Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: Homeowners Association Loses Exemption.

Citations: LTR 201329022

The IRS revoked the tax-exempt status of a homeowners association because its communal property isn't made available to the general public, but the IRS determined that the organization may make an election to be treated as a taxable homeowners association under section 528.

Person to Contact/ID Number: * * *

Contact Numbers:

Phone: * * *

Fax: * * *

501-04.00

Date: July 7, 2012

Taxpayer Identification Number: * * *

Form: * * *

Tax Period(s) Ended: * * *

LEGEND:

ORG = Organization name

XX = Date

Address = address

Dear * * *,

In a determination letter dated June, 19XX, you were held to be exempt from Federal income tax under section 501(c)(4) of the Internal Revenue Code (the Code).

Based on recent information received, we have determined you have not operated in accordance with the provisions of section 501(c)(4) of the Code. Accordingly, your exemption from Federal income tax is revoked effective May 1, 20XX. This is a final letter with regard to your exempt status.

We previously provided you a report of examination explaining why we believe revocation of your exempt status was necessary. At that time, we informed you of your right to contact the Taxpayer Advocate, as well as your appeal rights. On [date] you signed Form 6018-A, Consent to Proposed Action, agreeing to the revocation of your exempt status under section 501(c)(4) of the Code.

You are required to file Federal income tax returns for the tax period(s) shown above. If you have not yet filed these returns, please file them 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 contact the person whose name and telephone number are shown at the beginning of this letter.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing

Director, EO Examinations

* * * * *

Person to Contact/ID Number: * * *

Contact Numbers:

Telephone: * * *

Fax: * * *

Date: November 15, 2011

Taxpayer Identification Number: * * *

Form: * * *

Tax Period(s) Ended: * * *

LEGEND:

ORG = * * *

ADDRESS = * * *

Dear * * *,

We have enclosed a copy of the preliminary findings of our examination, explaining why we believe revocation of your exempt status under section 501(a) of the Internal Revenue Code (IRC) is

necessary. Your organization may instead make an election to be treated as a taxable homeowner's association under IRC § 528.

If you accept our findings, please sign and return the enclosed Form 6018-A, Consent to Proposed Action, to the individual listed above. We will then send you a final letter revoking your exempt status. Please also file Federal income tax return Form 1120-H for the tax year ending April 30, 20XX, with the individual listed above.

If you disagree with our findings, please provide in writing any additional information you believe may alter the findings. Your reply should include a statement of the facts, the applicable law, and arguments that support your position. Please also include any corrections to the facts that have been stated, if in dispute.

Upon receipt of your response, we will evaluate any additional information you have provided prior to issuing any final report of examination.

Please respond within 30 days from the date of this letter.

Thank you for your cooperation.

Sincerely,

Anne Jewell

Revenue Agent

Enclosure:

Form 886-A, Explanation of Items

Form 6018-A, Consent to Proposed Action

* * * * *

LEGEND:

ORG = Organization name

XX = Date

EIN = ein

State = state

County = county

POA = poa

Treasurer = treasurer

RA-1 = 1st RA

CO-1, CO-2, CO-3, CO-4 & CO-5 = 1ST, 2ND,

3RD, 4TH & 5TH COMPANIES

ISSUES

1. Does ORG (ORG) qualify as a tax exempt homeowners association under § 501(c)(4) of the Internal Revenue Code (IRC)?

2. Does ORG qualify as a for-profit homeowners association under IRC § 528?

3. What are the exempt and non-exempt function income and expenses as defined in IRC § 528?

4. If so, what are the tax implications of the revocation and reclassification of the organization under IRC § 528?

An alternative position based on if the organization continued to qualify as an organization exempt under IRC § 501(c)(4) is included at the end of the primary position.

