P. VETERANS' ORGANIZATIONS

1. Exemption Prior to 1972 Legislation

Before the enactment of IRC 501(c)(19) by Public Law 92-418, reproduced in 1972-2 C.B. 675, veterans' organizations generally qualified for exemption from federal income tax under IRC 501(c)(4) because most of the traditional activities of these organizations were recognized by the Service as primarily promoting social welfare. A few veterans' organizations were recognized as social clubs under IRC 501(c)(7).

IRC 501(c)(4) provides for the exemption of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. Reg. 1.501(c)(4)-1 provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.

A. Exemptions under IRC 501(c)(4)

Rev. Rul. 68-45, 1968-1 C.B. 259, describes a veterans' organization and holds that the organization qualified for exemption under IRC 501(c)(4) because it was primarily engaged in veterans' activities and other social welfare programs, notwithstanding that it derived a substantial portion of its support from bingo games open to the public. The organization's purposes were to promote comradeship among its member war veterans; to assist war veterans and their dependents; and to promote patriotism in the United States. The organization also participated in community welfare programs, such as providing and furnishing playgrounds for children and sports programs for teenagers. The revenue ruling states that the traditional activities of war veterans' posts have long been recognized as promoting social welfare in their communities. Rev. Rul. 68-46, 1968-1 C.B. 260. In reading Rev. Rul. 68-46, it should be borne in mind that it antedates IRC 501(c)(19), as well as the amendment of IRC 511 that extended unrelated business income tax to IRC 501(c)(4) organizations, and the exceptions to unrelated business income for member income set aside for certain purposes, and for income from bingo games. In short, read in its historical context, the ruling has limited applicability other than to suggest that a veterans' organization primarily engaged in promoting the welfare of the community qualified under IRC 501(c)(4), as would almost any other nonprofit organization so engaged.

B. Exemption under IRC 501(c)(7)

On the other hand, some veterans' organizations that did not qualify for exemption under IRC 501(c)(4) qualified for exemption under IRC 501(c)(7). For example, a subsidiary organization of a traditional veterans' organization, such as a wholly-owned organization that operated and maintained the parent organization's social facilities, has been recognized as exempt under IRC 501(c)(7). Rev. Rul. 66-150, 1966-1 C.B. 147. Once again, it should be borne in mind that this ruling predates the extension of unrelated business income tax to IRC 501(c)(7) organizations and the peculiar rules of IRC 512(a)(3) that make it highly unlikely that a veterans' organization created after 1969 would seek or willingly accept IRC 501(c)(7) status.

2. IRC 501(c)(19) and IRC 512(a)(4)

A. Reason for Enactment

Some exempt veterans' organizations furnish their members and dependents with one or more types of insurance. In those cases where organizations serve as commissioned agents for the insurance companies providing the insurance coverage, the organizations receive a portion of the premiums paid by members for their insurance. When the Tax Reform Act of 1969 extended application of the unrelated business income tax to virtually all tax exempt organizations, including IRC 501(c)(4) and 501(c)(7) organizations, veterans' groups expressed concern that the portion of premiums they retained would be subject to the tax. Their concern was intensified by the fact that the Tax Reform Act of 1969 provided specific exemption from the tax for insurance income of IRC 501(c)(8) fraternal beneficiary societies. In response to this worry, IRC 501(c)(19) and 512(a)(4) were enacted in 1972, effective retroactively to all taxable years beginning after December 31, 1969, to provide similar treatment for veterans' organizations on their insurance income. IRC 512(a)(4) excludes from the unrelated business income tax any amounts attributable to payments received by organizations described in IRC 501(c)(19) for life, sick, accident, or health insurance provided for their members or their dependents to the extent that the amounts are set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in IRC 170(c)(4), that is, exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Veterans' organizations that are described in IRC 501(c)(4) may still

qualify for exemption thereunder, but they will be subject to the unrelated business income tax on their insurance proceeds.

