Large Scale Association
Unique Tax Considerations

By Gary A. Porter, CPA

The large scale homeowners' association is different from smaller associations in its tax characteristics, just as in more obvious factors. I define a large scale association as any association of more than 500 units or lots, and/or a budget in excess of $1,000,000. Most large scale associations are property owners' associations or planned developments, rather than condominium associations.

So what is that sets these larger associations aside from their smaller counterparts? Primarily, it is the range of activities provided by the association. Most of the large scale associations provide recreational activities that are not available in smaller associations. These can include golf courses, tennis clubs, equestrian facilities, marinas and boating facilities, etc. These activities create tax problems for associations because of the way the tax law was written in 1976. Specifically, the qualifying tests to file Form 1120-H include a 90% test. This test states that 90% of the association's expenditures must be for the care, maintenance, and management of the common areas of the association. Associations with extensive recreational activities generally cannot meet this test. Congress, in 1976, apparently looked at the associations that existed and concluded that most were smaller associations maintaining only common areas, rather than large scale associations also responsible for maintaining recreational facilities and operations. In fact, in 1976, it is estimated that less than 30,000 associations existed. Now that number is estimated to be well in excess of 160,000.

The smaller association generally has two tax filing options available to it; either Form 1120-H, or Form 1120. This is a familiar discussion that all of us heard too many times. Based on a recent survey, approximately 85% of all associations in the United States qualify to file Form 1120-H, but almost <u>all</u> smaller associations will qualify. Fewer large scale associations will qualify.

These two options are not always available to larger associations. Often, the recreational activities will prevent these associations from qualifying to file Form 1120-H. That means that Form 1120 is the <u>only</u> option left available to these associations. And for large scale associations with $3,000,000 or more in reserves, this can result in higher taxes than would be paid on Form 1120-

Comparison of Tax Filing Options

#	Form #	Tax Attributes
1	**1120-H** Taxable homeowners Association	Pays tax on interest and any other non exempt income. Exempt income avoids taxation. **<u>No</u>** risk!
2	**1120** Nonexempt Membership Organization	Pays tax on interest and any other non member income. Net member income is subject to taxation. **<u>Very High Risk!</u>**
3	**501(c)(7)** Exempt Recreational Organization	Pays tax on interest and any other UBTI- Unrelated business Taxable Income. Exempt income avoids taxation. Low Risk!
4	**501(c)(4)** Exempt Social Welfare Organization	**Pays NO Tax!** Very low risk!

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H, so these associations suffer a penalty. In addition, these associations cannot avoid the inherent risk associated with Form 1120 on taxation of reserve balances (see attached article *Fright Night, IRS Style*).

However, large scale associations often have two additional options available to them that are not available to the smaller associations. These two options are qualifying for exemption under 501(c)(7) of the Code, or 501(c)(4) of the Code. Let's explore each of these alternatives.

501(c)(7) Organizations

IRC Section 501(c)(7) organizations are ***recreational organizations***. The sole functions of this organization must be recreational activities. Unfortunately, this excludes a large majority of homeowners association that would like to file as a 501(c)(7) organization. Revenue Ruling 75-494 clarifies this issue by stating that, if an organization maintained private roads that provided access to residences, rather than just access to recreational facilities, then that organization was involved in activities other than recreational activities and could not qualify as a 501(c)(7) recreational organization. In addition, even if the roads are publicly owned, the simple factor of having architectural control involves the organization in activities other than recreational activities and precludes them from the use of IRC Section 501(c)(7).

So why would the association want to qualify under 501(c)(7) anyway? Very simply, you avoid all the inherent risk associated with Form 1120 when you are a qualified 501(c)(7) organization. As a recreational organization, you would pay taxes only on your interest income, or net income from nonmember activities. The taxes you pay on this form are generally the same amounts you would pay on Form 1120, but you would do so without any tax risk whatsoever. That is what makes this filing option so attractive.

Several of our associations are qualified 501(c)(7) organizations, and we are quite familiar with the activities that allow an association to qualify under this section of the Code.

