

## IRS Private Letter Ruling 9539005-Operation and Maintenance of Recreational Facilities

### Cross Reference Data

#### Topical

Exempt organizations  
Fees for services Recreational facilities Unrelated business income

#### Citation

IRC Section-501 (c)  
Case  
-Rancho Santa Fe Association v. U.S.A  
Regulations Section-1.501(c) (4)-1

### Summary

Private Letter Ruling 9539005 holds that the operation and maintenance of recreational facilities by a homeowners' association organization exempt under IRC Sec. 501 (c)(4) will not cause the association to lose its exempt status if the amount is nominal and is not the core purpose of the organization. However, it will constitute unrelated business income subject to taxation, after the deduction of related expenses.

### Operation and Maintenance of Recreational Facilities Uniform Issue List Information:

UIL No. 0513.04-00

Unrelated trade or business-Sales and service to public

[Code Sec. 513]

This letter is in reply to the letter dated October 5, 1994, from your authorized representative, in which you requested a ruling with respect to the tax consequences of your proposed operation and maintenance of recreational facilities. As you requested, a separate letter is being issued on another matter.

Our records indicate that you are a homeowners' association recognized as exempt from federal income tax under section 501 (c)(4) of the Internal Revenue Code. You state that you are the homeowners' association for N, a large, isolated community that is similar to a town or village. N began operations in 1968 in a rural area. The area surrounding N is largely unpopulated and includes a National Forest, which borders N on three sides. N is 17 miles away from the nearest town.

You are a membership organization and all owners of residential units, resort area, or commercial areas within N are your members. You state that you administer and enforce the covenants, rules, and regulation to preserve the architecture and appearance of N, but that you provide no exterior maintenance for your members. You also provide common area, park, playground, and road maintenance, public safety services, fire and medical protection, forestry and environmental management, mosquito control, and the administration and enforcement of rules and regulations concerning bicycle use, automobile traffic, and safety.

You state that you own the streets, pathways, playgrounds, recreational amenities, and certain common areas within N. The common areas include 77 miles of roadway, 30 miles of bicycle and

pedestrian pathways, two swimming pools, 21 tennis courts, storage yards, and open spaces including common areas, corridors, and parks. The common areas, including the streets and pathways, are on approximately 1,400 acres of land. Of this amount, approximately 300 acres are attributable to the streets and pathways. The common areas include two parks, a playground, and approximately five miles of river frontage. One of the two parks consists of approximately 13 acres, three acres of which are developed to include picnic tables, a baseball diamond, volleyball nets, a basketball court, a children's playground, and eight tennis courts. The other park, O, consists of approximately two acres and includes picnic tables, volleyball nets, a horseshoe pit, a fishing dock, and a pavilion. While the first park is available to your members, guests, and the general public on a first-come, first-served basis, O is enclosed by a locked fence to which only your members have the combination.

N has its own post office and its own zip code, and includes a mall, a nondenominational church, grocery stores, restaurants, and other shops and professional services. Although there are some fences around N, the development is not enclosed. There are two paved roads and one dirt road that allow access into N. Generally, there are no restrictions on Ingress or egress except that the dirt road that leads to the National

Forest is a service road that is closed to vehicles except during emergencies. This restriction is required by Forest Service rules. None of the roads or other access points is monitored.

P is a limited partnership that currently owns a resort hotel and two golf courses in N. P is the successor organization to the limited partnership, Q, that was the original developer of N.

M is a business corporation owned by you and P You own 100% of the common stock of M and 69% of the preferred stock. The remainder of M's preferred stock is owned by P When M was formed, you owned 12 tennis courts, one swimming pool, and 30 miles of pathways, and O owned 16 tennis courts, one swimming pool, and 3 miles of pathways. All of these facilities were leased to M by you and P M was formed to centralize and consolidate the management and operation of these recreational facilities in order to create efficiencies that would save money and to present a single community based recreational program that would be easier for members of the community to use. M hired you and Q, and then P, to operate and maintain the leased properties. M also hired you to operate and maintain the pathways, which are open to the public without charge.

Shortly after the formation of M, Q's assets were purchased by R The owners of P believed that it would be in the best interest of P to consolidate its real estate holdings to facilities near its Lodge and to "transition" away from the operation of the facilities that were not near the Lodge. For this reason, you and P exchanged certain properties. Following the exchange, you owned both swimming pools, 21 of 25 tennis courts, and 30 miles of pathways.

M charges a fee for nonmember use of the recreational facilities. This fee Is assessed in one of two ways. The first way is that your members may pay M five percent of the gross rent they collect from the rental of houses, condominiums, or Lodge rooms. If your member pays this fee, the persons who rent your member's house or condominium may use the tennis courts and pools without charge. P, which owns the Lodge, pays this fee to M and the guests who stay at the Lodge can, therefore, use the recreational facilities without further charge. The second way is a per use fee. Nonmembers, whether they rent from members who do not pay the five percent fee or are daily visitors, can pay a nominal use fee for use of the tennis courts and pools if they so desire. The use of all other recreational facilities is free.

You and P are considering the dissolution of M. The primary reason for the proposed dissolution is

that the exchange of properties explained above has consolidated ownership of the recreational facilities in you and has made the existence of a distinct corporation to manage the facilities on a consolidated basis unnecessary. At this time, P has not decided whether it would maintain the three miles of pathways and four tennis courts that it owns or whether it would contract with you for the operation and maintenance of those facilities. Another reason you and P feel it is no longer desirable for M to continue as a separate corporation is to save the additional expense of operating M as a separate corporation, ending such expenses as the general liability insurance, annual accounting costs, and annual legal costs.

Section 501 (c) (4) of the Code provides for the exemption from Federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides 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.

Rev. Rul. 67-109, 1967-1 C.B. 136, holds that a nonprofit organization that is organized and operated solely for the purpose of establishing and maintaining a roller skating rink as a recreational facility in cooperation with a county government, in a building provided rent free by a county, is an organization described in section 501 (c)(4) of the Code where the rink is open to all the people of a county upon the payment of such nominal dues and admissions charges as are needed to defray operating expenses.

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

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

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 function constituting the basis of its exemption.

Section 1.513-1 (a) of the Income Tax Regulations provides, in part, that unless of the specific exceptions of section 512 or 513 of the Code is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includable in the computation of unrelated business taxable income if: (1) it is income from 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(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 it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that 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.

The information submitted indicates that you continue to meet the requirements of section 501 (c)(4) of the Code. As explained in Rev. Rul. 67-109, supra, the receipt of a nominal dues and admission charges as are needed to defray operating expenses of a recreational facility are considered to be related charges for a section 501(c)(4) organization within the meaning of section 1.513-1(d)(2) of the regulations .a

Therefore, considering all the facts and circumstances, we rule that the direct operation and maintenance by you of the recreational facilities now leased to M and the collection of the recreational fees by you will not constitute unrelated trade or business within the meaning of section 513 of the Code. In this ruling we are not expressing any opinion with respect to the tax consequences to any party upon the dissolution of M.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any such change should be reported to your key District Director. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to your key District Director.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter. Sincerely yours, Garland A. Carter, Chief, Exempt Organizations Technical Branch 5

Note:

a This private letter ruling reinforces the concept that an exempt association may charge a fee for services without losing its exempt status.

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.