

## IRS Letter Ruling 200728048

### Cross Reference Data

#### Topical

Exempt organizations  
Form 990  
Adverse determination  
Homeowners Association  
Access

#### Citation

IRC Sections 501(c)(7), 528  
Regulations Section 1.501(c)(7)-1  
Revenue Rulings 75-494, 69-280, 74-99

### Summary

Homeowners association previously exempt under IRC Section 501(c)(7) had its exempt status revoked as a result of an examination. The IRS explained that because the Association enforces architectural covenants it does not meet the requirements of IRC Section 501(c)(7). In addition, the Association does not meet the requirements of IRC Section 501(c)(4) because the Association's clubhouse and pool are not open to the public.

IRS Letter Ruling 200728048 - January 1, 2007

Symbol: Not Given

Uniform Issue List No. 0501.07-01

Exception from tax on corporations, certain trusts, etc. (Exempt v. not exempt); Social clubs; Profit v. not for profit.

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

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, The Examination Process, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, Consent to Proposed Adverse Action. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

\* \* \*

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely, Marsha A. Ramirez, Director, EO Examinations.

\* \* \*

Legend:

ORG = Name of Organization

SUB = Name of Subdivision

Num = EIN

XYZ = State Name

ISSUE

Does ORG continue to qualify for tax exempt status under section 501(c)(7) of the Internal Revenue Code (IRC) of 1986?

FACTS

ORG (Club) was incorporated in the State of XYZ on December 17, 19WW. The Articles of Incorporation state that "The general nature and objective of the corporation shall be to organize entertainment, recreation and community activities in the subdivision known as SUB in County, XYZ, and to engage in activities designed toward the civic and community betterment of said SUB." Membership in the Club is limited to residents of the subdivision of SUB.

The Club was granted exemption as an organization described in IRC section 501(c)(7) in August of 19VV. The Club filed another application for exemption in October. Their application was returned and they were provided a letter stating the Club was already exempt.

The Club's affairs are managed by the Board of Trustees. The Board is comprised of not more than 15 Officers and Trustees. The Club's Bylaws state in Article 2 - Requirements For Membership that “a condition of membership in the ORG shall be that a declaration of restrictive covenants be recorded against the property of the prospective member obligating the present owners and their successors in the title to belong to the ORG and pay the annual assessments for Club membership.” 1

The Building and Grounds Committee is responsible for the repair and maintenance of the Clubhouse, buildings, and grounds owned by the Club. The House Committee supervises the use of the facilities and equipment of the Clubhouse. The Swimming Pool Committee is responsible for the maintenance and upkeep of the pool and enforcement of the pool regulations. The swimming pool, Clubhouse, and common areas are not open to the general public. 2

The Club conducts various activities for the pleasure and enjoyment of their members, including: aerobics, arts and crafts, bowling outings, bridge, coffee hours, golf outings, poker, scrap booking, line dancing, to name a few. The Club publishes a newsletter, the ORG Bulletin, to inform members of upcoming or proposed events and to address any concerns voiced by residents. The newsletters are distributed to the members.

Most of the Club's receipts have been from membership dues and interest. The Club also announced in the June 20YY newsletter that the Club had successfully prevailed in two long term Deed Restriction violations law suits. The Club would be reimbursed for all legal and court expenses they had incurred in their protection of the covenant restrictions.

## LAW

Internal Revenue Code section 501(c)(7) exempts from federal income tax those organizations or clubs “organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.”

Section 1.501(c)(7)-1(a) of the regulations further states that “this exemption [under IRC § 501(c)(7)] extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.”

Revenue Ruling 75-494, 1975-2 C.B. 214 concludes that: “club providing social and recreational facilities, whose membership is limited to homeowners of a housing development, will be precluded from qualifying for exemption under section 501(c)(7) of the Code by owning and maintaining residential streets, enforcing restrictive covenants, or providing residential fire and police protection and trash collection service.”

