



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
TE/GE EO EXAMINATIONS
1100 COMMERCE ST. MAIL CODE 4920 DAL
DALLAS, TEXAS 75242

501.19-00

Date: January 10, 2011

Number: 201414027
Release Date: 4/4/2014

LEGEND
ORG - Organization name
XX - Date Address - address

ORG
ADDRESS

Employer Identification Number:
Form:
Tax Period(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Voice:
Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear :

In a determination letter dated January 19XX, you were held to be exempt from Federal income tax under section 501(c)(19) of the Internal Revenue Code (the 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. On August 23, 20XX, you signed Form 6018-A, *Consent to Proposed Action*, agreeing to the revocation of your exempt status under section 501(c)(19) of the Code.

You have filed taxable returns on Forms 1120, *U.S. Corporation Income Tax Return*, for the years ended December 31, 20XX, December 31, 20XX, and December 31, 20XX with us. 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

Internal Revenue Service

Department of the Treasury

TE/GE Exempt Organizations
915 Second Avenue, M/S W540
Seattle, Washington 98174

Date: January 11, 2010

Taxpayer Identification Number:

Form:

Tax Period(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Dear _____,

We have enclosed a copy of the preliminary findings of our examination, explaining why we believe revocation of your exempt status under section 501(a) of the Internal Revenue Code (Code) is necessary. Please respond within 30 days of the date of this letter.

As noted in the attached report, it would be possible to avoid revocation if you were to amend the organization's bylaws to include and limit the social member class. If you would like to take this option please submit the amended and signed bylaws to the individual listed above.

If you accept the proposed revocation, please sign and return the enclosed Form 6018-A, *Consent to Proposed Action*, to the individual listed above. We will then send you a final letter revoking your exempt status. Please also file Federal income tax returns (Forms 1120) for tax years ending December 31, 20____ and December 31, 20____, with the individual listed above.

If you disagree with our findings, please provide in writing any additional information you believe may alter the findings. Your reply should include a statement of the facts, the applicable law, and arguments that support your position. Please also include any corrections to the facts that have been stated, if in dispute.

Upon receipt of your response, we will evaluate any additional information you have provided prior to issuing any final report of examination.

Alternatively, you may have the option of entering into a *Fast Track* settlement agreement. Please refer to the information enclosed regarding the possibility of this option.

Thank you for your cooperation.

Sincerely,

Anne Jewell
Revenue Agent

Internal Revenue Service

Department of the Treasury

Enclosure:

Form 4564, Information Document Request

Form 886-A, Explanation of Items

Publication 4167, Appeals - Introduction to Alternative Dispute Resolution

Form 6018-A, Consent to Proposed Action

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

LEGEND

ORG - Organization name EIN - ein XX - date City - city State - state
 Agent - agent POA - poa Commander - commander Quartermaster - quartermaster
 Manager - manager DIR-1 - 1st DIR CO-1 THROUGH CO-3 - 1st THROUGH 3rd COMPANIES

ISSUES

1. Does the organization qualify for exemption under Internal Revenue Code (IRC) § 501(a) as an organization described under IRC § 501(c)(19)?
2. Does the organization qualify for exemption under IRC § 501(a) as an organization described under IRC § 501(c)(4)?
3. Does the organization qualify for exemption under IRC § 501(a) as an organization described under IRC § 501(c)(7)?
4. Does the organization qualify for exemption under IRC § 501(a) as an organization described under IRC § 501(c)(8) or IRC § 501(c)(10)?
5. If the organization qualifies for exemption under one of the above code sections, what is the correct amount of tax assessed to the organization as unrelated related business income tax (UBIT) imposed under IRC § 511 on Form 990-T, *Exempt Organization Business Income Tax Return*?
6. If the organization does not qualify for exemption under one of the above code sections, what is the correct amount of tax to be assessed on Form 1120, *U.S. Corporation Income Tax Return*?

FACTS

The Articles of Incorporation (AOI) for the organization were filed in State on December 13, 19XX. The document determines that the official name of the organization as DIR-1, ORG of the United States (Organization). Per the AOI, the organization is organized for Fraternal, Patriotic, Historic, and Educational purposes. Otherwise, it states that they are to preserve and strengthen comradeship within the membership, to assist worthy comrades, to perpetuate the memory and history of our dead and to assist their widows and orphans. The organization also states in its purpose that they are to maintain true allegiance to the government of the United States and fidelity to its constitution and laws, to foster true patriotism, to maintain and extend the institutions of American Freedom, to preserve, and defend the United States from all her enemies. The organization had retained a signed and stamped copy of the original articles of incorporation.

As the organization is exempt under a group ruling filed by the CO-1, the organization has not retained a copy of the exemption letter. During the examination it was determined that they were exempted from income tax as an organization described under IRC § 501(c)(19).

An examination of the Form 990, Return of Organization Exempt from Income Tax, for the period ending December 31, 20XX was initiated by the assigned agent of the Internal Revenue Service (Agent) on September 11, 20XX with the issuance of Letter 3611, *EO Initial Appointment Letter (No prior contact)*,

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Publication 1, *Your Rights as a Taxpayer*, and the initial Information Document Request (IDR). Initial appointment was conducted with assistance from Agent Agent on October 14, 20XX.

On October 2, 20XX the organization completed and signed a Form 2848, Power of Attorney and Declaration of Representative. The Form 2848 gave POA (POA), CPA, power of attorney privileges over income and employment tax matters for the years 20XX through 20XX.

The Agent interviewed Commander (Commander), Quartermaster (Quartermaster), Manager (Club Manager), and POA (POA) on October 14, 20XX concerning the activities and purpose of the organization. The following is a partial transcript of that interview.

Did you receive Publication 1, have you read it, and do you have any questions concerning your rights?

The quartermaster had read the publication and had no further questions.

To get a full understanding of your organization, please describe the history of your organization and all of its activities.

According to the articles of the organization they were created in 19XX. Their main activities include giving donations to various groups. The majority of the donations are spent on youth activates. The organization also runs a bar, bingo two nights a week and gambling (pull-tabs etc.). Other activates include an annual auction and "renting" the hall for memorial services and youth events. They collect little to no income from the rental of the hall. The organization also sponsors several of the local youth sports team.

Who is able to use your facilities?

The post has auxiliary members and social members that are able to use the bar and games besides actual members. Bartenders are required to check the membership license of all those using the bar. Guests can be brought in by a member but must also sign in with the guest book.

Do you have any activities that are open to the public?

Bingo games are open to the general public.

Who conducts the activities for the organization? Volunteers? Employees?

Employees dispense pull-tabs from behind the bar, however, there is a mix of volunteers and employees at other events.

The gambling revenue claimed as part of Program Service revenue. What is that income comprised of?

This included both the pull-tab and bingo income.

How much revenue is drawn in from Gambling activates? What different activities?

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Most of the income generated by the organization is from gambling activities. Some activities include bingo, pull-tabs, and punch boards.

How is the Gambling revenue accounted for?

The organization maintains separate bank accounts for this income. The income is used mostly for insurance and operating costs of the facility. Some donations are granted out of the gambling revenue.

How often are events held?

Bingo is held 2 nights a week (Sunday and Tuesday).

