TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
TE/GE EO Examinations
1500 Ormsby Station Court Suite A – Stop 700
Louisville, KY 40223

October 9, 2008

Release Number: **201405017**
Release Date: 1/31/2014
UIL Code: 501.03-00
ORG

Taxpayer Identification Number:

Form(s):

Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

Dear :

The purpose of this letter is to provide information that was discussed over the telephone on October 8, 20XX.

We have enclosed a copy of our draft report of examination explaining why we believe an adjustment of you organization's exempt status is necessary.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*, by **October 23, 20XX**. We will then send you a final letter modifying or revoking exempt status. You will also be required to file Forms 1120 for the periods listed above. Additional tax returns may also be required. These returns can be filed at a later date.

If you do not agree with our position or have additional information to present, please mail all information to the address in the heading of this letter so that we receive it by **October 23, 20XX.**

If we do not hear from you by **October 23, 20XX**, we will issue a final report. After we issue the report, you will have 30 days from the date the letter is mailed to file an appeal. Information on this process will be with the final report (if required).

If you have any questions or would like to arrange a conference with my manager, please call me at the telephone number listed under the contact information.

Thank you for your cooperation.

Sincerely,

Jason Jarvis
Internal Revenue Agent

Enclosure: Draft Report of Examination
Form 6018
Envelope

LEGEND
ORG - Organization name XX - Date State - state Motto - motto
President - president Treasurer - treasurer CO-1 & CO-2 - 1st & 2nd
COMPANIES

Issue:

Whether ORG (ORG) continues to meet the requirements of Internal Revenue Code (IRC) section 501(c)(3), and therein continues to qualify for exemption from Federal income tax.

Facts:

ORG was incorporated as a non-profit corporation under the laws of State on August 20, 19XX, with the name of ORG The purposes of the Corporation were:

1. To assist the local educational systems to implement curriculums that will be most informative of the Heritage and Culture of Indigenous People,
2. To maintain a mobile heritage museum to be used at school and other functions to aid children in understanding Culture and History,
3. To respect and advocate the educational resources of other organizations and programs in the community,
4. To support traditional community events and provide the mobile "ORG" for educational classes for youth and adults so as to enrich their knowledge of

On September 17, 19XX, articles of correction were filed to change the name to ORG

In October of 20XX, ORG was granted exemption under section 501(c)(3) of the IRC.

During our examination we requested documentation showing the amount of time devoted to your exempt activities and to your motto activities for calander years 20XX - 20XX. ORG indicated that they did not have any documentation.

ORG provided the following information relating to exempt vs. non-exempt activities.

- ORG indicated that five (5) board members usually devote approximately two (2) hours per quarter for board meetings. The board minutes were requested, but ORG failed to produce any minutes.

- ORG stated that the Project Coordinator conducts the charitable gaming operations and devotes about eleven (11) hours per week.

- ORG stated that the Secretary averages about fifteen (15) to twenty five (25) hours per week. The duties include taking care of the charitable gaming records, (work motto sessions, contact schools, libraries, museums, etc. to schedule showings), taking care of correspondence, maintain the museum, show the museum, conduct educational programs, organize benefit activities for the museum, etc.

- ORG has two motto sessions per week. Each session is staffed by pull-tabbers (sell pull-tabs), counter workers (sell motto paper and computers), motto caller, security guards, and a janitor.

- According to ORG, pull-tabbers and the motto caller usually devote eight (8) hours per week. The counter workers usually devote eleven (11) hours per week.

Based off of motto session sign-in sheets, it is estimated that six (6) pull-tabbers, two (2) counter helpers, and one (1) caller were present at each session.

On May 6, 20XX, an interview was conducted with Treasurer. Treasurer was the Treasurer and stated he attended almost every session in 20XX. Treasurer stated that the pull-tabbers did receive tips from the players and ORG did not want to know about the practice.

Gross Exemption Function Income vs. Gross Motto Income

The Form 990 for 20XX reported $ from charitable gaming activities and $ of donations that were received at the motto sessions.

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The quarterly gaming reported filed with the State Office of Charitable Gaming (OCG) reported charitable expenditures in the following amounts.

- ☐ 20XX $
- ☐ 20XX $
- ☐ 20XX $

In 20XX, transfers from the gaming account to the general account were $ occurred. Of these funds, approximately $ was used in the purchase of a truck. The truck was used to haul a traveling museum.

The $ in expenditures made in 20XX consisted of a $ check to the CO-1 and a $ check to the CO-2 (CO-2).

Assuming that the expenditures (contributions and expenditures on the truck) were made for an exempt purpose, over the three-year period ORG used % of the gross receipts for a charitable purpose.

A review of the pull-tab inventory for the 4th Quarter of 20XX, noted that 114 boxes were unaccounted for. ORG stated that these boxes were returned to the suppliers. ORG was unable to provide any documentation to prove that the boxes were returned to the suppliers. The suppliers were contacted and stated that the boxes were not returned.

