

National Office Technical Advice Memorandum Letter Ruling 9747003

Failure to Maintain Adequate Books and Records and Conducting Activities outside the Scope of Exempt Activities

Cross Reference Data

Topical

Exempt organizations Recordkeeping

Citation

IRC Sections-511, 513

Exempt veterans organization lost its exempt status because of failure to maintain adequate books and records, and for conducting activities that were outside the scope of its exempt function.

Failure to Maintain Adequate Books and Records and Conducting Activities Outside the Scope of Exempt Activities

Uniform Issue List Information:

UIL No. 0446.00-00

General rule for methods of accounting

UIL No. 0501.19-00

Exemption from tax on corporations, certain trusts, etc.

-Post or organization of armed force member (past or present)

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM [Code Secs. 446 and 501]

ISSUES

1. Under the circumstances described, does the subject organization meet the requirements for continued recognition of exemption under section 501 (c)(1 9) of the Internal Revenue Code?

FACTS

The organization is a veterans Post that is exempt under section 501 (a) of the Code as an organization described in section 501(c) (19), with deductibility of contributions under sections 170(c)(3) and 2522(a) (4). The Post, which was formed more than 10 years ago, has approximately ***** members.

The Post's facility where it conducts its activities is a one story building, approximately one-half of which consists of a "hail" with offices on one end, and one-half of which consists of a bar and restaurant. The hall, which is rented to members and nonmembers, serves as a meeting place for members and guests.

The Post, which has a state license to operate games of chance, sells pull-tabs in the bar. Pull-tabs and bingo are the main sources of gambling revenues. Pull-tabs are sold, as required by state law, in an area of about ***** feet square that is located in the bar. Pull-tab sales require one to three employees at all times. The Post stated that nonmember receipts from gambling are less than 50%. However, the Key District Office ("KDO") determined that nonmember receipts from gambling are over 50%. As noted above, during the year in question, sales of pull-tabs amounted to approximately \$*****.

The organization contributed a portion of its gross profits from lawful gambling to various charities. Such contributions are included among the expenditures which the state statute governing lawful gambling defines as "lawful purpose" expenditures. The statute limits the use of gross profits from lawful gambling to "lawful purpose" expenditures and allowable expenses related to the conduct of lawful gambling. The statute also imposes a percentage limitation on the amount of the gross profits that may be expended for allowable expenses. The Gambling Control Board of the state approved the Post's expenditure of a portion of the gross profits from gambling for the remodeling of the Post's facilities. The Gambling Control Board's authorization of such expenditures is required for characterization of the expenditures as "lawful purpose" expenditures.

The bar and restaurant are open to the public, and anyone can enter to purchase food, liquor or pull-tabs. Based upon the minutes of the Post's meetings, it appears that the Post advertised itself as "open to the public." The Post's liquor license is a commercial license for public sales. The city government considers the Post as "open to the public" and not eligible for a club license. A commercial license costs \$10,000, and a private club license costs \$1,000. Because the Post has a commercial license, it must be open to the public.

During the year examined, the restaurant was open from 11:00 a.m. to 2:30 p.m. Monday through Friday, from 5:00 p.m. to 10:00 p.m. Tuesday through Friday, and closed on Monday evening and weekends. The bar was open from 10:30 a.m. to 12:30 a.m. Monday through Saturdays. On Sundays the bar is open to members only. There are between ***** and ***** full and part-time employees.

During the year examined, the Post did not monitor member and nonmember use of the bar and restaurant, nor distinguish between member and nonmember restaurant income. Tests to determine member and nonmember use of facilities were conducted as part of the examination, as no records were kept for the year under examination. Most of the tests were determined by the KDO to be defective as to accuracy. The only test considered accurate by the KDO is one with respect to winners of \$100 or more from pull-tab gambling.

Winners of pull-tab prizes of \$100 or more from approximately a four month period were reviewed. The Post determined that 54% of the winners were members, but the KDO could not verify this number, as many names could not be identified as members. A test that was conducted over a three month period covering pull-tab winners of prizes of \$100 or more, indicated a member percentage of 42.6%, with nonmembers at 57.4%. The test is considered valid by the KDO, as the names are clearly indicated on the winning forms.

The Post's monthly minutes from membership meetings and board meetings of the executive committee indicate that the Post engaged in some exempt functions during the year examined. Also, according to the Post, for a 12 month period subsequent to the year under examination, its members spent 9,239 hours, an average of 11¹12 hours per year per member, involved in charitable and community activities, meetings and recreation. The Post determined that 94.69% of the member hours were spent on exempt activities; this percentage figure does not take into account nonmember business activity hours.