How do you determine if someone is a member or non-member?

Membership cards are checked at the bar. The cards are color coded to show if they are current.

Is this a membership organization?

What is the breakdown between veterans and non-veterans in your organization?

How do you keep track?

A list of members comes from the national organization every year.

May I see the documents kept to substantiate the membership requirements?

This documentation is kept in a card file.

What classes of members are there and are there any differences in voting rights?

There are regular members (those vetted by the national organization), some of these are annual and others are lifetime. Social members do not have voting rights.

Are there associate member classes? If yes, do they have voting rights?

The organization said there were no associate members. The organization does not consider social members an associate member class.

What are the dues & initiation fees for the various classes of members?

Dues are \$ a year where \$ goes to the national organization as a set figure.

Do you have an auxiliary organization? CO-2 or other Social Club?

There is a CO-2 of this organization and they are given a membership and allowed to use the bar like the regular members.

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There are approximately 118 auxiliary members. They have access to the organization's facilities.

What are the member benefits? Are there any ancillary benefits such as group health, accident, life and/or disability insurance, credit cards or cellular phone service?

Some insurance companies give a small discount to members and the national organization provides life and dismemberment benefits.

How often are general meetings and board meetings held? When are the meetings held? Where are the meetings held?

Monthly with board meetings preceding the general meeting usually.

Does the organization own, lease or sublease any real property? If so, is the property encumbered by debt?

The organization owns the building and a command car used in parades.

Is a portion of your property a bar or restaurant? If so how much?

According to the manager about half of the bottom floor is used as a bar area.

What portion of the building is used for gambling activities?

The same area as the bar is used for gaming activities as pull-tabs are sold from behind the bar. Bingo is held in the other half of the room.

Are there any employees of the organization? State the number and type of positions. Have all federal and state employment tax returns been timely filed?

There are 3 bartenders, one janitor, and one manager on staff at one time.

Which employees conduct each activity?

Bartenders sell pull-tabs from the bar. The manager supervises the workings of the bar and pull-tab operation.

How long is spent conducting those activities?

The organization allocates wages 50/50 between gambling and bar for the bartenders and the manager.

Is an auto available for use by any employee, including personal use? How is the personal use of the auto treated for W-2 purposes?

No, the organization has a command car but it is only used for official business.

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Are any officers or board members compensated? How is the compensation treated? (W-2/1099)

Quartermasters can be compensated, however, it was not drawn by the current quartermaster.

Does the organization maintain an accountable plan for reimbursements to officers, board members or employees per IRC 62(c)? (Does the organization require receipts for reimbursements and require vouchers/invoices?)

The organization pays very few reimbursements. The manager gets reimbursed for mileage if she drives to City (\$). Most expenses that would be reimbursable are paid out of cash on hand.

Did the organization pay any amounts to any individual for service performed for the organization (independent contractor)? If the amount was in excess of \$600 for a calendar year, did the organization file Forms 1096 and 1099-MISC? Describe the services performed.

There was work done on the building and no 1099 was filed. The organization did not know if the contractor should have gotten Form 1099.

How many people on average are in the bar on any given day? What percentage of those are auxiliary members? Social Members? Guests? Regular Members?

There are approximately 30-40 people a day in the bar on average. Of those 8 are auxiliary members, 8 are social members, the rest are guests and regular members.

The agent sampled the membership records as part of the examination of books and records. A total of 116 member records were reviewed. Out of the sample of 116 members, 45 member records (%) did not documentation to establish veteran credentials such as Form DD-14, etc.

Organizational records indicated that the post had 258 members that had been vetted by the national organization. In addition, organizational records showed that the post had a total of 198 social members in tax year 20XX as evidenced by the list of courtesy cards provided to social members. As stated in the initial interview, the post had 118 auxiliary members who have access and use of the post facilities.

The agent sampled the guest log book for tax year 20XX. The log book recorded 517 guests over a 182 day timeframe for an average of 2.83 guests for each day during the sampled.

As part of the examination, the organization provided financial statements for the year of 20XX and 20XX. Below is a consolidated income statement of the organization for both years under examination.

Consolidated Income Statement
ORG

	20XX	% of Total	20XX	% of Total
Revenue				
Bar Sales				
Liquor Sales				

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Beer Sales
 Cigarette Sales
 Gambling
 Pull-tab & Fishbowl Income
 Punchboard Income
 Bingo
 Bingo Income
 General
 Raffle Income
 Member Dues & Fees
 Donations - MISC
 Merchandise Sales
 Commission Income
 Total Revenue

Cost of Goods Sold
 Bar Sales
 Liquor
 Beer & Wine
 Bar Supplies
 Food
 Cigarettes
 Gambling
 Gambling Supplies
 Gambling Cash Prizes
 Gambling Merchandise Prizes
 Bingo
 Bingo Supplies
 Bingo Cash Prizes
 Total Cost of Goods Sold

Gross Revenue

 Operated Expenses
 Advertising
 Bad debts
 Business Taxes
 Cash Short (over)
 Casual Labor
 Cleaning & Janitorial
 Computer & Software
 Convention Expense
 Contribution Expense
 Bank Charges
 Depreciation
 Dues & Subscriptions
 Entertainment

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Freight & Postage		
Insurance		
Licenses & Fees		
Maintenance & Repairs		
Membership Fees		
Member Expense		
Office		
Payroll Taxes		
Phone		
Professional Fees		
Scholarship Awards		
Security		
Supplies		
Small Equipment		
Utilities		
Veterans Relief		
Quartermaster Allowance		
Wages - Bartenders		
Wages - manager		
Wages - CO-3		
Total Operating Expenses	_____	_____
Income from Operations		
Other Revenue & Expense		
Interest Income		
Sales of Inventory	_____	_____
Total Other		
Net Income (Loss)	=====	=====

Scholarship Awards did not appear on the consolidated financial statements created by the organization but was included in the operating expenses for the general fund operations in 20XX. This error was not repeated in 20XX. There were no other variations between the financial statements of the organization.

The financial statements provided by the organization show a break down of expenses for each activity in 20XX and 20XX, which provides the source documentation for the above table.

On October 14, 20XX, the agent held an initial closing conference with the individuals directly after the initial interview to discuss preliminary findings. These findings included a discussion of the filing requirements of the 990-T for that income generated by the public. The agent held a secondary closing conference on October 15, 20XX to discuss a possible revocation of the tax exempt status of the organization due to the membership requirements. The agent spoke with the POA several times to discuss the progress of this issue and possible solutions proposed.

LAW

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

Internal Revenue Code (IRC) §501(a) states that organization described under subsection (c) or (d) shall be exempt from taxation.

An organization described under IRC §501(c)(19) is a post or organization of past or present members of the Armed Forces of the United States and must be organized in the United States. Such an organization must also have at least 75% of its members be past or present members of the armed forces and substantially all of the other members are cadets, or spouses, widows, widowers, ancestors, or lineal descendants of past or present members of the armed forces or cadets. Otherwise, no amount of the net earnings of the organization can inure to the benefit of a private shareholder.

