TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
TE/GE EO Examinations
1122 Town and Country Commons Room 128
Chesterfield, MO 63017-8293

February 16, 2010

Release Number: 201037036
Release Date: 9/17/10
UIL Code: 501.19-00
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

LEGEND
ORG = Organization name XX = Date Address = address City = city State = State RA-1 & RA-2 = 1ST & 2ND RA President = president Vice President = vice president CO-1, CO-2, CO-3, CO-4, CO-5 & CO-6 = 1ST, 2ND, 3RD, 4TH 5TH & 6TH COMPANIES

Issue:

1. Whether ORG, doing business as ORG is operated exclusively for purposes listed in Treas. Reg. § 1.501(c)(19)-1(c).

2. Whether the net earnings of ORG inured to the benefit of the President.

3. Whether ORG has satisfied the recordkeeping and reporting requirements set forth in I.R.C. § § 6001 and 6033.

4. Whether ORG's exemption under I.R.C. § 501(a), as an organization described in I.R.C. § 501(c)(19), should be revoked effective January 1, 20XX.

5. Alternatively, if ORG's exemption under I.R.C. § 501(a), as an organization described in I.R.C. § 501(c)(19), is not revoked, whether the income that ORG received from its kitchen and drink operations, pool tables, and juke box should be treated as unrelated business income under I.R.C. § 512, and whether such income is subject to tax pursuant to I.R.C. § 511.

Facts: Background Information

ORG (hereinafter referred to as ORG) is a veterans organization that holds a group exemption for veterans organizations described in I.R.C. § 501(c)(19). ORG's web page states that its mission is to "unite veterans and their families by forming social clubs throughout the United States, which interact with other social veterans clubs."

ORG's website lists several advantages to be included in its group exemption as a subordinate organization. These advantages include selling liquor, operating on Sundays, holding bingo games, and obtaining liquor licenses in dry counties. ORG's website markets ORG and its group exemption to existing bars and restaurants located in State as a way to avoid restrictive local liquor laws and as a way to operate on a tax-exempt basis. ORG's website states that ORG will assist in a club's formation and application for a liquor license. ORG refers to its subordinate organizations as "clubs."

ORG's website requires that its clubs have at least 10 veteran members. ORG also requires its subordinate organization to send it proof of all veterans affiliation. One question that appears on ORG's web page is "do I have to be a members only club?" The response is "[a]lthough the tax advantages of being a members only club are greater, we do not require you to limit your organization to members.....Your doors may be kept open. By incorporating separately, you

keep control of your own club. It is your choice if you wish to keep your doors open or closed. We only ask that you honor members of other chapters."

ORG's Formation and Purpose

The ORG (hereinafter referred to as ORG) opened for business in 20XX under the ORG. ORG learned about the HQ from the President of the ORG's daughter. The ORG provided a packet of information to the president of the ORG to be filled out and filed with the ORG. According to ORG's Articles of Incorporation, the organization was formed to support all veterans and their families.

According to the bylaws, ORG's stated purpose is "uniting fraternally, veterans and the families of veterans, in order to work together to better the lives of all veterans and their families and to assist with any difficulties encountered by them." The bylaws further state that these purposes include, but are not limited, to the following:

- Helping fellow veterans and their families receive the benefits for which they are entitled;
- Finding employment for veterans and their families;
- Helping the homeless veterans find housing and re-adjust to civilian life;
- Carrying on programs to perpetuate the memory of deceased veterans and members of the armed forces, and to comfort their survivors;
- Sponsoring or participating in activities of a patriotic nature;
- Providing social and recreational activities for its members;
- Assisting the disabled and needy war veterans and their dependents;
- Promoting awareness of the prisoners of war and the missing in action issues;
- Promoting the general welfare and prosperity of all ORG corporations;
- Presenting and supporting the purposes of ORG before the public and the government.