FACTS

ORG, * * * (ORG) is currently classified as a tax-exempt organization under § 501(c)(4) of the Internal Revenue Code (IRC). Per the Articles of Incorporation ("Articles"), the organization was originally organized in State on October 3, 19XX. These Articles were later amended on October 3, 20XX to expand the stated purpose. The organization was created to "acquire, maintain and conduct building and property and activities for a community life and center at the ORG as above described, to engage in educational and recreational facilities for members; to acquire other property and construct buildings for such proposes; to foster and promote good citizenship among is members; to promote and foster educational, recreational; physical and social activities of its members and their friends; to engage in such activities as shall raise the standards of civic morality and community welfare." The 19XX Articles were expanded with the following language during the 20XX revision, "ORG's primary purpose is to own, repair, maintain, and improve the roads within the ORG, and to collect and disperse road maintenance fees related to the private roads within the plats of the Assessor's Plat of ORG in Volume 16 of Plats, records of County, State, or in Volumes 17, 18, and 19 of said records, or any additions thereto as platted."

The bylaws were also amended at this time. The current bylaws provide the following definition of a member:

". . . any Property Owner who chooses to pay an annual membership fee established by the Board of Directors to ORG for the rights to enjoy ORG Member Properties and the secondary purposes of ORG as outlined in the Amended Articles of Incorporation."

On October 22, 20XX, a Form 2848, Power of Attorney and Declaration of Representative, was received by the Internal Revenue Service allowing POA authority to discuss income tax for the tax periods ending April 30, 20XX through April 30, 20XX.

On September 20, 20XX, a Letter 3611 and Publication 1, Your Rights as a Taxpayer, and a Form 4564, Information Document Request ('IDR"), were issued to notify the organization of an examination of the Form 990, Return of Organization Exempt from Income Tax, for the year ended April 30, 20XX. The initial appointment was held November 5, 20XX, at POA's office. Treasurer, the Treasurer, and POA, POA, were present on behalf of the organization. The following is a summary of the relevant points of the initial interview (questions asked in bold and response in italics).

To get a full understanding of your organization, please describe the history of your organization and

all of its activities.

The organization was started in 19XX as a group of owners who purchased property from the RA-1. The original plan had 1100 lots which were completely undeveloped and were mostly for tents. The mission is to manage and maintain the roads of ORG. The roads were later deeded to ORG. The organization has changed several times over the years based on who has had power over the board of directors. The organization has been involved in 2 major law suits. The first in 20XX was based around additional assessments made to replace a bridge, the organization won the right to make assessments against the owners based on a formula but the formula was not specified. According to the organization, this suit also stated that the organization was not a homeowners association under state law. The formula determined was based on how many of the main and side roads were used when accessing the properties. The second law suit was a class action suit against the owners of the organization who were not paying assessments. This suit validated the formula used before with minor changes to make it more fair. The new formula was * * *% the old formula and * * *% the assessed value of the property. The suit also allowed the organization to place liens or even foreclose on properties. The organization currently has 95 owners in collections. This case also allowed them to collect for administrative and legal costs.

The organization had a road budget of $$* * * and an Admin budget of $* * * ~ $* * * (used for bookkeeping and lawyers as the organization has no employees). The organization is also in the process of selling some of their properties (some gained through foreclosure and some were road accesses). The properties owned by the organization include two beach access points and a stretch of river beach.

What are the rules for non-owners being on the property?

The road is not open to the public except in limited ways. The CO-1 road to the first arch is public access and the organization has an easement across the land from the first arch to the second arch (~1.5 miles). ORG owns the roads while the CO-1 has an easement. Per the CO-1, the only people who should be on the roads after the first gate are owners or those on official CO-1 business. The remainder of the road is marked as being for property owners and guests only. There are signs on both arches which state that the road is private.

The organization requires stickers to be present on cars that enter the property. If the sticker is not present on the car, the organization will place a note on the car. When asked, the treasurer stated that usually if a person is on the property, they are instructed to carry out their business, leave the premises and that they are not to return.

Does the organization have a gate or security guard shack?

The organization does have a guard shack but it has not been used in years.

How commonly does the organization receive income from logging?

This happens once every 100 years or so and was not for the sale of lumber but instead was compensation for use of the roads. The organization was paid $$.00. The lumber company was required to pay repair costs for any damage done to the roads. Per the treasurer, the money was used to pay for flood damage and the class action lawsuit.

