R. HOMEOWNERS' ASSOCIATIONS UNDER IRC 501(c)(4), 501(c)(7) AND 528

1. Introduction

A discussion of the exemption of homeowners' associations was included in the 1981 CPE textbook. However, because of questions and developments that have arisen since then, this topic has been updated and included in the 1982 textbook.

Generally, homeowners' associations are composed of homeowners in a particular area with membership usually being compulsory. Typically, the purposes for which these organizations are formed include the administration and enforcement of covenants for preserving the architecture and appearance of a particular area, and the ownership and maintenance of common property and facilities, such as recreational facilities, streets, and sidewalks. These organizations are usually supported by dues and assessments from members.

Depending on the activities engaged in, and also on the choice of the particular organization, a homeowners' association may generally qualify for exemption from federal income tax under IRC 501(c)(4), 501(c)(7), or 528.

2. Background - IRC 501(c)(4)

Generally, IRC 501(c)(4) provides a stricter standard for a homeowners' association to qualify for exemption than does IRC 501(c)(7) or 528. Specifically, under IRC 501(c)(4) a homeowners' association must operate for the benefit of the general public, i.e., it must provide a community benefit. The position of the Internal Revenue Service regarding the exemption of homeowners' associations under IRC 501(c)(4) is set-forth in a number of revenue rulings. The principal factor barring exemption in this area is the degree of private benefit served by the operation of the particular homeowners' organization.

Historically, the leading court case in the area of homeowners' associations is Commissioner v. Lake Forest, Inc., 305 F. 2d 814 (1962), which arose under the predecessor to IRC 501(c)(4). The case involved a nonprofit membership housing cooperative that provided low cost housing to its members. In denying exemption, the court stated that the organization was not organized exclusively for the promotion of social welfare. The court found that although its activities were

available to all citizens eligible for membership, "its contribution is neither to the public at large nor of a public character." The court looked to the benefits provided and not to the number of persons who received benefits through membership. Compare the decision in Lake Forest with that in Garden Homes Co. v. Commissioner, 64 F. 2d 593 (7th Cir. 1933), which held that a housing project formed and controlled by the local government qualified for exemption.

In the Mid-1960's the issue of exemption for an organization comprised of property owners was first considered for publication. Prior to Rev. Rul. 67-6, 1967-1 C.B. 135,* the Service had very little revenue ruling precedent delineating the differences between charitable purposes and civic (social welfare) purposes. This revenue ruling describes a membership organization formed by owners of property, consisting of less than 50 square city blocks, to preserve the appearance of its area by group action. The organization was involved in "community" type issues such as zoning, traffic, parking, lighting, sanitation and crime prevention. This revenue ruling holds that:

> Combating community deterioration through remedial action leading to the elimination of the physical, economic, and social causes of such deterioration is "charitable." Preserving and maintaining a historic or scenic area for the benefit and education of the general public also is "charitable." However, preserving the traditions, architecture, and appearance of a community for the benefit solely of residents of the community (as distinguished from the general public both within and without the community involved) is not "charitable." While such activities promote the common good and general welfare of the people of the community under section 501(c)(4) of the Code, they are not..."charitable"....

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* Rev. Rul. 67-6 was modified, by Rev. Rul. 76-147, 1976-1 C.B. 151, to remove any implication that preserving or improving a community does not benefit a sufficiently broad segment of the public to be charitable. So long as the community interests served by such activities are truly public in scope and not merely the private interests of a class of persons not themselves comprising a charitable class such activities may be regarded as "charitable."

Rev. Rul. 67-6 helped to provide some basis of authority for treating applications filed by homeowners' associations. It failed, however, to focus on some of the specific problems we have had with classifying certain activities of homeowners' associations as being in furtherance of truly social welfare purposes or in furtherance of the economic benefits of members.

In the late 1960's, a different type of homeowners' association than the civic type described in Rev. Rul. 67-6 appeared. For example, in Rev. Rul. 69-280, 1969-1 C.B. 152, the Service addressed the legal problems presented by a homeowners' association formed to maintain the exterior walls and roofs of members' homes in a housing development. In denying exemption under IRC 501(c)(4), the Service noted a similarity of facts and circumstances with those present in Lake Forest, Inc.; that is, the Service viewed this type of organization as failing to meet the requirements for exemption under IRC 501(c)(4) because it operated for the economic benefit or convenience of its members.