B. Qualification for Exemption

As initially enacted, IRC 501(c)(19) provided for the exemption for posts or organizations of war veterans, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization --

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

(2) at least 75 percent of the members of which are war veterans and substantially all of the other members of which are individuals who are veterans (but not war veterans), or are cadets, or are spouses, widows, or widowers of war veterans or such individuals, and

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

Reg. 1.501(c)(19)-1, issued pursuant to the statute, provides that a veterans' post or organization may be exempt as an organization described in IRC 501(c)(19) if: (1) at least 75 percent of the members are war veterans and at least 97.5 percent of all members are: war veterans; present or former members of the United States Armed Forces; cadets (including only students in college or university ROTC programs or at Armed Services academies); or spouses, widows, or widowers of war veterans, present or former members of the United States Armed Forces, or cadets; and (2) the organization is operated exclusively for one or more of the following purposes:

(a) To promote the social welfare of the community as defined in Reg. 1.501(c)(4)-1(a)(2);

(b) 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;

(c) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States;

(d) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors;

(e) To conduct programs for religious, charitable, scientific, literary, or educational purposes;

(f) To sponsor or participate in activities of a patriotic nature;

(g) To provide insurance benefits for their members or the dependents of their members or both; or

(h) To provide social and recreational activities for their members.

The regulations state that the term "war veterans" means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts).

Rev. Rul. 78-239, 1978-1 C.B. 162, provides that the term "period of war" as used in Reg. 1.501(c)(19)-1(b)(1) is the same as that set forth in 38 U.S.C. Section 101 (1970 and Supp.V 1975) concerning veterans' benefits. Such periods include:

1. April 21, 1898, through July 4, 1902;
2. April 6, 1917, through November 11, 1918;
3. December 7, 1941, through December 31, 1946;
4. June 27, 1950, through January 31, 1955; and
5. August 5, 1964, through May 7, 1975.

The Senate Report that accompanied the enactment of IRC 501(c)(19) states that veterans, other than war veterans, are those who served during peacetime and that any individual who is in the active Service of the Armed Forces is considered a veteran. S. Rep. No. 92-1082, 92d Cong., 2d Sess. 2-5 (1972).

C. Auxiliary Units or Societies

Reg. 1.501(c)(19)-1(a)(2) provides that an auxiliary unit or society of a veterans' post or organization and a trust or foundation for such post or organization may be exempt as an organization described in IRC 501(c)(19).

The regulations provide that a unit or society may be exempt under IRC 501(c)(19) if it is an auxiliary unit or society of a post or organization of war veterans. All of its members must be either members of an IRC 501(c)(19) war veterans' organization, or spouses of members of such an organization or be related to members of such an organization by blood within two degrees of consanguinity (which would include grandparents, brothers, sisters, and grandchildren, the most distant allowable relationships, but not uncles, aunts, cousins, nieces, or nephews). At least 75 percent of its members must be war veterans, spouses of war veterans, or related to war veterans by blood within two degrees of consanguinity. This qualification would prevent an auxiliary from consisting of more than 25 percent of persons who, for example, were cadets in an ROTC program or were former members of the Armed Forces who were not war veterans. (However, the regulations have not yet been amended to reflect the 1982 statutory change that eliminated the requirement that the veterans be war veterans. See the discussion in 3, below.) The auxiliary unit or society must be affiliated with, and organized in accordance with, the bylaws and regulations formulated by the post or organization of war veterans described in IRC 501(c)(19). A veterans' organization exempt under IRC 501(c)(4) does not suffice for this purpose.

D. Trusts or Foundations

Reg. 1.501(c)(19)-(e) provides that a trust or a foundation may be exempt as an organization described in IRC 501(c)(19) and Reg. 1.501(c)(19)-1(a)(2) if it is a trust or foundation for a post or organization of war veterans and meets the following requirements:

(1) the trust or foundation is in existence under local law and, if organized for charitable purposes, has a dissolution provision described in Reg. 1.501(c)(3)-1(b)(4), i.e., providing for distribution of assets upon dissolution for charitable purposes;

(2) the corpus or income cannot be diverted or used other than for funding of an IRC 501(c)(19) post or organization of war veterans, for IRC 170(c)(4) purposes, or as an insurance set aside as defined in Reg. 1.512(a)-4(b);

(3) the trust income is not unreasonably accumulated and, if the trust or foundation is not an insurance set aside, a substantial portion of the income is in fact distributed to such post or organization or for IRC 170(c)(4) charitable purposes; and

(4) it is organized and operated exclusively for one or more of the purposes enumerated in Reg. 1.501(c)(19)-1(c).

Paragraph (c) lists the eight purposes mentioned before.

