JAN 15 1999

No Third Party Contact
501.19.00
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4401.00-00
761.00-00
District Director
Key District Office (EP/EO)
Information Copy: Chief, EP/EO Division

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Group Exemption Number:

Years Involved:

Date of Conference:

Legend:

B -
C -
D -
E -
F -
G -
H -

b -
c -
d -

ISSUES:

1. Whether, under the circumstances described, the Post meets the requirements for continued recognition of exemption as an organization described in section 501(c)(19) of the Internal Revenue Code, with deductibility of contributions under sections 170(c)(3) and 2522(a)(4).

2. If the Post remains exempt under section 501(c)(19) of the Code, whether bingo revenues, bar/restaurant income from nonmembers, hall rental income and instant bingo revenues constitute unrelated business taxable income under section 512(a)(1).

3. Whether the Post's sale of pull-tabs results in its being liable for the gambling excise taxes under sections 4401 and 4411 of the Code.

4. Whether an arrangement between the Post and two other exempt organizations constitutes a partnership as described in sections 761 and 7701 of the Code.

FACTS:

The Post is a veterans' organization, which is exempt under section 501(a) of the Code as an organization described in section 501(c)(19), and which has deductibility of contributions under sections 170(c)(3) and 2522(a)(4). The Post is included in the B group exemption. The Post, which was incorporated on b, was issued a charter by B on c.

The Post follows the B National Constitution. The purposes as stated in the National Constitution are: To uphold and defend the Constitution of the United States of America; to maintain law and order; to foster and perpetuate a one hundred percent Americanism; to preserve the memories and incidents of their association in the Great Wars; to inculcate a sense of individual obligation to the community, state and nation; to combat the autocracy of both the classes and the masses; to make right the master of might; to promote peace and good will on earth; to safeguard and transmit to posterity the principles of justice, freedom and democracy; and, to consecrate and sanctify our comradeship by our devotion to mutual helpfulness.

Eligibility is open to anyone who was a member of the Army, Navy, Marine Corps, Coast Guard, or Air Force of the United States and assigned to active duty at sometime during a period of war, or who, being a citizen of the United States at the time of his entry therein, served on active duty in the Armed Forces of any of the governments associated with the United States. Service from the Armed Forces must have been terminated by honorable discharge or honorable separation. There are only active members. No person may be a member of more than one post at a time, and any person wishing to become a member must show his discharge papers and make an application in writing.

During the years under examination, the Post had more than 1,000 members. At the time of the examination by the Key District Office ("KDO"), the Post provided copies of the Form 214 showing the dates of military service for the past five years.

The Post's facility is a two story building consisting of a first floor with a bar, a juke box and a pin ball machine; a hall for bingo games and rental activities, and a kitchen and office space. The second floor of the facility contains a large office area and a conference/meeting room. During the first year under examination, the Post obtained an unsecured demand loan for the

purpose of constructing an addition to the building and a new roof.

The hall is rented to members and nonmembers. The rental contract indicates that all food and alcoholic beverages will be supplied by the Post, and services from an outside caterer will not be obtained. The Post provides tables and chairs, sets up the hall and cleans up the facility. The Post's representatives stated that the Post does not cater any events, and only coffee and tea are available on a self-serve basis. On its Form 990 for 1993, the Post reported hall rental income of $5,257. However, according to the KDO, the Daily Cash Sheets maintained by the Post indicated that hall rentals for 1993 totaled $49,993.94. One rental contract, dated April 4, 1992, that is similar to other rental contracts for the period, refeired to an open bar (bottle of whiskey $34.00 and keg beer $75.00), and food at $15.00 per person, expected attendance 250. During the winter, the facility is rented to condo/time share groups for their meetings. The contracts provide that the Post will provide coffee, tea, cream and sugar. The renter sets up the room.