The sale of these boxes would have reported gross income of $ and a net profit of $. These sales were never recorded, the income was not deposited into the bank, and the funds were not used for a charitable purpose.

In the state of State, all workers at a motto session must be volunteers. Workers at the motto session (pull-tabbers, chairperson, callers, and counter help) are not allowed to accept tips.

**If issue goes unagreed, additional information may be added **

Law:

Section 501(a) of the Internal Revenue Code exempts from taxation organizations described in subsection (c) or (d) under this subtitle unless such exemption is denied under section 502 or 503.

Section 501(c)(3)of the Code exempts from taxation: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, educational, or scientific purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Treasury Regulation 1.501(c)(3)-(a)(1)provides, in part, that: "In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt."

Section 1.501(c)(3)-1 of the Income Tax Regulations provides:

(c) Operational test--(1) Primary activities. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the Income Tax Regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) provides that the burden of proof is on the organization to establish that it is not organized and operated for the benefit of private interests.

Church in Boston v. Commissioner, 71 T.C. 102, 107 (1978), provides, in part, that the word "exclusively" does not mean "solely" or "without exception." An organization which engages in nonexempt activities can obtain and maintain exempt status so long as such activities are only incidental and insubstantial. (World Family Corp. v. Commissioner, 81 T.C. 958, 963 (1983).) Neither the Internal Revenue Code, the regulations nor the case law provide a general definition of "insubstantial" for purposes of 501(c)(3). This is an issue of fact to be determined under the facts and circumstances of each particular case. (World Family Corp. v. Commissioner, supra at 967.)

In Help The Children, Inc. v. Commissioner 28 TC 1128 (1957), the court held that an organization engaged in fund-raising activities through operation of motto games and whose actual charitable contributions consisted of contributions to charitable institutions of insubstantial amounts when compared to its gross receipts from operation of motto games, did not qualify for exemption under section 501(c)(3) of the Code.

Petitioner's fund-raising activities consisted of the operation of motto games at the Lodge of the Fraternal Order of the Eagles. It also operated a soda bar, and miscellaneous activities. Income from the soda bar and miscellaneous activities was reported on the returns as $ for 19 and $ for 19 . The gross receipts from the fixed charge or donation for the use of the motto cards were $ for 19 and $ for 19 .

Petitioner did not operate any charitable institutions and its actual charitable function consisted of contributions to various individual doctors and institutions. These contributions totaled $ in 19 and $3 in 19 . Its principal activity was the profitable operation of motto games on a business or commercial basis. The principal source of gross receipts was from the fixed charge or donation assessed against each player for the use of the motto cards.

Therefore, the court held that the petitioner failed to establish that it is entitled to a tax-exempt status in the taxable years in question.

In Make a Joyful Noise, Inc. v. Commissioner, 56 TCM 1003 (1989), the court held that operating regularly scheduled motto games on behalf of other exempt organizations was a trade or business unrelated to the organization's exempt purposes.

In that case, the court concluded that the petitioner failed to carry its burden of proving that its participation in motto games was an insubstantial part of its activities.

In P.L.L. Scholarship Fund, v. Commissioner, 82 TC 196 (1984) the Tax Court held that petitioner was not operated exclusively for exempt purposes under the provisions of section 501(c)(3), I.R.C. 1954, and section 1.501(c)(3)-1(c)(1), Income Tax Regs. Therefore, it is not exempt from Federal income tax.

Petitioner was incorporated as a nonprofit corporation for the purpose of raising money to be used for providing college scholarships. The money was raised from the operation of motto games on the premises of a commercial establishment.

The court stated that: "After careful consideration of the entire record, this Court finds that the petitioner has not carried its burden of showing that it was operated exclusively for an exempt purpose under the required standards."

The court further stated that: "Since the record in this case does not show that the petitioner was operated exclusively for exempt purposes, but rather indicates that it benefited private interests, exemption was properly denied."

In People of God Community v. Commissioner, 75 TC 127 (1980), the court held, that part of petitioner's net earnings inured to the benefit of private shareholders or individuals and that petitioner was not exempt as an organization described in section 501(c)(3), of the Internal Revenue Code of 1954.

The court stated that the burden falls upon petitioner to establish the reasonableness of the compensation. The court indicated that by basing compensation upon a percentage of petitioner's gross receipts, apparently subject to no upper limit, a portion of petitioner's earnings was being passed on to an individual.

The court stated that: "The statute specifically denies tax exemption where a portion of net earnings is paid to private shareholders or individuals. We hold here that paying over a portion of gross earnings to those vested with the control of a charitable organization constitutes private inurement as well. All in all, taking a slice off the top should be no less prohibited than a slice out of net."