3. Amendment to IRC 501(c)(19)

In view of the concern that many organizations might not continue to qualify for exemption because the number of war veterans was decreasing with the passage of time, Congress amended IRC 501(c)(19) on September 3, 1982, (Tax Equity and Fiscal Responsibility Act of 1982; Public Law 97-246) by deleting the requirement that 75 percent of the members be war veterans.

The amendment changed IRC 501(c)(19) to read:

(19) A post or organization of past or present members of the Armed Forces of the United States, or any auxiliary unit or society of, or a trust or foundation for, any such post or organization --

(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.

(Emphasis supplied)

A. Qualification for Exemption Under Present Law

Thus, the amendment changed the requirement that at least 75 percent of the members must be war veterans to the requirement that at least 75 percent of the members must be past or present members of the Armed Forces of the United States.

The definition of "Armed Forces" in IRC 7701(a)(15) is used in determining who is a member of the Armed Forces within the meaning of IRC 501(c)(19). That section defines the term "military or naval forces of the United States" and "Armed Forces of the United States" each to include all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each to also include the Coast Guard.

Membership in the National Guard is considered to constitute membership in the "Armed Forces" as that term is defined in IRC 7701(a)(15).

The regulations have not been amended to reflect the change in IRC 501(c)(19) and there is, at present, no active project to amend them. It is reasonable to assume that when they are amended they will remain essentially the same except that for years beginning after September 3, 1982, they will provide that at least 75 percent of its members will have to be present or past members of the Armed Forces of the United States rather than war veterans and that substantially all of the other members will have to be cadets, or spouses, widows, or widowers of such members of the Armed Forces or cadets. "Substantially all" means 90 percent. See S. Rep. No. 1082, 92nd Cong., 2d Sess. 5, reprinted in 1972-2 C.B. 713, 715. 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 must be cadets, or spouses, etc. Thus no more than 2.5 percent (10% X 25%) of an IRC 501(c)(19) organization's total membership may consist of individuals not mentioned in the statute.

Similar changes, substituting "past or present members of the Armed Forces of the United States" for "war veterans," presumably will be made in the regulations pertaining to auxiliary units or societies, and trusts and foundations.

4. Deductibility of Contributions

The fact that an organization of veterans qualifies as exempt under section 501(a) of the Code does not, of itself, mean that contributions to such organizations are deductible under IRC 170(c)(3). That section of the Code includes within the term "charitable contribution" a contribution or gift to or for the use of a post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization that is organized in the United States or any of its possessions, and no part of the net earnings of which inures to the benefit of any private shareholder or individual. The term "war veterans" within

the meaning of IRC 170(c)(3), means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts). Thus, IRC 170(c)(3) reads the same as IRC 501(c)(19) before its 1982 amendment. (A pending bill introduced in Congress on March 7, 1985, would eliminate "war" in "war veterans" where it appears in IRC 170(c)(3).) For contributions to be deductible, the organization must satisfy the membership requirement and a purpose requirement. As Rev. Rul. 84-140, 1984-2 C.B. 58, holds, the fact that a small percentage of the members of an organization formed as war veterans has not served in the Armed Forces will not, of itself, preclude an organization from being classified as a war veterans' organization under IRC 170(c)(3), provided at least 90 percent of its members are war veterans and substantially all the other members are either veterans (but not war veterans), or are cadets, or spouses, widows, or widowers of war veterans, veterans, or cadets. Thus, apparently, some very small number of members (the difference between "all" and "substantially all") of the remaining 10 percent need not fall into any of the listed categories, but may be members of the general public. This revenue ruling modifies and supersedes Rev. Rul. 59-151, 1959-1 C.B. 53.

5. Unrelated Business Income

As previously mentioned, Reg. 1.512(a)-4 provides that, except for special rules regarding insurance set-asides indicated in that section, veterans' organizations exempt under IRC 501(c)(19) are subject to the rules contained in IRC 511 through 514 regarding unrelated business income that are applicable to any organization listed in IRC 501(c).

A. Operation of Bar and Restaurant

IRC 511 and 512provide for tax on unrelated trade or business regularly carried on by organizations described in IRC 501(c), including those exempt under IRC 501(c)(19). IRC 513 defines unrelated trade or business as any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under IRC 501(a).