Revenue Ruling 69-280, 1969-1 C.B. 152 concluded that an organization that provides maintenance of exterior walls and roofs of members' homes in a housing development does not qualify for tax-exempt status under IRC section 501(c)(4). The organization was operating primarily for the benefit of individual members rather than the community as a whole.

Revenue Ruling 74-99, 1974-1 C.B.131 concluded that an organization must, in order to qualify for exemption under section 501(c)(4) of the Code, “serve a 'community' which bears a reasonably recognizable relationship to an area ordinarily identified as governmental, not conduct activities directed to the exterior maintenance of private residences, and the common areas or facilities it owns and maintains must be for the use and enjoyment of the general public.”

In *Commissioner v. Lake Forest, Inc.*, 305 F. 2d 814 (1962), it was held that the organization, a housing cooperative for World War II veterans and others, did not meet the requirements for tax-exempt status under IRC section 501(c)(4). The court found that the organization was not operating exclusively for “social welfare” purposes, but as a private economic enterprise. The court also determined that the organization was organized and operated for the benefit or convenience of its members by performing services that its members would otherwise have to provide for themselves,

#### GOVERNMENT'S POSITION

Based upon the applicable law and facts, ORG no longer meets the requirements for recognition of exemption under IRC section 501(c)(7) or any other section of the Code. This is because the Club administers and enforces covenants for preserving the architectural integrity and appearance of the housing development, contrary to Revenue Ruling 75-494. In addition, the Club cannot qualify for exemption under section 501(c)(4) of the Code, because the housing development's clubhouse and swimming pool are open only to your members and not to the general public.

#### TAXPAYER'S POSITION

The Club applied for and was granted tax-exempt status in 19WW. The organization was unaware of who completed that application for exemption and when that application was filed. Because the Club wanted to be compliant, the organization filed another application in 20VV. The Service returned the organization's check and sent a letter to the organization referencing the exempt status granted in 19WW. The officers of the organization were not told they were no longer a social club, but were instead a homeowners' association. During the examination the Revenue Agent solicited delinquent Forms 990 and 990-T for the years ending May 31, 20WW, 20XX, and 20YY. The organization paid the unrelated trade or business tax, failure to pay penalties, delinquency penalties and interest. The organization has subsequently filed Forms 990 and 990-T for the year ending May 31, 20ZZ.

The organization is not seeking a determination of whether or not they meet the requirements for section 7805(b) relief. The organization is requesting that the revocation's effective date be June 1, 20TT and that all monies paid (a total of \$9,760.67) be applied to any balance due when the Forms 1120-H are filed.

#### CONCLUSION

As a result of our examination of your Form 990 for the period ended May 31, 20XX, we have determined that your organization no longer qualifies as an exempt social club described in IRC section 501(c)(7) as of June 1, 20TT. Since you will no longer be an exempt organization, you will be required to file Federal income tax returns on Form 1120-H, U. S. Income Tax Return for Homeowners Associations. Forms 1120-H were solicited and received for the years ended May 31, 20XX, 20YY, 20PP and 20ZZ. 3

## Practical Considerations

1 The existence of architectural covenants is a clear violation of the intent of IRC Section 501(c)(7). In the authors' experience a number of associations were granted exempt status under IRC Section 501(c)(7) that also enforced architectural covenants, or maintained private roads, both activities prohibited by IRC Section 501(c)(7). Examinations of associations exempt under this section routinely result in discovery of these facts and revocation of exempt status.

2 The IRS looks at this issue only to determine if the Association may qualify under IRC Section 501(c)(4) as an alternate to IRC Section 501(c)(7). While the authors note this fact, we do not consider it completely determinative. The IRS is not an advocate for the taxpayer association and the authors' experience is that the IRS does not make an adequate analysis to perform a complete evaluation.

3 The IRS is incorrect on this matter. The Association would be technically required to file Form 1120 under the provisions of IRC Section 277, but may make an election under IRC Section 528 to file Form 1120-H. The other issue noted here is that the Association filed Forms 1120-H for four years, after the period for making an election to file such Form had expired. It is the authors' experience that the IRS will routinely demand filing of Forms 1120-H for prior years after the time for making an election has expired.

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.