Revenue Ruling 64-182, 1964-1 (Part 1) C.B. 186, concluded that an organization qualified for exemption under section 501(c)(3) of the Code where it used the proceeds from a business activity to conduct a charitable, program, "commensurate in scope" with its financial resources, of making grants to other charitable organizations. Thus, an organization whose principal activity is operating games of chance may nevertheless qualify for exemption, provided it uses the proceeds of that business activity in a real and substantial charitable program (such as charitable grant making) commensurate in scope with its financial resources, and other wise meets the requirements of exemption.

Christian Echoes National Ministry, Inc. v. United States, 470 F2d 849 (1972), held, in part, that "tax exemption is a privilege, a matter of grace rather than right".

Government's position:

Based off of the information that you have furnished, approximately % of ORG time was devoted to charitable gaming activities.

On average, there were six (6) pull-tabs that worked eight (8) hours per week (2,496 hours per year), two (2) counter person that worked eleven (11) hours per week (572 hours per week), and one (1) project coordinator that worked eleven (11) hours per week. All of the time devoted was related to the motto operation which does not serve any charitable purpose.

The Secretary devoted approximately 1040 hours per year. Their duties included activities related to the motto operation and the museum. An allocation of % was used.

Even if the five (5) board members met and discussed exempt purpose business, a total of 40 hours per year would be devoted to exempt purpose activities.

Gross income from you exempt function activities was $.

% of your gross income came from your charitable gaming activities.

You are operated similar to the organizations described in Make a Joyful Noise v. Commissioner; Help the Children v. Commissioner; and P.L.L. Scholarship Fund, v. Commissioner. Those cases involved organizations engaged primarily in fund raising activities through motto games. The courts held that neither organization qualified for exemption under section 501(c)(3) of the Internal Revenue Code because they were not operated exclusively for exempt purposes.

The examination revealed that you underreported pull-tab sales in 20XX by $, and failed to deposit he net proceeds of $.

Since you were unable to substantiate that the funds were used for legitimate motto expenses and/or IRC 501(c)(3) purposes, they are considered to have been used for nonexempt purposes for the private benefit of your motto workers and motto managers.

Such expenditures do not serve charitable or other purposes within the meaning of section 501(c)(3) of the Internal Revenue Code.

Because a substantial part of your activities is not in furtherance of an exempt purpose, we have determined that you are not operated exclusively for an exempt purpose pursuant to section 501(c)(3) of the Internal Revenue Code and section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

We have determined that a substantial amount of income from your motto operation inured to the private benefit of your motto workers and motto managers.

In addition, by engaging in substantial activities that serve private rather than public interests, you are not operated exclusively for one or more exempt purposes pursuant to section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations. (See Church in Boston v. Commissioner and World Family Corp. v. Commissioner.)

The amount of income distributed from the motto account for charitable and other IRC 501(c)(3) purposes in the year ended 20XX was $, year ended 20XX was $0, and year ended 20XX was $ ($7,500 listed as charitable contribution and $111,479 in truck payments) respectively. The percentage of gross motto income distributed for charitable purposes was approximately 0. % for the year ended 20XX, 0.0% for year ended 20XX, and approximately % for the year ended 20XX.

Based on the amount of gross motto income that was distributed for charitable purposes, we have concluded that the amount of the proceeds received from your motto activities to conduct charitable and educational programs is not "commensurate in scope" with the financial resources of your motto operation. (See Revenue Ruling 64-182, 1964-1 (Part 1) C.B. 186)

Taxpayer's position:

The taxpayer's position is unknown at this time.

On a telephone call on October 8, 20XX, President indicated that they will have no choice but to agree.

Conclusion:

Based on the analysis of your activities and the sources and amounts of your gross income and expenses, we have determined that you no longer meet the requirements for exemption under section 501(c)(3) of the Internal Revenue Code.

You are operated similar to the organizations described in Make a Joyful Noise v. Commissioner; Help the Children v. Commissioner; and P.L.L. Scholarship Fund, v. Commissioner. Those cases involved organizations engaged primarily in fund raising activities through motto games. The courts held that neither organization qualified for exemption under section 501(c)(3) of the Internal Revenue Code because they were not operated exclusively for exempt purposes.

Based on the amount of gross motto income that was distributed for charitable purposes, we have concluded that the amount of the proceeds received from your motto activities to conduct charitable and educational programs is not "commensurate in scope" with the financial resources of your motto operation. (See Revenue Ruling 64-182, 1964-1 (Part 1) C.B. 186)

Because a substantial part of your activities is not in furtherance of an exempt purpose, we have determined that you are not operated exclusively for an exempt purpose pursuant to section 501(c)(3) of the Internal Revenue Code and section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

We have determined that a substantial amount of income from your motto operation inured to the private benefit of your motto workers and motto managers.