For what reason was the organization property logged?

The logging was occurring on the land on the other side of the property and the logging company had an easement across the organization in order to reach their property.

What access is given to the general public to view the waterfalls and the river?

The public are not given access to view the waterfalls and river. The waterfalls are located beyond the area with the CO-1 easement.

What benefit do you provide to the general public?

No benefit is provided to the public.

What are the requirements for being a property owner?

They must own property within the organization's serviced area.

What classes of members or property owners are there and are there any differences in voting rights?

There are no classes of property owners and in order to vote you must be in good standing (have paid all assessments).

What are the dues & initiation fees for the various classes of members?

Assessments are between $$* * * and $$* * * a year based on the formula.

Does the organization own, lease or sublease any real property? If so, is the property encumbered by debt?

The organization owns roads and other properties. None are encumbered by debt.

Per the transcript of the class action law suit posted on the organization's website, the organization is not primarily a membership based organization. The determination was made that the organization may solicit voluntary membership and dues for all purposes besides the maintenance of the roads.

The law suit establishes the validity of the agreement between ORG and the CO-1. This agreement establishes a basis for dues assessments to the ORG members to maintain the .6 of a mile that is owned by the CO-1.

The law suit finds that the administrative costs of the organization, including legal fees from this lawsuit, may be assessed against the owners.

The Class Action finds that the correct assessment formula would be * * *% of the implied easement formula (IE) and * * *% the assessed value of the property. The determination of commercial use of the property is also important as commercial activity increases traffic on the roads. The determination was made that a surcharge of $* * * per lot may be assessed for commercial use.

The minutes for the board meeting held March 7, 20XX, state that there was an issue with guests being on the property and being told that they were not allowed to have access to the property. The organization requires that owners display a sticker on their car to show that they are allowed to park on the property. Guests would receive a hanging tag. These plans were finalized January 9, 20XX with each owner receiving two guest tags with the option to purchase more for $* * * a pair. The minutes for June 6, 20XX state that a sign should be posted at CO-2 to notify non-residents that only residents and their guests may park on CO-3. Money was allocated for this activity.

During the tour of the facility, several posted signs were observed. The signs stated that the roads

are private roads for owners only. Signs were observed on both the first and second arches.

The following are the income and expenses as reported by the organization.

Income Statement

Per further discussion, it was noted that the logging company owned property within the organization's boundaries. The logging company paid a total of $$* * * as a "special assessment" for the use of the roads by the logging trucks. The logged area was located behind the land owned by the organization. The logging activity was in process from October 20XX through April 20XX, a total of 26 weeks.

Per the ORG response to an IDR dated January 4, 20XX, the organization noted two expenses which could be directly related to the existence of logging trucks on the roads. These expenses as shown below are for lumber and repairs on a bridge within the organization's boundaries. The expenses were incurred in the next fiscal year, ten months after the end of the logging activity.

Per an ORG IDR response, there are a total of 405 property owners in the organization. Of these, 160 are permanent residents who are likely to drive on the roads an average of twice a day, once as they leave and once when they return.

The remaining 245 property owners are non-residents and more likely to use the roads on a more intermittent basis. On average, they may drive the roads twice per time in residence. Per the ORG IDR response, it is likely that the non-residents used the facility an average of 7 times during the six months that the logging company was using the roads.

Per the ORG IDR response, "A large logging truck does much more damage to a road than a passenger car or pickup truck. For purposes of this analysis, it is assumed that a logging truck does twice as much damage as a passenger car or pickup truck."

ORG spent a total of $$* * * on road maintenance during the year ended April 30, 20XX.

LAW

IRC § 501(c)(4)

IRC § 501(c)(4)(A) holds that civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

It also requires that no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

Revenue Ruling 74-99, 1974-1 C.B. 131, modifies Rev. Rul. 72-102, to make clear that a homeowners' association, oft the kind described in Rev. Rul. 72-102 must, in addition to otherwise qualifying for exemption under section 501(c)(4) of the Code, satisfy the following requirements: (1) It must engage in activities that confer benefit on a community comprising a geographical unit which bears a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district thereof; (2) It must not conduct activities directed to the exterior maintenance of private residences; and (3) It owns and maintains only common areas or facilities such as roadways and parklands, sidewalks and street lights, access to, or the use and

enjoyment of which is extended to members of the general public and is not restricted to members of the homeowners' association.

