# D. UPDATE ON GAMING ACTIVITIES

**by**
**Glenn Cunningham and Amy Henchey**

## 1. Introduction

Charitable bingo and/or other charitable games are legal in 46 states and the District of Columbia. The only states not allowing charitable gaming are Arkansas, Tennessee, Hawaii, and Utah. Based on a report issued by the National Association of Fundraising Ticket Manufacturers, as reported in The Chronicle of Philanthropy (Oct. 18, 1994) in 1993, Americans bet more than $7 billion on charitable games. The report includes information from only 25 states and the District of Columbia; thus, the actual volume of charitable gaming was undoubtedly greater than $7 billion.

State laws permitting charitable gaming are summarized in Appendix A to this article. Bingo and various forms of "instant" games account for approximately 95% of the charitable gaming gross receipts. Instant games include scratch-offs and pull-tabs, which are also known as charitable gaming tickets, breakopens, hard cards, banded tickets, jar tickets, pickle cards, Lucky Seven cards, Nevada Club tickets, instant bingo tickets, and other such names.

As charitable gaming has increased in volume, so has its importance in the work of exempt organizations specialists. This article provides an overview of exempt organization tax issues relating to gaming activities. This updates an article in the 1990 CPE Text, at pp. 292-307.

## 2. EO Gaming Focus Group

The Assistant Commissioner (Employee Plans/Exempt Organizations) created an Exempt Organizations Gaming Focus Group (Group) to address gaming issues relating to exempt organizations. The Group includes representatives from the Exempt Organizations Division in Headquarters, Issue Specialists from the regions, and an attorney from the office of Associate Chief Counsel (Employee Benefits & Exempt Organizations). The Group's objectives are to provide the regions with technical support on gaming issues, coordinate and monitor regional gaming activities, develop gaming compliance initiatives to identify and address noncompliance, advise EP/EO personnel of new developments in the gaming industry, and develop educational materials for the EO community and training

programs for EO specialists. The Group has been involved in helping develop EO gaming examination guidelines, which are in clearance.

Another function of the group is to maintain a liaison with the North American Gaming Regulators Association (NAGRA). NAGRA's members are federal, state, local, and Canadian provincial government agencies that regulate legalized gaming. Members include commissioners of state lotteries, racing board directors, state and local law enforcement agencies, and officials from departments of commerce and revenue and offices of state attorneys general.

NAGRA member agencies typically regulate bingo, pull-tabs, lotteries, raffles, and Las Vegas or casino nights conducted by nonprofit organizations for fund raising purposes. The Internal Revenue Service is a NAGRA member through the Office of the Assistant Commissioner (EP/EO). This membership allows all IRS employees to participate in NAGRA activities as members.

NAGRA holds semi-annual conferences that provide a forum for member agencies to exchange regulatory and enforcement information, and share procedures, techniques, and experiences. The conferences update members on the latest and most successful techniques for regulating, auditing, and investigating gaming related activities. EP/EO benefits from the regulatory and enforcement information, procedures, and experiences of the agencies that regulate legalized gaming activities conducted by exempt organizations.

3. Unrelated Business Income Tax Issues

A. In General

The rules applicable in determining whether an exempt organization is subject to unrelated business income tax as a result of gaming activities are discussed generally in Announcement 89-138, 1989-45 I.R.B. 41 (Nov. 6, 1989), reprinted as Appendix B to this article. In general, as noted in Announcement 89-138, income from regularly conducted gaming activities is treated as unrelated business income, unless a specific exception applies.

B. Exceptions

(1) IRC 513(f) Exception

IRC 513(f) provides that the term "unrelated trade or business" does not

include any trade or business which consists of conducting certain bingo games. Reg. 1.513-5(d) defines bingo game. Games other than bingo, such as "instant bingo" and other pull-tab games, are not within the IRC 513(f) exception. This exception is discussed in the 1990 CPE Text, at p. 297.

Proceeds from the conduct of any bingo games (as defined in IRC 513(f)(2)) are "exempt function income" for a political organization, to the extent such amounts are segregated for use only for the organization's exempt function. See IRC 527(c)(3)(D).