Federal Tax Regulations (Regulations) §1.501(c)(19)-1(b) speaks about the membership requirements of an organization described under IRC §501(c)(19). Regulations §1.501(c)(19)-1(b)(1) states that there are two membership requirements that must be met for the organization to qualify as an organization described under IRC §501(c)(19). The first requires that 75% of the members of the organization be war veterans. A "war veteran" is defined as persons, whether or not present members of United States Armed Forces, who have served in the Armed Forces during a period of war. This definition includes the Korean and Vietnam conflicts.

Regulations §1.501(c)(19)-1(b)(2) states that of the total membership, 97.5% must be a war veteran, a present or former member of the Armed Forces, a cadet (which includes only students in college or university ROTC programs or students at Armed Services academies), or a spouse, widow, or widower of individuals listed above.

Regulations §1.501(c)(19)-1(c) states that the organization must be organized exclusively to promote the social welfare of the community as defined in §1.501(c)(4) -1(a)(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, to provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States, to carry on programs to perpetuate the members of deceased veterans and members of the Armed Forces and to comfort their survivors, to conduct programs for religious, charitable, scientific, literary, or educational purposes, to sponsor or participate in activities of a patriotic nature, to provide insurance benefits for their members or dependents of their members or other, or to provide social and recreational activities for their members.

IRC §501(c)(4) describes organizations that are organized exclusively for the promotion of social welfare or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality and the net earnings of which are devoted exclusively to charitable, education, or recreational purposes.

Regulation §1.501(c)(4)-1(a)(2)(i) states that an organization operated exclusively for the promotion of social welfare is primarily engaged in promoting in some way the common good and general welfare of the community. The organization is operated primarily for the purpose of cringing about civic betterments and social improvements.

Regulations §1.501(c)(4)-1(a)(2)(ii) states that the promotion of social welfare does not included the direct or indirect participation in political campaigns nor can it qualify if the primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

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Revenue Ruling 68-46 states that a veterans organization will not qualify for exemption under IRC §501(c)(4) if it is primarily engaged in a trade or business open to the public as the organization is not primarily organized to promote the social welfare of the community.

IRC §501(c)(7) excludes from income tax clubs that are organized for pleasure, recreation, and other nonprofit purposes, substantially all of the activities of which are for such purposes and no part of the net earnings inure to the benefit of any private shareholder.

Regulations §1.501(c)(7)-1(a) state that besides those requirements listed above such clubs must be supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified if it raises revenues from members through the use of club facilities or in connection with club activities.

Regulations §1.501(c)(7)-1(b) states that a club that engages in a business such as making its social and recreational facilities available to the general public or selling other products is not organized and operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not jeopardize exemption.

Revenue Ruling 66-150 states that an organization which operates a social club as its primary activity qualifies for exemption under IRC §501(c)(7).

Public Law 94-568 (1976 HR 1144) states that substantially all of the income received by an organization must be for the exempt purpose stated in IRC §501(c)(7). Limitations have been adopted by the Internal Revenue Service to determine the tax exempt status of an organization. The limitations state that an organization may receive no more than % of their gross income from non-member use of the facility and no more than 35% from both non-member use and investment.

In *West Side Tennis Club v. Commissioner* (111 F.2d 6) the court determined that more than an insubstantial amount of income received from non-members would jeopardize the tax exempt status of an organization described in IRC §501(c)(7).

IRC §501(c)(8) excludes from income tax fraternal organizations that operate under a lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system. Such an organization must also provide payment of life, sick, accident or other benefits to members of such an organization.

Regulations §1.501(c)(8)-1(a) defines "operating under a lodge system" to mean carrying on its activities under a form of organization that comprises local branches, charter by a parent organization and are largely self-governing. Such an organization must also have an established system for payment of its members or dependents like, sick, accident, or other benefits.

Revenue Ruling 64-194 states that organizations exempt under IRC §501(c)(8) must provide benefits to a substantial portion of their members, however, it is not required to supply benefits to all members. The secondary class who are not entitled to benefits in the case discussed in the Revenue Ruling is also classified in the bylaws of the organization and no portion of the dues collected from those members is used to pay the benefits provided to others.

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IRC §501(c)(10) excludes from income tax those domestic fraternal organizations that are operated under a lodge system and the net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes and do not provide payment of life, sick, accident, or other benefits.

Regulations §1.501(c)(10)-1(a) states that with the exception that the organization does not provide payment of benefits to members and must devote its net earnings exclusively to religious, charitable, scientific, literary, educational, or fraternal purposes. Also, an organization described in IRC §501(c)(7) is not qualified as an organization exempt under IRC §501(c)(10).

IRC §512(a)(1) provides that "unrelated business taxable income" is the gross income earned by any organization through a unrelated trade of business that is regularly carried on, less deductions allowed by this chapter which are directly connected with the carrying on of such trade or business.

IRC §512(a)(4) provides a special rule for organization described under IRC § 501(c)(19). The rule states that any amount attributable to the payment of life, sick, accident, or health insurance for members or their dependents which is set aside. If any amount of the moneys set aside is used for a purpose other than the above described, such amount shall be included in unrelated business income for that taxable year.

Regulations §1.512(a)-1(a) defines "unrelated business taxable income," except as otherwise provided in §1.512(a)-2, §1.512(a)-4, or paragraph (f) of this section, as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the IRC, but also must be directly connected with the carrying on of unrelated trade or business. Except as defined in paragraph (d)(2) of this section, to be "directly connected with" the conduct of unrelated business for purposes of IRC §512, and item of deduction must have a proximate and primary relationship to the carrying on of that business. If such income is derived from multiple unrelated business activities, then the unrelated business taxable income is the aggregate of the gross income from all such activities less the aggregate of the deductions allowed with respect of all such activities.

Regulations §1.512(a)-1(b) defines expenses, depreciation, and other similar items that are attributable solely to the conduct of unrelated business activities are those proximately and primarily related to that business activity. Such expenses qualify for deduction to the extent that they meet the requirements of IRC §162, IRC §167, or other relevant section of the IRC. Thus, the wages of personnel employed full-time in carrying on unrelated business activities are directly connected with the conduct of said activity and are deductible in computing unrelated business taxable income if they otherwise qualify under the requirements of IRC §162.

Regulations §1.512(a)-1(c) provides instruction when facilities or personnel are used for both exempt activities and the conduct of an unrelated trade or business. The regulation provides that expenses, depreciation, and similar items shall be allocated between the two activities on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business is proximately and primarily related to that business activity and shall be allowable as a deduction in computing unrelated business taxable income to the extent provided by IRC §162, IRC § 167, or other relevant Code section.

In *Rensselaer Polytechnic Institute v. Commissioner* (732 F.2d 1058, 2nd Cir. 1984), the court held that when allocating expenses from one fixed location to multiple exempt and non-exempt activities a reasonable allocation factor for expenses should be based on actual use of the facility. For instance, when allocating indirect expenses, such as depreciation, a reasonable basis would be actual factory hours used for the non-exempt purpose.

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In Louisiana Credit Union League v. United States (693 F.2d 525, 5th Cir. 1982), the court held that, if an activity is not substantially related to the exempt purpose of the organization, the income generated from such an activity is taxable as unrelated business income. In such a situation, the court holds that it is not necessary to prove unfair competition between the organization and a taxable entity.