The activities of the Post consist of providing a bar, restaurant and lounge for members, guests and visitors; hosting parties and banquets for members, guests and visitors; providing two scholarships a year; sponsoring Christmas parties for the needy; Adopt-a-Vet program; bull roasts; sponsoring a Boy Scout troop; blood drives; contributions to area charities, and other miscellaneous activities. The Post publishes a monthly newsletter containing a Commander's Report, Service Officer's Report, news and a calendar. In 1992, 11,707 hours were spent on community service activities, while in 1993 there were 4,620 hours. Community service activities included hospital visits, and assisting the Humane Society, the Paramedic Foundation, Port Wardens, Boy Scout Troops, AARP tax help, Health Fairs, local schools, and assisting veterans in distress.

The Post requires guests to register when entering the facility. When the registers are filled, they are disposed of. During the examination, the only guest register available covered October 1994 to May 1995. A review of the register indicated that approximately 16-18% of those who signed in were members of the general public. It was noted by the KDO that members did not always sign in with the guests, and the date was not always indicated. No records were maintained by the Post to show gross receipts received from members and nonmembers. Through interviews, the KDO determined that nonmembers paid for their own purchases.

The Post holds weekly bingo games in the Post hall. The Post is also a partner with two other tax-exempt organizations in a bingo operation called D. D owns and operates a bingo hall at

a separate location and organizes bingo games open to the public six days a week during the summer months. The bingo operation was formed by the Post and the two other organizations approximately 30 years ago. D has its own Employer Identification Number. Each organization provides three members to act as the bingo committee and to operate the games. The property, which is jointly owned by the three organizations, is staffed by paid employees who are not members of the organizations. D, which is not a tax-exempt organization, maintains separate books and records that are kept at the Post. D does not report its income and expenses, but the three organizations evenly share the net profits, and report the net income on their individual Forms 990. Gross receipts and expenses are not reported by any of the organizations. Salaries, wages and employment taxes are paid by D, and Forms W-2 are issued. D also operated bingo games at another location during the years under examination; subsequently it was determined that the property is being rented to a commercial business, and bingo games are no longer held at that location. A review of the bingo reports indicates that distributions were made to various charitable organizations and/or activities, and one distribution was made to the Post home for a new roof.

During the examination the KDO determined that instant bingo tickets (pull-tabs) were sold at the bar by paid bartending staff and at weekly bingo games. The Post's representatives stated that the instant bingo tickets were sold at the bar only and were not sold at the weekly bingo games. No records were maintained by the Post on the gross revenue from the selling of pull-tabs, payouts, or amounts of deposits. The KDO also determined that the primary activities of the Post are the operation of the bar/lounge and bingo activity.

The Post filed Forms 990 for the years under examination; no Forms 990-T were filed. The Forms 990 were incomplete in that net revenues were reported from some activities, income was underreported, and income was not segregated by activities. Parts VII and VIII were not completed, nor all schedules attached.

An auxiliary, E, supports the Post and is separately chartered by the B Auxiliary National Constitution and By-laws. The Auxiliary is tax-exempt under section 501(c)(19) of the Code, as it is included in F's group ruling. The E organization issues membership cards to members, who are permitted to use the Post's facilities and participate in the programs and services of the Post. Auxiliary members cannot vote at Post meetings, hold positions as a Post officer, or serve on or be appointed to a Post committee.

G is a society within the Post that is separately chartered and has a separate Employer Identification Number ("EIN"). The G society abides by the H Constitution and Bylaws and is generally considered a youth society. It is not recognized as tax-exempt. Membership cards are issued by the H organization. The G society elects its own officers, uses the Post's facilities and participates in programs and services of the Post. The G members cannot vote at Post meetings, hold positions as a Post officer, or serve on or be appointed to a Post committee. The G society has its own bank account, collects its own dues and pays the H organization. These dues are reported on the Post's Form 990. This society is fairly inactive, as there are approximately 26 members (three war veterans, nine children and 14 other members). A review of the applications on file indicated that most of the applicants were over 21 years of age.

