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Charitable Gaming: Gambling for a Good Cause Is Not Always a Winning Hand

Charitable organizations often raise funds through gambling activities, such as bingo, raffles, casino nights, and drawings authorized by state law. Unfortunately, many charities proceed with such fundraisers without considering the requirements and limitations of federal, state, and local laws and the potential penalties that may be imposed when the applicable rules are not followed.

Federal, state and sometimes local law regulate charitable gaming activities. Federal law restrictions arise from the organization's tax-exempt status. To maintain this preferred status, the organization must strictly adhere to the requirements of the Internal Revenue Code (the "Code"). State law restrictions arise from prohibitions on gambling activities, as well as state charitable solicitation laws. Local laws may also impact gambling activities. Given the heavily regulated nature of charitable gaming activities, charities need to be aware of and comply with federal, state, and local law to ensure they play the fundraising game with a winning hand.

Federal Tax Law Considerations

Most organizations that engage in public fundraising to support their activities are charitable organizations under Section 501(c)(3) of the Code. Such status affords both exemption from federal income tax and the much-desired qualification to receive tax-deductible contributions. With these benefits, however, come a number of restrictions and reporting obligations that may impact the organization's gaming and other fundraising activities.

- **Impact of Gaming on Tax-Exempt Status.** To obtain and maintain tax-exempt status as a 501(c)(3) organization, the charity must be organized and operated exclusively for religious, scientific, literary, educational or other charitable purposes. Gaming,¹ however, is not considered a "charitable" activity, even if the proceeds from gaming activities are used to pay for charitable programs of the organization. Accordingly, a charity that conducts gaming as a substantial part of its activities may jeopardize its tax-exempt status.
- **Unrelated Business Taxable Income.** A 501(c)(3) organization that regularly carries on a trade or business that is not substantially related to its exempt purpose may be subject to tax on the income from such unrelated trade or business. The IRS generally views gaming as a trade or business that is not substantially related to any charitable purpose. To avoid the tax

¹ The Internal Revenue Service ("IRS") defines gaming to include, among other things, bingo, pull-tabs, Texas Hold-Em Poker and other card games, raffles, scratch-offs, casino nights, and coin-operated gambling machines such as slot machines or video blackjack or poker. See IRS Publication 3079, *Tax-Exempt Organizations and Gaming* (June 2010).

on unrelated business income (“UBI”) (and the requirement to file the applicable tax return, a Form 990-T), the charity must demonstrate that the gaming activities are not regularly undertaken or that an exception from UBI applies. Among the available exceptions are those for certain bingo games and activities conducted with substantially all volunteer labor.

- **Internal Controls and Recordkeeping.** All tax-exempt organizations must maintain complete books and records so that they can satisfy their reporting obligations and determine any tax liabilities that they may have. Organizations that engage in gaming activities must maintain records of gross receipts from gaming, prize payouts, and other related disbursements to substantiate information submitted on their annual returns filed with the IRS.
- **Reporting Requirements.** All 501(c)(3) organizations, other than private foundations, are required to file an annual information return (i.e., a Form 990, Form 990-EZ, or Form 990-N) with the IRS. Those that file the Form 990 or Form 990-EZ and receive more than \$15,000 in gross revenues from gaming activities² are required to complete Part III of Schedule G, *Supplemental Information Regarding Fundraising or Gaming Activities*. The disclosures required in Part III of Schedule G include gross revenues from gaming, cash and non-cash prizes awarded, direct gaming expenses (including rent or costs of facilities), the percentage of volunteer labor used to conduct the gaming activities, the states in which the organization operated gaming activities or holds gaming licenses, the amount of proceeds spent on the organization’s charitable activities, and information about gaming managers or third

party contractors who receive gaming revenue.

- **Reporting Winnings and Withholding Income Taxes.** If a charity pays a winner more than a certain amount (the amount varies depending on the type of gaming activity), the charity must report the amount and certain information about the winner to the IRS. The charity may also be required to withhold income taxes from the winnings.

State Gambling Laws

With limited exceptions, the laws of the fifty states and the District of Columbia make it a crime for any person or entity to conduct gambling activities. As an exception, charitable organizations are permitted to use gambling activities to generate funds to advance the organization’s charitable purposes. This charitable-gambling exception, however, is subject to restrictions and regulation. It is typically limited to charitable, public interest, and religious organizations, which are permitted to conduct limited forms of gambling. Forty-eight states recognize the charitable-gambling exception, with only Hawaii and Utah prohibiting all forms of gambling, including charitable gambling. Although each state has different rules and restrictions with respect to charitable gambling, there are a number of concepts common to all.

- **Eligible Organizations.** The charitable-gambling exception is typically available only to nonprofit organizations that are created for a charitable, public interest, or religious purpose (“Eligible Organizations”). State statutes usually require that the dominant purpose of the nonprofit organization must be to: advance a charitable, public, or religious interest; conduct religious activities; benefit veterans of the armed forces; provide a civic or service benefit (e.g., volunteer fire companies); or promote the welfare of the aged, poor, or infirmed.
- **Authorized Games.** Even when charitable gambling is permitted, the types of games authorized, the use of the proceeds, the

² For purposes of the Form 990 or Form 990-EZ, gaming does not include fundraising events in which participants can play casino-style games for non-cash items donated to the organization.

location of the games, and the days/hours of operation are heavily restricted. Authorized games typically include bingo, raffles, pull tabs, and drawings. Most states preclude Eligible Organizations from conducting traditional casino-style gambling, such as blackjack, craps, roulette, or slot machines, although a few states permit Eligible Organizations to offer casino nights.