ORG's Business Operations, Business Activities, and Members

ORG operates its business on a cash basis at Address, City, State. The building's facade exhibits signs reflecting the name "ORG" but no signs indicating that this is a Veterans organization. (See Exhibit 1.) The facility consists of a main floor with an area of approximately 20XX sq. ft. of space for dancing. There are tables on the main floor and upstairs that surround the dance floor. There are two full service bars and a kitchen in the back. (See Exhibits 2 and 3.) There is another area, CO-1, in a separate room that has pool tables, televisions, dart boards, and a juke box. CO-1 has a separate entrance that can be accessed from outside the building by a separate door, if the customers choose not to come in through the main entrance. (See Exhibit 4.)

ORG has one web site on MySpace.com, website. The web site does not mention anything about this organization being a organization. There are photos on the web site

showing customers riding the mechanical bull, dancing on the dance floor, and playing pool in the CO-1 facility. (See Exhibit 5.)

ORG's facilities are open Friday and Saturday nights, 8 pm until 1:30 am. The organization is also open on Sunday from 8 pm until midnight. The kitchen is open from 8 pm until 1 AM. It is freely open to both members and nonmembers (general public). The ORG averages approximately 100 people per night. For a special event, the organization may have 200 to 300 people.

ORG, as of December 20XX, had 15 veterans' members. The ORG pays the headquarters $ per year in dues. Dues for the members to the ORG are $ per year. No register is kept for members or nonmembers to sign in to use the facilities. The ORG is open to the public based on interview testimony from the principle officer. ORG does not account for member and nonmember bar/kitchen sales separately. According to the organization, more of the bar/kitchen receipts are from nonmembers than from members. According to the interview of the organization's President, member benefits are discounted food and drinks.

Employees of ORG have the option to buy insurance through CO-2 and accident insurance, and to have a membership at CO-3. The employees do not receive discounted drinks or food. Sodas are free to veterans, employees, and designated drivers.

ORG stated that it has the following activities:

a. Quarterly meetings and minutes have to be provided to the HQ organization.
b. Operation of the bars, kitchen, dart boards, juke box, mechanical bull, and pool tables is open to both members and nonmembers.
c. Hold fundraisers for different organizations, such as: CO-4; the Sheriff's Department; and the Fraternal Order of the Police.

A review of the ORG's activities could not determine the extent of member participation since the organization did not keep adequate records showing member participation vs nonmember participation.

ORG's Financial Information

Membership Facts do not show bona fide members.

According to ORG's 20XX Form 990 return, the gross sales[1] of the organization totaled $. The organization's gross receipts per the audit were $, and its expenses for liquor, rent, utilities, taxes, advertising, food, and other services were (after examination) $ for

* * * *

[1] For purposes of this discussion, the term "gross sales" means "gross receipts" as reported on the organization's Form 990.

the year 20XX.The organization's gross receipts on the Form 990 return for 20XX totaled $. ORG's gross receipts per the audit for 20XX were $, and the expenses for liquor, rent, utilities, taxes, advertising, food, and other services were (after examination) $. For information regarding the revenue and expenses, see Exhibit A.

ORG pays the ORG $ per year in dues. The books and records of the organization did confirm these payments for 20XX and 20XX.

The President of the organization provided a copy of a contract that is a divorce agreement for splitting the profits with his ex-wife. This contract reads as if this is a regular business and not an exempt organization. The purpose of this contract, per the President, is that if the business is sold, the ex-wife would receive 30% of the President's 55% of the business. If there's any profit, she receives part of the profit. The President of the organization is paying her money every Monday based on the net profit of the organization, with the maximum of $ that is to be paid to her, according to the contract. See Exhibit B.

In reviewing the installment agreement between the organization and CO-6, the signature page states the borrower is "a general partnership" and is signed by President, President; Vice-President, Vice President; and RA-1, Vice-President's wife. See Exhibit C.

ORG's Activities, Revenues, and Expenses

In reviewing the activities for ORG, the organization was unable to provide a breakdown of the hours being spent; the amount of revenue generated; and / or the expenses incurred for the years under examination. In reviewing the minutes, nothing is mentioned about special events / fundraisers for veterans.

ORG's activities consist of:

1. Quarterly meetings and minutes;
2. Operation of the bars, kitchen, dart boards, juke box, mechanical bull, and pool tables; and,
3. Fundraisers that are held for different organizations.