(2) "Volunteer Labor" Exception

IRC 513(a)(1) and Reg. 1.513-1(e)(1) except from the definition of unrelated trade or business any trade or business in which "substantially all" the work is performed for the organization without compensation. The regulations do not specify a particular percentage as satisfying the substantially all requirement for this exception; however, the term "substantially all" is found elsewhere in the Internal Revenue Code and has been interpreted to be 85 percent or more. See, e.g., Reg. 53.4942(b)-1(c); Reg. 1.514(b)-1(b)(1)(ii).

The term "compensation" has broad application. In Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner, 42 T.C.M. 1202 (1981), aff'd in part and rev'd in part, 696 F.2d 372 (5th Cir. 1983), the Tax Court stated that even free drinks or food provided to workers may be considered compensation for purposes of IRC 513(a). On appeal, however, the Fifth Circuit reversed the Tax Court's determination that any monetary or non-monetary payment, no matter how small, is compensation under the Code. Instead, the Fifth Circuit held that whether non-monetary "payment" is compensation must be decided based on the facts and circumstances of each case. Using this as a guide, the Court of Appeals concluded that the drinks and food given to workers in the Waco Lodge case were not compensation within the meaning of IRC 513(a)(1) since the average worker received the equivalent of only $0.63 an hour. The court stated that it did not believe the Code's definition of compensation was meant to include such a "trifling" inducement.

Where an organization conducting gaming activities makes a "contribution" to another exempt organization in return for the grantee providing "volunteer" labor, that amount is considered compensation in applying the volunteer labor exception in IRC 513(a). In this scenario the organization is paying another organization for workers, the activity is not being performed for the payor

organization without compensation. It is irrelevant that the workers are not compensated directly by the organization sponsoring the gaming activities.

Tips received by workers from patrons constitute compensation within the meaning of IRC 513(a)(1). See Executive Network Club, Inc. v. Commissioner, T.C. Memo. 1995-21. Thus, if workers receive tips, their labor is not performed "without compensation" for purposes of this exception.

(3) Exempt Organization Gaming in North Dakota

Where an exempt organization in North Dakota conducts gaming activities, and such games were legal in that state as of October 5, 1983, income derived from the gaming activities is not subject to unrelated business income tax. See Appendix B to this article and the discussion in 1990 CPE Text, at pp. 298-99.

Legislation has been proposed which would effectively abrogate the statutory provisions which limit this exception to North Dakota. If enacted, S. 751 would effectively except from UBIT income from conducting games of chance (other than bingo) which do not violate state law, provided a state law was in effect as of October 5, 1983 allowing the conduct of such games of chance by nonprofit organizations.

(4) Deduction of "Lawful Purpose Expenditures"

In South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. 168 (1986), acq. in result, 1987-2 C.B. 1, the Tax Court held that a tax-exempt social club in Massachusetts could deduct "lawful purpose expenditures" under IRC 162. These expenditures are amounts required under state law to be committed to so-called "lawful" purposes in order for the organization to retain its state gaming license. The court reasoned that such payments were not charitable contributions subject to the 10-percent-of-income limitation under IRC 512(b)(10), because they were involuntary expenditures made to obtain a quid pro quo. Instead, they were deductible, as "ordinary and necessary", under IRC 162 as being in the nature of a license retention expense. The Service acquiesced in the result of the case.

Until further guidance is available, the issue of deductibility of these lawful purpose expenditures and similar amounts under IRC 162 should be resolved consistent with the Service's acquiescence in the South End case. For this purpose, no distinction should be made based on whether the organization making the expenditure is described in IRC 501(c)(7) or some other provision, or on whether

the gaming proceeds were donated to other charitable organizations or spent in the organization's own charitable activities.

It should be noted that although lawful purpose expenditures may be allowed as deductions in computing unrelated business income tax, the state law definition of "lawful purpose" may differ from what is exempt under a particular paragraph of IRC 501(c). Thus, lawful purpose expenditures that do not further an organization's tax-exempt purpose may adversely affect exempt status.

