Appendix 10A

National Office Technical Advice Memorandum Letter Ruling 9539001—Treatment of Assessments by a Time-share Association

Cross Reference Data

Topical

Agents
Annual inclusion
Contributions to capital
Gross income
Prepaid assessments
Taxable income
Time-share developments
Year of inclusion

Citation

IRC Sections—61—2A, 118—2C, Proposed HR 1350, 451 (not included in this *Guide*), 528—2K
Case—*The Board of Trade of the City of Chicago and Subsidiaries v. Commissioner*—4B
Revenue Rulings—70-604—6H, 74-563—6N, 75-370—6P, 75-371—6Q
Revenue Procedure—71-21—9A

Summary

This ruling holds that the time-share condominium was required to include in gross income for the year of receipt excess member assessments collected prior to the budget year for which they were made. It could not take advantage of IRC Sec. 528 and Rev. Rul. 70-604 governing homeowners' associations because the management activities went beyond the maintenance of the common areas to include providing maid service and linens and furnishing individual units.

Prepaid assessments, a portion of which were allocated to reserve accounts for repairs and capital replacements, could not be deferred to the following year in order to match revenues with expenses because the reserve portion applied to years in addition to the following year.

Payments to the reserve accounts were not capital contributions under IRC Sec. 118. The management association determined the amount of payments and when they were collected. Those sums were part of the maintenance fees paid for services rendered, and no *separate capital contribution bank account was maintained*.

Treatment of Assessments by a Time-share Association

Uniform Issue List Information:

UIL No. 61.29-01
Gross income v. not gross income, Agents—conduits, Agent v. not an agent
UIL No. 451.01-00
General rule for taxable year of inclusion, Annual theory

June 08, 1995

[Code Secs. 61 and 451]

ISSUES

1. **Whether amounts collected as annual assessments from taxpayer's members in excess of annual expenses are includible in taxable income.**

2. **Whether prepaid assessments collected in one year allocable to the next budget year are includible in gross income in the year of collection.**

3. **Whether member assessments allocated to various repair and replacement reserve accounts are includible in gross income when received.**

FACTS

Taxpayer is the management association for **a time-share condominium project** located in the state of a. The project is comprised of one building with 104 apartment units, each of which is dedicated for interval ownership for 51 weeks per year. Each of the e owners is deeded an interval ownership of a unit for at least one week per year. Units may be rented for the specified period by the owners or exchanged with other parties. **Taxpayer, with the assistance of a professional management company, operates and maintains the entire property including the individual apartment units. Maintenance includes the provision of linen and towels and maid service for the units as well as maintaining the pool, hot tub, and meeting room.**

In addition to the Declaration of Condominium and the association bylaws, taxpayer is governed by two chapters of statutory law of a, one dealing with condominiums in general and the other specifically directed to vacation and time-share plans. A board of directors is elected by the members each year; the board determines the budget and assessment amounts on an annual basis. Each member is sent a copy of the budget and a notice of amounts due, including a notation of reserve accounts, prior to the end of the preceding year. **Since these member payments are billed prior to the beginning of the next year, a sizable sum is collected from the members, so-call[ed] prepaid assessments, prior to the next budget year.**

Under applicable state law, the association budget must include reserve accounts for capital expenditures and deferred maintenance. These accounts must include roof replacement, building painting, and pavement resurfacing, based on an estimated life and replacement cost formula. Reserve funds are to remain intact unless their use for other purposes is approved in advance by a majority vote of the voting interests at a duly called meeting of the association. **There is no requirement that the reserve accounts be placed in separate bank accounts and taxpayer did not do so during the years in question.** These accounts, plus a reserve for replacement of personal property, were maintained on taxpayer's books.

The association is an accrual basis taxpayer, using a calendar tax year.

Issue 1. Excess Assessments

Taxpayer is a corporate entity, separate from its member-owners, and subject to the income tax imposed on taxable income under section 11 of the Internal Revenue Code. During each of the taxable periods in question, income from member assessments to support its operations exceeded deductible expenses as shown on the tax returns and books of the association. These income amounts are separate from any "prepaid assessments" allocated to the next budget year noted earlier.

