

# IRS CLOSING THE DOOR ON EXEMPT ASSOCIATIONS

By: Gary A. Porter, CPA

All of us have heard the continual discussion of which tax return to file; Form 1120, or Form 1120-H. But for a small number of fortunate associations, there are other options. Thousands of associations, mostly larger scale associations, qualify for tax exemption as recreational organizations [501(c)(7)] or “social welfare organizations” [501(c)(4)]. Many don’t realize it, and have failed to apply for this status. How do I know? I have prepared dozens of tax exemption applications for associations, taking them tax exempt for the first time. In the process, these associations have received (on a combined basis) more than one million dollars in tax refunds for taxes previously paid.

These associations enjoy a considerable advantage over those that do not qualify. Recreational Organizations pay approximately the same income tax as an association filing Form 1120. However, they do so with none of the risks associated with filing Form 1120. Social Welfare organizations pay no tax at all, not even on the interest income earned on their reserves. (A future article will discuss the intricacies of qualifying for these exempt status categories.) Unfortunately, while the benefits are great, it is difficult to qualify for either of these two special exempt classification categories. The Internal Revenue Service (IRS) just made it a lot tougher, by placing a built-in tax on any association that attempts to go tax exempt.

Due to the repeal of the General Utilities Doctrine by the 1986 Tax Reform Act, gain or loss generally must be recognized in corporate liquidations and sales in connection with them. The 1986 Act also directed the IRS to prescribe regulations that are necessary to carry

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*So what happens on an asset transfer? Under the proposed regulations, a taxable corporation transfers all, or substantially all, of its assets to a tax exempt entity would recognize gain or loss as if the transferred assets were sold at their fair market values (Proposed Regulation Section 1.337(d)(4)(a)(1)).*

*Lastly, and perhaps the most scary of all provisions, is that this Proposed Regulation also applies to organizations making an election under Internal Revenue Code Section 528. This means that any association filing a Form 1120 who changes to a Form 1120H is potentially running a risk that it may inadvertently incur a substantial tax liability. Tax advisors are urged to use extreme caution until this matter is further clarified.*

out the purposes of the General Utilities Doctrine. The 1988 Tax Act stipulated that regulations being developed should ensure that these purposes could not be circumvented through the use of tax exempt organizations. The IRS has now issued Proposed Regulations that generally would require a corporation (association) to recognize gain or loss on either the transfer of assets to a tax exempt entity, or a change in the corporation’s status from taxable to tax exempt.

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There is some mitigating language in the regulations.



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However, Regulation 1.337 (d)-4 states that there would be no income or loss recognition if the change in status of the association occurred within three years of the corporation's formation, or within three years of the corporation's having lost a previously held tax exempt status, or within three years after the Regulations are finalized, if the entity was exempt or had unsuccessfully applied for exemption before the proposed Regulations were published (January 15, 1997) [proposed Regulation Section 1.337(d)(4)(a)(3)(i)].

So what happens on an asset transfer? Under the proposed regulations, a taxable corporation transfers all, or substantially all, of its assets to a tax exempt entity would recognize gain or loss as if the transferred assets were sold at their fair market values (Proposed Regulation Section 1.337(d)(4)(a)(1).

**However, no gain or loss would be recognized on transferred assets that are used by the exempt entity in an activity subject to the unrelated business income tax.** In that case, the gain would be recognized when the exempt entity sold the assets or stopped using them in an unrelated trade or business. This is particularly troubling for Associations.

For most associations if they are seeking 501(c)(7) [recreational organization] status, the primary assets are likely to be very large scale recreational facilities such as a golf course. The primary use of that golf course would be by association members, which is part of the exempt activity, not part of the nonexempt activity. This means the transfer would be taxable. In addition, there would have to be an allocation made as to the exempt portion verses the nonexempt portion. Unfortunately, the Regulations are silent on how to perform this allocation.

Associations seeking exemption under 501(c)(4), [social welfare organizations] would also face substantial problems. Any significant common are

elements transferred, such as golf courses, would be taxable to the extent used by members. If the golf course is also open to the public, an allocation must be made between public and nonpublic portion. If the amenity is determined to be completely in relation to the organization's exempt purpose, then the entire asset would be taxable upon transfer.

So how bad would this tax hit an association? Look at the language in the Proposed Regulation. The excess of market value over tax basis would be the measure of gain on a transfer of common area assets from a taxable corporation to a nontaxable corporation. Let's take an example of a relatively new golf course, which may have a market value of \$20 million dollars. However, the tax basis of this asset will be zero as the asset was donated to the corporation by the developer. The developer would have taken a deduction for the development cost of the golf course as a part of its sale of the entire development. Therefore, this represents a contribution to capital from the developer, and the Internal Revenue Code and case law clearly support the fact that there is no basis attributable to the organization receiving such donated assets in this case. The association would therefore be taxed on \$20 million at the time of transfer.

What this Proposed Regulation does is effectively shuts the door on the formation of exempt organizations, unless such exempt status is received within three tax years of the year of the corporation's formation. This is highly unlikely for most associations that have significant amenities such as those described above. In almost any large scale association, the developer involvement will extend considerably beyond three years, and it is highly unlikely that the developer will take steps to obtain this exempt status prior to turnover.

### Status Change

The Proposed Regulations also affect a taxable



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corporation that changes its status from taxable to tax exempt. The Regulation treats this transaction as if the taxable corporation had transferred all of its assets to a tax exempt entity immediately before the change in status is effective (Proposed Regulation Section 1.337(d)(4)(a)(2)). Gain would be recognized on the transferred assets at that time, except to the extent that the transferred assets are to be used in unrelated trade or business activities.

### Effective Date

The Proposed Regulations are to apply to asset transfers occurring more than the 30 days after the Final Regulations are published, unless subject to a written binding contract exception. As of this date, the Proposed Regulations have not become final and are still in a proposed form. While Proposed Regulations may stay in a proposed form for as long as ten years, we have no indication from the IRS, nor will they provide any indication, as to when these Regulations

will be made final. It is now a critical issue for associations who are considering exempt status to file for such exemption immediately to make sure that they complete the process before the Regulations take effect.

Associations that think they may qualify for exempt status should contact their tax advisor to see if action should be taken on this matter.

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