ISSUE 1 - LAW:

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

> (a) organized in the United States or any of its possessions,
>
> (b) at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, 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.

Section 1.501(c)(19)-1 of the Income Tax Regulations provides that to be described in section 501(c)(19) of the Code an organization must be operated exclusively for one or more of the purposes listed in that section. Section 1.501(c)(19)-1(c)(8) of the regulations lists as one of these purposes the provision of social and recreational activities for the organization's members.

Section 1.501(c)(19)-1(c) of the regulations provides that an organization described in section 501(c)(19) of the Code 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 the widows and orphans of deceased veterans, (3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States, (4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors, (5) To conduct programs for religious, charitable, scientific, literary, or educational purposes, (6) To sponsor or participate in activities of a patriotic nature, (7) To provide insurance benefits for their members or dependents of their members or both, or (8) To provide social and recreational activities for their members.

In Senate Report No. 92-1082, 92nd Cong. 2d Sess., Congress stated that for purposes of section 501(c)(19) of the Code, "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.

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 or his delegate may from time to time prescribe.

Section 6033(a)(1) of the Code provides, except as provided in section 6033(a)(2), every organization exempt from tax under section 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.

Rev. Rul. 59-95, 1959-1 C.B. 627, concerns an exempt organization that was requested to produce a financial statement and a 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 provisions 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 exempt status.

ISSUE 1 - RATIONALE:

An organization described in section 501(c)(19) of the Code carries out activities in furtherance of its exempt purposes only when the activities are exclusively in furtherance of the purposes listed in section 1.501(c)(19)-1(c) of the regulations. Among these purposes is the provision of social and recreational activities for its members. Therefore, when a veterans' organization described in section 501(c)(19) provides social and recreational activities for its members, or for guests whose expenses are paid by members, it is engaged in activities in furtherance of its exempt purposes.

Where goods or services are furnished to nonmembers who provide payment for such goods or services, their furnishing is outside the scope of section 1.501(c)(19)-1(c) of the regulations. Generally, if an organization has not kept adequate books and records concerning its financial transactions with nonmembers and more than 50 percent of its gross receipts are derived from sales transactions (e.g. restaurant and bar sales), the presumption will be that the organization's exempt status should be revoked because it is not primarily engaged in section 501(c)(19) activities. However, this presumption may be rebutted. All facts and circumstances must be reviewed to determine whether or not the organization primarily engaged in section 501(c)(19) activities.

Here, the Post has presented evidence that during the years under examination it engaged in extensive activities that were in furtherance of exempt purposes under section 501(c)(19) of the Code. Such activities include patriotic activities, social activities, membership meetings, and various charitable and social welfare activities.

During the time of the examination there was no permanent mechanism in place to maintain records to distinguish between income from "veteran" members, members' families, bona fide guests, auxiliary members, and non-veterans, in activities such as the bar/lounge, gambling and social activities. However, the information provided indicates that at most only 16 to 18% of the visitors to the bar/lounge may be considered members of the general public. Under these circumstances, members of the general public, if any, using the Post's facilities may raise an unrelated business income tax ("UBIT") issue (see infra), but would not adversely affect the Post's tax-exempt status under section 501(c)(19) of the Code.

Whether members of the E auxiliary and the G society should be considered members of the Post for purposes of section 501(c)(19) of the Code must be considered to determine if the

Post meets the membership requirements of section 501(c)(19). The members of a section 501(c)(19) auxiliary that is related to a post are not considered members of the post, as the auxiliary is a separate organization. Here, the E auxiliary is separately formed and is recognized as tax-exempt and, therefore, E's members are not considered members of the Post.

Even though the G society is not recognized as tax-exempt, it is an association and has a separate EIN. Members of G are not considered members of the Post under the Constitution and By-laws of B. Based upon the information presented, the G society is a separate organization from the Post, and the members of the G society should not be considered members of the Post. Even if the G members were treated as members of the Post, this would not adversely impact the Post's exemption under section 501(c)(19) of the Code, as non-veteran members of the G society would comprise less than 2.5% of the Post's total membership. Therefore, the Post would fall within the membership limitations under section 501(c)(19).

