

**General Counsel Memorandum 35570-General Counsel's Response to Proposed [at That Time]
Revenue Ruling 74-99 [IRC Section 501 (p)(4)]**

Cross Reference Data

Topical

Exempt organizations
Form 990

Citation

IRC Section-501(c)(4)

Regulations Section--1.337(d)-4

Cases -

-Rancho Santa Fe

-Flat Top Lake Association v. U.S.A.

-Commissioner v. Lake Forest, Inc.

-Lake Petersburg Association v. Commissioner

-Portland Golf Club v. U.S.

Revenue Ruling-74-99

Summary

GCM 35570 is the response to proposed (at that time) Rev. Rul. 74-99. It takes the position that the inherent nature of a homeowners' association prevents It from qualifying as exempt under IRC Sec. 501 (c)(4). However, see the Notes to this GCM.

General Counsel's Response to Proposed [At That Time] Revenue Ruling 74-99 [IRC Section 501(c)(4)]

GCM 35570

Date Numbered: November 23, 1973

REV RUL.74-99

Internal Control Number: CC:I-72-73 Br.5:SWGGarrett 0501.04-00

WADE F HOBBS, JR.

Acting Assistant Commissioner (Technical)

Attention: Director, Miscellaneous and Special Provisions Tax Division

By a memorandum (T:MS:EO:R:1) dated January 29, 1973 you forwarded for the comments or concurrence of this office a proposed memorandum of technical advice in the above case to the District Director, Seattle.

ISSUE

A nonprofit corporation was formed by a real estate developer and has been operated to provide maintenance services to both the common areas (including recreational facilities thereon) and the private lots and dwellings within a townhouse development. Membership in the organization is required of and restricted to all lot owners in the development pursuant to the terms of a Declaration of Covenants, Conditions and Restrictions

relating to the property made and filed by the developer, and the terms of the organization's articles of incorporation and bylaws.

The question is whether this organization qualifies for recognition of exemption as a social welfare organization described in Int. Rev. Code of 1954, §501(c) (4).

CONCLUSION

You have concluded that the organization qualifies as a social welfare organization exempt under Code §501 (c)(4). This conclusion is based on your determination that the primary activity of the organization (measured solely, it appears, by comparing its expenditures in providing services to the common areas, including the recreational facilities, with its expenditures in providing services to the private lots and dwellings and finding that the former constitute more than 50% of its total expenditures) is maintaining and preserving common or community facilities and property, and that such activity is comparable to the activities of the organization held qualified as a social welfare organization under Code §501 (c) (4) in Rev. Rul. 72-102, 1972-1 C.B.149. Thus, notwithstanding that the subject organization also engages in maintaining private lots and residences to a substantial extent (an activity held not to qualify as the promotion of social welfare in Rev. Rul. 69-280, 1969-1 C.B. 152) you conclude that the organization satisfies the test set out in Regs. 1.501(c)(4)-1 (a) of being primarily engaged in the promotion of social welfare,

We disagree with your conclusions. We believe the fact that membership in the Association is mandatory, and limited, together with the fact that direct private benefits flow to the members from the Association by virtue of both the organizational scheme and the operations of the Association, prevent the organization from qualifying as a social welfare organization described in Code §501(c)(4).

ANALYSIS

Code §501 (c)(4) provides, in part, that 'Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare' qualify for exemption under Code §501(a).

Regs. 1.501(c)(4)-1 (a) (2)(1) says, in part, that:

"An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. . . ."

[Rev. Rul 72-102] ... and that any benefits to the developer or the individual members of the organization are merely incidental to that purpose and do not disqualify the organization under Code §501 (c)(4).

However, in the light of our increasing experience with and knowledge of so-called "Homes (or Homeowners') Associations" since we considered Rev. Rul. 72-102 and the case underlying it, we now have serious reservations whether the organization described in that revenue ruling should have been recognized as exempt under Code §501 (c) (4). In any event, we do not believe such recognition can or should be extended to organizations like the

The Association has such an integrated intermixture of the purposes and activities of the organizations described in Rev. Ruls. 69-280, 69-281 and 72-102 that we believe it would be incorrect as a matter of law to classify the organization under Code §501(c)(4).