The legal problem that was developing was how to deal with cases involving benefits to the members. This problem was present in cases involving organizations applying under IRC 501(c)(3) as well as IRC 501(c)(4). Some guidance was provided by publication of Rev. Rul. 67-325, 1967-2 C.B. 113, which held that an organization providing community recreational facilities only to a restricted portion of the residents in its community, is not entitled to recognition of exemption from federal income tax under IRC 501(c)(3). The rationale behind this revenue ruling is that such facilities must be made available to the general public, and that the only exception to this would be a restriction required by the nature or size of the facility, or a restriction limiting the facilities to a particular charitable class, such as the poor. See also Rev. Rul. 80-205, 1980-2 C.B. 184, discussed later in this topic.

It was not until 1972 that the Service published the first revenue ruling describing the type of homeowners' association that is the main subject of this topic. Rev. Rul. 72-102, 1972-1 C.B. 149, deals directly with the legal significance of property owners' receiving direct economic benefits.

3. Rev. Rul. 72-102

In Rev. Rul. 72-102, the Service held that a homeowners' association, which was formed by a real estate developer to administer and enforce covenants for preserving the architecture and appearance of a housing development and to own and maintain common areas, streets and sidewalks, qualified for exemption under

IRC 501(c)(4) because it served the common good and general welfare of the people in the development. This revenue ruling noted that for purposes of IRC 501(c)(4), a neighborhood, precinct, subdivision, or housing development may constitute a community. It was also noted that although this type of organization may have helped the developer sell houses or may have served to preserve and protect property values in the community, (thereby benefiting the homeowner members of the organization), the benefits that accrued were merely incidental. Rev. Rul. 72-102 also distinguished Rev. Rul. 69-280 by stating that the organization described in Rev. Rul. 69-280 was operated primarily and directly for the benefit of the individual members, rather than for the community as a whole.

Consideration should be given to some of the background facts in Rev. Rul. 72-102. The property included in the housing development consisted of only 38 residential units and the surrounding common areas. The property owned by the association consisted of streets, sidewalks, parking area, and a common area. There were no recreational facilities.

The concern that the Service had at this time was whether a cluster of 38 townhouses within a larger residential development constituted a "community" within the meaning of Reg. 1.501(c)(4)-1(a)(2)(i). That is, can an organization of this type and size be "promoting in some way the common good and general welfare of the people of the community?" There was no question that Rev. Rul. 67-6 (preserving the appearance of a community) favored exemption, but would equating such a small development to a community be inconsistent with Rev. Rul. 67-325 (community recreational facility)? At this point, the Service considered two important factors:

1. the precise size of an organization, i.e. whether or not its size and composition are such as to justify considering it as a community, is <u>not</u> the pivotal question; and,

2. any attempt to define "community" solely on the basis of size or number of homes in the development would be arbitrary and unrealistic.

The Service recognized that other factors must be considered in determining whether a particular homeowners' association is providing a "community" benefit. Although a general and broad definition of a "community" is provided in Rev. Rul. 72-102, it is meant to stand for the proposition that the activities of an organization representing even one small segment of a "community" can benefit the whole

"community." It should be noted that in coming to these conclusions, the Service also realized that there was no compelling legal argument for denying recognition of exemption to homeowners' associations despite their marked differences from the "neighborhood improvement association" discussed in Rev. Rul. 67-6.

Under IRC 501(c)(4) the Service employees a primary activities test. Consequently, questions arose as to the qualification of homeowners' associations providing administrative and maintenance services for areas of condominium property that are owned by members of the organization as tenants in common. The maintenance included exterior and/or interior maintenance on each member's individually owned residential unit. The activities of these organizations seemed to fit into Rev. Rul. 72-102, but the exterior and interior maintenance activities were proscribed by Rev. Rul. 69-280.

It was the opinion of the Service, as supported by court decisions, that the concept of a condominium system of ownership, particularly the essential characteristic of a system wherein unit owners associate together for the sole purpose of regulating administration and maintenance of their own property, is fundamentally incompatible with the concept of social welfare within the meaning of IRC 501(c)(4). See Consumer Farmer Milk Coop. v. Commissioner, 186 F. 2d 68 (CA 2; 1950), affirming 13 T.C. 150 (1949); Commissioner v. Lake Forest, Inc., supra.; People's Educational Camp Society, Inc. v. Commissioner of Internal Revenue, 331 F. 2d 923, (CA 2, 1964). As a result, in Rev. Rul. 74-17, 1974-1 C.B. 130, the Service did not resort to a primary activities test to resolve this question.