Flat Top Lake Ass'n, Inc v. US holds that an organization will not qualify for tax exempt status under IRC § 501(c)(4) if it restricts its facility and activities only to members. It sites Rev Rul 74-99 which states that a homeowner's association must serve a "community" which bears a reasonably, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit. Second it must not conduct activities directed to the exterior maintenance of any private residence, Third common areas or facilities that the homeowners' association owns and maintains must be for the use and enjoyment of the general public.

IRC § 528

IRC § 528(a) holds that a homeowners association (as defined in subsection (c)) shall be subject to taxation under this subtitle only to the extent provided in this section. A homeowners association shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes. A tax is imposed for each taxable year on the homeowners' association taxable income of every homeowners association. Such tax shall be equal to 30 percent of the homeowners' association taxable income.

IRC § 528(c) defines a homeowners association as an organization which is a condominium management association, a residential real estate management association, or a timeshare association if such organization is organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property, 60 percent or more of the gross income of such organization for the taxable year consists solely of amounts received as membership dues, fees, or assessment's from owners of residences or residential lots in the case of a residential real estate management association, or 90 percent or more of the expenditures of the organization for the taxable year are expenditures for the acquisition, construction, management, maintenance, and care of association property and, in the case of a timeshare association, for activities provided to or on behalf of members of the association, no part of the net earnings of such organization inures (other than by acquiring, constructing, or providing management, maintenance, and care of association property, and other than by a rebate of excess membership dues, fees, or assessments) to the benefit of any private shareholder or individual, and such organization elects (at such time and in such manner as the Secretary by regulations prescribes) to have this section apply for the taxable year.

IRC § 528(c)(3) defines the term "residential real estate management association" as any organization meeting the requirements of subparagraph (A) of paragraph (1) with respect to a subdivision, development, or similar area substantially all the lots or buildings of which may only be used by individuals for residences.

IRC § 528(c)(5) defines "association property" as property held by the organization, property commonly held by the members of the organization, property within the organization privately held by the members of the organization, and property owned by a governmental unit and used for the benefit of residents of such unit.

IRC § 528(d) For purposes of this section, defines homeowners association taxable income as an amount equal to the excess (if any) of the gross income for the taxable year (excluding any exempt function income), over the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income). The section also allows for the following modifications, there shall be allowed a specific deduction of $100, no net operating loss deduction shall be allowed under Link section 172, and no deduction shall be allowed under part VIII

of subchapter B (relating to special deductions for corporations).

IRC § 528(d)(3) defines “exempt function income” as any amount received as membership dues, fees, or assessments from owners of real property in the case of a residential real estate management association.

Federal Tax Regulations (Regulations) § 1.528-1., Homeowners associations

(c) Residential real estate management association. — Residential real estate management associations are normally composed of owners of single-family residential units located in a subdivision, development, or similar area. However, they may also include as members owners of multiple-family dwelling units located in such area. They are commonly formed to administer and enforce covenants relating to the architecture and appearance of the real estate development as well as to perform certain maintenance duties relating to common areas.

TAXPAYER’S POSITION

The taxpayer’s position is being solicited at this time.

GOVERNMENT’S POSITION

Issue #1

Does ORG (ORG) qualify as a tax exempt homeowners association under § 501(c)(4) of the IRC?

ORG does not qualify as a tax exempt homeowners association. Per the findings of Revenue Ruling 74-99 and Flat Top Lake Ass’n Inc v. U.S., there are three requirements for a homeowners association to be considered tax exempt under IRC § 501(c)(4). One, the organization must engage in activities that confer benefit on a community comprising a geographical unit which bears a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district thereof. Two, it must not conduct activities directed to the exterior maintenance of private residences. Finally, it must own and maintain only common areas or facilities such as roadways and parklands, sidewalks and street lights, access to, or the use and enjoyment of which is extended to members of the general public and is not restricted to members of the homeowners’ association.