Reg. 1.513-1(d)(2) provides that trade or business is "substantially related" to exempt purposes only if the conduct of business activities has a substantial causal relationship to the achievement of the exempt purposes of the organization and contributes importantly to such achievements. This regulation also provides

that whether trade or business activity contributes importantly to the accomplishment of exempt purposes depends in each case on the facts and circumstances presented.

IRC 512(a)(3), enacted in 1969, provides special rules regarding "unrelated business taxable income" for organizations exempt under IRC 501(c)(7) or 501(c)(9). All income other than "exempt function income" and less certain deductions is subject to the tax on unrelated trade or business. IRC 512(a)(3)(B) provides that "exempt function income" for an organization exempt under IRC 501(c)(7) or 501(c)(9) is limited to, with certain exceptions, the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members, or their dependents or guests, goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

As previously explained, prior to the enactment of IRC 501(c)(19) in 1972, veterans' organizations were exempt under either IRC 501(c)(4) or IRC 501(c)(7) depending on their activities. A veterans' organization operating a bar and restaurant as its primary activity would have had to be exempt, if at all, under IRC 501(c)(7) as a social club because such an activity is not considered promotion of social welfare within the meaning of IRC 501(c)(4). Section 1.501(c)(19)-1(c) of the regulations provides a list of eight traditional purposes of veterans' organizations. It states that a veterans' organization is exempt under IRC 501(c)(19) if it meets the requirements of sections 1.501(c)(19)-1(a)(1) and 1(b) of the regulations and is operated exclusively for <u>one</u> or more of the listed purposes. The eighth purpose listed is to provide social and recreational activities for members. Thus, clearly an IRC 501(c)(19) organization can be operated exclusively to furnish social and recreational activities for members. A question then arises whether it was the intent of this provision to allow veterans' organizations exempt under IRC 501(c)(19) broader latitude in furnishing social and recreational services than is permitted to those organizations that were or still are exempt under IRC 501(c)(7) and are therefore automatically subject to unrelated business income tax on nonmember income not set aside for charitable purposes (i.e., income that is not "exempt function income").

This question has been considered by the National Office, and a tentative conclusion, not finalized as of this writing, has been reached. (Where no published precedent exists, cases involving this issue must be referred to the National Office under the rules of Rev. Proc. 84-46, 1984-1 C.B. 541, and Rev. Proc. 80-26, 1980-1 C.B. 691.) It is currently the position of the National Office that Congress had

the opportunity to extend the treatment of nonmember receipts for social clubs under IRC 512(a)(3) to veterans' organizations when it enacted IRC 501(c)(19), but it chose not to. Therefore, in determining whether nonmember receipts of an IRC 501(c)(19) organization should be unrelated trade or business, consideration should be limited to IRC 501(c)(19) and the regulations related to it to see whether the activity is indeed unrelated to the performance of the function which is the basis for the exemption.

Although making an organization's recreational facilities available to members to entertain their guests may be considered part of providing social and recreational activities to members and thus to further that exempt purpose, we believe that merely being accompanied by a member does not mean that an individual is being entertained by a member. When the guest pays the exempt organization for its bar and restaurant services, he or she is not being entertained by a member. Instead, in that situation, the IRC 501(c)(19) organization is providing social and recreational activities directly to a nonmember rather than as a service to a member. The National Office has tentatively concluded that providing such services directly to nonmembers does not further the exempt purpose in Reg. 1.501(c)(19)-1(c)(8) in an important way. Consequently, the income received by an IRC 501(c)(19) organization from bar or restaurant sales to nonmembers who pay their own way is subject to unrelated business income tax if the sales activity is regularly carried on and none of the other exceptions under IRC 512 or 513 apply. The provision of such services to guests who pay for them does not have a substantial causal relationship to the exempt purpose of providing social and recreational activities for members or to any other purpose listed under Reg. 1.501(c)(19)-1(c).

