Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:CORP:5- PLR-111801-99
Date:
April 10, 2000

Re:

LEGEND:

Taxpayer =

State Z =

City X =

a =

b =

c =

p =

q =

r =

s =

t =

Date 1 =

Date 2 =

Date 3 =

This letter responds to your letter dated June 28, 1999, submitted on behalf of your client, Taxpayer, requesting a ruling that a proposed special assessment to property owners of record on Date 3 qualifies as a contribution to capital under section

118(a) of the Internal Revenue Code. Additional information was submitted by facsimile on December 7, 1999 and by letters on December 20, December 31, 1999 and March 7, 2000. The material information submitted for consideration is summarized below.

Taxpayer was incorporated on Date 1 as a State Z not-for-profit corporation. Taxpayer is a non-exempt organization for federal income tax purposes and is subject to § 277. Taxpayer is an accrual method taxpayer using a fiscal year ending on Date 2. Taxpayer is a membership corporation currently comprised of approximately a members, all persons owning residential real property within a gated development. Taxpayer has not issued stock and, accordingly, does not have stockholders. Taxpayer's facilities are located in City X.

Taxpayer was created pursuant to the Declaration of Protective Covenants and Restrictions (Declaration). Taxpayer was organized for the purposes of owning, managing, maintaining and caring for the common areas of the gated development. The Declaration sets forth the rights and obligations of the members. The Declaration in Article c provides that upon the dissolution of Taxpayer, members are entitled to receive the remaining assets pro rata after any dedication to any applicable municipal or other governmental authority of any property determined by the Board to be appropriate.

The Declaration provides for assessments both for operating expenses and also for capital expenses. The Declaration in Article b provides for annual assessments to be used for the benefit of members, their guests and invitees. Specifically the annual assessment is to be used for, among other things, maintenance and operation of the common areas, including the country club. The annual assessments are determined on the basis of a break-even annual operating budget excluding depreciation charges. In addition, the Declaration in Article b provides for Special Assessments for the purpose of defraying the cost of any construction, reconstruction, unexpected repair or replacement of a capital improvement made to the common area and the country club. The country club includes the clubhouse.

The current clubhouse was built in the early 1980's. The membership has outgrown the current clubhouse and the clubhouse is in need of extensive repair and refurbishment. The proximity of the facility to the ocean has caused many of the structures of the clubhouse to deteriorate. Additionally, the decor has become outdated. The membership anticipates that the property values of the members will be enhanced by the expenditure of capital funds on the structures.

To raise the necessary funds for the renovation of the clubhouse facilities (current improvements), Taxpayer approved the Capital Reserve Contribution Special Assessment (the Special Assessment). In addition to raising funds for the renovation of the clubhouse presently planned, this Special Assessment is also planned to raise funds for future capital improvements (future improvements), over and above the annual operating budget. This assessment has been assessed to all property owners of record

on Date 3 and to future owners purchasing property after Date 3. Each current and each future member of Taxpayer will be assessed $p. Fifty percent or $q, was billed on the Date 3 accounts receivable statements, with the remaining 50 percent to be billed 364 days later. The Special Assessment to the property owners of record on Date 3 will amount to $r. The anticipated construction expenditures for the club house facilities renovation is $s. There will be a remaining contingency of $t. The request for a ruling pertains only to that part of the Special Assessment assessed to property owners of record on Date 3 for current improvements.

The Special Assessment will be in addition to the annual dues obligation. The funds raised in the Special Assessment from the current members will be earmarked exclusively for capital expenditures for the presently planned renovation of the clubhouse and will be accounted for in the books and records separately from all other funds of Taxpayer. The members will pay the Special Assessment in addition to their annual dues obligation. When a new member purchases a membership, the new member will be required to pay the Special Assessment amount. These amounts will be earmarked for capital expenditures and will be accounted for in the books and records separately from all other funds of Taxpayer. Any member whose membership ceases within a 10 year time period from the initial Capital Reserve Contribution Special Assessment will receive a prorated portion of the assessment back, reduced 10% per year starting after the first year. If the member resigns and leaves the planned unit development, within the first year, the entire capital contribution will be refunded.

Taxpayer makes the following representations:

(a) that the Special Assessment is pro rata,

(b) that the Special Assessment is restricted to capital renovations,

(c) that the Special Assessment is motivated by the expected increase in the value of member properties,

(d) that the Special Assessment is intended to be a capital contribution, no part of which will be used to pay for goods, services, or a right to use the facilities,

(e) that regular assessments will continue to cover the cost of non-capital expenditures,

(f) that the Special Assessment is earmarked for application to capital expenditures and will be accounted for in the books and records separately from all other funds of the Taxpayer.

Section 61(a) and section 1.61-1 of the Income Tax Regulations provide that gross income means all income from whatever source derived, unless excluded by law.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer. We must determine whether the Special Assessment to property owners of record on Date 3, or some part of the Special Assessment qualifies as a contribution to the capital of the Taxpayer.

Section 1.118-1 provides in part that if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. The section provides that section 118 also applies to contributions to capital made by persons other than shareholders. Further, the section provides that the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered.

In United Grocers, Ltd. v. U.S., 308 F.2d 634 (9th Cir. 1962), the court held that monthly payments by members of a nonprofit retail cooperative, which provided merchandise and services to both members and nonmembers, were made as payment for reduced prices through patronage dividends paid to members. The court stated that the motive or purpose and intent in making the payment is a "dominant factor" in determining whether it was a capital contribution or a taxable payment for goods and services.