In South End Italian Independent Club, Inc. v. Commissioner (87 T.C. 168, 1986), a president is set involving the use and deductibility of net income from gaming. This case refers to a situation where Massachusetts law stated that income received beano games must be donated for charitable, religious, and educational uses. It was determined that contributions used in this manner are fully deductible from "unrelated business income" as an expense. This requirement is included in many states laws and local law governs the disposition of income from gaming for a lawful purpose.

Per Washington Administrative Code 230-07-010, Organizations conducting gaming activities within the State of Washington are required to use all net income from gambling activities exclusively for lawful purposes stated on the organization's license application.

IRC §61(a) defines gross income. Per this section, gross income includes all income from whatever source derived and includes but is not limited to compensation for services, gross income derived from business, gains from dealing in property, interest, rents, royalties, dividends, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts, pensions, income from the discharge of indebtedness, distributive share of partnership income.

Regulations §1.61-1(a) states that gross income is income realized in any form. This can be realized as cash, services, meals, accommodation, stock, or other property.

IRC §102(a) specifically excludes the value of property acquired by gift, bequest, devise, or inheritance from gross income.

Regulations §1.102-1(a) states that property received as a gift is not includible in gross income, however, any income received from said property is includable.

IRC §277(a) provides that membership organizations that are primarily operated to furnish goods or services to members may only deduct such expenses attributed to those goods or services to the extent of the income derived during such a year from members or transactions with members. If such deductions exceed the income generated by members in any taxable year the balance is treated as if it is attributable to the paid or incurred for members in the succeeding year.

Deductions allowed by IRC §§ 243, 244, and 245, which relate to dividends received by corporations, shall not be allowed by organizations which fall under IRC § 277.

Revenue Ruling 20XX-73 refers to a taxable membership organization which has significant non-member income. The ruling holds that net operating losses from member transactions cannot be used to offset income received from non-members. Investment income is also considered non-member income and not eligible to offset losses from member transactions. IRC §277(a) requires that the member losses be carried forward to the next tax year as expenses in providing goods and services to members. The ruling also holds that non-member transactions are fully deductible against all income.

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TAXPAYER'S POSITION

The agent made minor changes to the calculations shown in this report in the Addendum to this report issued when it was noted that the agent had not correctly calculated the deductions from taxable income. The organization has agreed with the revised findings as evidenced by the signed Form 6018-A and converted Forms 1120 filed with the agent.

GOVERNMENT'S POSITION

ISSUE # 1

Does the organization qualify for exemption under IRC §501(a) as an organization described under IRC §501(c)(19)?

It is the government's position that this organization does not qualify for exemption under IRC §501(c)(19).

IRC §501(c)(19) requires that % of total membership of the veterans organization be made up of current or former members of the United States Armed Forces.

The organization falls short of this figure due to the social members who are not considered veterans per the definition outlined in the discussion of this IRC section. Regulations §1.501(c)(19)-1(b)(2) states that of the total membership % must be cadets or spouses or widows of a war veteran or cadet.

Per the facts above, the organization has 258 members who have been vetted as veterans by the national organization. They also have a total of 198 social members listed in a roster of the organization. If it is assumed that all of the members vetted by the national organization are veterans the following calculation shows if the organization qualifies as an IRC § 501(c)(19).

Enter taxpayer's name:	=>	ORG
Enter tax year ending in month/day/year format:	=>	12/31/20XX
<u>War veterans</u>	=>	258
<small>(Persons who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts))</small>		
<u>Veterans</u>	=>	0
<small>(Present or former members of the United States Armed Forces)</small>		
<u>Cadets</u>	=>	0
<small>(Including only students in college or university ROTC programs or at Armed Services academies)</small>		
<u>Spouses, widows, or widowers</u>	=>	0

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(Spouses, widows, or widowers of individuals described in the two above categories (war veterans, veterans, and cadets))

All Others

=>

198

Total Membership

456

Membership Requirement Test

percent test	%	Fail
percent test	%	Fail

Contribution Deductibility Test

percent test	%	Fail
---------------------	----------	-------------

It is also noted in the Facts section to this report that the organization did not have adequate documentation (Form DD-214, etc.) for all of the members vetted by the national organization. Should those members without documentation also be removed from the total count of veteran members the figures are as seen below.

Sample of Master Member List	116
Number without Documentation	<u>45</u>
Percentage without Documentation	%
 Total Number on Membership List	 258
Percentage without Documentation	<u>%</u>
Calculated number off List without Documentation	100.09

Then the calculation for the membership percentage is below.

Enter taxpayer's name: =>

ORG

Enter tax year ending in month/day/year format: =>

12/31/20XX

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<u>War veterans</u>	=>	158
(Persons who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts))		
<u>Veterans</u>	=>	0
(Present or former members of the United States Armed Forces)		
<u>Cadets</u>	=>	0
(Including only students in college or university ROTC programs or at Armed Services academies)		
<u>Spouses, widows, or widowers</u>	=>	0
(Spouses, widows, or widowers of individuals described in the two above categories (war veterans, veterans, and cadets))		
<u>All Others</u>	=>	298
<u>Total Membership</u>		456

Membership Requirement Test

percent test	%	Fail
percent test	%	Fail

Contribution Deductibility Test

percent test	%	Fail
---------------------	---	-------------

In both of the above tests, the organization fails to meet the membership requirement to qualify as an organization described under IRC §501(c)(19). As such, the organization no longer qualifies for exemption from Federal income tax under IRC §501(c)(19).

ISSUE # 2

Does the organization qualify for exemption under IRC § 501(a) as an organization described under IRC § 501(c)(4)?

It is the government's position that this organization does not qualify for exemption from taxation under IRC §501(c)(4) as a social welfare organization.

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A social welfare organization must be organized exclusively for the promotion of social welfare and the net earnings must be devoted exclusively to charitable, educational, or recreational purposes. Regulations §1.501(c)(4)-1(a)(2)(i) and (ii) state that such an organization must be primarily engaged in promoting the common good and general welfare of the community. As such an organization cannot qualify for exemption if the primary activity is operating a social club for the benefit of their members.

This organization's primary activities include the operation of a bar, selling pull-tab games, and the operation of bingo for members and guests. These activities are for the benefit, pleasure, and recreation for members and guests. An organization can not qualify for exemption if their primary activity is the operation of a social club. As such, this organization does not qualify for exemption under IRC §501(c)(4).

ISSUE # 3

Does the organization qualify for exemption under IRC § 501(a) as an organization described under IRC § 501(c)(7)?

It is the government's position that this organization does not qualify for exemption under IRC § 501(c)(7).

Organizations exempt under IRC §501(c)(7) must be supported primarily by membership fees per Regulations §1.501(c)(7)-1(a). However, such an organization will not lose its exemption if income is raised from services performed to members. Regulations §1.501(c)(7)-1(b) states that if an organization engages in a business of opening its social and recreational facilities to the general public, it is not operated exclusively for pleasure, recreation, and social purposes. Public Law 94-568 states that substantially all of the income received from an organization must fall under the exempt purpose of an organization described under IRC §501(c)(7). Limitations were placed on the percentage of non-member income a social club exempt under IRC 501(c)(7) could receive. An organization can receive up to % of its income from Investment and Non-Member income. Of that, no more than % can be received from non-member use of the facility.