State statutes requiring certain expenditures as a condition of a gaming license vary greatly. Such statutes may--

- permit internal expenditures (gaming funds are retained and spent to further an organization's tax-exempt purpose(s)) and/or external expenditures (gaming funds are contributed to other organizations prescribed by State law);
- require a payout amount (e.g. 100%, 35% , etc.) from gaming activity;
- define allowable use of gaming activity proceeds;
- designate the period of time in which the net proceeds derived from the gaming activity must be expended;
- define authorized expenses that may be paid or incurred in connection with the operation of the gaming activity;
- limit authorized expenses to a percentage of the adjusted gross income from the activity (e.g. authorized expenses may not exceed 65% of the adjusted gross income from bingo activity);
- require a separate checking account for the gaming activity from which "lawful" purpose donations and gaming expenses excluding prizes are paid; and
- permit funds from the conduct of a gaming activity to be commingled with general operating funds but restrict their use to "lawful" purposes.

This list is not all inclusive or representative of any particular state.

Therefore, the parameters of each state's gaming laws must be reviewed in deciding if a deduction claimed for a lawful purpose expenditure in a particular case is allowable, in whole or in part, based on the South End holding. Additional issues may also be presented as to whether the deduction is allowable in a particular case.

4. Gaming Income in Public Support Determinations

Whether income from a particular gaming activity is unrelated business taxable income may be a factor in determining the organization's private foundation status. That, in turn, may have other consequences.

Gross receipts that are not from an unrelated trade or business (including, for example, bingo receipts that are non-taxable under IRC 513(f)) are generally excluded from public support computations in determining if an organization is described in IRC 170(b)(1)(A)(vi). Such receipts are included in both the denominator and the numerator of the support fraction in determining if an organization is described in IRC 509(a)(2).

Because unrelated business income is included in IRC 509(a)(2) determinations on a net basis, see IRC 509(a)(2)(B) (in contrast to including income from "not unrelated" activities on a gross basis, see IRC 509(a)(2)(A)(ii)), IRC 501(c)(3) organizations that receive a significant portion of their support from non-taxable gaming activities such as excepted bingo will generally be classified as other than private foundations pursuant to IRC 509(a)(2). Also, where deductions are allowed for "lawful purpose expenditures," the net UBI figure will generally be fairly low. Organizations with a small net UBI figure may readily satisfy either public support test (IRC 509(a)(1)/170(b)(1)(A)(vi) or IRC 509(a)(2)), with a relatively small amount of "good" support. In contrast, where no deduction for lawful purpose expenditures is available, larger amounts of public support are needed to satisfy the public support tests.

An IRC 501(c)(3) organization that receives all its support from gaming activities that are unrelated trade or business may face certain adverse consequences. If the organization's sole source of support is from an unrelated trade or business, it will not meet the requirements for classification as a publicly supported organization under either IRC 509(a)(2) or IRC 509(a)(1)/170(b)(1)(vi). Accordingly, it may be a private foundation.

Classification as a private foundation has numerous consequences for the

organization. For example, under IRC 4943, a foundation and disqualified persons with respect to it may not together hold more than 20 percent of the interest in a business enterprise. The term "business enterprise" generally includes the active conduct of a trade or business, including any activity regularly carried on for the production of income from the sale of goods or the performance of services and that constitutes an unrelated trade or business under IRC 513. See Reg. 53.4943-10(a)(1).

If an organization is classified as a private foundation because its sole source of support is from an unrelated trade or business, it will have excess business holdings in a business enterprise within the meaning of IRC 4943(a)(1), and the organization must divest itself of them. Generally, the organization must cease to operate its gaming activities (or at least substantially restructure its operations and sources of support).

5. Exemption Issues

A. Effect of Illegal Gaming Activities on Exempt Status

How illegal gaming activities affect exempt status may depend on the particular subsection under which exemption is recognized. The purposes of organizations exempt under IRC 501(c)(3), for example, may not be illegal or contrary to public policy; illegal purposes/activities are not "exclusively" charitable and, if substantial, adversely affect IRC 501(c)(3) status. Because IRC 501(c)(4) organizations must exclusively promote social welfare, the illegality doctrine's application under that subsection is similar to that under IRC 501(c)(3). (See generally 1994 CPE text, at pp. 155-79, for a discussion of illegality/public policy considerations.) In contrast, Rev. Rul. 69-68, 1969-1 C.B. 153, held that a gaming activity furthered the exempt purposes of an IRC 501(c)(7) organization even though the activity was illegal under local law.