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) 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.

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.

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

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

Section 1.6033-1 (h)(2) of the regulations provides that every organization which has established its right to exemption from tax, whether or not it is required to file an annual return of information, shall submit such additional information as may be required by the district director for the purpose of enabling him to inquire further into its exempt status and to administer the provisions of subchapter F (section 501 and the following), chapter 1 of the Code and section 6033.

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

financial statement and statement of its operations for a certain year. However, its records were so incomplete that the organization was unable to furnish such statements. The Service held that the failure or inability to file the required information return or otherwise to comply with the provision of section 6033 of the Code and the regulations which implement it, may result in the termination of the exempt status of an organization previously hold exempt, on the grounds that the organization has not established that it is observing the conditions required for the continuation of its 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 such activities are carried out exclusively In furtherance of the purposes listed in section 1.501(c)(19)-i(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.

Although relatively little documentation has been provided with respect to the Post's exempt activities during the year in question, we believe the Post conducted some exempt activities under section 501 (c)(19), including patriotic activities, social activities, membership meetings, and various charitable activities. However, even considering the Information provided in connection with a year subsequent to the year under examination, it appears that member activity was relatively minimal when compared with the Post's bar, restaurant and gambling activities available to the public.

During the year under examination there was no permanent mechanism in place to maintain records to distinguish between income from bona fide members, members' families, bona fide guests, Auxiliary members, and nonveteran income, with respect to the Post's bar, restaurant and gambling activities.

While the operation of a bar, restaurant and gambling activities may further an exempt purpose under section 501 (c)(1 9), such activities are not engaged in for the members' social and recreational benefit when the facility is open to the public. The KDO determined that over 50% of the usage of the bar and restaurant was by members of the general public. No accurate records were maintained indicating use by members and nonmembers. As noted above, the Post engaged in public advertising and has a commercial liquor license that costs 10 times more than a club license; such license requires that the operation be open to the public. Public advertising and possessing a commercial liquor license are further indications that the Post's facilities were operated for the general public and not exclusively for exempt purposes. Based upon the available information, the operation of the bar and restaurant (with attendant gambling) is a public activity and only incidentally a member activity.

The level of activity with the general public engaged in by the Post overshadows the organization's exempt activities, particularly in view of the absence of adequate books and records pertaining to the year in question, which is required by sections 6001 and 6033 of the Code and sections 1.6001-1 and 1.6033-1 of the regulations.

Based upon the Information submitted, the Post has not met its burden of proof by furnishing sufficient records to show that it is not operating a business for profit by operating a bar, restaurant, and gambling activities open to the general public. These activities establish that the Post Is not operated exclusively for exempt purposes under section 501(c)(19) of the Code.

Although the Post undoubtedly carried on some programs in furtherance of exempt purposes under section 501(c) (19) of the Code, based upon an analysis of the whole operation and in view of the unavailability of adequate records, we believe that the business activities relating to the operation of the bar and restaurant facility and the gambling operation, all of which were available to the public, predominate over the inadequately documented exempt activities.

ISSUE 1-CONCLUSION

Under the circumstances described, the subject organization does not meet the requirements for continued recognition of exemption under section 501 (c) (19) of the Code.

A copy of this memorandum is to be given to the organization. Section 611001(3) of the Code provides that it may not be used or cited as precedent.

Notes:

- a To avoid jeopardizing its exempt status, an exempt organization needs to make sure that the activities performed are either related to its exempt purpose or are nominal in amount.
- b Exempt organizations must maintain adequate books and records to demonstrate they are in compliance with tax law with respect to allocation between exempt function and nonexempt function activities.

Gary Porter, CPA is licensed by the California Board of Accountancy and the Nevada Board of Accountancy. His practice is limited to common interest realty associations consisting of condominium, homeowners, timeshare, cooperative and condo hotel associations. Mr. Porter id the creator and coauthor of PPC's (Practitioners Publishing Company) Guide to Homeowners Associations and Other Common Interest Realty Associations and Homeowners Association Tax Library, in addition to more than 200 articles. Mr. Porter has been quoted or published in The Wall Street Journal, Kiplinger's Personal Finance, Money Magazine, The Practical Accountant, Common Ground, Condo Management, and CAI's The Ledger Quarterly. He has been working with homeowners associations since 1976, and has been a frequent presenter at industry and CPA venues; speaking at events for more than 30 state CPA societies.