In Washington Athletic Club v. U.S., 614 F.2d 670 (9th Cir. 1980), the court, relying on its earlier decision in United Grocers, stated that it was unnecessary to decide whether there was a meaningful distinction between a shareholder and a member of a non-stock corporation in determining whether a payment qualifies under section 118(a). The membership fees and dues at issue in Washington Athletic Club were segregated from other funds and deposited into a capital improvement fund, all expenditures from which were used solely for capital improvements rather than operating expenses. In holding that club members could have had no investment motive for payment of the fees and dues, the court emphasized the following factors: (1) a long-term member who had paid a greater amount of dues had no greater rights on liquidation than a new member; (2) upon termination of membership, a member simply forfeited all amounts previously paid, losing any right to share in the club's assets on liquidation; and (3) membership conferred no significant rights other than the use of the club facilities and the right to vote for the board of directors. Id. At 675. The court also noted that the earmarking of the payments for capital improvements, although relevant, was not determinative of whether the payments were capital contributions.

In Board of Trade v. Commissioner, 106 T.C. 369 (1996), the Tax Court held that transfer fees received by a futures exchange from the transferees of exchange memberships constituted nontaxable contributions to capital within the meaning of section 118(a). The court noted that a member-owner's receipt of goods or services from the corporation does not in itself negate a contribution to capital. Id. at 379.

Rather, the test is whether the payor has an investment motive in making the payment. Id. at 381. The court then set forth a three factor test for determining the existence of an investment motive: (1) whether the fee is earmarked for application to a capital expenditure; (2) whether the payors are the equity owners of the corporation and the payment increases the corporation's equity capital; and (3) whether the members have the opportunity to profit from their investment in the corporation. Id. at 386.

The Internal Revenue Service in revenue rulings has also focused on the motive or purpose and intent in making a contribution when determining if an assessment qualifies as a contribution to capital. In Rev. Rul. 75-371, 1975-2 C.B. 52, the unit owner-members of a condominium levied and collected a special assessment each month for fourteen months from each unit owner. The assessment was deposited in a special account and used only to replace the outdoor furniture surrounding the swimming pool of the condominium housing project. The revenue ruling cited United Grocers, Ltd. as authority that the dominant factor in determining whether special assessments were contributions to capital or payment for goods or services was the motive or purpose and intent in making the contribution. Thus, in holding that the special assessment was a contribution to the capital of the condominium management corporation, the ruling stated:

> Moreover, the availability of various types of personal property, including outdoor furniture, adds to the attractiveness or usefulness of the condominium project and therefore, enhances the value of a unit owner-shareholder's property. Since ownership of the taxpayer is inextricably and compulsorily tied to the acquisition and enjoyment of a unit owner's property, this enhanced value is sufficient to show the motive or purpose and intent for paying the special assessment is something other than a payment for services rendered by the taxpayer to its unit owner-stockholders.

Id. at 52. The ruling emphasized three factors: (1) the assessment was earmarked and segregated from other funds; (2) the assessment was pro rata on each unit owner-stockholder; and (3) replacement of the outdoor furniture added to the attractiveness or usefulness of condominium project as a whole, thereby enhancing the value of each unit owner-stockholder's property. See also Rev. Rul. 74-563, 1974-2 C.B. 38 (special assessment levied by an incorporated homeowners' association to be used only for paving a community parking area constituted a contribution to capital under section 118(a)).

In the facts presented by Taxpayer, the Special Assessment as it pertains to funds for the immediate renovation of the clubhouse satisfies each of the three criteria identified by the Tax Court in Board of Trade as indicating an investment motive by the payors. First, the Special Assessment of the property owners of record on Date 3 is earmarked for capital improvements to the clubhouse. Amounts received pursuant to the assessment are segregated from other funds received from the members and used

solely to make capital improvements. Further, Taxpayer's operating expenses and non-capital expenditure items will continue to be covered by the significant annual dues (currently $u).

Second, payment of the Special Assessment enhances the members' collective interest in Taxpayer through capital improvements to Taxpayer's primary asset, the clubhouse. See Board of Trade, 106 T.C. at 390 and n.22; Rev. Rul. 75-371, 1975-2 C.B. 52; Rev. Rul. 74-563, 1974-2 C.B. 38. Although each member's individual interest in Taxpayer does not directly reflect the amount of the Special Assessment paid by such member, member equity is increased by payment of each assessment. As mentioned above, in the event of dissolution of Taxpayer, after provision for creditors and payment of all costs and expenses of the dissolution, and after any dedication to any applicable municipal or other governmental authority of any property determined by the Board to be appropriate, members would be entitled to distribution of assets of Taxpayer. See Board of Trade, 106 T.C. at 390; Rev. Rul. 75-371, 1975-2 C.B. 52.

Third, members have an opportunity to profit from their investment in Taxpayer in the sale of their homes to third parties. The attractiveness and usefulness of the clubhouse adds to the attractiveness or usefulness of the condominium development and therefore, enhances the value of each member's property. See Board of Trade, 106 T.C. at 390; Rev. Rul. 75-371, 1975-2 C.B. 52.

Accordingly, based on the foregoing analysis and representations of Taxpayer, we rule as follows:

The payment of the Special Assessment to Taxpayer by property owners of record on Date 3 for the current improvements to the clubhouse qualifies as a contribution to capital under section 118(a). Therefore, the Special Assessment payment to Taxpayer by property owners of record on Date 3 for the renovation of the clubhouse will be excluded from its gross income under section 61(a).

No opinion is expressed with regard to the characterization of payments by property owners for any future improvements. Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations. Specifically, no opinion is expressed under section 277, on the characterization of any interest earned by Taxpayer, or on the regular assessments paid to Taxpayer by its members for services which Taxpayer renders to its members, or on any special assessment for costs, capital or otherwise, other than the special assessment of property owners of record on Date 3 for the renovation of the clubhouse. The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,
Assistant Chief Counsel (Corporate)
By: Debra Carlisle
Chief, Branch 5