Even where the illegality/public policy doctrine applies, however, the Service is generally not well-situated to make determinations about the illegality of activities under laws other than the Internal Revenue Code. If a state or locality has not taken action with respect to a purported illegal act, the Service should generally not declare the act illegal and revoke exemption unless the act violates a fundamental federal public policy. Thus far, the courts have found only racial discrimination to be such an act. See Bob Jones University v. United States, 461 U.S. 574 (1983).

IRC 513(f)(2)(C), however, requires the Service to tax the proceeds of any game of bingo that violates State or local law. Therefore, conducting any game of bingo that violates any State or local law, may result in unrelated business income tax being imposed (provided no other exclusion from unrelated business income tax applies).

Thus, illegal activity may be used as a basis for proposing revocation or denial of exempt status under IRC 501(c)(3) or 501(c)(4), but it should generally not be the sole basis, unless the state has made a judicial or an administrative adjudication of illegality. If the organization is engaged in an illegal activity, there is usually a concomitant private benefit, inurement, or substantial non-exempt purpose. Any proposed revocation or denial of exemption should address all issues fairly presented by the facts of the particular case, but a finding of inurement, for example, will generally present a better case for denial than assertions of illegality.

B. "Commensurate Test"

Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186, concluded that an organization qualified for exemption under IRC 501(c)(3) 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 otherwise meets the requirements for exemption. If an organization conducts a charitable program as described in Rev. Rul. 64-182, it is not a "feeder" organization whose exemption is prohibited by IRC 502, even though its primary activity is a business activity. See also Reg. 1.501(c)(3)-1(e)(1). (For additional background on the issue addressed in Rev. Rul. 64-182, see G.C.M. 32689 (Apr. 27, 1964) and G.C.M. 34682 (Nov. 17, 1971).)

In many instances, a bingo or pull-tab operation is the principal activity for the charitable organization. Bingo and pull-tab operations generally do not further IRC 501(c)(3) purposes directly (aside from the use the organization makes of funds derived therefrom). Thus, to qualify for exemption, the organization must operate a real and substantial charitable program "commensurate in scope" with its financial resources.

In two cases, the Tax Court has held that organizations operating charitable

games did not demonstrate a real charitable program, justifying exemption under IRC 501(c)(3). See Help the Children, Inc. v. Commissioner, 28 T.C. 1128 (1957); and Pius XII Academy v. Commissioner, T.C.M. 1982-97.

Whether an organization is operating a "real and substantial" charitable program, as described in Rev. Rul. 64-182, depends on all the facts and circumstances of the case. Probably the most significant factor is whether a relatively low payout reflects private benefit or inurement in the operation of the gaming activity. See, e.g., Rev. Rul. 67-5, 1967-1 C.B. 123, where the Service held that an organization that engaged in activities beneficial to the founder and his family, but detrimental to the foundation, operated for a substantial non-exempt purpose and served the private interests of the founder. Thus, in any case involving possible application of Rev. Rul. 64-182 adverse to the organization, the possibility of private benefit or inurement should be considered.

C. Inurement and Private Benefit

IRC 501(c)(3) organizations may not engage in transactions that serve private interests more than insubstantially or that allow their earnings to inure to the benefit of private shareholders or individuals. The penalty for such violations is revocation of IRC 501(c)(3) status.

Abuses may exist in tightly-controlled bingo operations. Sometimes, organizations are formed by individuals with no apparent charitable history. The stated exempt purpose of these organizations is to conduct gaming operations and make grants to other organizations. The organization then employs the individuals who created it to operate the gaming activities. If the organization was created to provide employment or business opportunities for related parties, the organization may have a substantial non-exempt purpose precluding exemption under IRC 501(c)(3). See, e.g., P.L.L. Scholarship Fund v. Commissioner, 82 T.C. 196 (1984), where bingo games conducted by a scholarship fund in a commercial establishment serving food and drink were found not operated exclusively for exempt purposes. The owners of the establishment, Pastime Lounge, Ltd. (P.L.L.), controlled the organization and allowed players to be solicited for food and drinks sold by their employees.

Private benefit/inurement is often found where gambling activities are conducted by a for-profit operator. All aspects of arrangements with for-profit entities involved in the gambling activities (leases, supply arrangements, management contracts, etc.) should be carefully scrutinized to ensure that the

gambling activity exclusively benefits charity.

See 1990 CPE Text, at pp. 16-71, for an overview of private benefit/inurement issues.