Several facets of Rev. Rul. 72-102 complicate consideration of a case like the subject one:

1. As written, Rev. Rul. 72-102 equates a single housing development with a "community" within the meaning of that term as it is used in Regs. 1.501(c)(4)-1 (a) to implement the statutory phrase "Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare." The regulations defining the promotion of social welfare are quoted. Treas. Reg. 1.501(c)(4)-1(a)(2).

COMMENT. It seems manifest from the statutory language and the interpretation of that language in the regulations that a broader community than one comprised of and restricted to those purchasers of homes in a single housing development was contemplated by the framers of the statute.

Although an exact delineation of the boundaries of a "community" contemplated by Code §501 (c)(4) may not be possible, we believe that the term is most properly interpreted as embracing only those geographical units that bear a reasonably recognizable relationship to what is most commonly regarded as a community—that is, one comprising an area ordinarily identified as a governmental subdivision, or a unit or district thereof. We are persuaded that "community" in the Code §501 (c)(4) sense should be read to mean something more than an arbitrarily structured unit deriving directly from, and geared to, the relationship between purchasers of homes in a real estate development and the developer who built them. It is unfortunate that the language of Rev. Rul. 72-102 suggests otherwise not only because such a definition of a "community" is in itself unduly flexible, but also because of the complications it creates when considered in combination with the other factors in the case. As a general rule, the factors underlying the creation of an association serving such a narrowly and artificially structured "community" as the one in the Rev. Rul. would evidence that the association was animated principally by selfish interests of those directly involved in its organization and operations, and whether any broader public benefit was served would be at best of secondary concern to the organization.

2. In addition to the fact that Rev. Rul. 72-102 accepts a real estate development, or subdivision, as a "community" for Code §501 (c)(4) purposes, it states, without more, that membership in the association involved is required of all homeowners in the development.

COMMENT: No attempt is made in the ruling to explore or evaluate the significance of the compulsory membership requirement. Such a requirement strongly indicates the essentially private nature of such a homeowners' association and of the benefits it produces, of course. An essential and inseparable purpose of such an organization is to serve the private property interests of the members and as a rule every activity the association undertakes is colored by and imbued with that purpose. If this were not true there would be no conceivable basis on which the compulsory feature of the membership could be impressed on the property owners. It may be conceded that the services these associations are designed to and do perform enhance the aesthetic value of and preserve the tangible property values in the immediate area. The association thus consequently may be said to benefit in some degree the community of which that neighborhood is a part, but these effects are, as with any maintenance of private property, the by-products of an over-riding private interest.

3. Rev. Rul. 72-102 describes the properties owned and maintained by the association there involved as "common green areas, streets, and sidewalks for the use of all development residents," and as "certain non-residential, non-commercial properties of the type normally owned and maintained by municipal governments."

COMMENTS: No mention is made of the presence of any recreational facilities, and, in fact, there were no such facilities at least as of the time of the original consideration of the underlying case.

It may be possible to contain the principle for which the revenue ruling stands within the boundaries of the above described areas but troublesome issues come to mind. For example, in the case of an association owning and maintaining recreational facilities in common areas, the line between a Code §501 (c)(4) facility and a Code §501 (c)(7) facility is difficult to draw and tends to become meaningless if the subdivision is the community since it is well known that local governments own and maintain such facilities for the benefit of their citizens.

The problems that are inherent in the position taken in Rev. Rul. 72-102 have an obvious spill-over effect into all cases involving the proper classification of homeowners' associations for federal tax purposes. Thus, we believe that as a minimum the Rev. Rul. needs clarification and some modification in at least four important and inter-related respects: 1) The unqualified idea conveyed by the Rev. Rul. that a real estate subdivision is the equivalent of a community for Code §501 (c) (4) purposes must be corrected. Otherwise, it is very difficult to counter the argument that the activities of any homeowners' association whose membership is comprised of all the residents of "the community" are beneficial to the community as a whole. 2) The Rev. Rul. fails to attach proper significance to the combination of factors recited in the factual description of the association in question: a) In the first place, such an association is formed by a commercial and developer as a part of a plan for the development of a subdivision; and b) membership in the association is required of all lot purchasers in the development; and c) membership is open only to the developer and lot purchasers; and d) both because of the association's organizational format and operational plan, direct private benefits designedly flow to both classes of members with benefit to the public (as distinguished from the membership) at best a secondary concern of the association; and e) the existence of the association and its membership derive directly from, and are inextricably tied to, contracts for the sale and purchase of private property.