Although the Post's completing of its Forms 990 for the years in question was not entirely sufficient, we believe the Post has generally maintained the records required under section 6001 of the Code to determine that it meets the requirements for continued recognition of exemption under section 501(c)(19). Unlike the situation described in Rev. Rul. 59-95, supra, any failings of the Post with respect to recordkeeping and filing returns do not rise to a level that would support revocation of exemption under section 501(c)(19). The KDO may wish to consider whether an inadequate records notice may be appropriate under these circumstances.

ISSUE 1 - CONCLUSION:

Based upon the information presented, the Post meets the requirements for continued recognition of exemption as an organization described in section 501(c)(19) of the Code, with deductibility of contributions under sections 170(c)(3) and 2522(a)(4).

ISSUE 2 - LAW:

Section 511(a) of the Code provides for the taxation of unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code provides, in part, that the term "unrelated business taxable income" means the gross income derived by an organization from any "unrelated trade or business"

(as defined in section 513) regularly carried on by it, less certain deductions, and computed with the modifications provided in section 512(b).

Section 512(b)(3) of the Code excludes rents from real property and all rents from personal property leased with such property if the rents attributable to such personal property are an incidental amount of the total rents received. The exclusion does not apply if more than 50% of the lease is attributable to personal property, or if the determination of the amount of such rent depends on the income or profits derived by any person from the property leased.

Section 1.512(b)-1(c)(2) of the regulations excludes rents from real property, and rents from personal property leased with real property, if the rents attributable to personal property generally do not exceed 10 percent of the total rents from all property leased.

Section 1.512(b)-1(c)(5) of the regulations states that payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rent from real property. Generally services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant.

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis of its exemption under section 501. The term does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation.

Section 513(c) of the Code provides that for the purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of

goods or the performance of services. An activity does not lose identity as a 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, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Section 513(f) of the Code provides that the term "unrelated trade or business" does not include the conduct of certain bingo games. In 1984, Congress passed Pub. Law 98-369, sec. 311(a), subsequently clarified in 1986 by Public Law. 99-514, sec. 1834, to apply the same treatment to certain "other games of chance" that were then in operation and conducted under a state law enacted on April 22, 1977, subsequently amended to October 5, 1983. This law applies only to gaming activities conducted in the State of North Dakota.

Announcement 89-138, 1989-45 I.R.B. 41, was published by the Service as a reminder to tax-exempt organizations that income from the public conduct of certain bingo games and other gaming activities may be subject to the unrelated business income tax imposed by section 511(a) of the Code. The Announcement recaps the rules applicable to this area. Currently, income from the conduct of charitable gaming activities, other than bingo, is excluded from the definition of unrelated business taxable income only in the State of North Dakota.

Rev. Rul 69-178, 1969-1 C.B. 158, provides that income from a short term lease that included utilities and janitorial services was rent within the meaning of section 512(b)(3) of the Code and should be excluded in determining unrelated business taxable income.

ISSUE 2 - RATIONALE:

Although the Post is exempt from federal income tax under section 501(c)(19) of the Code, it is still subject to tax on income derived from any unrelated trade or business regularly carried on by it. The Post is subject to the unrelated business income tax on such income if three conditions are present: (1) the income is from a trade or business, (2) the trade or business is regularly carried on, and (3) the trade or business is not substantially related to the exercise or performance by the Post of its exempt function.

The sale of goods or performance of services for the production of income is a trade or business, even when undertaken

by a tax-exempt organization. The Post derives profits from activities such as the sale of food and beverages, pull-tabs, bingo, and hall rentals, and displays the required profit motive. Such activities, therefore, constitute a trade or business for purposes of section 513 of the Code.