D. Exemption Issues - Other Than IRC 501(c)(3)

IRC 501(c) describes several categories of organizations whose exempt function includes providing social or recreational activities for members and their guests. These include social clubs under IRC 501(c)(7); fraternal organizations under IRC 501(c)(8) or 501(c)(10); and veterans' organizations under IRC 501(c)(19). Such organizations generally may, consistent with exempt status, conduct recreational gaming activities in which members and guests participate. Gaming activities involving the general public, however, do not directly further exempt social/recreational purposes.

IRC 501(c)(4). In general, the conduct of gaming as a recreational activity does not bring about civic betterment and social improvement and thereby promote social welfare within the meaning of IRC 501(c)(4). This conclusion is implicit in Rev. Rul. 66-150, 1966-1 C.B. 147, which held that an organization did not qualify for exemption under IRC 501(c)(4) where it operated social facilities (including bar, restaurant, and game room) for members of an IRC 501(c)(4) veterans' organization and their guests. See also Reg. 1.501(c)(4)-1(a)(2)(i) and G.C.M. 39061 (Apr. 4, 1983).

In rare circumstances, however, providing recreational facilities for members may promote social welfare. For example, Rev. Rul. 74-361, 1974-2 C.B. 159, held that providing recreational activities for members of a volunteer fire department promoted social welfare because providing such activities helped the organization retain its volunteer members and fostered a spirit of camaraderie and cooperation, thereby helping the members better perform the exempt function of fighting fires in the community. Thus, generally, for IRC 501(c)(4) purposes, it does not matter whether the activity is conducted for members or nonmembers.

IRC 501(c)(5). Gaming activities are not related to the exempt purposes of a labor organization exempt under IRC 501(c)(5). See Rev. Rul. 59-330, 1959-2 C.B. 153.

IRC 501(c)(6). Like providing luncheon and bar facilities (see Rev. Rul. 70-244, 1970-1 C.B. 132), gaming activities do not directly further business

league purposes and therefore would generally not, standing alone, support exemption under IRC 501(c)(6). Moreover, substantial gaming activities may demonstrate violation of the prohibition in Reg. 1.501(c)(6)-1 that the purpose of a business league may not be to engage in a regular business of a kind ordinarily carried on for profit.

IRC 501(c)(7). Recreational gaming activities involving members and their guests furthers the exempt social and recreational purposes of a social club exempt under IRC 501(c)(7). See Rev. Rul. 69-68, 1969-1 C.B. 153; Rev. Rul. 74-425, 1974-2 C.B. 373.

IRC 501(c)(8)/501(c)(10). Recreational gaming activities of fraternal associations exempt under IRC 501(c)(8) or 501(c)(10) are related to the exempt social and recreational ("fraternal") purposes of such organizations to the extent of members' participation in such activities. To the extent nonmembers participate in such activities, however, the activities are generally not related to the exempt purposes of fraternal organizations. See G.C.M. 39061 (Apr. 4, 1983).

IRC 501(c)(19). The exempt purposes of a veterans' organization under IRC 501(c)(19) include "[t]o promote the social welfare of the community as defined in . 1.501(c)(4)-1(a)(2)" and "[t]o provide social and recreational activities for their members." Reg. 1.501(c)(19)-1(c). Thus, recreational gaming activities for members are related to the exempt purposes of veterans' organizations exempt under IRC 501(c)(19). However, to the extent gambling activities involve the general public or nonmembers, they do not further the exempt purposes of an IRC 501(c)(19) organization.

6. Books and Records

Reg. 1.6001-1(c) requires exempt organizations to keep such permanent books of account or records as are sufficient to show specifically items of gross income, receipts, and disbursements. In addition, organizations must keep such books and records as are required to substantiate the information required by IRC 6033 and the regulations thereunder.

With respect to liability for unrelated business income tax under IRC 511, organizations must also maintain books and records, required by Reg. 1.6001-1(a), sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown on Form 990-T.

Specific record-keeping requirements are provided concerning non-member

income of social clubs exempt under IRC 501(c)(7). See Rev. Proc. 71-17, 1971-1 C.B. 683. (Note, however, that Rev. Proc. 71-17 has not been updated to reflect significant changes in IRC 501(c)(7) that were enacted in 1976, and should therefore be used with caution.)