The organization satisfies the first and second requirements for exemption but does not satisfy the third requirement The organization, as stated during the initial interview and seen during the tour of the road, does not allow members of the general public access to their road or the common areas maintained by the organization. As noted in the facts above, ORG will ask persons who do not have a parking decal or hanging tag not enter their property again. The organization also posted signs in several locations along the road which state that only members and their guests are allowed access to the road. As such, the communal property of ORG is not made available to the general public and the organization can not qualify under IRC § 501(c)(4).

Issue #2

Does ORG qualify as a for-profit homeowners association under IRC § 528?

Per their bylaws, ORG is organized as a for-profit homeowners association under IRC § 528, as a residential real-estate management association.

IRC § 528 defines a homeowners association as an organization which is organized and operated to

provide for the acquisition, construction, management, maintenance, and care of association property. A residential real-estate management association is any organization meeting the requirements of a subdivision, development, or similar area substantially all the lots or buildings of which may only be used by individuals for residences.

Given the conclusion reached in Issue #1, ORG is operated to manage and maintain the roads of CO-3. Per the current articles of incorporation, the organizations primary purpose "is to own, repair, maintain, and improve the roads within the ORG, and to collect and disperse road maintenance fees related to the private roads within the plats of the Assessor's Plat of ORG in Volume 16 of Plats, records of County, State, or in Volumes 17, 18, and 19 of said records, or any additions thereto as platted." This furthers the argument that the organization is organized in such a way as to qualify for exemption under IRC § 528.

Issue #3

What are the exempt and non-exempt function income and expenses as defined in IRC § 528?

Per IRC § 528(d), the taxable income of a homeowners association is the gross income for the taxable year less any exempt function income and any deductions that are directly connected with the production of the gross income. IRC § 528(d)(3) further defines "exempt function income" as any amount received as membership dues, fees, or assessments from owners of real property in the case of a residential real estate management association.

As noted in the initial interview and the books and records of the organization, the organization receives the majority of their money from assessments made for road and administrative fees. These amounts would be considered "exempt function income" to an IRC § 528 organization. The organization's purpose is to conduct activities which support the community as a whole rather than provide a specific benefit. To support this purpose the organization may impose annual or special assessments for road maintenance.

As noted in the initial interview, the organization also received $$* * * from a logging company for use of the road. This income was classified as a "special assessment." The fundamental difference between a special assessment for road maintenance and the "special assessment" made against the logging company is in the purpose for which it is assessed. A valid special assessment would be assessed against the entire property owner community or a distinct portion of such community in order to pay for an unusual repair, such as the replacement of a culvert or to fix the damage from a flood. In comparison, the "special assessment" made against the logging company was not made in response to the need for an unusual repair, nor was it an assessment that was paid by any distinct portion of the community. The assessment was instead a payment for use of the road by an outside party to alleviate some of the cost of maintaining the road as well as paying for any additional costs associated with increased traffic. As such, this income would not be considered "exempt function income."

The total exempt function income is $* * * in the year ended April 30, 20XX and $* * * in the year ended April 30, 20XX. The non-exempt function income includes all investment and other income that is not related to the exempt purpose of an IRC § 528 organization. This is income is as follows.

Non-Exempt Function Income

The Non-exempt function expenses are those expenses which are directly connected to the production of the non-exempt income. In this instance, while the organization may not deduct any portion of expenses from the interest income as it has not directly related expenses, it may deduct

any expenses which are directly related to the income from the logging company. These expenditures have been allocated using the method below:

Per IRC § 528(d), the organization may deduct only those expenses which are directly related to the production of the non-exempt function income.

The organization identified the following transactions as directly related to damage caused by the logging trucks.

While these transactions are directly related to the unrelated business activity, they may not be deducted in the year ended April 30, 20XX as they were not incurred until the following year. However, these costs are fully deductable in the following year as valid road maintenance expenses.