A trade or business is considered to be regularly carried on when the activity is conducted with sufficient frequency and continuity to indicate a continuing purpose of the Post to derive some of its income from such activity. The Post's activities occur on a very frequent basis and, therefore, these activities are regularly carried on.

Clearly, the Post's activities constitute a regularly carried on trade or business. The real issue here, however, is whether these activities are substantially related to the Post's exempt purposes, and whether any of the exceptions contained in sections 512 - 513 of the Code are applicable. Before any activity can be considered substantially related, a nexus must exist between the goods sold or the services provided and the accomplishment of the Post's exempt purposes. If a nexus does exist, then the revenue generated from such activities will not be treated as unrelated business taxable income.

Section 1.501(c)(19)-1(c)(8) of the regulations lists the provision of social and recreational activities for its members as one of the appropriate exempt purposes of a veterans' organization. This provision permits a post to operate a bar or restaurant for its bona fide members. Any socializing or recreational endeavors sponsored or facilitated by a post should first and foremost focus on the bona fide veteran members. Use of a post's facilities by those other than such veterans needs to be closely scrutinized.

With respect to sales of food and beverages, gambling activities and hall rentals, for purposes of section 501(c)(19) of the Code, revenues derived from bona fide members are not taxable, while amounts from the general public are subject to tax. Falling within the nontaxable category are bona fide guests, i.e., individuals who are accompanied by a bona fide member and who do not themselves pay for food, beverages, or gambling. Also coming within the nontaxable category are certain family members and relatives of the bona fide members, including spouses, children, grandchildren, parents, grandparents, and siblings. These categories of individuals are set forth in section 1.501(c)(19)-1(d)(2) of the regulations, which denotes the membership requirements for auxiliary units of veterans' organizations. Also, members of the Post's auxiliary units or societies would fall within the nontaxable category in computing unrelated business taxable income.

One question presented is whether the use of the Post's facilities by a member of the G society furthers the exempt purpose of the Post. As organized, the G society is an appropriate Post function and the use of the Post's facilities in most instances would be appropriate. Based upon the information presented, income from members of the G society would meet the substantially related test, as their activities are sponsored by the Post and further Post purposes.

Another nontaxable category consists of individuals who, although they are not members of the local Post, are members of other posts that are covered by the B group exemption. In accordance with this category, any bona fide member of a state or national B organization, or a local B post could partake of the social and recreational activities offered by the Post. Any revenues resulting from such activities would not constitute unrelated business taxable income because the "substantially related" test under section 513(a) of the Code would be met.

On the other hand, the substantially related test would not be met where food, beverages, and gambling activities are made available to nonmembers of the Post, paying guests, members of the public, and members of veterans' organizations not part of B. Thus, providing goods and services to the foregoing categories of individuals does not contribute importantly to the accomplishment of any exempt purpose listed in section 1.501(c)(19)-1(c) of the regulations.

With regard to amounts derived from hall rentals, the prior analysis is also applicable to the extent that use of the hall by members and individuals in other nontaxable categories would not be subject to tax. With respect to hall rentals that would otherwise be taxable, the question presented is whether such amounts constitute rent from real property that may be excluded from the computation of unrelated business taxable income under section 512(b)(3) of the Code. In connection with some of the rental activities, it appears that the Post may be providing catering services, food and beverages that would result in certain amounts not being treated as excludable rental payments. See section 1.512(b)-1(c)(5) of the regulations. Other hall rental activities, such as those involving condo/time share meetings, where only self-service coffee and tea might be made available, do meet the requirements as rent from real property under section 512(b)(3). In these instances, the Post appears to be similar to the organization described in Rev. Rul. 69-178, supra, which was paid only for the use of space. Whether total hall rentals were approximately $5,000 in 1993, or ten times that amount, is a question of fact which must be resolved by the Post and the KDO.