The information required by IRC 6033 (for Form 990 reporting purposes) includes "gross receipts." See IRC 6033(a)(1); Reg. 1.6033-2(a)(1). "Gross receipts" is defined in Reg. 1.6033-2(g)(4) (relating to the 990 filing requirement) as the gross amount received from all sources, "without reduction for any costs or expenses . . . ." Many organizations erroneously report (on Form 990) gaming revenues net of prizes. For this reason, the Instructions to Form 990 recently clarified this point. Also, organizations under examination have sometimes been unable to substantiate gross receipts from gaming activities. Since IRC 6033 requires gross receipts to be reported on the return, the regulations under IRC 6001 require the maintenance of books and records needed to substantiate gross receipts.

7. Applications for a Group Exemption Letter

The issuance of a group exemption letter is an administrative procedure which has been in existence for several decades. The procedures were instituted to relieve the Service from the burden of individually processing a large number of applications involving the exempt status of organizations that are affiliated with each other, and also are organized and operated for the same purpose. The procedures for obtaining and maintaining a group exemption letter are contained in Rev. Proc. 80-27, 1980-1 C.B. 677 and section 7667 of IRM 7600, Processing Determination Letter Applications. It should be emphasized that these procedures were established for the convenience of the Service. Regardless of whether an organization is included in a group exemption or whether it has received an individual exemption letter, all organizations are subject to the same rules for maintaining their tax-exempt status.

The standards for issuing a group exemption letter or inclusion in a group exemption are not lower than those for issuing individual exemption determinations. This means that the standards regarding a full description of the proposed purposes and activities, including assurances covering inurement and private benefit where applicable, have to be satisfied. In this respect, where an organization's activities include gambling (bingo, pull-tabs, casino nights), the Service needs to consider all the facts and circumstances surrounding the operation of the gambling activity before it can reach a conclusion as to an

organization's qualification for recognition of exemption.

Because of the in-depth review that is required before an organization that is participating in any gambling activity can be recognized as exempt, the group exemption procedure is inappropriate for these cases. Unless all gambling cases are subject to similar review, the group exemption procedures could provide unscrupulous operators through Federal tax-exempt status the means to obtain state/local gaming licenses to conduct commercial gambling ventures. An applicant requesting a group exemption on behalf of a group of organizations engaged in any gambling activity should be informed that, pursuant to section 8.01 of Rev. Proc. 95-4, 1995-1 I.R.B. 97, the Service will not issue a group exemption letter under these circumstances, but will individually rule on each complete application submitted by a subordinate.

8. Other Considerations

A. Federal Excise Taxes on Wagering

Internal Revenue Code Sections 4401 and 4411 impose excise taxes on the gaming industry.

The excise taxes apply to all race and sports book establishments whether they are legal or illegal. The provisions also apply to pull-tabs, punch boards, or other similar games.

IRC 4401(a)(1) imposes a .25% tax on certain wagering transactions authorized under state law.

IRC 4401(a)(2) imposes a 2% tax on wagering transactions not authorized under state law.

IRC 4411(a) imposes occupational taxes of $500 on any person liable for the tax under IRC 4401(a)(2) and on paid employees who accept wagers for such persons. IRC 4411(b) imposes occupational taxes of $50 on any person liable for the tax under IRC 4401(a)(1) and on paid employees who accept wagers for such persons.

The tax is imposed on any wager placed in a "wagering pool" with respect to a sporting event or a "contest," if conducted for a profit.

A wagering pool conducted for profit includes any method or scheme for the distribution of prizes to one or more winning bettors based on the outcome of a sports event, a contest, or a combination or series of such events or contests, if the wagering pool is managed and conducted for the purpose of making a profit. If a wagering pool or lottery is operated with the expectation of a profit in the form of increased sales, attendance, or other indirect benefits, the event is staged for profit.

A contest includes any type of competition involving speed, skill, endurance, popularity, politics, strength, appearances, etc., such as a general or primary election, the outcome of a nomination convention, a dance marathon, a log rolling, wood-chopping, weight-lifting, corn-husking, beauty contest, etc.