The excess assessments were not included in taxpayer's reported taxable income under section 63 based on the applicability of Rev. Rul. 70-604, 1970-2 C.B. 9. That revenue ruling describes a situation where a condominium management corporation assesses its stockholder-owners for the purposes of managing, operating, maintaining, and replacing the common elements of the condominium property. This is the sole activity of the corporation and it is not authorized to engage in any other activity. At a meeting held each year, the stockholder-owners decide to either refund any excess assessments to themselves or to have the excess applied against the following year's assessments. The ruling concludes that the excess assessments for the taxable year over and above the actual expenses paid or incurred for the purposes described above are not taxable income to the corporation since the excess, in effect, has been returned to the stockholder-owners.

In this case, the District Director determined that taxpayer does not qualify for the benefits of the revenue ruling and included the excess assessments in taxable income. That determination is based on the findings that (1) the association does not have as its sole activity the management and maintenance of the common areas of the property; (2) the purposes, nature, and scope of the time-share association's activities are materially distinguishable from those of a regular condominium association; [a] **and (3) the association did not, in effect, return excess assessments to the unit-owners.**

Taxpayer's point of view is that (1) the "sole activity" language in the revenue ruling is not critical to the holding and, even if it is, the sole activity here is to maintain common elements which include the multiple-use units themselves;[(1)] (2) the operation, budgeting, and administration of a time-share condominium project is essentially the same as a regular residential condominium as evidenced by the detailed requirements established by a law; (3) and excess assessments each year were applied to the next year's assessments by using the excess to pay the first-occurring expenses as required by the association's bylaws.

Taxpayer draws considerable comfort from the legislative history and statutory provisions of section 528, which provides, in general, for tax exempt treatment of member payments to a qualified homeowners association. The argument is made that no meaningful distinction exists between this taxpayer and an association governed by section 528 with respect to the principles of what is considered gross income and how excess amounts collected are treated for tax purposes. Further, taxpayer suggests the term "common elements" is similar to the concept of association property in Treas. Reg. S1.528-3, which is defined as including property owned in common by members of the association. However, to whatever extent Congress was announcing policy on the taxation of condominium associations in section 528, it also enacted strict requirements as to the organizational and operational structure of the homeowner associations that are entitled to the benefits of that policy. **Taxpayer does not qualify under section 528 and we see no justification for lifting concepts from that statutory provision to apply to a non-qualifying organization.**

Similarly, **the benefits of Rev. Rul. 70-604 are limited to a taxpayer where the factual pattern in question is substantially similar to the facts stated in the revenue ruling.**Rev. Rul. 70-604 obviously was published as a rule of practical convenience for both taxpayers and the Service but it essentially constitutes an administrative exception to the inclusion of income under section 61 of the Code and, as such, must be strictly construed.

In this case, we are not persuaded that the fact the management corporation in the revenue ruling solely maintained the common elements is insignificant. Inclusion of such an express statement in the ruling indicates an intention to confine the exclusion determination to an association having no other business activity, whether or not related to the property. The point is made a second time in the same sentence by a reference to the by-laws which do not authorize any other activity. Aside from the express emphasis on this point, it is not unexpected that such a deviation from established tax accounting principles would be carefully confined to an association performing that single business function for the payers. Here, taxpayer goes far beyond maintaining the common elements of the grounds or hallways. It maintains the units themselves, furnishes the apartments, and provides linen and maid services.

Of course, if the entire residential project, including the units themselves, is considered the "common elements", as taxpayer suggests, the association may indeed be engaged in the sole activity of maintaining the common elements. But it seems undeniable that the phrase had no such expansive meaning when used in Rev. Rul. 70-604[(2)] and no amount of redefinition or different structuring of property interests twenty-five years later can change the intended meaning in 1970. Even if the multiple use of one apartment by 51 owners can be said to change the residential character of the unit, all the other owners of units in the building do not have an undivided interest or right to occupy with regard to that one unit as they would have with such traditional common elements of hallways, swimming pools, and elevators.

Another deficiency is apparent in taxpayer's effort to use Rev. Rul. 70-604. The facts here do not indicate that the member-owners were given any option to have excess assessments returned to them for any year in question. It seems to us this is a critical factor in the revenue ruling supporting the rationale that those amounts, in effect, were returned to the unit owners. **No vote was taken in an annual meeting of the members on the disposition of the funds,** [b] as occurred in the revenue ruling. No opportunity was provided for a determination by the members as to a refund or application of the excess to the next year's assessments so as to justify the conclusion that the monies were, in effect or in fact, returned to the payers. [c] **This criteria is not achieved by a provision in taxpayer's bylaws mandating that excess assessments be applied to the following year's expenses.** [d] **Without a determination by the members, on an annual basis,[(3)] as to the disposition of the excess payments, the rationale and the holding of the revenue ruling become inapplicable.**