The organization may deduct an allocated portion of the years total road maintenance expenses to the unrelated business activity. Using a slightly modified version of the allocation method provided by ORG, the road maintenance costs may be allocated using the estimated road use by logging trucks shown below.

Estimated Road use by Logging Trucks

The estimated number of trips made by logging trucks was calculated using the following calculation method provided by ORG.

Estimated number of Trips by Logging Trucks

The explanation for the damage severity factor per ORG is as follows, “A large logging truck does much more damage to a road than a passenger car or pickup truck. For purposes of this analysis, it is assumed that a logging truck does twice as much damage as a passenger car or pickup truck.” The organization used a damage severity factor of 3 to represent this increased damage.

The estimated number of trips by property owners was calculated using the following calculation method provided by ORG.

Estimated number of Trips by Property Owners

In addition to the allocation factor shown above, the agent also allocated the portion of road maintenance expenses that would have been incurred during the logging assuming that the maintenance expense was incurred evenly over the course of the year. This calculation has been shown below.

Allocated Total Maintenance Expenses

This maintenance cost figure is then multiplied by the estimated use by logging trucks to calculation the total maintenance expense allocable to the logging activity as shown below.

Given the above calculation the organization may deduct a total of $* * * from the income received from the logging trucks using the roads.

As such the total net non-exempt function income is shown in the following table.

Net Non-Exempt Function Income

Issue #4

If so, what are the tax implications of the revocation and reclassification of the organization under IRC § 528?

Given the conclusions reached in Issues #1 through 3, the organization can possibly qualify as an organization exempt under IRC § 528. However, this Code section requires that in any given year the organization have either 60% of the total income of the organization consist of membership dues, fees, or assessments from owners of residences or residential lots, or 90% or more of the expenditures of the organization are for the acquisition, construction, management, and care of association property.

ORG, given the income statement shown above, has the following percentages of income from membership dues, fees and assessments.

Percentage of Exempt Function Income

As noted in the figures above, the organization meets the 60% exempt function income test in only the year ended April 30, 20XX. The year ended April 30, 20XX, did not qualify due to the non-exempt function income received from the logging company.

ORG, given the income statement above, has the following percentages of expenditures made for the acquisition, construction, management, maintenance, and care of association property. This figure includes all expenditures made including those made as a result of the logging trucks using the road.

Percentage of Exempt Function Expenditures

The organization also does not qualify for this Code section under the expenditure test as in nether year do they meet the 90% requirement. As such, the organization may not make the election to be treated as a homeowners association under IRC § 528 for the year ended April 30, 20XX but may for the year ended April 30, 20XX.

IRC § 528(d) defines a homeowners association taxable income as the amount equal to the excess (if any) of the gross income, less the exempt function income, for the taxable year, less any deductions which are directly connected with the production of those non-exempt activities. Exempt function income is defined as any membership dues, fees, or assessments from owners of real property.

The calculation of taxable income for the year ended April 31, 20XX has been shown in the first table below and includes investment income and any additional income that is received by the organization in a given year.

Form 1120-H

U.S. Income Tax Return for Homeowners Associations

For Year Ended April 31, 20XX

The second table calculates the taxable income for the year ended April 31, 20XX as that year does not qualify for the IRC § 528 election. This has been calculated using the corporate tax rate.

Form 1120

U.S. Corporation Income Tax Return

For Year Ended April 31, 20XX

CONCLUSION

As noted in the above analysis, the organization does not qualify for exemption under § 501(c)(4) of the IRC but does qualify under IRC § 528 as a taxable homeowners association for the year ended April 30, 20XX. As such, the organization may make an election in the year ended April 30, 20XX and all subsequent years when filing the Form 1120, to instead file the Form 1120-H if they continue to qualify. In the year ended April 30, 20XX, the organization would be assessed $* * * in income tax.

In the year ended April 30, 20XX, the organization does not qualify for exemption under either IRC § 501(c)(4) or § 528. As such, they must file Form 1120 for the year in question. The tax to be assessed in the prior year would be $* * *.

