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memorandum

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subject: Organization

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LEGEND

Organization=
X=
State Y=
XX=

ISSUES

Whether a veterans organization, whose primary activity consists of running a bar or restaurant, qualifies as an organization described in § 501(c)(19).

CONCLUSIONS

A veterans organization, whose primary activity consists of operating a bar or restaurant, qualifies as a § 501(c)(19) organization if (1) a sufficient percentage of its members are veterans or permitted family members of veterans; (2) no more than an insubstantial part of its activities consist of providing food and beverages to individuals who are not members or their guests; and (3) no part of the organization's earnings inure to the benefit of any private shareholder or individual.

FACTS

Organization is a veterans organization that holds a group exemption for veterans organizations described in § 501(c)(19). Their mission is to unite veterans and their families by forming social clubs throughout the United States, which interact with other social veterans clubs. So far, it has approximately X subordinate organizations, all located in State Y, which are included in its group exemption. It is our understanding that the primary activity of the subordinate organizations is the operation of bars and restaurants.

Organization lists several advantages to joining as a subordinate organization, called clubs. For instance, clubs can sell liquor, operate on Sundays, hold bingo games, and obtain liquor licenses in dry counties. Organization also markets the Organization and its group exemption to existing bars and restaurants located in State Y as a way to avoid restrictive local liquor laws and as a way to operate on a tax-exempt basis. Furthermore, the Organization will assist in a club's formation and application for a liquor license.

Organization, however, advises that its clubs are required to have veteran members.

An Organization newsletter dated XX, indicates that all subordinate organizations agree, in part, to: (1) send Organization a yearly report of what it has done as a veterans club; and (2) maintain at least ten veteran members and to send Organization proof of all veterans affiliation.

The Tax-Exempt and Government Entities ("TEGE") Division is examining Organization and several subordinate organizations.

LAW AND ANALYSIS

A. Background

Prior to the enactment of § 501(c)(19) by Public Law 92-418, 1972-2 C.B. 675, many veterans organizations qualified for exemption from federal income tax under § 501(c)(4) because most of the traditional activities of these organizations were

recognized by the Internal Revenue Service ("IRS") as primarily promoting social welfare. Staff of Joint Comm. on Taxation, 109th Cong., Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations, JCX- 29-05 NO 8, (Comm. Print 2005). The traditional activities of veterans organizations that were social welfare organizations included promoting patriotism, preserving the memory of those who died in war, and assisting veterans in need. Id. A veterans organization whose primary activity consisted of operating social facilities for its members was not able to qualify for exemption as a § 501(c)(4) social welfare organization, but it could qualify as a social club under § 501(c)(7). Rev. Rul. 66-150, 1966-1 C.B. 147; S. Rep. No.1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713; H.R. Rep. No. 851, 92d Cong., 2d Sess. 1 (1972).

In 1972, Congress enacted § 501(c)(19) and § 512(a)(4) to address the concern that a veterans organization exempt under § 501(c)(4) or (7) may be subject to unrelated business income tax on the provision of insurance to its members. S. Rep. No.1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713.[1] Section 512(a)(4) excludes amounts attributable to, or set aside by, a § 501(c)(19) veterans organization for the payment of life, sick, accident, or health insurance benefits for their members and their members' dependents. Public Law 92-418, 1972-2 C.B. 675.

B. Section 501(c)(19) Exemption Requirements

1. In General

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

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

(b) at least 75 percent of its members are past or present members of the Armed Forces of the United States,

(c) substantially all of its other members are individuals who are cadets or are spouses, widows, widowers, ancestors or lineal descendants of past or present members of the Armed Forces of the United States or of cadets, and

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

2. Membership Requirement

[1] "Before the enactment of the Tax Reform Act of 1969, there was no tax on the insurance activities of the veterans' organizations since the unrelated business income did not apply to social welfare organizations and social clubs. However, the 1969 Act extended the application of the unrelated business income tax to virtually all exempt organizations including social welfare organizations and social clubs." S. Rep. No.1082, 92d Cong., 2d Sess. 2 (1972) reprinted in 1972-2 C.B. 713.

