CAI SCORES A MAJOR VICTORY

IRS ISSUES FINAL REGULATION 1.337(D)-4

By: Gary A. Porter, CPA

Amidst a flurry of year end activity, The Internal Revenue Service issued Treasury Decision 8802 on December 29, 1998, which accepted as final proposed Treasury Regulation 1.337(d)-4. This Regulation was discussed in detail in the Summer 1998 issue of The Ledger Quarterly "IRS Closing Door on Exempt Associations."

The major thrust of this Regulation was to prohibit tax abuse of taxable corporations contributing assets to exempt corporations to avoid taxation. In this very wide net cast by the IRS, some associations were inadvertently caught. The most egregious example was associations that are allowed by the Internal Revenue Code to annually elect to file either Form 1120 or Form 1120-H. This Regulation, as originally written, would have put an end to that practice. The reason? Any association switching from Form 1120 to Form 1120-H was a taxable corporation (on Form 1120) that was contributing its assets (cash, common areas, golf courses, etc.) to an exempt organization (on Form 1120-H). All this by making a simple election allowed under Code Section 528. This was clearly not intended by Congress. CAI's legislative staff, working with volunteer leaders, drafted a response and comment to the Proposed Regulation last summer. That letter, and discussions with the IRS staff tax attorney who wrote the Regulation, have now borne fruit. Associations' exempt under IRC Section 528 have specifically been excluded from the Final Regulation. This eliminates a horrible risk and burden that would have been placed on the industry.

This was the most feared section of the Proposed regulation, as it would undoubtedly have placed many tax practitioners in a very awkward situation when they switched from Form 1120 to Form 1120-H relying on Code Section 528, not knowing that could have an unforeseen consequence. While the added tax may have been very small, it could also have amounted to millions of dollars, as in the example below. In the final result, the homeowners would pick up the tab for this election that resulted in an inadvertent tax liability. The potential impact on the industry could have been enormous, with nothing but a detrimental effect to the entire industry. This was clearly a case of good intentions run amok. CAI's actions in averting this disaster have saved homeowners incalculable tax dollars.

Also included in the Proposed Regulation were associations seeking exemption under Code Sections 501(c)(4) as social welfare organizations, and under Codes Section 501(c)(7) as recreational organizations. While we did not score a complete victory here, we did score a very important partial victory. The proposed regulation would also have taxed any corporation (association) seeking exemption under either of the two code sections cited above, unless such conversion from taxable to tax exempt occurred within the first three years of the corporation's existence. This presented an impossible situation, because I have never seen an association come out from under developer control within three years, and developers don't file for exempt status. In fact, I'm not sure the developers are aware of the possibility of gaining tax exempt status. They don't have much stake in the matter, as they are not the ones who will be paying (or not paying) the taxes' years downstream as reserves build up.

> ***"Through the hard work of CAI National staff and the author of this article, CAI was successful in getting IRC Section 528 eliminated from the final regulation. This removes what would have been a horrible burden to the entire industry."***

We requested that the three-year period be extended to a much more realistic ten years. We were joined in this effort by two other organizations sharing mutual interests, the Club Managers Association of America and the National Clubs Association, both of whom represent organizations qualifying under IRC Section 501(c)(7). Their interests were the same as ours, as they have the same long lead time with developers. The IRS saw fit to grant us seven years for associations under IRC Section 501 (C)(7). They did not grant the additional time for associations that qualify for exemption under IRC Section 501(c)(4). We do not understand the logic of the differentiation made between the two types of organizations, but suspect that it was a result of intense lobbying by the other interested trade groups. While they shared our interest on 501(c)(7) organizations, they rarely represent 501(c)(4) organizations. The Final Regulation now leaves us in the position of seeking a legislative solution to the problem created by poor drafting of the document. So, we can congratulate ourselves on

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our victories, but the battle is not yet over. I expect that we will join with these same two organizations to go to Congress and request a legislative (as opposed to regulatory) solution to the three and seven-year versus ten year issues. Meanwhile, we must concentrate on educating developers regarding this issue so that they will file for tax exempt status before the current three or seven-year deadline expires.

What this means for associations now is that January 28, 1999 (the effective date of the regulation is 30 days after it becomes final) was the final date that exemption applications may be filed for most associations claiming exemption under IRC Sections 501(c)(4) or 501(c)(7) without being subject to the three or seven year rules. After that date, any association not meeting the three or seven-year test may be subject to taxation at the time of transfer on the excess of market value over tax basis of all assets transferring from the taxable to the tax exempt entity. As an example, if an association has $10,000,000 in market value of assets, as in a golf course and amenities, it would be required to pay tax on that gain of approximately $2,000,000. This clearly offsets any benefit to be gained by going exempt. While not specifically stated, it appears that an association that has consistently filed Form 1120-H is already considered exempt, and so could file for exemption under Code Section 501(c)(4) without being subject to this Regulation.

There is also the possibility of avoiding taxation if it can be substantiated that there is no excess of market value over book value of the corporation's assets. If an association's assets consisted of financial assets only, cash, assessments receivable, etc., previously reported on income tax returns, then there does not appear to be any difference between market and book value. Therefore, there is nothing to tax.

A different position could arguably be taken if physical assets, such as greenbelts, monument entry signs, and fences, etc., existed. The position here is that these physical assets have no market value. It is difficult to place a market value on assets that cannot be severed from the common areas or sold. Likewise, they produce no income. While this may sound like a reasonable position, any association so attempting would be wise to first seek a private letter ruling from the IRS on the proposed transaction to make sure that no taxes would be assessed. While this is a costly process, it would not be wise to proceed in this area without some assurance as to the outcome.

While the above argument could be made for the types of common areas described in the preceding paragraph, it would appear much less reasonable to argue that other, frequently encountered common area assets such as clubhouses, swimming pools, tennis courts, and golf courses have no market value. There is an important difference in the type of common area asset. First, these are the types of items which can be readily valued, at least in a non common area setting, by the IRS. Second, these types of assets can easily generate revenues, making it possible to value an income stream. Associations are advised to proceed with extreme caution in this area.

In summary, while the game is not completely over, the rules have just changed substantially. It has just gotten more complex, and more difficult to achieve the desired objective of obtaining exempt status for your association.

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