In touring the facility, there were posters and flyers for male and female strippers to be seen. The largest part of the building consists of a large dance floor; tables on the main floor and upstairs; two bars; and a stage for bands or a DJ. The organization rents a mechanical bull once a month per their web site. In the interview of one of the bar tenders, he stated that when he started working there, he wasn't aware that the organization was a organization and that he thought it was just a regular bar.

The organization will have sports nights such as Super Bowl Sunday or UFC fights to bring in customers. ORG sponsors a golf charity twice a month with donations going to Shriners. ORG sponsors a local softball team and a Dirt track car. ORG has a cover charge when bands play. The DJ gives away T-Shirts and T-shirts are provided as uniforms for the staff.

LAW AND ANALYSIS

Tax Exemption – Veterans Organizations

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

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

The Section 501(c)(19) Exemption Requirements

In General

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

(a) organized in the United States or any of its possessions,

* * * *

[2] "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.

(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 Unites States or of cadets, and

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

Membership Requirements

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

In addition, I.R.C. § 501(c)(19)(B) requires that substantially all other members of an organization be cadets or spouses, widows, widowers, ancestors, or lineal descendants of veterans or cadets. According to the Senate Report accompanying the legislation, "substantially all" means 90 percent. See S. Rep. No. 1082, 92nd Cong. 2d Sess. 5 (1972), reprinted in 1972-2 C.B. 713, 715. Therefore, of the 25 percent of the members that do not have to be veterans, 90 percent must be cadets, or spouses, etc. Consequently, no more than 2.5 percent (10% x 25%) of an I.R.C. § 501(c)(19) organization's total membership may consist of individuals not mentioned in the statute.[3]

Neither, I.R.C. § 501(c)(19), its legislative history, nor the regulations under I.R.C. § 501(c)(19) define what it means to be a member of a veterans organization. However, whatever the organization requires for one to become a member, the organization must maintain records tracking who its members are and the proportions in the various categories of membership permitted under I.R.C. § 501(c)(19)(B) (member of armed forces, cadet, relative, etc.) to substantiate that its members are veterans or other permitted members. See I.R.C. § 6001 and Treas. Reg. §1.6001-1(c).[4]

* * * *

[3] Prior to 20XX, ancestors and lineal descendent were not included in the statutory list of persons permitted to be members. In 20XX, Congress amended I.R.C. § 501(c)(19) to include ancestors or lineal descendents of present or former members of the United States Armed Forces or cadets in the statutory list of individuals who may be members of an organization. The regulations have not been updated to reflect this change nor do they reflect the 1982 statutory change eliminating a requirement that veterans be veterans of war.

[4] Section 6001 of the Code provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury of his delegate may from

footnote continues next page

Operational Test

Section 1.501(c)(19)-1(c) of the regulations provides that an organization exempt under I.R.C. § 501(c)(19) must be operated exclusively for one or more of the following purposes:

1) To promote the social welfare of the community as defined in section 1.501(c)(4)-1(a)(2) of the regulations,
2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents and widows and orphans of deceased veterans,
3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States,
4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,
5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,
6) To sponsor or participate in activities of a patriotic nature,
7) To provide insurance benefits for their members or the dependents of their members or both, or
8) To provide social and recreational activities for their members.

Treas. Reg. § 1.501(c)(19).

Social and Recreational Activities for Members

While Treas. Reg. §1.501(c)(19)-1(c)(8) does not address what it means to "exclusively" provide social and recreational activities for members it is similar to the exempt purpose contained in I.R.C. § 501(c)(7), as both provisions permit an exempt organization to operate social and recreational facilities for its members. In fact, prior to the enactment of I.R.C. § 501(c)(19), a veterans organization whose primary activity consisted of operating a bar or restaurant for the benefit of its members would have to qualify as § 501(c)(7) social club to be tax-exempt. See Rev. Rul. 60-324 and Rev. Rul. 69-219.[5] These organizations, prior to 1976,

continued footnote

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

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

were required to operate "exclusively" for the pleasure and recreation of its members. See I.R.C. § 501(c)(7) (1975). Thus, the rulings and case law under I.R.C. § 501(c)(7) are useful for purposes of determining whether an I.R.C. § 501(c)(19) veterans organization is providing social and recreational activities exclusively for its members.

