printing & Pubs	
39	travel	
40	conf, conv	
41	interest	
42	Depreciation	
43a	Misc	



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

43b	Insurance
43c	Taxes, Fees
43d	Donations
43e	Bank Charges
44	Total

**Tax Effect:**

Because the revocation is deemed to be correct, then the tax effect of converting from the Form 990 to the Form 1120 for the years ended December 31, 20XX and 20XX should be completed by the organization. Because there was no response to the revocation letter, a substitute for return was prepared by the Internal Revenue Service examiner. The information from the Form 990s, if it was transferred to the Form 1120 for the applicable years, would yield the following tax effect:

Line	Line Title	20XX	20XX
1c	Gross Receipts	\$	\$
2	Cost of Goods Sold		
3	Gross Profit	\$	\$
27	Total Deductions		
28	Taxable Income	\$	
30	Taxable Income	\$	
31	Total Tax	\$	

This tax does not include applicable interest.