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

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

Neither, § 501(c)(19), its legislative history, nor the regulations under § 501(c)(19) define what it means to be a member of a veterans organization. Section 7.25.19.4.2 of the Internal Revenue Manual states that an organization's requirements for membership are normally defined in its governing documents, but they could also be defined in its minutes. Whatever the organization requires for one to become a member, the organization must maintain records tracking who its members are and the proportions in the various categories of membership permitted under § 501(c)(19)(B)(member of armed forces, cadet, relative, etc.) to substantiate that its members are veterans or other permitted members. See § 6001 and Treas. Reg. § 1.6001-1(c).[3]

3. Operational Test

[2] Prior to 2003, ancestors and lineal descendent were not included in the statutory list of persons permitted to be members. In 2003, Congress amended § 501(c)(19) to include ancestors or lineal descendents of present or former members of the United States Armed Forces or cadets in the statutory list of individuals who may be members of an organization. The regulations have not been updated to reflect this change nor do they reflect the 1982 statutory change eliminating a requirement that veterans be veterans of war.

[3] Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, shall keep adequate records as the Secretary of the Treasury or his delegate may from time to time proscribe. Every organization exempt from tax under § 501(a) and subject to the unrelated business income tax, including veterans organizations, must keep such records. Treas. Reg. § 1.6001-1(c). These books and records are required to be available for inspection by the Service. Treas. Reg. § 1.6001-1(a). In addition, veterans organizations are required to keep books and records to substantiate information reported on their information return. Section 6033 and Treas. Reg. § 1.6001-1(c). They are also required to submit additional information to the Service for the purpose of enabling the Service to inquire further into its exempt status.

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

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

One of the questions in this case is whether the subordinate organizations are operating their bars and restaurants exclusively to provide social and recreational activities for their members within the meaning of Treas. Reg. § 1.501(c)(19)-1(c)(8). In GCM 38603, we noted that exemption under § 501(c)(19) covers an organization whose activities consist of providing food and beverages to its members. Treas. Reg. § 1.501(c)(19), however, does not address what it means to "exclusively" provide social and recreational activities for members. Furthermore, there are no cases or revenue rulings regarding the operation of veterans organizations for the social or recreational activities of their members under § 501(c)(19).

As noted above, the permitted purpose reflected in Treas. Reg. § 1.501(c)(19)-1(c)(8) is similar to the exempt purpose contained in § 501(c)(7) as both provisions permit an exempt organization to operate social and recreational facilities for its members. In fact, prior to the enactment of § 501(c)(19), a veterans organization whose primary activity consisted of operating a bar or restaurant for the benefit of its members would have to qualify as a § 501(c)(7) social club to be tax-exempt. *See* Rev. Rul. 60-324 *and* Rev. Rul. 69-219.[4] These organizations, prior to 1976, were required to operate "exclusively"

[4] In 1976, Congress amended § 501(c)(7) replacing "exclusively" with "substantially all". This change was

for the pleasure and recreation of its members. See § 501(c)(7) (1975). Thus, the rulings and case law under § 501(c)(7) may be useful for determining whether a § 501(c)(19) veterans organization is providing social and recreational activities exclusively for its members.

In West Side Tennis Club v. Commissioner, 111 F.2d 6 (2nd Cir. 1940), the Second Circuit upheld the board of tax appeals determination that a social club was not exempt because a substantial amount of its income was received from the general public. In that case, the West Side Tennis Club was organized to provide tennis facilities for the use and enjoyment of its members. The facilities were only available to members for most of the year; however, the club hosted annual national championship tennis matches that were open to the general public. The club shared in the ticket proceeds from these matches. The Second Circuit upheld the board of tax appeals determination that the national championship matches were a substantial and profitable business which jeopardized the club's exemption. West Side Tennis Club, 111 F.2d at 7.[5]

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

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

In 1971, the Service issued Revenue Procedure 71-17, 1971-1 C.B. 683, which contains guidelines for determining the impact of an organization's nonmember gross receipts on its exempt status under § 501(c)(7). The revenue procedure provides that

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effected to establish that social clubs will not jeopardize their exempt status if they receive 35% of their gross receipts from non-membership sources. However, only 15% of their gross receipts may be derived from nonmembers' use of club facilities or services. Pub. L. No. 92-568, S. Rep. 1318, 94 Cong., 2d Sess. (1976).

[5] In The Minnequa University Club v. Commissioner, T.C. Memo 1971-305 (1971), the Tax Court upheld the Service's determination that a § 501(c)(7) organization was no longer exempt from Federal income tax because at least 30 percent of its income over a 5 year period was derived from the general public.

"[a] significant factor reflecting the existence of a nonexempt purpose is the amount of gross receipts derived from use of a club's facilities by the general public." The revenue procedure went on to provide a safe harbor for organizations serving the general public:

> As an audit standard, [the gross receipts derived from general public] alone will not be relied upon by the Service if annual gross receipts from the general public for [use of the club's facility] is $2,500 or less or, if more than $2,500, where gross receipts from the general public for use is five percent or less of total gross receipts of the organization. Id. at § 3.01.