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

In West Side Tennis Club v. Commissioner,111 F.2d 6 (2nd Cir. 1940), cert. denied, 311 U.S. 674 (1940), the Second Circuit upheld the board of tax appeals determination that a social club was not exempt because a substantial amount of its income was received from the general public. West Side Tennis Club was organized to provide tennis facilities for the use and enjoyment of its members. The facilities were only available to members for most of the year; the club hosted annual national championship tennis matches, however, that were open to the general public. The club shared in the ticket proceeds from these matches. The Second Circuit upheld the board of tax appeals determination that the national championship matches were a substantial and profitable business which jeopardized the club's exemption. West Side Tennis Club, 111 F.2d at p. 7.[6]

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

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

* * * *

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

In 19XX, the Service issued Revenue Procedure 71-17, 19XX-1 C.B. 683, which contains guidelines for determining the impact of an organization's nonmember gross receipts on its exempt status under I.R.C. § 501(c)(7). The revenue procedure provides that "[a] significant factor reflecting the existence of a nonexempt purpose is the amount of gross receipts derived from use of a club's facilities by the general public." The revenue procedure went on to provide a safe harbor for organizations serving the general public:

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

Rev. Proc. 71-17, 19XX-1 C.B. 683 at § 3.01.

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

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

Rev. Proc. 71-17, Section 3.03.

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

and income consisted of nonmember functions and nonmember income. Therefore, the Court held "revocation of its exemption was proper." Id.

Inurement

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

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

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

Inurement may take many forms and an organization's earnings may inure to the benefit of private individuals in ways other than by the actual distribution of dividends or payment of excessive salaries. See Founding Church of Scientology v. United States, 412 F.2d 1197, 1200 (1969), cert. denied, 397 U.S. 1009 (1970) (excessive compensation paid to insiders); Founding Church of Scientology, 412 F.2d 1197, 1200 (1969), cert. denied, 397 U.S. 1009 (1970) (excessive rents paid to insiders as landlords); Easter House v. U.S., 12 Cl. Ct. 476 (1987) (loans to insiders on advantageous terms); Rev. Rul. 56-138, 1956-1 C.B. 202 (excessive employee benefits provided to insiders); Anclote Psychiatric Center, Inc. v. Commissioner, T.C. Memo 1998-273 (purchase of assets from insiders for more than fair market value or sale of assets to insiders for less than fair market value). Moreover, the unaccounted for diversions of a charitable organization's resources by one who has complete and unfettered control can constitute inurement. Founding Church of Scientology of California v. United States, 823 F.2d 1310, 1316. See also, Parker v. Commissioner, 365 F.2d 792, 799 (8th Cir. 1966), cert. denied, 385 U.S. 1026 (1967); Kenner v. Commissioner, 318 F.2d 632 (7th Cir. 1963).

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

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

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

In The Founding Church of Scientology v. United States, 412 F.2d 1197, 1201 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970), in addition to receiving salary, commission, and royalty payments, the founder of the church, and several members of his family, received unexplained payments in the nature of loans and reimbursements for expenditures made in plaintiff's behalf, for expenses and other purposes. The Court of Claims held that the plaintiff was not entitled to exemption from Federal income tax because it failed to prove that no part of the corporate net earnings benefited private individuals. Thus, the plaintiff's claim was denied and the petition was dismissed.