B. Operation of Hotel Facility

Moreover, in another case the National Office has issued a letter ruling to the effect that the mere fact that nonmembers may be active duty personnel who might qualify for membership does not change the result. In a recent case, an IRC 501(c)(19) organization operated a hotel facility for members and nonmembers. The ruling was based on G.C.M. 39403, dated August 30, 1985, which concluded that the rental of rooms to nonmembers did not in and of itself have a substantial causal relationship to any exempt purpose described in Reg. 1.501(c)(19)-1(c), even if the nonmembers were active duty personnel. Reg. 1.501(c)(19)-1(c)(8) describes as an exempt purpose for IRC 501(c)(19) organizations "to provide social and recreational activities to members." This means members of the organization and not merely members of the Armed Forces of the United States generally. Thus,

the individuals involved must become members of the organization before their entertainment furthers this exempt purpose. The only exception to this rule would be active duty personnel who are at the club as guests of members, i.e., a member is paying for them. It is only in the limited context of this host-guest relationship that the commingling between members and nonmember active duty personnel can be said to further the recreational purpose of the organization. The mere presence of nonmember active duty personnel, absent any personal relationship with the members, does not fulfill the exempt purpose.

In the same case, the organization argued alternatively that allowing nonmember active duty personnel to use the facilities promotes the social welfare within the meaning of Reg. 1.501(c)(19)-1(c)(1) (which cross-references to Reg. 1.501(c)(4)-1(a)(2)) because the community in general benefits from such use. The National Office decided to the contrary. (However, this does not foreclose the possibility that the use by such nonmember active duty personnel might, under certain circumstances, such as during a time of national emergency or armed conflict, further social welfare.) Further, the renting of rooms to such personnel is not within the ambit of Reg. 1.501(c)(19)-1(c)(5), which states that the conducting of programs for religious, charitable, scientific, literary or educational purposes is an exempt purpose. The rental of rooms does not fulfill any of these purposes.

C. Furnishing Banquet Facilities

Moreover, if an IRC 501(c)(19) veterans' organization provides banquet services to member-sponsored groups, it furthers the exempt purpose of providing social and recreational activities for members, but providing such services to nonmember groups is not in furtherance of any exempt purpose. It does not fulfill the exempt purpose set forth in Reg. 1.501(c)(19)-1(c)(1) to promote the social welfare of the community as defined in Reg. 1.501(c)(4)-1(a)(2).

D. Sale of Bottled Liquor

If an IRC 501(c)(19) veterans' organization sells bottled liquor to members and nonmembers, the sales will not be deemed to be in furtherance of the exempt purpose of providing social and recreational activities for members. Rev. Rul. 68-535, 1968-2 C.B. 219, holds that the sale of liquor by an IRC 501(c)(7) social club to members for consumption off the premises is neither in furtherance of, nor related to, the club's exempt purpose of providing social and recreational activities to its members. Nor would the result be different if the seller is an IRC 501(c)(19)

organization, or if the bottles bear the organization's emblem, or, generally, even if the liquor is consumed on the premises. See G.C.M. 39403, dated August 30, 1985.

E. Gambling Activities

Some states allow certain types of gambling activities by organizations exempt under IRC 501(a). Although the Deficit Reduction Act of 1984, Pub. L. 98-369, made no change in the Internal Revenue Code in regard to gambling, the Act itself states that for purposes of IRC 513 the term "unrelated trade or business" does not include a trade or business that consists of conducting a game of chance if --

(1) the game of chance is conducted by a nonprofit organization;

(2) the conducting of the game by the organization does not violate any state or local law; and

(3) as of October 5, 1983, there was a state law in effect that permitted the conducting of the game of chance only by a nonprofit organization.

However, some gambling activities may not be subject to unrelated business income tax if conducted under certain circumstances by IRC 501(c)(19) organizations even though they do not meet the DEFRA provisions. The gambling activities discussed herein are not bingo games as defined in IRC 513(f)(2) and Reg. 1.513-5(d), and the principles discussed are considered without regard to the application of the DEFRA provisions which may eventually be interpreted as applying only to North Dakota. They are carried on regularly and paid labor is used in conducting the activities. They may or may not be legal or sanctioned under state or local laws or ordinances.

IRC 501(c)(7) provides for exemption from federal taxation for social clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

Rev. Rul. 69-68, 1969-1 C.B. 153, holds that the operation of gaming devices open only to members and their guests does not affect the status of a social club exempt under IRC 501(c)(7). The revenue ruling reasons that gambling supplies those elements of diversion that are commonly accepted as pleasure and

recreation and thus are proper activities within the meaning of IRC 501(c)(7) even if an additional purpose for the gambling activity is to raise money.