While the presence of any of the foregoing factors might not alone bar exemption under Code §501(c)(4) for an otherwise qualified organization, in combination they strongly suggest a private organization formed for the business and/or personal benefit of its members. Thus, facts justifying qualification of such an association under Code §501(c)(4) must be clearly shown to overcome the presumption that it is essentially a private organization. There are several court decisions involving an interpretation of Code §501 (c)(4) that generally illuminate the line of demarcation between an organization that is formed and operated essentially or primarily for private benefit and, hence, fails to qualify under Code §501 (c)(4) and one formed and operated essentially or primarily for public benefit and, hence, qualified for recognition under Code §501 (c)(4). See the excerpts from such decisions quoted in G.C.M. 35440, Homeowners' Associations, 1-94-73 (Aug. 16, 1973). 3) The scope of the phrase "non-residential, non-commercial properties of the type normally owned and maintained by municipal governments" used in the Rev. Rul. in referring to common areas an exempt association may maintain needs more precise definition so that the limits of what is covered by the term "common areas" are better understood. The mere factual statement in the Rev. Rul. of the areas involved has not proved sufficient in practice, apparently, to prevent unduly liberal interpretations of the phrase "common areas" by so-called homeowners' associations that are seeking recognition of exemption under Code §501 (c)(4) to encompass areas that are really little more than extensions of areas of privately owned property. There are "common areas" that could be recognized as appropriate areas for ownership and maintenance by a homeowners' association consistent with recognition of exempt status for the association under Code §501(c)(4). Those areas could be generally identified to be those traditionally recognized as the direct concern of units of government in the exercise of their power and duty to safeguard and regulate community health, safety and welfare. Specifically, such areas might include the ownership and maintenance in an established subdivision of street lights, public roadways and parklands, a common trash and garbage collection facility, fire hydrants, and the like. The ownership and

maintenance of such areas and facilities in a subdivision could under certain conditions qualify as producing a benefit to the whole community of which the particular subdivision in question is but a part. 4) Although Rev. Rul. 72-102 is silent on the point, the Service should also make clear in any further ruling dealing with the requirements for recognition under Code §501 (c)(4) that such exempt status does not extend to organizations maintaining areas from which all but the members of the organization are, or can be, excluded, or to organizations performing services directly to the members by maintenance of their private property or otherwise.

In our opinion a revenue ruling embodying the above suggested modifications and clarification of the position announced in Rev. Rul. 72-102, recognizing the exemption under Code §501 (c) (4) of homeowners' associations that satisfy such standards, could be published.

For homeowners' associations that could not or did not meet the Code §501 (c)(4) standards there may be ways under other provisions of the Code, such as Subchapter T relating to corporations operating on a cooperative basis, for instance, in which the affairs of such associations could be so arranged that they would have little or no taxable income.

A rough draft of a proposed revenue ruling dealing with the points herein discussed is attached hereto.

Note:

- a General Counsel's opinion does not agree with that of the District Director. GCM 35570 represents a change in opinion by General Counsel when compared to GCMs 34219 and 35440. General Counsel is apparently taking the position that the inherent nature of an association would prevent it from qualifying as exempt under IRC Sec. 501 (c)(4).

Gary Porter, CPA is licensed by the California Board of Accountancy and the Nevada Board of Accountancy. His practice is limited to common interest realty associations consisting of condominium, homeowners, timeshare, cooperative and condo hotel associations. Mr. Porter is the creator and coauthor of PPC's (Practitioners Publishing Company) Guide to Homeowners Associations and Other Common Interest Realty Associations and Homeowners Association Tax Library, in addition to more than 200 articles. Mr. Porter has been quoted or published in The Wall Street Journal, Kiplinger's Personal Finance, Money Magazine, The Practical Accountant, Common Ground, Condo Management, and CAI's The Ledger Quarterly. He has been working with homeowners associations since 1976, and has been a frequent presenter at industry and CPA venues; speaking at events for more than 30 state CPA societies.