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

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

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

We understand that the Organization subordinates serve both members and nonmembers at their bars and restaurants. It is not clear from the facts what percentage of the people served are nonmembers, guests or dependents of members or individuals from the general public at large nor is it clear what percentage of revenues comes from nonmembers. If the standards for exemption under § 501(c)(19) track the standards under § 501(c)(7) prior to 1976, and we believe that it is reasonable to construe the statute in that parallel fashion, then an organization is operating to provide social and recreational activities to members, as required under Treas. Reg. § 1.501(c)(19)-1(c)(8) when it provides social and recreational activities to nonmembers who are guests or dependents. The provision of these activities to individuals who are not members, guests or dependents, however, does not further any of the purposes listed in the regulation. Accordingly, if a substantial amount of an organization's activities consist of providing beverages and food to nonmembers who are neither family members nor guests of members, then the organization is not operated exclusively for one or more permitted purposes as required under Treas. Reg. § 1.501(c)(19)-1(c).[6]

With respect to the Organization's subordinate organizations, if the organizations started as for-profit businesses and have not changed their operations, the organizations are possibly serving beverages and food to individuals without verifying whether or not the individuals are members, bona fide guests, or members of the general public. The Organization materials appear to flag the existence of a membership requirement, but they do not address the extent to which clubs must serve members versus nonmembers nor do they flag the need to keep records to substantiate the extent of member use. We recommend that agents review all records to determine the extent to which the subordinate organizations are serving the general public. As stated above, the failure to have books and records establishing that the organizations meet the requirements for exemption under § 501(c)(19) and the accompanying regulations jeopardizes the organization's exempt status.

It should be noted that where an organization is serving its members, but its members consist of individuals not permitted by § 501(c)(19)(B), the organization will not qualify for exemption under § 501(c)(19), but it may qualify for exemption as a § 501(c)(7) social club. That is, an organization may qualify as a § 501(c)(7) organization even though it is not serving veterans or others that are permitted to be § 501(c)(19) members. Therefore, before deciding on enforcement action, we recommend that the agents determine whether the organization under audit qualifies for exemption as a § 501(c)(7) organization if it fails to qualify for exemption as a § 501(c)(19) organization.

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[6] In situations where the bar or restaurant serves the general public, but the service is not substantial, the income received by a § 501(c)(19) organization attributable from bar or restaurant sales to individuals from the general public who are neither guests nor relatives of members is subject to the unrelated business income tax if the sales activity is regularly carried on and none of the other exceptions under §§ 512 or 513 apply.

3. Inurement Proscription

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

There are no cases or rulings interpreting this statutory or regulatory language under § 501(c)(19). However, the inurement prohibition in § 501(c)(19) parallels exactly the language found in § 501(c)(3). Accordingly, we believe that the case law, as well as the regulatory and other guidance, on inurement under § 501(c)(3) may be used by analogy in interpreting prohibited inurement under § 501(c)(19).

An organization will not qualify for exempt status under § 501(c)(3) if it is organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly by such private interests. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). In GCM 39862, we stated that inurement refers to the non-incidental diversion of assets, which are supposed to be dedicated to charitable purposes, to an insider of the organization. See Treas. Reg. § 1.501(a)-1(c); Ginsburg v. Commissioner, 46 T.C. 47. (1966).

Inurement takes many forms: excessive compensation paid to insiders, Founding Church of Scientology v. U.S., 188 Ct. Cl. 490, 501 (1969); excessive rents paid to insiders as landlords, Founding Church of Scientology; loans to insiders on advantageous terms, Easter House v. U.S., 12 Cl. Ct. 476 (1987); excessive employee benefits provided to insiders, Rev. Rul. 56-138, 1956-1 C.B. 202; purchase of assets from insiders for more than fair market value or sale of assets to insiders for less than fair market value, Anclote Psychiatric Center, Inc. v. Commissioner, T.C. Memo 1998-273.

Given the nature of the materials from Organization soliciting new subordinate organizations, and the information gathered to date in examinations, it appears that some formerly closely-held for-profit businesses have converted to non-profit tax-exempt veterans organizations under Organization's group exemption. If the business has otherwise continued as it did before, there is the potential for the former business owners to be continuing to pay themselves amounts that may not qualify as reasonable compensation or to be covering personal expenses with the resources of the organization. Even if the organizations are satisfying the membership and operational requirements, they will not qualify as exempt under § 501(c)(19) if they are allowing earnings to inure to the benefit of insiders. Further examination of the facts is necessary to establish who is an insider with respect to the various subordinate organizations and what compensation or other personal benefits they are receiving.

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Please call (202) 622-6010 if you have any further questions.

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