In Rev. Rul. 74-17, the Service distinguished its treatment of homeowners' associations, as described in Rev. Rul. 72-102, from that of condominium associations. Rev. Rul. 74-17, held that while condominium associations and homeowners' associations provided similar services, a substantial distinction existed between them. Specifically, the essential nature and structure of condominium ownership, both statutory and contractual, is inextricably and compulsorily tied to the owner's acquisition and enjoyment of the property. Basic condominium ownership necessarily involves common ownership of all condominium property in the development, the care and maintenance of which would constitute the provision of private benefit to the owners to a degree that would disqualify it from exemption under IRC 501(c)(4).

At the same time the Service was publishing Rev. Rul. 74-17, Rev. Rul. 72-102 was being reconsidered because it was felt that it complicated consideration of cases like the one described in Rev. Rul. 74-17.

Since consideration of Rev. Rul. 67-6, the Service remained concerned over the degree of private benefit served by these neighborhood or community homeowners' associations. Generally, these associations:

1. are formed by a commercial land developer;

2. have compulsory membership;

3. have membership open only to the developer or builder and the lot purchasers;

4. Provide direct private benefits to the members with any benefit to the general public at best a secondary concern of the association because of the association's organizational format and operational plan; and

5. involve the existence of an association and a membership that is derived directly from, and is inextricably tied to, contracts for the sale and purchase of private property.

The Service realized that Rev. Rul. 72-102 failed to adequately address these characteristics.

As written, Rev. Rul. 72-102 equates a single housing development with a "community" as that term is used in Reg. 1.501(c)(4)-1(a). It was the legal opinion of the Service that the statutory language indicated that a broader community than one comprised of and restricted to those purchasers of homes in a single housing development, was contemplated by Congress. It was also recognized that no mention was made of the presence of any recreational facilities, and, in fact, there were no such facilities in the underlying case behind Rev. Rul. 72-102.

The Service also realized that the term "common areas" needed more precise definition to prevent unduly liberal interpretations that might encompass areas that are really little more than extensions of privately owned property. In addition, the Service continued to hold that a homeowners' association could not qualify under

IRC 501(c)(4) if it performed services directly for its members by maintenance of their private property.

Therefore, by publishing Rev. Rul. 74-99, 1974-1 C.B. 131, the Service sought to clarify the circumstances in which a homeowners' association, as described in Rev. Rul. 72-102, may qualify for exemption under IRC 501(c)(4). Both Rev. Rul. 74-99 and Rev. Rul. 72-102 presume that homeowners' associations are essentially and primarily formed and operated for the business or personal benefit of their members. Rev. Rul. 74-99 held that in order for a homeowners' association to qualify for exemption under IRC 501(c)(4):

1. it must serve a "community" that bears a reasonably recognizable relationship to an area ordinarily identified as governmental;

2. it must not conduct activities directed to the exterior maintenance of private residences; and,

3. the common areas or facilities it owns and maintains must be for the use and enjoyment of the general public.

Rev. Rul. 74-99 specifically addressed and attempted to clarify the definition of "community" that was contained in Rev. Rul. 72-102. It states that a "community," within the meaning of IRC 501(c)(4), is not merely "an aggregation of homeowners bound together in a structured unit formed as an integral part of a plan for the development of a real estate subdivision and the sale and purchase of homes therein." Although it was stated that an exact delineation of the boundaries of a "community," within the scope of IRC 501(c)(4), was not possible, it was noted that the term as used in this section, "has traditionally been construed as having a reference to a geographical unit bearing a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district thereof." No minimum size was set.

Rev. Rul. 74-99 was no sooner published than the National Office became aware of additional concerns that focused on whether these associations were serving the private benefit of their members. The following questions had to be considered:

1. Can a homeowners' association qualify for exemption under IRC 501(c)(4) if it provides recreational facilities such as

swimming pools, tennis courts, and/or picnic areas for use only by its members?

