

TAX ALERT FOR EXEMPT ASSOCIATIONS

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The Internal Revenue Service (IRS) issued Technical Advice Memorandum No. 9747003 in late 1997. This Ruling potentially affects all tax exempt organizations that conduct activities open to the public in addition to activities provided for members. This is just another round in the continuing battle between the IRS and tax exempt organizations that bring in revenues through nonmember activities not directly related to the exempt purpose of the organization. While the subject organization of the Ruling was a Veterans Post, the tax principle established applies to all tax exempt organizations equally.

The Veterans Post conducted activities open to the general public including a bar, restaurant and gambling activities. The IRS determined that with respect to the members of the Veterans Post, these activities were in accordance with the organization's exempt purpose. However, these same activities provided to members of the general public constituted taxable unrelated business activities.

The Veterans Post's downfall was that it failed to keep adequate books and records on its nonmember transactions, and it received more than 50% of its gross receipts from the operation of the bar, restaurant and gambling operations. Because the Veterans Post could not prove this due to failure to maintain adequate books and records, the presumption was that the entire amount came from nonmembers since the facilities were open to the public. The IRS concluded that the organization was not primarily engaged in activities for the furtherance of its tax exempt purpose. While this could have cost the organization its exempt status, the IRS simply opted to treat this income as taxable. This may have had the same effect, depending on how much income remained that was still considered exempt function income. While unstated in the Ruling, it appears obvious that if the organization maintained adequate books and records, it could overcome the IRS' conclusions for future years.

Any exempt homeowners associations (under IRC § 501(c)(4) or (7)) that conducts both exempt function and nonexempt function activities must keep careful records to

“Failure to maintain adequate books and records triggers tax on nonexempt income and threatens exempt status.”

document the allocation of taxable income. This concept was most clearly set forth in the Portland Golf Club Supreme Court Decision (see Fall 1991 issue of the Ledger Quarterly). However, the issue of record keeping was not addressed in that case. When an association has unrelated business taxable income, it is required to keep adequate books and records. For instance, a 501(c)(7) association with a golf course should record all rounds of golf by members and nonmembers. The subsequent allocation of expenses related to nonmember activities' hinges on this critical information.

If an association fails to maintain adequate records, and receives a determination similar to the Veterans Post described above, it could face disastrous results. If the association maintains and operates bars, restaurants and golf courses and other significant recreational amenities, significant taxable income could result. Worse, loss of exempt status is a possibility. The association should be careful to maintain adequate records to avoid loss of exempt status.

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