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

In Church of Scientology of California v. Commissioner, 823 F.2d 1310 (9th Cir. 1987), cert. denied, 486 U.S. 1015 (1988), the Court of Appeals affirmed the Tax Court's judgment which upheld the Commissioner's assessment of tax deficiencies and penalties against the church, following the revocation of the church's tax exempt status. The Court of Appeals reviewed the Tax Court's factual finding that a portion of the church's net earnings inured to the benefit of L. Ron Hubbard, and his family, and OTC, a private for-profit corporation, for clear error. In finding that a portion of the church's net earnings inured to the benefit of L. Ron Hubbard, his family and OTC, the Tax Court isolated two indications of inurement, overt and covert inurement. The overt indications included salaries, living expenses, and royalties, and the covert indications included "debt repayments" and L. Ron Hubbard's unfettered control over millions of dollars of church assets. The Tax Court concluded that these indications, when viewed in light of the self-dealing associated with them, coupled with the church's failure to carry its burden of proof and to disclose the facts candidly, proved conclusively that the church was operated for the benefit of L. Ron Hubbard and his family. Id. at p. 1317. In addition to Hubbard's salary, the church paid for all of the Hubbards' living and medical expenses aboard the cruise ship Apollo. The church paid substantial royalties to L. Ron Hubbard for his books, recordings and E-meters. The record revealed that L. Ron Hubbard had unfettered control over millions of dollars in church assets, and supported the Tax Court's conclusion that L. Ron Hubbard had unfettered control over Church of Scientology Trust Fund assets. Additionally, the Tax Court found that church income incurred to the benefit of L. Ron Hubbard in a "grand scale" in the form of "debt repayments." Id. at p. 1319. In sum, the Tax Court held that "significant sums of money inured to the benefit of L. Ron Hubbard and his family" during the years at issue. The Court of Appeals found no clear error and noted that "[a]lthough neither the salaries nor the living expenses necessarily constituted evidence of inurement, the cumulative effect of Hubbard's use of the Church to promote royalty income, Hubbard's unfettered control over millions of dollars of church assets, and his receipt of untold thousands of dollars worth of "debt repayments" strongly demonstrate inurement." Id.

Recordkeeping and Reporting Requirements

Every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time prescribe. See I.R.C. § 6001. Every organization exempt from tax under I.R.C. § 501(a), and subject to the tax imposed by I.R.C. § 511 on its unrelated business income, must keep such permanent books or accounts or records, including inventories, as are sufficient to establish the amount of gross income, deduction, credits, or other matters required to be shown by such person in any return of such tax. Such organization shall also keep such books and records as are required to substantiate the information required by §6033. See Treas. Reg. §§ 1.6001-1(a) and 1.6001-1(c). The books or records required by section 1.6001-1 shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law. See Treas. Reg. §1.6001-1(e). Except as provided, every organization exempt from tax under I.R.C. § 501(a) shall file an annual return, stating specifically the items of gross income, receipts and disbursements, and such other information for the purposes of

carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe, and keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. See I.R.C. § 6033(a)(1).

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

An organization's failure or inability to file required information returns or otherwise to comply with the provisions of I.R.C. § 6033 and the regulations which implement it, may result in the termination of the organization's exempt status based on the grounds that the organization has not established that it is observing the conditions that are required for the continuation of its exempt status. See Rev. Rul. 59-95. These conditions require the filing of a complete and accurate annual information return (and other required federal tax forms) and the retention of records sufficient to determine whether the organization is operated for the purposes for which it was granted tax-exempt status and to determine its liability for any unrelated business income tax. Id.

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

Unrelated Business Income Tax

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

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

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

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

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

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

IRC §501(c)(19) provides for the exemption from federal income tax of a post or organization of veterans of the Armed Forces of the United States if such post or organization is:

a) organized in the United States or any of its possessions,
b) at least 75% 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, or widowers of past or present members of the Armed Forces of the United States or of cadets, and
c) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

With respect to the membership requirements under Section 501(c)(19) of the code, in Senate Report No. 92-1082, 92nd Cong. 2d Sess., 1972-2 C.B. 713 at 715, Congress stated that "substantially all" means 90 percent. Therefore, of the 25 percent of the members that do not have to be past or present members of the Armed Forces of the United States, 90 percent have to be cadets, or spouses, etc. Thus, only 2.5 percent of a section 501(c)(19) organization's total membership may consist of individuals not mentioned above.

IRC Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time prescribe.

Section 1.501(c)(19)-1(c) of the Regulations provides that an organization exempt under §501(c)(19) must be operated exclusively for one or more of the following purposes:

1) To promote the social welfare of the community as defined in Section 1.501(c)(4)-1(a)(2),
2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents and widows and orphans of deceased veterans,
3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States,
4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,
5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,
6) To sponsor or participate in activities of a patriotic nature,
7) To provide insurance benefits for their members or the dependents of their members or both, or
8) To provide social and recreational activities for their members.

Section 1.6001-1(a) of the Regulations 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.