2. What is the effect on exemption of providing patrol or guard service for the benefit of members?

3. Can a homeowners' association own and maintain parking facilities only for its members?

Questions one and three above, as well as two additional questions were addressed in Rev. Rul. 80-63, 1980-1 C.B. 116. Question two above, has not been answered by publication.

4. Rev. Rul. 80-63

In Rev. Rul. 80-63, the Service provided answers to several questions regarding whether the conduct of certain activities would affect the exempt status under IRC 501(c)(4) of otherwise qualifying homeowners' associations. This revenue ruling states that, as contemplated by Rev. Rul. 74-99 for purposes of IRC 501(c)(4), the term "community" does not embrace a minimum area or a certain number of homeowners. The answers given to questions 2 and 4 state that a homeowners' association that does not represent a community cannot, under Rev. Rul. 74-99, restrict the use of its recreational or parking facilities to its members only and qualify for exemption under IRC 501(c)(4).

It has been noted, however, that an erroneous inference has been drawn from the answers to questions 2 & 4 in that revenue ruling. From those answers, it may be inferred that if such restrictions were imposed by a homeowners' association that represents a community, it would still qualify for exemption under IRC 501(c)(4) without determining whether there is a community benefit. Moreover, questions 2 and 4 of Rev. Rul. 80-63 are misleading in focusing attention on the concept of "community," while diverting attention from certain critical factors that must be considered to determine whether the homeowners' association can overcome the presumption that it has been formed and operated in furtherance of private benefit.

5. "Critical Factors" for Exemption Under IRC 501(c)(4)

As noted above, certain critical factors have not been given the emphasis necessary to determine whether the homeowners' association's activities benefit the

community. In addition, concern with the concept of "community" has directed attention away from these critical factors.

The first concern that must be dealt with is whether the association can overcome the presumption of private benefit. To do this, an in-depth analysis of the activities and services performed by the association is necessary. Even though the Service utilizes a primary activities test under IRC 501(c)(4) in determining qualification, a strict approach has been taken in certain areas that bear directly on the concept of promoting the common good and general welfare of the community, such as, providing for direct services to individual members. As a result, provision of interior or exterior maintenance of the home is incompatible with being an organization formed for the "common good" of the people of the community and patent evidence that the homeowners' association is operating primarily for the mutual benefit of its members. See Rev. Ruls. 69-280 and 74-99. Therefore, unless this activity was only de minimis, exemption would be precluded, notwithstanding the general primary activities test under IRC 501(c)(4).

It would also be patent evidence that a homeowners' association is not operating primarily for social welfare within the meaning of IRC 501(c)(4), if it restricts access by the general public to its "common" streets, sidewalks and green areas. Unless the restriction is a temporary one for public health or safety, such action by the homeowners' association is an exercise by the members of their private property rights. As the Supreme Court stated in Kaiser Aetna v. United States, 444 U.S. 164, 176, (1979), "the right to exclude others" is "one of the most essential sticks in the bundle of rights that are commonly characterized as property." (See also Rev. Rul. 80-107, 1980-1 C.B. 117.) Once again, no primary activities test would be employed.

In contrast to the above, the Service does not believe that restrictions on admittance to recreational facilities would be necessarily incompatible with exemption under IRC 501(c)(4). As mentioned earlier, Rev. Rul. 67-325 would allow reasonable restrictions based on the size and nature of the facility. Therefore, with respect to recreational facilities, it is the current position of the Service that all of the services and activities performed by the association must be considered to determine: first, whether the association overcomes the prima facie burden of private benefit; and, second, whether its primary activities are in furtherance of the common good and general welfare of the community, as opposed to furthering benefits to its members only. Thus, in this area, the Service utilizes the primary activities test for social welfare organizations.

This position is compatible with the Service position published in Rev. Rul. 80-205, 1980-2 C.B. 184. In Rev. Rul. 80-205, the Service stated that it will not follow the decision in Eden Hall Farm v. United States, 389 F. Supp. 858 (W.D. Pa. 1975), which held that an organization providing recreational facilities for employees of selected corporations qualifies as a social welfare organization. The Service held that an organization that imposes limitations on the use of its (recreational) facility, other than those limitations that were inherent in the nature of the facility, primarily benefits the individuals or private groups that are allowed to use the facility and any benefit to the community or promotion of the social welfare of the community is purely incidental.