The tax is also imposed on any lottery, which includes the numbers game, policy, punch boards, and similar types of wagering conducted for profit. The term lottery does not include:

1) games where the wagers are placed, the winners are determined, and the prizes are distributed in the presence of all persons placing wagers in such game;

2) any drawing conducted by an organization exempt from tax under section 501, if no part of the net proceeds derived from such drawing inures to the benefit of any private shareholder or individual.

Most legal wagering conducted by non-profit organizations relates to lotteries. "Pull-tab" or "instant" games meet the definition of taxable wagers placed in a lottery. Bingo games are specifically excluded from the tax. The term "lottery" does not include any wagering conducted by an exempt organization if no part of the net proceeds derived from the activity inures to the benefit of any individual. See Rev. Rul. 57-241, 1957-1 C.B. 419. See also P.L.R. 8806001 (May 18, 1987); G.C.M. 39740 (May 31, 1988). Card games, roulette games, dice games, bingo, keno, and gambling wheels usually are excluded from the term "lottery."

Certain gaming activities which are "conducted by" organizations exempt under IRC 501 are not subject to wagering excise and occupational taxes, pursuant to IRC 4421(2)(B). Rev. Rul. 69-21, 1969-1 C.B. 290, provides that a "drawing" that is "conducted by" an organization exempt under IRC 501 must, in fact, be operated by such organization to be excluded from wagering taxes. This would

also be true for IRC 527 organizations. There is a basic distinction between mere sponsorship of a drawing and actual conduct thereof. In general, "conduct" denotes supervision and control, as distinguished from lending the name of an organization to the activity or endorsing it.

Form 730, Tax on Wagering, is used to compute and pay the excise tax under IRC 4401. Form 11-C, Special Tax Return and Application for Registry-Wagering, is used by the person who accepts the wagers subject to excise tax to pay the annual occupational tax under IRC 4411. Form 11-C is also used by each individual who accepts wagers for another person to register under IRC 4412 and pay the annual occupational tax.

The wagering tax is discussed generally in Publication 510, Excise Taxes for 1995.

B. Withholding and Information Reporting

The Instructions for Forms 1099, 1098, 5498, and W-2G provide the requirements for filing Form W-2G, Certain Gambling Winnings, and for withholding on certain gaming winnings. In essence, whether withholding and/or reporting are required depends on the type of gaming, the amount of the gaming winnings, and the ratio of the winnings to the wager.

Winnings (not reduced by the wager) from a bingo game or slot machine play of $1,200 or more are reportable gaming winnings and require the completion of a Form W-2G by the payor of the prize. The winner of a single prize of $1,200 or more must furnish the payor with proper identification, along with his/her Social Security Number (SSN). If the winner provides this information, withholding is not required. If the prize winner does not provide a taxpayer identification number (e.g., SSN), the payor must withhold 31% of the proceeds. This is referred to as backup withholding. See Temp. Reg. 7.6041-1; Announcement 92-162, 1992-47 I.R.B. 110.

For pull-tab prizes, a single prize of $599.99 or less does not require completion of Form W-2G or withholding of federal income tax. A single prize of at least $600, but not more than $5,000, requires the completion of Form W-2G by the payor. The prize winner must furnish the payor with proper identification along with his/her SSN. If the winner provides this information, withholding is not required; otherwise, the payor must withhold 31% federal income tax. Backup withholding applies to the amount of the winnings reduced, at the option of the

payor, by the amount wagered. A single prize winning, less the wager, exceeding $5,000 requires the completion of Form W-2G, as well as withholding of 28 percent federal income tax from the amount of winnings less the amount wagered. See Reg. 31.3402(q)-1; IRM 7(10)(16)9.5; Announcement 93-1, 1993-3 I.R.B. 60; Rev. Rul. 85-46, 1985-1 C.B. 334.

Form W-2G must also be filed for certain winners of door prizes given away in conjunction with a regular gaming occasion. If the winnings are non-cash, the fair market value of the item won is considered the amount of the winnings. A single door prize valued at $1,199.99 or less does not require completion of Form W-2G or withholding of federal income tax. A single door prize valued at $1,200 or more requires the filing of a Form W-2G by the organization. See P.L.R. 8642002 (June 30, 1986).