- **Other Restrictions.** The proceeds from such charitable gambling operations must be used for the organization's charitable, public interest, or religious purposes. In addition, many states limit where charitable games may be played to the physical location of the Eligible Organization or to a location leased by the Eligible Organization. Most states will review the appropriateness of the physical location when deciding to award a charitable gambling license. In certain states, such as Pennsylvania and New York,³ local municipalities must also approve charitable gambling in order for the Eligible Organization to conduct such activities within the municipality's jurisdiction. Given the limitations regarding the physical location of the gaming activities, offering charitable gambling on the Internet is not a viable option in most states, and some states expressly prohibit offering charitable games over the Internet.
- **Prize Limits.** States restrict the amount of prizes that may be awarded by an Eligible Organization. For example, in Pennsylvania, a prize for a single charitable game, other than weekly drawings, generally may not exceed \$500, the total prizes awarded during any seven-day period may not exceed \$5,000, and only \$5,000 in total prizes may be awarded in raffles during any one-month period.⁴ Similarly,

New York does not permit a single prize in excess of \$300 for any charitable game, except for raffles, which are limited to a single prize of \$50,000.⁵

- **Registration and Licensing.** To be an Eligible Organization, the nonprofit must submit an application to the appropriate state or local licensing agency and pay a license fee in order to obtain a license to offer charitable games. The state or local agency will investigate, or require certification of, the entity's qualifications and merits of the application including: (i) the organization's charitable, public interest, or religious purpose; (ii) the appropriateness of the physical location for the charitable games; (iii) the moral character of the organization's members; (iv) conduct of games in accordance with state law; (v) assurance that no compensation will be paid to any person managing, operating, or assisting in the charitable games; and (vi) verification that the organization is duly authorized to conduct charitable games. The license fee varies by state but typically does not exceed \$500.

Gambling as a Charitable Solicitation

Charities that raise funds through gambling activities also must consider whether such activities will trigger the state charitable solicitation laws where they operate. Most states have laws that regulate solicitations for charitable contributions. In general, "solicitation" is broadly defined to include any direct or indirect request for a contribution in response to a representation that it will be used for a charitable purpose. Such a request can include selling or offering to sell a chance, ticket, or other thing of value, as well as an announcement requesting the public to attend or participate in a contest, game, party, or other form of entertainment. Therefore, any gambling activity that includes a charitable appeal is likely to trigger application of

³ See 10 P.S. § 324; N.Y. Gen. Mun. § 187.

⁴ See 10 P.S. § 315. Larger prizes may be permitted if the Eligible Organization obtains a special permit. See *id.* § 315(d).

⁵ N.Y. Gen. Mun. § 189.

the charitable solicitation laws of the state(s) in which the appeal is made.

Although the charitable solicitation laws vary from state to state, such laws typically require organizations soliciting charitable contributions to register with a state agency such as the Department of State or Office of the Attorney General prior to engaging in solicitations (unless an exemption applies), file annual reports with the state agency, and make specified disclosures to donors and potential donors. Some states mandate the inclusion of specific language in solicitation materials and acknowledgements of contributions.

Complying with state charitable solicitation laws can be a particular challenge for charitable organizations that engage in gambling or other fundraising activities in multiple states. For example, a charity may solicit donations by telephone, mail, or e-mail in more than one state, publicize or hold fundraising events in more than one state, or post a solicitation request on its website. Such activities may subject the organization to the charitable solicitation registration and reporting requirements in those states in addition to the organization's home state.⁶ In certain cases, the charity may be required to disclose on its Form 990 or 990-EZ the states in which it is registered or licensed to solicit funds (or has been notified it is exempt from registration or licensing requirements). Such disclosures are likely to be of particular interest to the state charity officials tasked with enforcing the charitable solicitation laws, who may use such disclosures as an enforcement tool.

The burden of complying with the charitable fundraising regulations of multiple states may be eased to a degree through the use of a standardized registration form. Thirty-six states and the District of Columbia currently accept the Uniform Registration Statement ("URS") for Charitable Organizations⁷ in lieu of the state registration form. Although the URS provides for a degree of standardized reporting to meet state registration and

renewal requirements, its effectiveness in reducing the burden of multi-state registration is limited for two reasons. First, 18 of the 37 jurisdictions that accept the URS require state-specific documentation or filings in addition to the URS. Second, the URS has not been officially sanctioned for use in fulfilling annual financial reporting/renewal requirements, so the annual filing requirements must be determined and complied with on a state-by-state basis.

Failure to comply with the state charitable solicitation laws can have serious consequences. Although the sanctions vary from state to state, they may include both civil and criminal penalties for noncompliance, with potentially hefty fines. The governmental body enforcing the charitable solicitation law may also issue a cease and desist order, which would effectively bar a noncompliant organization from engaging in any fundraising activities in the applicable state until the organization comes into compliance, negotiates a settlement, and pays the applicable fines. More significant from a public relations perspective, however, is the loss of reputation that may deter donors from giving to an organization if they are uncertain about the organization's business practices and ability to comply with legal requirements.

Conclusion

Gambling activities are an effective way for charities to increase public awareness of their causes and to raise funds to support their activities. Organizations that engage in charitable gambling activities without considering the many federal and state restrictions and conditions on gambling risk substantial penalties and negative publicity. Accordingly, charities would be wise to consult with knowledgeable legal counsel prior to engaging in gambling activities to ensure that such activities are conducted in compliance with applicable charitable gambling and solicitation laws.

⁶ While the legal requirements regarding online fundraising remain unsettled, a charitable organization that has a place of business in a state and uses the Internet for fundraising should register to conduct charitable solicitation activity in that state.

⁷ Available at http://www.multistatefiling.org/c_statement.htm.

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