501(c)(4) Organizations

Let's look at the **IRC Section 501(c)(4)** option. This Code Section applies to ***social welfare organizations***. At this point, everyone should be asking, "what is a social welfare organization and, what does that have to do with homeowners associations?" A social welfare organization is any organization which provides a public benefit. Revenue Ruling 75-286 held that an organization as small as a block association that was created for beautification of city streets only one block long can qualify as a 501(c)(4) organization.

So what type of an association can qualify here? There are two key considerations of whether or not an association can qualify under 501(c)(4). The first and most prevalent is **public access**. If the association is maintaining common areas such as parks, green belts, recreational playing fields such as baseball fields and soccer fields etc., that are accessible by the general public, then that association may qualify as a 501(c)(4) organization. There cannot, however, be any significant private benefit in a 501(c)(4) organization. This precludes condominium associations from being able to qualify under this Section of the code, because the maintenance of the exterior of private dwellings would constitute a private benefit not allowed by this Section.

The second way for an organization to qualify under this section is for the association itself to qualify as a **community**. This is much more difficult, and is legitimate only in very rare circumstances. However, again, several of our associations do qualify under the "community" concept in addition to those that qualify under the public access issue. "Community" as defined by the IRS does not mean the "world-at-large." So what does it take to qualify as a "community?" Basically, you would have to look like a government organization. The association would have to cover approximately the same geographic boundaries of an existing governmental organization. Not just any governmental organization, but a governmental organization that has powers roughly equivalent to those of the city, including the powers of eminent domain and police powers. In most governmental jurisdictions, that means it will have to have approximately the same geographic boundaries of a city. In California, it means you could also have the same geographic areas as a special tax district that has these powers, or California Community Services District. The committee structure of many large scale associations mimics the structure of governmental entities.

So why would an association want to gain 501(c)(4) status? This is the best one of all, because, when an association

gains exemption under 501(c)(4), it pays no taxes. Not even on its interest income, because the organization is deemed to exist for public benefit.

What is "public benefit," and what does it take to qualify in this Section? The most significant case in recent years governing this area of tax law is the *Rancho Santa Fe vs. Commissioner* case. In this case, a gated community qualified as a 501(c)(4) organization, apparently for two reasons; (1) it constituted a community in and of itself, and (2) it had sufficient public access.

If you are a gated community, what kind of public access does it take? Unfortunately, that must be decided on a facts and circumstances case. Each association is unique, and each will be uniquely considered for determination of whether or not they grant sufficient public access. The law governing this area is spread out between several Code Sections, Regulations, Revenue Rulings, Private Letter Rulings, and court cases. It is not embodied in a single location. The individual preparing the tax exemption application on IRS Form 1024 must be intimately familiar with all of the significant rulings dealing with this area of tax law. General Counsel memorandum 35570 and Private Letter Ruling 8028010 both allowed "limited non public access" that was "incidental" to the primary exempt purpose of the organization.

More than knowing the law, you must be able to write the application in such a manner as to properly present the facts. This must be done in an appropriate manner that both clearly and accurately states the issues, and benefits the association. An example of this is balancing the issue of access with restrictive signs.

> *Several of our association clients that are not gated have public streets serving the association, but also have restrictive signs placed on the green belts and parks. These signs state that the green belts and parks are restricted for the private use of the members of the association only. This is a critical "access" factor for the association. The association's hope is that the signs keep nonmembers from using association common areas. But, most of these associations do not have adequate security to keep outsiders from using these "open" common areas. Properly written, you can present what is an apparent restriction as an unenforceable restriction. If you carefully construct the arguments discussing the restrictive signs, and other mitigating factors, this factor will not kill an exemption application. Further, Revenue Ruling 80-63 also clearly states that some restricted access within an association will not be fatal to its ability to qualify under 501(c)(4). We often use this example in writing about the restrictions to swimming pools and spas. Generally, these must be behind locked gates as a matter of local law. Consequently, we cite health and safety codes as the reason that these are not accessible to the general public, and further disclose what is often a low proportionate maintenance cost compared to total operating costs. If the reserve allocation to the restricted areas compared to the overall common areas of the association is small, it will prove that they are not significant in amount.*

Other Considerations

If your large scale association doesn't look like either of the above described entities, does that mean that you are completely precluded from ever availing yourself of the benefits of these two Code Sections? Not necessarily. But, at this point, you must do more work. You may also begin to wonder if the amount of trouble and bureaucracy you are creating is worth it. But there are further steps you can take.