As was stated in Revenue Ruling 66-150, any organization that operates a social club as its main activity will qualify for exemption provided it meets all other criteria for exemption. ORG operates a bar and other social activities as its primary activity. As such it will qualify for exemption if it has less than % of its income being generated by non-member use of the facility. For an organization exempt under IRC 501(c)(7), all income received from non-members is subject to taxation as unrelated business income. This amount includes income received from non-members from bingo.

Per the facts given above the following calculation has been created to estimate the total amount of income generated by non-member use of the facility during the tax years under examination.

Income Received from Non-Members

Account	Amount Per Income Statement	Allocation Factor	Amount Allocable	Percent of Total Income	Allocation Method
Bar Sales					Method 1
Gambling Sales					Method 1
Bingo					Method 2

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Allocation Methods:

Method 1: Used to determine the amount of non-member income generated by the bar and gambling operations.

Per the initial interview, there are 30 to 40 people in the bar over the course of a typical day. Included in that group are 8 auxiliary members and 8 social members. It was also calculated that on a given day there are 2.83 guests on a typical day. To calculate this allocation figure I have taken the number of auxiliary members and guests and divided that figure by 35 total customers in the bar. This percentage determines the amount of income from these activities is generated by non-members.

Method 2: Used to determine the amount of bingo sales attributable to non-members.

This activity is open to the public and the organization does not track how many members or non-members are using the facility at these times. As such, it was determined that the whole amount of such income is taxable to the organization as being from non-members.

Amendments must be made to the organizing documents to include social members as a membership class. Otherwise, all income generated by social members is taxable to the organization as non-member income.

As noted above, non-member income is % of total income which significantly exceeds the % limitation set forth in Public Law 94-568. This amount can not be considered insignificant. In the case West Side Tennis Club v. Commissioner, it was determined that if an organization had more than an insignificant amount of income received from non-members, it would jeopardize the exempt status of the organization as a IRC §501(c)(7).

As such, this organization does not qualify for exemption under IRC §501(c)(7).

ISSUE # 4

Does the organization qualify for exemption under IRC § 501(a) as an organization described under IRC § 501(c)(8) or IRC § 501(c)(10)?

It is the government's position that this organization could qualify for exemption under IRC §501(c)(8) if certain criteria are met.

IRC §§ 501(c)(8) and (10) are both organizations which are organized under a lodge system as defined in Regulations §1.501(c)(8)-1(a). Organizations exempt under these IRC sections are similar to each other but have a few major differences. The first difference is that IRC §501(c)(8) requires that the organization provide life, sick, accident, or other benefits to members. While this requirement is not absolute, a substantial number of members must be eligible for coverage per Revenue Ruling 64-194. Organizations described under IRC §501(c)(10) can not provide such benefits to its members. The second difference is Regulations §1.501(c)(10)-1(a) limits the uses of the net earnings of the organization if exempt under IRC §501(c)(10).

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As stated in the initial interview, the organization provides benefits to their members though a plan provided by the national organization. This is a qualifying factor for exemption under IRC §501(c)(8). Also, as the organization is organized under the national organization but is otherwise independent it is treated as being operated under a lodge system.

A veteran's organization that wishes to be exempt under this IRC section must have a membership that consists of mostly members. They are, however, allowed to have multiple classes of members as long as they are outlined and limited in the bylaws of the organization. If such a class is not outlined then a large portion of the income generated by the organization is taxable as unrelated business income. As this organization has a substantial number of social members, they would need to amend their bylaws to include the social member class or they would not qualify for exempt status.

Therefore, if the organization were to change their bylaws to include the social member class as well as a restriction on the number of social members at any given time, this organization would qualify as an organization described under IRC §501(c)(8).

ISSUE # 5

If the organization qualifies for exemption under one of the above code sections, what is the correct amount of tax assessed to the organization as UBIT imposed under IRC § 511 on Form 990-T, Exempt Organization Business Income Tax Return?

If the organization were to be exempt under IRC §501(c)(8) a certain percentage of the income received from the bar and gaming activities is subject to UBIT under IRC §511. All figures in the following discussion are calculated under the assumption that the bylaws of the organization have been changed to include the additional class of members as discussed in Issue #4. It has also been assumed that the allocation factors will not have changed between 20XX and 20XX besides the Gross Profit Percentage. Unrelated business income is defined for the organization if exempt under IRC §501(c)(8) in the following discussion and table outlined in Calculation of Tax.

Unrelated Business Income

Per IRC §512(a)(1), an organization described under IRC §501(c)(8) is subject to "unrelated business income tax" from any unrelated trade or business that is regularly carried on by the organization. Regulations §1.512(a)-1(a) further defines "unrelated business taxable income" as any amount derived from such an unrelated business, less those expenses allowable under chapter 1 of the IRC and proximate and primary to the conduct of such unrelated business. Expenses that are generated by more than one activity should be allocated between them on a reasonable basis such as the actual use of the facility. See Regulations §1.512(a)-1(c) and Rensselaer Polytechnic Institute v. Commissioner.

Additional issues arise with income generated from gaming. Lawful purpose expenditures may be deducted against gaming income under IRC §162 as a business expense if that income is used in accordance with the state laws for the lawful purposes. See South End Italian Independent Club, Inc. v. Commissioner. The Washington Administrative Code 230-07-010, states that net income received from gaming activities must be used for the lawful purposes stated in the application for the gaming license.

As a large portion of the income received by the organization as wagers is transferred to the Post account and then used for operations and other disbursements it is likely that this organization's income from

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gambling will be deductible as a lawful purpose deduction. The lawful purpose deduction is calculated as the net income from gambling activities after being allocated. The deduction has been calculated as part of the calculation of tax portion of this report. The amount of the lawful purpose deduction for 20XX is \$ and \$ in 20XX.

The table below shows the amount of income allocable to non-members for the years 20XX and 20XX.

20XX

Account	Amount Per Income Statement	Allocation Factor	Amount Allocable
Bar Sales			
Gambling Sales			

20XX

Account	Amount Per Income Statement	Allocation Factor	Amount Allocable
Bar Sales			
Gambling Sales			

The allocation factor used to determine the above amounts of income using the same allocation method listed in Issue # 3 dealing with unrelated business income for a IRC § 501(c)(7). Per the initial interview, it was determined that there are eight auxiliary members who use the clubs facilities on a typical day. A six month sample was also taken of the guest register to determine the number of guests who use the clubs facilities on a typical day. The two classes of non-members listed above have been added together. The final allocation factor is further explained in the Allocation Methods portion of this report. The calculation of the number of non-members present is as follows.

Total Guests	
Guests	517
Days the Club was open to guests	182.5
Guests per day	2.83

Total Non-Members	
Auxiliary members	8
Guests	2.83
Total non-members per day.	10.83

Allocation Methods

Percentage of Non-Members

This figure is calculated by taking the total number of non-members on a typical day and dividing it by 35 total patrons as determined from the initial interview. This figure provides a good estimate for expenses that would otherwise be fully allocated to the bar or social areas of the facility. The factor will be used to allocate

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direct cost of goods sold for Bar Sales and Gambling as well as to allocate the wages of the Bartenders and Manager and any other expenses that can be directly attributed to the non-exempt activities. This factor will also be used to further allocate all of the below allocation methods to determine the percentage of each allocation that is attributable to non-members. The factor has been calculated below.