Section 1.6001-1(e) of the Regulations 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.

Section 1.6033-2(a)(1) of the Regulations 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 income, gross receipts and disbursements, and such other information as may be prescribed in the instructions issued with respect to the return. Such return shall be filed annually regardless of whether such organization is chartered by, or affiliated or associated with, any central, parent, or other organization. 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.

Section 1.6033-2(i)(1) of the Regulations 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.

Section 1.6033-2(i)(2) of the Regulations 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. 68-46, 1968-1 C.B. 260, describes another veterans' post. After an analysis of all the facts and circumstances, the Service determined that the post's primary activity was the conduct of a business rather than social welfare activity. The organization's business activities involved the rental of its commercial office building and operating a public banquet and meeting hall with a bar and dining facilities. Although the organization carried on veterans' programs and other social welfare activities, based on an analysis of the whole operation, it was concluded that the business activities relating to the operation of the facility exceeded all other activities, and the social welfare programs were not its primary activity.

Rev. Rul. 61-158, 1961-2 C.B. 115, describes an organization that was created exclusively for the promotion of social welfare, but whose principal activity was conducting a lottery on a weekly basis with the general public. Its principal source of income was the gross receipts from the weekly lottery. The major portion of the profits of the lottery was used for the payment of general expenses of the organization and only a small portion was used for social welfare purposes. The ruling holds that the organization is not operated exclusively for the promotion of social welfare because its primary activity is the conduct of a business for profit. Accordingly, it is not exempt under Section 501(c)(4) of the Code.

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.

Taxpayer's Position

Government's Position and Conclusions

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

An organization described in I.R.C. § 501(c)(19) carries out activities in furtherance of its exempt purposes only when such activities are carried out exclusively in furtherance of the purposes listed in Treas. Reg. § 1.501(c)(19)-1(c). Among these purposes is the provision of social and recreational activities for its members. If an organization makes its facilities available to the general public to a substantial degree, and/or a significant amount of the organization's income is received from the general public, the organization may lose its tax exemption. In the instant case, very few documents were produced during the examination that demonstrated the exempt activities in which ORG engaged during the years at issue. ORG was unable to provide records that demonstrated the amount of income for members, their families, guests, auxiliary members, and nonveterans. Nor did the organization provide records to demonstrate who used the facilities (i.e., members, members' families, guests, non-veterans, etc.) on a daily basis.

According to information that ORG's President, President, provided during the initial interview, and based on the records that the organization provided for review, it has been determined that more than 50% of the organization's gross receipts were derived from the general public's use of the organization's facilities (i.e., drinks) in 20XX and 20XX, respectively. This determination is further supported by comparing the average amount each of the 15 members of the organization, and/or their families, would have had to spend each year in order to reach the organization's total gross receipts for 20XX and 20XX. For 20XX, the average amount a member and/or their family would have had to spend at the organization would have been $. For 20XX, the average amount would have been $. Given the fact that ORG had only 15 members and 100 customers per night and because it lacks the records to substantiate the source of its gross receipts, we have determined that ORG is operating a business that is open to the public and it is not operating exclusively to provide social and recreational activities to its members.

Based on the evidence that has been produced to date, it appears that the organization's exempt activities are insignificant in comparison to ORG's operation of the business. Moreover, ORG failed to substantiate what purpose was served by the donations.

Issue 2. ORG's net income inured to the benefit of its President, President, during 20XX and 20XX, respectively.

In the mortgage note for the business, the loan document states the borrowers are: President, President; Vice-President, Vice President; and RA-1, Vice President's wife. This loan appears to benefit the three partners as the contract does not mention the tax exempt organization anywhere in it. The contract also states that this is "A General Partnership". (See Exhibit C.)

There is a contract between President, President, and RA-2, spouse; that states that entitled to half of the profits for the weekend sales from the business. It states that the maximum amount to be paid to her is $, and this is to be paid every Monday. (See Exhibit B.)

An organization does not qualify for exemption from federal income tax under section 501(c)(19) of the Code if any of its assets or earnings inure to the benefit of any insiders. See Treas. Reg. § 1.501(c)(19)-(a)(1). Although stated in terms of the "net earnings" of an organization, the inurement doctrine applies to any transfer of an organization's assets. See People of God Community v. Commissioner, 75 T.C. 127, 133 (1980).