6. IRC 501(c)(7)

As an alternative to exemption under IRC 501(c)(4), a homeowners' association whose primary function is to own and maintain certain recreational areas and facilities may elect exemption as a social club under IRC 501(c)(7) rather than under IRC 501(c)(4). See Rev. Rul. 69-281, 1969-1 C.B. 155, and Rev. Rul. 80-63. This alternative may prove to be desirable where the association seeks to restrict use of its facilities to members, offers incidental community benefits and has little or no nonmember income subject to tax under IRC 512(a)(3). However, Rev. Rul. 75-494, 1975-2 C.B. 214, provides that, a homeowners' association may not qualify under IRC 501(c)(7) if it owns and maintains residential properties that are not a part of its social facilities, administers and enforces covenants for preserving the architecture and appearance of the housing development, or provides the development with fire and police protection.

Therefore, a homeowners' association that does not qualify for exemption under IRC 501(c)(4) may qualify under IRC 501(c)(7) where it provides only qualifying social and recreational activities. It would, however, be subject to certain UBIT rules that are not applicable to organizations exempt under IRC 501(c)(4).

7. IRC 528

IRC 528 was enacted under the provisions of the Tax Reform Act of 1976, to provide homeowners' associations with another alternative to exemption under IRC 501(c)(4). Qualifying homeowners' associations that are exempt under IRC 528 are taxable only to the extent provided therein. IRC 528 exempts from income tax any dues or assessments received by qualified homeowners' associations from property owner-members of the organization, where these dues and assessments

are used for the maintenance and improvement of its property. All homeowners' associations described in IRC 528 may qualify for this sort of quasi-exempt status by election.

IRC 528 defines a qualified "homeowners' association" as an organization that is a condominium management association or a residential real estate management association if:

1. it is organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property;

2. it elects to have the section apply for the taxable year;

3. no part of the net earnings of the association inures to any private shareholder or individual;

4. 60 percent or more of the association's gross income consists solely of amounts received as membership dues, fees, or assessments from owners of residential units, residences or residential lots (exempt function income); and,

5. 90 percent or more of the association's expenditures for the taxable year are expenditures for the acquisition, construction, management, maintenance, and care of association property.

The legislative history of IRC 528 indicates that Congress recognized the difficulty most homeowners' associations have in meeting the requirements of Rev. Rul. 74-99. IRC 528 reflects Congress' view that it is not appropriate to tax the revenues of anassociation of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity. House Report No. 94-658; 94th Congress, 2d Session, H.R. 10612 (November 12, 1975). (Reproduced in 1979-3 (Vol. 1) C.B. 373.)

IRC 528(b) has recently been amended to provide for a 30 percent tax on homeowners' associations exempt under IRC 528, thus lowering the tax rate. This makes exemption under this section more attractive.

Under IRC 528, a homeowners' association that qualifies for exemption under that section would be taxed on any income or support received that did not constitute dues or assessments paid by its property owner-members for maintenance and improvement of its property. Compare this with IRC 501(c)(4), which provides qualified homeowners' associations with exemption from federal income tax on all income and support received that is related to its purposes. The drawback to exemption under IRC 501(c)(4), for purposes of a homeowners' association, is the higher standard imposed by it for qualification, as opposed to IRC 528 (which provides an easier standard, but more restricted benefits). A homeowners' association that is exempt under IRC 501(c)(4) would likely also be qualified for exemption under IRC 528, although this does not automatically hold true in the reverse.*

8. Conclusion

In order to qualify for exemption under IRC 501(c)(4), homeowners' associations with the general characteristics described in Rev. Rul. 72-102 must overcome the presumption that they are essentially and primarily formed and operated for the benefit of their members. This can be done by a demonstration that the organization is primarily formed and operated for the benefit of the community. A homeowners' association may impose some reasonable restrictions on the use and enjoyment of a small portion of its overall common property or facilities and still qualify for exemption under IRC 501(c)(4). As alternatives to exemption under IRC 501(c)(4), a homeowners' association may elect to seek exemption under IRC 528, or it may restrict its primary function to the ownership and maintenance of recreational areas and, if it otherwise qualifies, qualify for exemption as a social club under IRC 501(c)(7).

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* See Publication 588, Condominiums, Cooperative Apartments, and Homeowners Associations, which describes homeowners' associations in some depth.