The aforementioned distinction between nontaxable members, et al., and taxable members of the public is also applicable to amounts derived from bingo games and so-called "instant bingo." Thus, amounts attributable to bingo and instant bingo played by members of the Post would not be subject to tax, because such activities are substantially related to the accomplishment of social and recreational purposes set forth in section 1.501(c)(19)-1(c) of the regulations. With regard to the revenues derived by the Post through D's bingo operation, it appears that the exception to unrelated trade or business for certain bingo games under section 513(f) of the Code would be applicable. Specifically, these games comport with the definition of "bingo" under section 513(f)(2)(A), the games were not ordinarily carried out on a commercial basis, and state or local law was not violated. Under these circumstances, the bingo games did not constitute an unrelated trade or business under section 513. In contrast, "instant bingo" does not meet the definition set forth in section 513(f) and, therefore, amounts derived by the Post from individuals who fall within the previously described taxable categories constitute unrelated business taxable income. See Julius M. Israel Lodge of B'nai B'rith No. 2113 v. Commissioner, T.C. Memo 1995-439, aff'd 98 F.3d 190 (5th Cir. 1996).

ISSUE 2 - CONCLUSION:

A. There is no UBIT on income from members of the Post, members of its auxiliary and society, bona fide guests, members of other B Posts, bingo games covered by section 513(f) of the Code, and hall rentals that do not include catering or other services.

B. Restaurant/bar and pull-tab/instant bingo income from nonmembers, paying guests, members of the public, and members of unrelated veterans' organizations is subject to UBIT.

C. Income from hall rentals to nonmembers where the rent includes catering food and beverages is subject to UBIT.

ISSUE 3 - LAW:

Section 4401(a) of the Code imposes (1) on any wager authorized under state law a tax equal to 0.25 percent of the amount wagered and (2) on any wager not authorized under state law a tax equal to 2 percent of the amount wagered.

Section 4411(a) of the Code imposes a special tax of $500 per year to be paid by each person who is liable for the tax

imposed under section 4401 or who is engaged in receiving wagers for or on behalf of any person so liable.

Section 4411(b) of the Code substitutes $50 for $500 in subsection (a) in the case of (1) any person whose liability for tax under section 4401 is determined only under paragraph (1) of section 4401(a) and (2) any person who is engaged in receiving wagers only for or on behalf of persons described in paragraph (1).

Section 4421 of the Code provides that wagers include lotteries conducted for profit, but section 4421(2)(B) excludes from the term "lottery" any drawing conducted by an organization exempt from tax under sections 501 and 521, if no part of the net proceeds derived from such drawing inures to the benefit of any private shareholder or individual.

Tip jar and pull-tab games have been determined to be forms of lotteries. See Rev. Rul. 54-240, 1954-1 C.B. 254, and Rev. Rul. 57-258, 1957-2 C.B. 418. Also, they are considered "drawings" for purposes of the exclusion provided by section 4421(2)(B).

ISSUE 3 - RATIONALE:

Amounts wagered in drawings conducted by exempt organizations are not subject to wagering tax as long as no part of the net proceeds inures to the benefit of any private shareholder or individual. Generally under the rationale of Knights of Columbus Council #3660 v. United States, 783 F.2d 69 (7th Cir. 1986), raising substantial revenue from wagering activities open to the public for a long period of time to defray organizational operating expenses and to subsidize membership, recreational, and social activities constitutes private inurement. If the wagering activities are not open to the public, but are limited to members and bona fide guests, the use of the proceeds to defray operating expenses, etc. does not constitute inurement. Also see Rochester Liederkrantz, Inc. v. United States, 456 F.2d 152 (2d Cir. 1972).