Treatment under IRC § 528 is an election made every year upon the filing of the tax return. An organization may qualify for exemption in one year but not the next due to unusual income. As such, the total tax to be assessed against the organization is $* * *.

ALTERNATIVE POSITION

In the alternative, if the organization continues to qualify for exemption under IRC § 501(c)(4), should the income from logging truck using the road received by the organization in the year ended April 30, 20XX be considered unrelated businesses income under IRC § 511.

ISSUES

1. Is the revenue received from the logging company related to the exempt purpose of the organization?

2. If not, what expenses may be allocated to the unrelated business income?

3. What is the total unrelated business income tax due?

FACTS

On September 20, 20XX, a Letter 3611 and Publication 1, Your Rights as a Taxpayer; and a Form 4564, Information Document Request (IDR) were issued to notify the organization of an examination of the Form 990, Return of Organization Exempt From Income Tax, for the year ended April 31, 20XX. The initial appointment was held November 5, 20XX at the Power of Attorney's Office. Treasurer, the Treasurer, and POA, POA, were present on behalf of the organization. The following is a summary of the relevant points of the initial interview in relation to the income from the Logging activity.

How commonly does the organization receive income from logging?

This happens once every 100 years or so and was not for the sale of lumber but instead was compensation for use of the roads. The organization was paid $* * * as well as the lumber company fixing any damage done to the roads. Per the treasurer, the money was used to pay for flood damage and the class action lawsuit.

For what reason was the organization property logged?

The logging was happening on the land on the other side of the property and the logging company had an easement across the organization in order to reach their property.

Per further discussion, it was noted that the logging company owned property within the organization and paid a total of $$* * * as a “special assessment” for the use of the roads by the logging trucks. The area being logged is behind the area owned by the organization. The logging activity was in process from October 20XX through April 20XX, a total of 26 weeks.

Per the Information Document Request (IDR) response dated January 4, 20XX, the organization noted two expenses which could be directly related to the existence of logging trucks on the roads. These expenses as shown below are for lumber and repairs on a bridge within the organization. The expenses were incurred in the next fiscal year, ten months after the end of the logging activity.

Per IDR response, there are a total of 405 property owners in the organization. Of these 160 are permanent residents who are likely to drive the roads an average of twice a day, once as they leave and once when they return.

The remaining 245 property owners are non residents and more likely to use the roads on a more intermittent basis. On average, they may drive the roads twice per time in residence. Per the ORG, it is likely that the non-residents used the facility an average of 7 times during the six months that the logging company was using the roads.

Per ORG, “A large logging truck does much more damage to a road than a passenger car or pickup truck. For purposes of this analysis, it is assumed that a logging truck does twice as much damage as a passenger car or pickup truck.”

ORG spent a total of $$* * * on road maintenance during the year ended April 30, 20XX. ORG did not file a Form 990-T for the period in question.

LAW

IRC § 512(a)(1) provides that the term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions which are directly connected with the carrying on of such trade or business.

Treasury Regulations (Regulations) § 1.512(a)-1(a) defines “unrelated business taxable income” as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in § 1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be “directly connected with” the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see § 1.584-2(c)(3).

Regulations § 1.512(a)-1(b) defines expenses, depreciation, and other similar items that are attributable solely to the conduct of unrelated business activities as those which are proximately and primarily related to that business activity. Such expenses qualify for deduction to the extent that they meet the requirements of IRC § 162, IRC § 167, or other relevant section of the Internal Revenue Code. Thus, the wages of personnel employed full-time in carrying on unrelated business

activates are directly connected with the conduct of said activity and are deductable in computing unrelated business taxable income if they otherwise qualify under the requirements of IRC § 162.

Regulations § 1.512(a)-1(c) provides that when facilities or personnel are used for both exempt activities and the conduct of an unrelated trade or business, expenses, depreciation, and similar items shall be allocated between the two activities on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business is proximately and primarily related to that business activity and shall be allowable as a deduction in computing unrelated business taxable income to the extent provided by IRC § 162, IRC § 167, or other relevant Code section.

TAXPAYER'S POSITION

The taxpayer's position is unknown at this time.