For instance, we have advised associations to spin off recreational activities and recreational common areas into a separate 501(c)(7) organization in which all of the members will automatically participate. Sometimes, that will allow the remainder of the association to qualify under Code Section 501(c)(4). More often, moving the recreational activities out will allow the remainder of the association to qualify under IRC Section 528 to file Form 1120-H. This is because it will no longer be violating the 90% expenditure test, as the recreational activities which cause this violation had been moved out to a separate entity. This may not save much in taxes, but eliminates the risks associated with Form 1120.

Planning, or How to do it Wrong

We have seen associations make major mistakes in the planning and development stage, or in the consolidation stage. In the planning and development stage, developers have a unique opportunity in large scale associations to form

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the associations in a manner that provides long term financial benefits. We are advising one developer, who had planned to create five associations within a master development using strictly geographic boundaries as the determining factor, to reconsider the structure of the corporate profiles. The developer's previous plan would have created six fully taxable associations, with none qualifying to file any form except Form 1120, as a nonexempt membership organization, the highest risk form of tax entity. By restructuring the organization (before it was set in concrete) we were able to create one 501(c)(7) recreational organization, one 501(c)(4) master association, and five associations that all qualified to file Form 1120-H. None of the associations has any tax risk, and the tax savings to the master association will amount to millions of dollars during the next few decades.

One of the most outstanding mistakes we have seen was a Master Association that consolidated its 12 sub-associations into the master association leaving a single legal entity. I don't know the motivation behind this consolidation, but I'm sure that there were valid reasons for it. However, of the 1,850 residential units that were consolidated into this master association, there were only some 300 condominium units. 1,550 were single family homes in what had been several separate property owners' associations. By combining the 300 condominium units in with the 1,550 single family homes, the association eliminated any possibility to qualify as 501(c)(4) organization. If they had consulted with us instead, we would have advised them to keep the condominium units out as a single sub association within the master association. This sub association would be subject to all of the same rules, and would pay the same dues to the master association. By keeping them separate, the remaining 1,550 homes would have qualified as a 501(c)(4) organization, because there was wide-open access to this particular association. We calculated the tax savings at something just more than $100,000 per year that could have been achieved had the association been aware of the tax ramifications of their actions. I first discovered this association only six months after this 2-year consolidation process had been concluded. When I informed the general manager of the mistake that had been made, he turned pale, and said he never wanted to hear me discuss this issue again. The manager had been employed there only a short time, and was not a part of the decision-making process. However, he recognized that this was an issue that could tear the community apart, as well as possibly causing a major malpractice suit against the association's law firm.

<u>Revocation of Exempt Status</u>

If your association ever held exempt status under 501(c)(4) and later had that status revoked, don't necessarily accept this as the final word. In two instances we have been successful in regaining 501(c)(4) exempt status for the association by proving that the IRS made an incorrect determination when they revoked exempt status. On one of these associations, we achieved this even after two CPA firms and a tax attorney had failed to regain the exempt status. While we believe these people fought gallantly, they simply weren't experienced enough in this area of tax law. We have prepared dozens of exemption applications for associations. We have already experienced and tested many of the issues that other tax preparer's have never even thought about. If your association is paying any significant income tax and thinks there is a possibility that you may qualify based upon the discussion set forth above, please contact us for an evaluation.

<u>How to do it Right</u>

If you have concerns in this area, have an experienced, competent professional carefully review your options. We at Porter & Company have prepared dozens of exemption applications, and have obtained tax refunds exceeding one million dollars for our clients. In addition, those same clients have saved more than $1,000,000 in taxes on a continuing basis since we obtained exempt status for them. Please contact us if you have any questions.

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