RECENT TAX RULINGS

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In 1999, the Internal Revenue Service (IRS) issued several low-level rulings that have direct application to the community association industry. While these rulings are at such a level that they may not be cited as a precedent, they also provide clear insight into the IRS' reasoning regarding specific tax transactions and that allows us to independently reach the same conclusions. Therefore, when reading these rulings and applying the same law, we may use the same underlying law to cite as a precedent when taking positions that are similar to those in the subject rulings. From that standpoint, these lower-level rulings are extremely important documents.

In Miscellaneous Document No. 99 ARD 218-1, FSA 1992-0630-4, the IRS addressed several issues relating to a condominium association. The association that was the subject of this Field Service Advice (FSA) was a condominium association that qualified to file Form 1120-H under Internal Revenue Code Section 528, but chose not to. Accordingly, the association filed Form 1120. In addition, the association reached a settlement on a construction defects lawsuit and received certain proceeds from the defendants in that case. A Field Service Advice (FSA) is a device by which an IRS field auditor may formally request guidance on specific technical issues from the national office of the Internal Revenue Service. In this case, the agent wanted to receive information on the following four issues:

1) Whether amounts received in settlement of the construction defects lawsuit by the association is includable in the association's income.

2) Whether the association may exclude from income excess general (operating) assessments (under Revenue Ruling 70-604) that are placed into an accumulative reserve fund that will not necessarily be applied to the following year's assessment.

3) Whether a homeowners association, which does not elect under Section 528, may invoke the treatment of IRC Section 277 for deductions incurred by membership organizations.

4) Whether Section 277 permits a nonexempt association to aggregate excess general assessments into a reserve account and deduct that amount from taxable income as expenses attributable to furnishing future services for the members.

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The IRS reached the following conclusions relating to these matters:

1) Amounts received by the homeowners association as proceeds from the construction defects lawsuit brought by the association <u>on behalf of</u> the unit owners does not constitute income to the association. The IRS in this case referred back to Revenue Ruling 81-152 as being the authoritative guidance.

2) A nonexempt homeowners association may not exclude from income general assessments placed into accumulated reserve fund, will not be applied to the following year's assessments and have not specifically been segregated for a specific capital expenditure. Apparently, the association had excess member income and applied that directly into reserves. In this case, the association apparently put the money into reserves and then failed to specifically earmark that for a specific capital purpose. The IRS clearly stated that Revenue Ruling 70-604 provides a one-year only carryover of income to this single subsequent following year.

3) The IRS indicated that it is mandatory for homeowners association that does not elect under IRC Section 528 and meets the criteria of IRS Section 277 to apply the treatment of that section.

4) IRC Section 277 may <u>not</u> be used to expand the types of deductions which membership organization would otherwise be entitled to take. In other words, the set-aside of money for future capital expenditures does not qualify as a current deduction. If the association has carefully followed all of the guidelines related to special assessments under Code Section 118 and Revenue Ruling 75, 370, 371 & 74-563, then the association could have successfully excluded these member assessments from membership income of the current tax year.

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In Miscellaneous Document 99 ARD 055-8, FSA 19911004, the IRS ruled upon the matter of initial membership fees of a country club. The issues in which the field agent requested rulings were:

1) Whether membership fees paid to the club were exempt from taxes as contributions of capital under IRC Section 118, or were taxable as payments for goods or services under Section 277.

2) If the membership fees paid which were accounted for as capital transactions were instead to be re-characterized by the IRS as fees for the payments for goods or services subject to taxation, does that constitute a change in method of accounting?

The IRS concluded that membership fees paid to the club by full equity members constituted contributions to capital under IRC Section 118 and therefore were excluded from income.

However, the initial membership contributions of nonequity members were determined to be membership income under IRC Section 277. There were sufficient differences between the two types of membership to indicate that for nonequity members there was no equity build up, nor were they assessed the same rate. Therefore, the amounts received from nonequity members constituted membership income under IRC Section 277.

With respect to the second issue, the IRS determined that the re-characterization of income by the IRS under audit would not constitute a change of an accounting method. The IRS quoted a number of tax court cases supporting the conclusions on both of these matters.

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