Percentage of Non-members	
Total non-members per day	10.83
Patrons per day	<u>35</u>
	%

Percentage of Space

Per the tour of the facility, it was noted that the building is three floors with the middle floor being 1/3rd the size of the other floors. The top floor is used solely for member activities. It was also noticed that the bar and socializing area usually used on a typical day is approximately 1/2 of the bottom floor. The middle floor holds the offices of the organization. It was the agent's assumption that the bar and socializing space is used for both members and non-members.

The office was used for the supervision of activities conducted in the bar and socializing area. As such, the agent has assumed that % of the space is used in these functions as calculated in the computations below. The factors calculated below will be used to allocate the fixed costs associated with the use of the facility.

Percentage of Space - Bar	
Bottom Floor Percentage of Whole	_____
Percentage of Bottom Floor Devoted to the Bar	_____

Percentage of Space - Office	
Bottom Floor Percentage of Whole	_____
Percentage of Middle Floor Devoted to the Office	_____

These factors are further allocated based on the percentage of non-members who participate in the activities.

Percentage of Space - Bar	
Percentage of Space - Bar	_____
Percentage of Non-members	_____

Percentage of Space - Office	
Percentage of Space - Office	_____
Percentage of Non-members	_____

The combined factor for the Percentage of Space is %.

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Percentage of Time

Per a conversation with the POA and per the initial interview, it was determined that the staff spent approximately half of their time on gaming activities and half on the bar activities. The agent has determined that this allocation figure is reasonable for the activities performed.

Activities Shared between the Bar and Gaming Activities

The agent has assumed that, as with staff time, all other expenses are evenly split between the two activities besides those that are directly attributable to one activity, such as cost of goods sold. As such, all expenses will be allocated % to bar activities and % to gaming activities. These amounts will be further allocated by percentage of non-members participation.

Gross Profit Percentage

This factor takes the total receipts from activities that may have non-member income reportable on Form 990-T divided by the total gross receipts of the organization for each year. This is used to allocate items which can not measured in percent of time or percent of space. The factor is further allocated based on the percentage of non-members to participate in the activities.

20XX

Gross Profit Percentage

Gross Revenue from Income Sources

Total Gross Revenue _____

Gross Profit Percentage

Non-Member Percentage _____

20XX

Gross Profit Percentage

Gross Revenue from Income Sources

Total Revenue Profit _____

Gross Profit Percentage

Non-Member Percentage _____

Allocated Expenses

The expenses will be allocated for each activity in the same manner as the preparer of the financial statements as being associated with each activity per the financial statements provided by the organization. The exception to the above statement is that the preparer of the statements included all operating expenses for the bar as being directly attributable to the bar only. The agent has determined that these operating expenses should be allocated using the same % allocation method used to determine the correct

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amount of wages for each activity. Some expenses included in the calculation of the net income from the bar activities can also be attributable to the general operation of the club and as such have been allocated further by either percent of space or percent of gross profit. All figures have been further allocated by the percentage of non-members.

The amounts allocated have been calculated below.

Cost of Goods Sold

As these expenses are directly attributable to the income generated from non-members in this case the expenses have been allocated based on the percentage on non-members, as calculated above, multiplied by the total expense shown on the financial statements. These calculations have been shown below.

	20XX			
Bar Sales	Amount	Factor	Allocated	Expense
Liquor				
Beer & Wine				
Bar Supplies				
Food				
Cigarettes				
Gambling				
Gambling Supplies				
Gambling Cash Prizes				
Gambling Merchandise Prizes				
Total Allocated Cost of Goods Sold				

	20XX			
Bar Sales	Amount	Factor	Allocated	Expense
Liquor				
Beer & Wine				
Bar Supplies				
Food				
Cigarettes				
Gambling				
Gambling Supplies				
Gambling Cash Prizes				
Gambling Merchandise Prizes				
Total Allocated Cost of Goods Sold				

Advertising

As advertising is substantially related to the earning of income and not the space associated with the collection of income this expense have been calculated based on the gross profit percentage, defined above, multiplied by the advertising costs for the bar and gaming activities. The advertising expenses have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below.

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20XX

Advertising	Amount	Factor	Allocated Expense
Bar			
Gaming			

20XX

Advertising	Amount	Factor	Allocated Expense
Bar			
Gambling			

Bad Debts

As the accounting for bad debts is substantially related to the collection of income and not the space associated with the collection of income this expense have been calculated based on the gross profit percentage, defined above, multiplied by the bad debt expense for the bar and gaming activities. The bad debt expense expenses have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below.

20XX

Bad debts	Amount	Factor	Allocated Expense
Bar			
Gambling			

20XX

Bad Debt	Amount	Factor	Allocated Expense
Bar			
Gambling			

Business Taxes

The amounts below are the actual figures paid by the organization for the payment of business taxes per the financial statements provided by the organization. As business taxes are calculated based off of the income generated the agent has used the gross profit percentage, calculated above, to allocate this figure. The allocation calculation is below.

20XX

Business Taxes	Amount	Factor	Allocated Expense
Bar			
Gambling			

20XX

Business Taxes	Amount	Factor	Allocated Expense
Bar			
Gambling			

Cash Short (over)

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The amounts shown below for Cash Short (over) are the actual figures displayed on the financial statements provided by the organization. As this figure is amount is directly related to the action of holding activities in the bar or games, the amount have been allocated based on a strict percentage of non-members. This is calculated below.

20XX

Cash Short (over)	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

20XX

Cash Short (over)	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Cleaning & Janitorial

The amount for cleaning and janitorial expense was only noted in the expenses listed for the bar. There is no further information to suggest that this amount relates the entire building. As such, the agent has allocated this amount only to the area that holds the bar using the percentage of space calculation for the bar area, as calculated above. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. The amount allocated has been calculated below.

20XX

Cleaning & Janitorial	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

20XX

Cleaning & Janitorial	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Computer & Software

As computer and software expense is substantially related to the collection of income and not the space associated with the collection of income this expense have been calculated based on the gross profit percentage, defined above, multiplied by the computer and software costs for the bar and gaming activities. The advertizing expenses have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below. There were no Computer & Software expenses claimed for 20XX.

20XX

Computer & Software	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
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Bar
Gambling

Bank Charges

As the fees charged by the bank are substantially related to the earning and deposit of income and not the space associated with the collection of such income this expense have been calculated based on the gross profit percentage, defined above, multiplied by the total bank charges for the bar and gaming activities. The bank charges have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below.

	20XX		
Bank Charges	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Bank Charges	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Depreciation

The depreciation claimed by the organization has been allocated based on the total percentage of space that is used by the organization in operation of the bar and gaming activities. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such, this has been calculated using the total allocation factor that is the combination of the space allocated to the bar and the space allocated to the office multiplied by half the amount listed in the financial statements provided by the organization. The allocation has been calculated below.