We also determined that you failed to deposit approximately $ of gross pull-tab proceeds in the bank account for ORG for the year ended December 31, 20XX.

Since you were unable to substantiate that the funds were used for legitimate motto expenses and/or IRC 501(c)(3) purposes, they are considered to have been used for nonexempt purposes for the private benefit of your motto workers and motto managers.

By engaging in substantial activities that serve private rather than public interests, you are not operated exclusively for one or more exempt purposes pursuant to section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations. (See Church in Boston v. Commissioner and World Family Corp. v. Commissioner.)

Based on the facts, law and conclusions cited above, we have determined that you no longer qualify for exemption under section 501(c)(3) of the Internal Revenue Code.

Therefore, your exemption under section 501(c)(3) of the Internal Revenue Code is revoked effective January 1, 20XX, the first day of the year that we determined that you are not operated exclusively for exempt purposes.

Contributions made to you after January 1, 20XX , are not deductible under section 170 of the Internal Revenue Code.

You are required to file Forms 1120 and pay Federal income tax for all years beginning after January 1, 20XX.

You are also required to file Forms 11-C & 730 for all required periods after January 1, 20XX.

These forms can be filed at a later date, and may be prepared by the Internal Revenue Service.

Alternative Position:

In the event that ORG remain tax-exempt, are the unaccounted for pull-tab sales considered unrelated business income (UBI)?

Facts:

Same as above.

Law:

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c), which includes section 501(c)(3).

Section 512(a)(1) of the Code provides that as a general rule, except as otherwise noted, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 512) regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b)(3)(A) of the Code provides that, with certain exceptions, one of the modifications referred to in section 512(a)(1) is that there shall be excluded from the term "unrelated business taxable income" all rents from real and personal property.

Section 513(a) of the Code defines the term "unrelated trade or business" as 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 the charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 513(a)(1) of the Code provides that the term unrelated trade or business 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 1.512(b)-1(c)(2)(i) of the regulations provides that, in general, rents from real and personal property, and the deductions directly connected therewith, are excluded in computing unrelated business taxable income.

Section 1.512(b)-1(c)(5) of the regulations provides that for purposes of section 1.512(b)-1(c), 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, does not constitute rent from real property.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that, in general, any activity of an exempt organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 of the Code is a trade or business for purposes of sections 511-513. Further, the term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether gross income from a trade or business is "regularly carried on" within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question-- the activities, that is, of producing or distributing the goods or performing the services involved--and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 1.513-1(e)(1) of the regulations refers to section 513(a) of the Code which specifically states that the term "unrelated trade or business" 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.

FINAL-REG, TAX-REGS, §1.513-5. Certain motto games not unrelated trade or business
§1.513-5. Certain motto games not unrelated trade or business

(a) In general. —Under section 513(f), and subject to the limitations in paragraph (c) of this section, in the case of an organization subject to the tax imposed by section 511, the term "unrelated trade or business" does not include any trade or business that consists of conducting motto games (as defined in paragraph (d) of this section).

(b) Exception. —The provisions of this section shall not apply with respect to any motto game otherwise excluded from the term "unrelated trade or business" by reason of section 513(a)(1) and §1.513-1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) Limitations

(1) Motto games must be legal. —Paragraph (a) of this section shall not apply with respect to any motto game conducted in violation of State or local law.

(2) No commercial competition. —Paragraph (a) of this section shall not apply with respect to any motto game conducted in a jurisdiction in which motto games are ordinarily carried out on a commercial basis. Motto games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried on (within the meaning of §1.513-1(c)) by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether motto games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether motto games may be conducted by for-profit organizations, or if State law limits or confines the conduct of motto games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether motto games are ordinarily carried out on a commercial basis.

(d) Motto game defined. —A motto game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term "motto game" means any game of motto of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term "motto game" does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

(e) Effective date. —Section 513(f) and this section apply to taxable years beginning after December 31, 1969.

Government's Position:

A review of the pull-tab inventory of 20XX, noted that 115 boxes were unaccounted for. ORG stated that these boxes were returned to the suppliers. ORG was unable to provide any documentation to prove that the boxes were returned to the suppliers. The suppliers were contacted and stated that the boxes were not returned.

The sale of these boxes would have reported gross income of $ and a net profit of $. These sales were never recorded, the income was not deposited into the bank, and the funds were not used for a charitable purpose.

Since you were unable to substantiate that the funds were used for legitimate motto expenses and/or IRC 501(c)(3) purposes, they are considered to have been used for nonexempt purposes for the private benefit of your motto workers and motto managers.

The net profit of $ is considered UBI in the event ORG remains tax-exempt.

Taxpayer's Position:

The taxpayer's position is unknown.

Conclusion:

In the event that ORG remains tax-exempt, the unaccounted for pull-tab sales of $ are considered UBI.