In determining whether gambling activities are unrelated trade or business of an IRC 501(c)(19) organization, the only issue is whether they have a substantial causal relationship to the exempt purpose of the organization. The gambling activities discussed would otherwise be unrelated trade or business.

As previously mentioned, providing social and recreational activities to members is an exempt function of veterans' organizations exempt under IRC 501(c)(19). Reg. 1.501(c)(19)-1(c)(8). If gambling is a proper exempt activity for social clubs exempt under IRC 501(c)(7), it would be difficult to argue that the gambling activities described above operated by veterans' organizations exempt under IRC 501(c)(19) should be treated differently. When providing social and recreational activities to members, such organizations are performing a function analogous to a social club's. Consequently, such gambling activities to the extent of member participation have been found to have a substantial causal relationship to the exempt social and recreational purposes of such organizations. See, for example, G.C.M. 39061, dated Nov. 21, 1983.

However, when nonmembers participate in the gambling activities, even if they may not participate except as guests of members, the receipts from their participation generally are subject to the tax on unrelated trade or business. Even if the individuals participating in the gambling activities are guests of members and are accompanied by members, providing gambling activities to them does not have a substantial causal relationship to the exempt purpose of providing social and recreational activities to members because the expenses of the guests' participation, presumably, are not borne by the members. Guests primarily gamble with their own money rather than with money of the members when the guests participate in this type of gambling activity. The mere presence of guests of members at these gambling activities does not in itself further in an important way this exempt function. Entertainment provided to guests of members is only related to this exempt function if the cost of the entertainment of the guests is borne by the members rather than the guests. If, in a particular case, the gambling expenses of a guest are borne by a member, the gambling activity of that guest may be substantially related to this exempt function.

Although making the organization's recreational facilities and social activities available to members to entertain their guests may under certain circumstances be considered part of providing social and recreational activities to

members and thus further that exempt purpose, merely being accompanied by a member does not mean that an individual is being entertained by a member. When guests spend their own funds to participate in gambling activities operated by these organizations, they are not being entertained by the members. A guest is only being entertained by a member at a social or recreational activity or facility of the organization for which there is a charge for such participation in the activity or use by the guest if the member pays that charge. When guests gamble with their own money, the organizations are providing recreational activities in the form of gambling directly to nonmembers rather than as a service to members. Providing recreational activities such as gambling to nonmembers directly rather than as a service to members does not have a substantial causal relationship to the exempt purpose of providing social and recreational activities to members and must as a result be considered unrelated trade or business, as long as it is a business regularly carried on and no other exceptions, including the DEFRA provisions, to sections 511 and 512 apply.

Further, under the facts and circumstances of a particular case, a certain gambling activity may essentially be a predominantly public activity and only incidentally a member activity. For example, if a veterans' organization exempt under IRC 501(c)(19) has a punchboard in a public tavern where permitted by law and 80 percent of the receipts from the punchboard come from payments by nonmembers for gambling by nonmembers who are not even participating as guests of members but are simply members of the public, the entire activity including participation by members would be considered unrelated trade or business because the gambling is not being conducted primarily as recreation for members. Under those circumstances, the principal function of the activity is to raise funds for the organization, not to provide recreation for members. Although some members still participate in the gambling activity, the recreation provided them has become incidental to the overriding purpose and effect of raising funds from the public. IRC 513 requires that the trade or business at issue be substantially related to the exempt purposes of the organization involved aside from the fund-raising elements of the activity in order for it not to be considered unrelated trade or business.

This conclusion is not in conflict with Reg. 1.513-5(c)(3), Example (3). The examples in Reg. 1.513-5(c)(3) are only intended to specify the parameters of the application of the "bingo exception" to gambling activities which would otherwise be unrelated trade or business. The examples are not intended to change the criteria for determining whether any activity including gambling is related to an organization's exempt purposes.

However, providing this type of gambling activity does not have a substantial causal relationship to the exempt purposes of veterans' organizations exempt under IRC 501(c)(4) because such activities, regardless of whether members or nonmembers participate in them, do not promote the social welfare as required by that section. Consequently, veterans' organizations exempt under IRC 501(c)(4) are involved in unrelated trade or business under IRC 513 whenever they conduct such gambling activities.