	20XX		
Depreciation	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Depreciation	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Dues & Subscriptions

As the payment of dues and subscriptions is substantially related to the operation of the club and not the space associated with the production of income this expense have been calculated based on the gross

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profit percentage, defined above, multiplied by the amount of dues and subscriptions paid by the organization for the bar and gaming activities. This expense have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below.

	20XX		
Dues & Subscriptions	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Dues & Subscriptions	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Entertainment

The amount listed in the financial statements provided by the organization for Entertainment has been deemed by the agent as fully attributable to the operations of the bar and pull-tab operations. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such this expense has been allocated based on the percent of non-member participation in the bar and gaming activities. The allocation has been calculated below.

	20XX		
Entertainment	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Entertainment	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Insurance

The amounts listed below are the actual amounts shown on the financial statements provided by the organization for the insurance for each activity. As these amounts are distinct for the two activities the agent has determined that the amounts are fully attributable to the activities listed. As such they have been allocated based on the percent of non-member participation in the activities. The calculation of the allocation factor has been listed below.

	20XX		
Insurance	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

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20XX

Insurance Amount Factor Allocated Expense
 Bar
 Gambling

Licenses & Fees

The amounts listed below are the actual amounts shown on the financial statements provided by the organization for the insurance for each activity. As these amounts are distinct for the two activities the agent has determined that the amounts are fully attributable to the activities listed. As such they have been allocated based on the percent of non-member participation in the activities. The calculation of the allocation factor has been listed below.

20XX

Licenses & Fees Amount Factor Allocated Expense
 Bar
 Gambling

20XX

Licenses & Fees Amount Factor Allocated Expense
 Bar
 Gambling

Maintenance & Repairs

The amount listed on the financial statements provided by the organization did not include all expenses listed as repairs and maintenance and as such I have allocated this expense only to the space occupied by the bar. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. The amount has been allocated using the percentage of space attributable to the bar

20XX

Maintenance & Repairs Amount Factor Allocated Expense
 Bar
 Gambling

20XX

Maintenance & Repairs Amount Factor Allocated Expense
 Bar
 Gambling

Office

The amount listed in the financial statements provided by the organization for the office has been allocated based on the percent of space attributable to the office only. Also, as the amount is listed only on the bar

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expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such, half of the allocated expense is attributable to the bar and half to the gaming activity.

	20XX		
Office	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Office	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Payroll Taxes

This figure was calculated by taking the allocated figure for wages and multiplying it by %, the tax rate on Social Security and Medicare. As such the amount calculated below is fully attributable to the non-member portion of wages.

	20XX		
Payroll Taxes	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Payroll Taxes	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Phone

As the expense from the telephone is not substantially related to neither the space associated with the production of income nor is directly attributable to the production of income in the bar and gaming activities, this expense have been calculated based on the gross profit percentage, defined above, multiplied by the telephone costs for the bar and gaming activities. The telephone expense have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below.

	20XX		
Phone	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

	20XX		
Phone	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

Bar
Gambling

Professional Fees

As professional fees are not is substantially related to the collection of income nor the space associated with the collection of income this expense have been calculated based on the gross profit percentage, defined above, multiplied by the professional costs for the bar and gaming activities. The professional fees have been evenly distributed between the bar and gaming activities as it was assumed that half of all general operating costs associated will be allocated in this manner. The allocations have been calculated below.

20XX

Professional Fees	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

20XX

Professional Fees	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Security

The security expense claimed by the organization has been allocated based on the total percentage of space that is used by the organization in operation of the bar and gaming activities. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such, this has been calculated using the total allocation factor that is the combination of the space allocated to the bar and the space allocated to the office multiplied by half the amount listed in the financial statements provided by the organization. The allocation has been calculated below. There were no Security expenses claimed for 20XX.

20XX

Security	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Supplies

The supplies expense claimed by the organization has been allocated based on the total percentage of space that is used by the organization in operation of the bar and gaming activities. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such, this has been calculated using the total allocation factor that is the combination of the space allocated to the bar and the space allocated to the office multiplied by half the amount listed in the financial statements provided by the organization. The allocation has been calculated below.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

20XX

Supplies	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gaming			

20XX

Supplies	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Small Equipment

The small equipment expense claimed by the organization has been allocated based on the total percentage of space that is used by the organization in operation of the bar and gaming activities. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such, this has been calculated using the total allocation factor that is the combination of the space allocated to the bar and the space allocated to the office multiplied by half the amount listed in the financial statements provided by the organization. The allocation has been calculated below. There were no Small Equipment expenses claimed for 20XX.

20XX

Small Equipment	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Utilities

The utilities expense claimed by the organization has been allocated based on the total percentage of space that is used by the organization in operation of the bar and gaming activities. Also, as the amount is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar. As such, this has been calculated using the total allocation factor that is the combination of the space allocated to the bar and the space allocated to the office multiplied by half the amount listed in the financial statements provided by the organization. The allocation has been calculated below.

20XX

Utilities	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

20XX

Utilities	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

Wages

The amounts listed below except for the wages for CO-3 are taken directly from the financial statements provided by the organization. As the descriptions of actions performed by each position show that wages for the bartenders and manager are fully attributable to the conduct of the bar and gaming activities. As such these amounts have been allocated using the percent of non-member participation. The amount listed for Wages CO-3 is not fully attributable to the conduct of the taxable activities. As such this amount has been calculated using the percentage of space attributable to the bar and office areas of the organization. Also, as the amount of Wage CO-3 is listed only on the bar expenses in the financial statements provided by the organization and relates to the operation of the bar, the agent has used the assumption that half of this expense is attributable to gaming and half to the operation of the bar.

20XX

Wages - Bartenders	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			
Wages - manager			
Bar			
Gambling			
Wages - CO-3			
Bar			
Gambling			

20XX

Wages - Bartenders	<u>Amount</u>	<u>Factor</u>	<u>Allocated Expense</u>
Bar			
Gambling			
Wages - manager			
Bar			
Gambling			
Wages - CO-3			
Bar			
Gambling			

Calculation of Tax

Calculation of Unrelated Business Income Tax

	20XX			20XX		
	Amount	Allocation	Allocated Expense	Amount	Allocation	Allocated Expense
Income						
Bar Sales						
Gambling Sales						
Total Income						
Expense						

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

Cost of Goods Sold

- Bar Sales
 - Liquor
 - Beer & Wine
 - Bar Supplies
 - Food
 - Cigarettes
- Gambling
 - Gambling Supplies
 - Gambling Cash Prizes
 - Gambling Merchandise Prizes

Operated Expenses

- Advertising
 - Bar
 - Gaming
- Bad debts
 - Bar
 - Gambling
- Business Taxes
 - Bar
 - Gambling
- Cash Short (over)
 - Bar
 - Gambling
- Cleaning & Janitorial
 - Bar
 - Gambling
- Computer & Software
 - Bar
 - Gambling
- Bank Charges
 - Bar
 - Gambling
- Depreciation
 - Bar
 - Gambling
- Dues & Subscriptions
 - Bar
 - Gambling
- Entertainment
 - Bar
 - Gambling
- Insurance
 - Bar
 - Gambling
- Licenses & Fees

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

Bar
 Gambling
 Maintenance & Repairs
 Bar
 Gambling
 Office
 Bar
 Gambling
 Payroll Taxes
 Bar
 Gambling
 Phone
 Bar
 Gambling
 Professional Fees
 Bar
 Gambling
 Security
 Bar
 Gambling
 Supplies
 Bar
 Gambling
 Small Equipment
 Bar
 Gambling
 Utilities
 Bar
 Gambling
 Wages - Bartenders
 Bar
 Gambling
 Wages - manager
 Bar
 Gambling
 Wages - CO-3
 Bar
 Gambling
 Total Expenses

Unrelated Business Taxable Income

 Less: Specific Deduction

 Less: Lawful Purpose Deduction

 Adjusted UBIT

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX	

Tax Rate

%

%

UBIT

ISSUE # 6

If the organization does not qualify for exemption under one of the above code sections, what is the correct amount of tax to be assessed on Form 1120, U.S. Corporation Income Tax Return?