GOVERNMENT'S POSITION

ISSUE # 1

Is the revenue received from the logging company related to the exempt purpose of the organization?

The income received from the logging company is not related to the exempt purpose of the organization.

Per the Bylaws of the organization, the organization is organized "acquire, maintain and conduct building and property and activities for a community life and center at the ORG as above described, to engage in educational and recreational facilities for members; to acquire other property and construct buildings fur such proposes; to foster and promote good citizenship among is members; to promote and foster educational, recreational; physical and social activities of its members and their friends; to engage in such activities as shall fraise the standards of civic morality and community welfare." As such, the organizations purpose is to conduct activities which support the community as a whole rather than provide a specific benefit. To support this purpose the organization may impose annual or special assessments for road maintenance.

The fundamental difference between a special assessment for road maintenance and the "special assessment" made against the logging company is in the purpose for which it is assessed. A valid special assessment would be assessed against the entire property owner community or a distinct portion of such community in order to pay for an unusual repair, such as the replacement of a culvert or to fix the damage from a flood. In comparison, the "special assessment" made against the logging company was not made in response to the need for an unusual repair, nor was it an assessment that was paid by any distinct portion of the community. The assessment was instead a payment for use of the road by an outside party to alleviate some of the cost of maintaining the road as well as paying for any additional costs associated with increased traffic.

As such, the $$* * * paid by the logging company was a payment for use rather than a valid assessment and is therefore unrelated to the exempt purpose of a IRC § 501(c)(4) homeowner's organization.

ISSUE #2

If not, what expenses may be allocated to the unrelated business income?

Per IRC § 512(a)(1), the organization may deduct only those expenses which are directly related to

the production of the unrelated business income.

The organization identified the following transactions as directly related to damage caused by the logging trucks.

While these transactions are directly related to the unrelated business activity, they may not bee deducted in the year ended April 30, 20XX as they were not incurred until the following year. However, these costs are fully deductable in the following year as valid road maintenance expenses.

The organization may take deduction of a portion of the years total road maintenance expenses as allocated to the unrelated business activity. Using a slightly modified version of the allocation method provided by ORG, the road maintenance costs may be allocated using the estimated road use by logging trucks shown below.

Estimated Road use by Logging Trucks

The estimated number of trips made by logging trucks was calculated using the following calculation method provided by ORG.

Estimated number of Trips by Logging Trucks

The explanation for the damage severity factor per ORG is as follows, “A large logging truck does much more damage to a road than a passenger car or pickup truck. For purposes of this analysis, it is assumed that a logging truck does twice as much damage as a passenger car or pickup truck.” The organization used a damage severity factor of 3 to represent this increased damage. The agent disagrees with the damage factor used by the organization as it would represent three times as much damage rather than twice as much damage. As such, the agent has used 2 as the damage factor.

The estimated number of trips by property owners was calculated using the following calculation method provided by ORG.

Estimated number of Trips by Property Owners

In addition to the allocation factor shown above, the agent also allocated the portion of road maintenance expenses that would have been incurred during the logging assuming that the maintenance expense was incurred evenly over the course of the year. This calculation has been shown below.

Allocated Total Maintenance Expenses

This maintenance cost figure is then multiplied by the estimated use by logging trucks to calculation the total maintenance expense allocable to the logging activity as shown below.

Given the above calculation the organization may deduct a total of $* * * from the income received from the logging trucks using the roads.

ISSUE # 3

What is the total unrelated business income tax due?

Per the calculations shown in Issue #1 and 2, the organization owes $* * * in unrelated business income tax. This figure has been calculated as follows: Unrelated business income tax is a * * *% tax

on the unrelated income less any directly related expenses.

Allocation of Income and Expenses from the Logging Company

Unrelated Business Income Tax

CONCLUSION

ORG allowed a logging company to use their roads for a fee. As this transaction is not typical of organizations defined under IRC § 501(c)(4) it is considered to be unrelated to the exempt purpose of the organization and is therefore subject to Unrelated Business Income Tax In this case the total tax due was calculated at $* * * for the transaction in question.

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