To sustain an assertion of tax, the facts must show the source and disposition of the net proceeds from wagering. For example, if it is shown that wagers were accepted from nonmember/guest sources, the wagering proceeds were commingled with other bar or bingo revenue, and those proceeds were applied in part for general operating expenses or to subsidize the bar and food operations and in part for charitable purposes, a proportionate amount of the wagering proceeds could be deemed to have inured to the benefit of the members. If, on the other hand, the wagering revenue is separately accounted and is

earmarked solely for charitable purposes, no inurement can be attributed to the wagering activities and no liability for tax arises. The facts as presented do not adequately demonstrate that the proceeds have not inured to the benefit of private individuals.

ISSUE 3 - CONCLUSION:

Based upon the above, the Post has not met the exception of section 4421 of the Code, as it has not shown that funds were not spent for operating expenses. The Post has not shown that inurement did not occur.

ISSUE 4 - LAW:

Sections 761(a) and 7701(a)(2) of the Code provide that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated association, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

Section 301.7701-1(c) of the Procedure and Administration Regulations that existed prior to January 1, 1997, provided that the term "partnership" is not limited to the common-law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships.

Prior to January 1, 1997, the classification of any particular unincorporated organization was determined under the tests and standards set out in old sections 301.7701-2, 301.7701-3, and 301.7701-4. Old section 301.7701-2(a)(1) set forth six major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests.

Old section 301.7701-2(a)(2) provided that characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. Old section 301.7701-2(a)(3) provided that because associates and an objective to carry on a business and divide the gain therefrom are generally common to corporations and partnerships, an unincorporated organization that has such characteristics will be classified as a partnership if it lacks at least two of the remaining four characteristics.

ISSUE 4 - RATIONALE:

A partnership is created for income tax purposes when persons join together their money, goods, labor, or skill for the purposes of carrying on a trade, profession, or business and when there is a community of interest in the profits and losses. Commissioner v. Tower, 327 U.S. 280 (1946). Whether a partnership exists depends on whether the taxpayer and others intended to join together in order to carry on a business for joint economic gain. Commissioner v. Culbertson, 377 U.S. 733 (1949). The following factors, none of which are conclusive, are evidence of this intent:

> the agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profit and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

The arrangement between the Post and the other exempt organizations constitutes a business entity for federal income tax purposes because the organizations appear to have joined together for economic gain. The written agreement that discusses the relationship among the organizations with respect to their jointly-owned property shows that the Post and the two other exempt organizations had intended to establish a business venture. The organizations agreed to share equally in the supervision, operation, management and control of the bingo games conducted on the property. Separate books and records were maintained for the bingo operations in the name selected by the organizations. In addition, the organizations agreed to share equally in all net profits or losses resulting from the bingo operation. The arrangement between the Post and the two other exempt organizations is an unincorporated organization that carries on a business or venture.

The arrangement between the Post and the two other exempt organizations has associates and an objective to carry on a business and divide the gains therefrom. The arrangement between the Post and the two other exempt organizations lacks two or more of the corporate characteristics of centralization of management, continuity of life, limited liability, and free transferability of interests. Therefore, the arrangement would be classified as a partnership for federal income tax purposes under the old section 301.7701 regulations.

Because the arrangement between the Post and the two other exempt organizations is a partnership, the Post and the two other exempt organizations are required to file partnership returns under section 6031 of the Code. Because the Post and the two other exempt organizations failed to file a partnership return, the Post may be subject to a penalty under section 6698 for 1992 and 1993. However, because the income from the organizations' bingo operations is not unrelated business income and the Post reported this income on Form 990 for 1992 and 1993, it may be unnecessary to impose the penalty under section 6698. Cf. Rev. Rul. 92-49, 1992-1 C.B. 433. (Penalties for failure to meet reporting requirements under sections 6031 or 6041 are not imposed if a taxpayer, in good faith, treats a certain arrangement as either a joint venture or a lease.)

ISSUE 4 - CONCLUSION:

The arrangement between the Post and the two other exempt organizations is a partnership and the Post is required to file partnership returns under section 6031 of the Code. However, it may be unnecessary to impose a penalty under section 6698.

A copy of this memorandum is to be given to the organization. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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