It is the government's position that if the organization is unable to change their bylaws they will no longer qualify for exemption from taxation and, therefore, must be reorganized as a taxable corporation.

IRC § 61(a) describes gross income as all income derived from any source unless specifically excepted. Regulations § 1.61-1(a) states that gross income is any income realized in any form. Income can be in the form of cash, services, meals, accommodation, stock, or other property.

IRC § 102(a) provides a specific exemption from gross income for property that is received by gift. However, this does not exclude any income received from the operation of such property.

IRC § 277(a) provides that membership organization that are primarily operated to furnish goods or services to members may deduct only those expenses attributed to those goods or services to the extent of the income received. Any losses in the must be carried forward to the next year. Revenue Ruling 20XX-73 expands this to state that an organization with significant non-member income can not use losses from member transactions to offset income received from non-members. Income from investment is also considered non-member income for the purposes of this section.

Calculation of Tax

As per IRC § 277(a), expenses incurred due to non-members can be deducted to their full extent and expenses related to members may only be deducted up to the extent of the income received. As such, I have allowed, to their full extent, those expenses noted above as being generated by non-members and have calculated the net income (loss) from member activities below.

	Income (Loss) from Members 20XX			20XX		
	Amount	Allocated to Non-members	Member Income	Amount	Allocated to Non- members	Member Income
Income from Members						
Bar Sales						
Gambling						
Bingo						
General						
Sales of Inventory						
Total Income from Members						
Cost of Goods Sold						

Form **886-A**
(Rev. January 1994)**EXPLANATIONS OF ITEMS**Name of taxpayer
ORGTax Identification Number
EINYear/Period ended
12/ 31/20XX**Bar Sales**Liquor
Beer & Wine
Bar Supplies
Food
Cigarettes**Gambling**Gambling Supplies
Gambling Cash Prizes
Gambling Merchandise Prizes**Bingo**Bingo Supplies
Bingo Cash Prizes

Total Cost of Goods Sold

Gross Revenue

Operated ExpensesAdvertising
Bad debts
Business Taxes
Cash Short (over)
Casual Labor
Cleaning & Janitorial
Computer & Software
Convention Expense
Contribution Expense
Bank Charges
Depreciation
Dues & Subscriptions
Entertainment
Freight & Postage
Insurance
Licenses & Fees
Maintenance & Repairs
Membership Fees
Member Expense
Office
Payroll Taxes
Phone
Professional Fees
Scholarship Awards
Security
Supplies
Small Equipment
Utilities
Veterans Relief

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

Quartermaster Allowance			
Wages - Bartenders			
Wages - manager			
Wages - CO-3			
Total Operating Expenses			
Income from Operations			
Other Revenue & Expense			
Interest Income			
Total Other			
Net Income (Loss)			

As such, there will be an IRC § 277 loss carry forward of \$ in 20XX and \$ in 20XX.

Taking the above facts into account, the taxable income per Form 1120 is illustrated below. The deduction disallowance per IRC § 277 are included in the calculation as a line item under Line 26: Other Deductions.

Income Per 1120

	20XX	20XX
	Detail	Detail
Income		
1(a) Gross receipts or sales		
Bar Sales		
Gambling		
Bingo		
General		
Sales of Inventory		
1(b) Less returns and allowances		
1(c) Balance		
2 Cost of Goods Sold		
Bar Sales		
Gambling		
Bingo		
3 Gross profit		
4 Dividends		
5 Interest		
Interest Income		
6 Gross rents		
7 Gross royalties		
8 Capital gain net income		
9 Net gain or (loss) from Form 4797		

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer ORG	Tax Identification Number EIN	Year/Period ended 12/ 31/20XX

10	Other Income	\$ -	\$ -
11	Total Income		

Deductions

- 12 Compensation of Officers
- 13 Salaries and wages
 - Wages - Bartenders
 - Wages - manager
 - Wages - CO-3
- 14 Repairs and maintenance
 - Maintenance & Repairs
- 15 Bad Debts
 - Bad debts
- 16 Rents
- 17 Taxes and Licenses
 - Licenses & Fees
- 18 Interest
- 19 Charitable contribution
 - Contribution Expense
- 20 Depreciation from Form 4562
 - Depreciation
- 21 Depletion
- 22 Advertising
 - Advertising
- 23 Pension, profit-sharing, etc.
- 24 Employee benefit programs
- 25 Domestic production activities deduction
- 26 Other Deductions
 - Business Taxes
 - Cash Short (over)
 - Casual Labor
 - Cleaning & Janitorial
 - Computer & Software
 - Convention Expense
 - Bank Charges
 - Dues & Subscriptions
 - Entertainment
 - Freight & Postage
 - Insurance
 - Membership Fees
 - Member Expense
 - Office
 - Payroll Taxes
 - Phone
 - Professional Fees
 - Scholarship Awards
 - Security

Form 886-A (Rev. January 1994)		EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer ORG		Tax Identification Number EIN		Year/Period ended 12/ 31/20XX
	Supplies			
	Small Equipment			
	Veterans Relief			
	Quartermaster Allowance			
	Deductions disallowed per IRC § 277			
27	Total Deductions			
28	Taxable income before NOL Deduction and Special Deductions			
29(a)	Less: Net Operating Deduction			
29(b)	Less: Special Deductions			
30	Taxable Income			
	Tax Rate			
31	Total Tax			

CONCLUSION

As was noted in the above facts and analysis there are two possible conclusions dependent on the amendment of the organization's bylaws to include the social members as a membership class.

If the organization were able to amend their bylaws it would be possible to reclassify the organization currently organized under IRC § 501(c)(19) to an organization organized under IRC § 501(c)(8). As IRC § 501(c)(8) allows for a more lenient membership policy, it would be possible to define the social members as a membership class. As such, income received from the social members would not be taxed as unrelated business income.

If the organization were able to amend their bylaws to include this membership class income from auxiliary members and members of the general public would still be subject to tax as unrelated business income. As such, the Form 990-T would show a tax liability of \$ and \$ in 20XX and 20XX respectively.

If the organization were unable to amend their bylaws the tax exempt status of the organization would be revoked and the tax liability per the Form 1120 would be \$ and \$ in 20XX and 20XX respectively.