The prohibition on inurement in I.R.C. § 501(c)(19) is absolute even if the amount involved is considered to be de minimus. The Internal Revenue Service has the authority to revoke an organization's exempt status for inurement regardless of the amount of inurement. See Spokane Motorcycle Club v. U.S., 222 F. Supp. 151 (E.D. Wash. 1963);

Based on the foregoing, the reported income that the organization paid to the President's spouse in 20XX and 20XX, respectively, constitutes inurement. See Treas. Reg. § 1.501(c)(19)-(a)(1).

Issue 3. ORG has failed to satisfy the recordkeeping and reporting requirements provided by I.R.C. §§ 6001 and 6033.

As is discussed more fully above, in order to qualify for exemption under I.R.C. § 501(c)(19), 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.

During the years under examination, ORG failed to maintain records which distinguished the income that it derived from "veteran" members, the members' families, bona fide guests, auxiliary members, and non-veterans in connection with the organization's operation of its bar and/or lounge. Also, the organization produced very few records that substantiated the activities that it claimed were engaged in for exempt purposes. Additionally, the organization's Forms 990 for 20XX and 20XX do not accurately reflect the organization's activities, the nature of its income and/or expenses, or the amounts of its income and expenses as required under I.R.C. §§ 6001 and 6033, and the regulations promulgated under those sections.

Issue 4. ORG does not qualify for exemption under I.R.C. § 501(c)(19), and therefore its tax exempt status should be revoked for the following reasons:

1. ORG does not operate exclusively for exempt purposes, as required, because it primarily operates a bar and more than a substantial amount of sales are to the general public.

2. ORG's net income inured to the benefit to its founder and President during the years under examination.

3. ORG failed to meet the recordkeeping and reporting requirements required by I.R.C. §§ 6001 and 6033.

As indicated above, the operational test is not satisfied where any part of the organization's earnings inures to the benefit of private shareholders or individuals. ORG has operated in the

same manner since it was included in ORG's group exemption in April of 20XX. Accordingly, we have determined that recognition of exemption as an organization described in section 501(c)(3) is revoked effective as of April 1, 20XX. ORG is required to file Form 1120 returns for all open tax years ending after April 1, 20XX.

Issue 5. Alternatively, if ORG's exemption under I.R.C. § 501(a), as an organization described in I.R.C. § 501(c)(19), is not revoked, it is the government's position that, effective January 1, 20XX, the income that ORG received from its bar operations, vending machines, Keno, and gaming activities is unrelated business income under I.R.C. § 512, which is subject to tax pursuant to I.R.C. §511. In determining whether an income-producing activity is an unrelated trade or business, it must be shown that (1) there is a trade or business; (2) the trade or business is regularly carried on; and (3) the conduct of the trade or business is not substantially related to the organization's exempt purpose or function. See Treas. Reg. § 1.513-1(a).

As is discussed more fully above, gross income is derived from an unrelated trade or business if the trade or business is not substantially related (other than through production of funds) to the purposes for which exemption is granted. See Treas. Reg. § 1.513-1(d)(1). To escape taxation as unrelated business income, the organization's activities, which give rise to the income, must contribute directly and importantly to the accomplishment of one or more of the organizations exempt purposes. See Treas. Reg. § 1.513-1(d)(2).

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

Since the organization's bar income that was derived from the general public is unrelated to the organization's exempt purposes, and the organization failed to maintain records that delineated between the income that it derived from members and non members, and because it was unable to establish which part of the income was related to and/or generated by members of the organization as opposed to nonmembers, such income should be considered to be unrelated trade or business income and it is therefore subject to income tax. No reasonable basis was provided to explain how such income was determined. Accordingly, the organization is liable for $12,694.20 in Federal income tax for the year ending December 31, 20XX, and $6,477.36 in Federal income tax for the year ending December 31, 20XX. The organization is

required to file Form 990-T returns for all subsequent tax years. See Exhibit B for a list of taxable income & deductible expenses determined during the audit and form 4549 for computations of the Federal income tax owed.

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

Internal Revenue Service