Rev. Rul. 66-150, 1966-1 C.B. 147, holds that providing social and recreational activities to members of IRC 501(c)(4) veterans' organizations, such as use of bar and restaurant facilities, does not promote the social welfare. Thus, recreational activities analogous to those provided members by IRC 501(c)(7) social clubs, including this type of gambling activity, do not have a substantial causal relationship to the exempt purposes of IRC 501(c)(4) veterans' organizations even though such activities are proper exempt activities for IRC 501(c)(19) organizations.

It should be noted that the above situation is distinguished from that in Rev. Rul. 74-361, 1974-2 C.B. 159. That revenue ruling concludes that providing recreational activities to members furthers the exempt purposes of volunteer fire companies exempt under IRC 501(c)(4). This conclusion is confined to volunteer fire companies. Members of volunteer fire companies have unique needs for recreation; the recreational activities were found to promote the social welfare not because they benefit the community in and of themselves, but instead because the activities help the members to better perform their exempt function of fighting fires.

If the gambling activities were extended to the general public by an IRC 501(c)(4) organization, they would still be an unrelated trade or business. Although in some circumstances providing recreational activities to the general public might be found to benefit the community, and thus promote social welfare, it would depend on the nature of the recreational activities provided. There is nothing inherently beneficial to the community in having gambling activities available. In fact, many sectors of the community might consider it detrimental, as is evidenced by the fact that in most jurisdictions gambling activities are either illegal or severely limited.

Therefore, this type of gambling activity conducted by veterans' organizations exempt under IRC 501(c)(4) results in unrelated trade or business,

regardless of whether members or nonmembers participate, because the activity does not promote the general welfare of the community as required under IRC 501(c)(4).

F. Solicitation of Funds - Greeting Cards

A recent court decision has held that an IRC 501(c)(19) veterans' organization did not realize unrelated business income from the sale of greeting cards. Veterans of Foreign Wars of the United States, Department of Missouri, Inc. v. United States, 601 F. Supp. 7 (W.D. Mo. 1984). The organization mailed to members boxes of Christmas cards along with a solicitation letter asking for a contribution of at least $3.00 and a reorder form for more Christmas cards for an additional $3.00 a box. Recipients of the cards were under no legal obligation to give or pay money to the organization. Each box of Christmas cards had a wholesale value of $1.05, and a retail value of $2.00. The net receipts of the card program were not reinvested into the card program but were used for the organization's general operating fund and its service programs for military veterans.

The court cited Reg. 1.513-1(b), which provides that an organization does not engage in a trade or business when it sends out low cost articles incidental to the solicitation of charitable contributions. It held that the organization did not engage in a trade or business because the greeting cards were distributed as low cost articles incidental to the solicitation of contributions, and because the organization did not reinvest proceeds from its campaign into the greeting card program, thereby gaining no competitive advantage from its exempt status and indicating that it was not operated as a trade or business.

The court stated that the case was directly controlled by the Seventh Circuit's decision in Hope School v. United States, 612 F.2d 298 (7th Cir. 1980). The government had argued that the Seventh Circuit's decision was incorrect. In that case, a charitable organization operated a Christmas card program for the solicitation of charitable "contributions." The program was operated for the school by a private business which received $1.10 for each box of cards sold. The school requested "contributions" of $2.00 or more in conjunction with the cards mailed to potential contributors. The Seventh Circuit held that the program came within the exception for low-cost articles and stated that the tax did not apply because the primary purpose of the tax was to discourage unfair competition with commercial enterprises. The Service believes that a trade or business exists if mailed items accompanying solicitations have more than a commercially negligible value and

that, regardless of the existence of unfair competition, an organization that regularly carries on unrelated trade or business is subject to tax under IRC 511.

Because of weaknesses in the administrative record, the VFW Dept. of Missouri case was not appealed. However, the Service is now pursuing another case in the U.S. Tax Court involving the application of the unrelated business income tax to Christmas card distribution programs of this nature.

A pending bill, H.R. 2492, contains an amendment that would provide that unrelated business income of an IRC 501(c)(3) or 501(c)(19) organization would not include activities related to the distribution of low cost articles if such distribution is incidental to the solicitation of charitable contributions. The term "low cost articles" would mean any articles that have a cost of not in excess of $5.00 to the organization that distributes such items.

For a further discussion of these court cases, see the topic on fundraising organizations (Topic G of this CPE text).