C. Withholding for Nonresident Aliens

IRC 871(a)(1)(A) generally imposes a tax of 30 percent of the amount received from sources within the United States by a non-resident alien individual as "fixed or determinable annual or periodical gains, profits, and income." IRC 1441(a) generally requires any person having control over such payments to withhold and pay over the tax. The tax and withholding requirements generally apply to U.S. source gaming winnings of non-resident alien individuals. See Barba v. United States, 2 Ct. Cl. 674 (1983). Form 1042 and 1042S are used to report the tax. (The withholding tax is discussed generally in Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Corporations.)

IRC 871(j) exempts from tax under IRC 871(a)(1)(A), and thus from withholding requirements, the proceeds of wagers placed in blackjack, baccarat, craps, roulette, and big-6 wheel games.

Withholding requirements do not apply to residents of certain treaty partners (currently Germany, Hungary, India, Italy, Malta, Netherlands, Spain, Tunisia, and the United Kingdom). Patrons from these countries should complete Form 1001, which should be on file with the establishment that allows the exemption.

A chart of the reporting and withholding thresholds for gaming transactions is printed as Appendix C to this article.

D. Employment Taxes and Tip Income

Frequently, gaming workers receive substantial tips from patrons. Pursuant to IRC 3121(q) (FICA), IRC 3306(s) (FUTA), and IRC 3401(a)(16) and 3401(f) (FITW), tips received in the course of employment are subject to employment tax requirements under the circumstances specified in those sections.

Where a worker receives no direct compensation from the exempt organization, the organization may contend that tips are not received in the course of employment of the worker by the organization. Whether an employer-employee relationship exists in a given case depends on application of the factors delineated in Rev. Rul. 87-41, 1987-1 C.B. 296. See generally IRM 7(10)(16)9.4 regarding employment taxes on tip income; and IRM 7(10)(16)4.8, and Exhibit 7(10)(16)0-10 thereto, regarding determination of employer-employee relationship.

E. Disclosure to States for Tax Administration Purposes

The Service may work in partnership with state/municipal tax and non-tax law enforcement agencies to ensure that exempt organizations engaged in charitable gaming are voluntarily complying with federal tax laws. Whenever the Service establishes a working partnership with state/municipal tax and non-tax law enforcement agencies, such as through a Memorandum of Understanding, it must ensure compliance with federal disclosure and privacy laws relative to taxpayer rights. In addition, information obtained from sources outside the Service for purposes of verifying the filing of required returns, payment of tax, exempt status, proper reporting of income, deductions or credits, or otherwise determining compliance with the tax laws must be directly tax related and necessary to the administration of the tax laws. See IRM 7(10)8(10).

IRC 6103(d)(1) permits disclosure of returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52, and subchapter D of chapter 36, to any state agency, body, or commission (or its legal representative) charged under the laws of the state with the administration of any state tax law. Disclosure of Federal tax information pursuant to IRC 6103(d) may not be made for non-tax-functions of a State agency. IRM 1272, Chapter (33)00 (Disclosure to States for Tax Administration Purposes), discusses disclosure of federal tax returns and return information to state tax agencies under IRC 6103(d)(1).

Disclosure of Federal returns and return information to a state tax agency under IRC 6103(d)(1) is restricted to the state agency's justified tax administration

need for and use of such information. The state agency may use the tax returns and information for any state tax administration purpose authorized by the "Agreement on Coordination of Tax Administration," which is executed by the Commissioner of Internal Revenue and the head of a state agency. This "basic" agreement provides for the mutual exchange of tax data between a specific state agency and the Service. An "implementing" agreement supplements the basic agreement by specifying the detailed working arrangements and items to be exchanged, including tolerances and criteria for selecting those items, as agreed to by the state tax agency and IRS districts and affected service centers.

Since IRC 6103(d) disclosures may be made only for the purpose of, and to the extent necessary in, the administration of state tax laws, the Service may not share tax information with a state agency for non-tax functions under the authority of IRC 6103(d). However, non-tax state agencies may have access to tax information pursuant to taxpayer disclosure authorizations that comply with IRC 6103(c) and Reg. 301.6103(c)-1.

The Disclosure Officer should be consulted before any Federal return and return information are disclosed to a state tax agency to determine the detailed working arrangements and items to be exchanged, including tolerances and criteria for selecting those items as agreed to by the state tax agency and the IRS districts and service centers.

**[Note: Appendix A, B, and C not included in this document]**