As to whether excess assessments were actually used to reduce the next year's membership fee requirements, the District was unable to find sufficient evidence that this occurred. In our view, this is primarily a factual issue for the District to determine based on the books, records, and computational data available to the agent. In any event, **we have concluded that taxpayer fails to come within the application of Rev. Rul. 70-604 for the reasons stated above.**

Issues 2 and 3—Prepaid Assessments/Reserve Accounts

Membership payments required for a budget year are determined by taxpayer prior to that year and are collected, to a sizable extent, from the members in November and December of the prior year. The Service determined that these member payments, so-called prepaid assessments, should be included in the association's income in the year of receipt whereas taxpayer contends these amounts can be deferred to the next taxable year to be matched with expenses. A portion of the prepaid assessments is or will be allocated to reserve accounts for repair and replacement purposes, the taxable status of which is also in dispute.

Section 451 of the Internal Revenue Code provides that the amount of any item of gross income shall be included in the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing income, such amount is to be properly accounted for as of a different period. Section 1.451-1(a) of the regulations provides that under an accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Under these principles, the actual receipt of the prepaid assessments would trigger inclusion in gross income when received. However, taxpayer claims deferral of this income based primarily on Rev. Proc. 71-21, 1971-2 C.B. 549. That revenue procedure allows an accrual method taxpayer in certain circumstances to defer the inclusion in gross income for Federal tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. If the payments are received pursuant to an agreement requiring the subject services to be performed before the end of the next year, the payments may be included in gross income as earned through the performance of the services. With exceptions not applicable here, the revenue procedure does not apply if any portion of the services is to be performed after the end of the next succeeding taxable year or at an unspecified future date which may be after that period. [e]

Examples provided in the revenue procedure to illustrate these rules include specific contracts for landscaping work and repairing television sets within strict time limitations. **When one attempts to apply the deferral rules to an entire corporate enterprise perpetually maintaining a residential facility, it is difficult to avoid the fact that a portion of the funds received in any given year will ordinarily have to be set aside for maintenance far beyond the succeeding taxable year.** That appears to be the case here where various reserve accounts for future services were established by taxpayer and are required by state law.

It is this statutory requirement to establish specific reserves that leads taxpayer to conclude that the reserve funds are not includible in the association's gross income at all and, therefore, provide no impediment to the applicability of Rev. Proc. 71-21. The theory is that the association is not able to use these monies for any other purpose than those prescribed by statute, has only ministerial authority over those funds, and thus is a mere agent for the members with respect to these reserve funds.

As to this purported principal-agent relationship, some of the relevant considerations in determining whether an agency exists are whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and the assets belonging to the principal.*National Carbide Corp. v. Commissioner*, 336 U.S. 422, 437 (1949). One court decision from taxpayer's jurisdiction, b, notes that a principal in an agency relationship retains the right to control the conduct of the agent with regard to the details of the engagement.

It is certainly true that in this case the association and its management firm operate the business for the benefit of the association members. But income earned here comes from the members themselves and is attributable to services of employees of the association. Transmitting any earned monies back to the purported principals is prohibited by the Articles of Incorporation, Article XII. **Essential details on determining the amounts of the reserve funds and when to use those funds are in the hands of the Board of Directors, not the members.**

Taxpayer insists the association has mere ministerial authority as an agent over reserve accounts for roof replacement, building painting, pavement resurfacing, and other such items because these accounts are required by state law. Further, reserve funds are to remain in these accounts unless their use for other purposes is approved in advance by a vote of the members. c. But these statutory provisions apply to both capital expenditures and deferred maintenance in general with the above items listed as minimal reserves that must be established. If an association is a mere agent with regard to the named accounts, it must also be an agent, under these provisions, on any funds set aside for routine maintenance that would clearly be currently included in gross income for Federal tax purposes.

In any event, we are reluctant to find an agency relationship in this context based on the mere fact that reserve accounts must be established and maintained on the association's books. Furthermore, it is doubtful that the state itself intended such a result. In another section of this same statute governing time-share operations, the state legislature expressly made the association an agent for an affiliated exchange company for costs incurred by that company in connection with denying the use of accommodations to a delinquent unit-owner. d. Any such provision is conspicuously absent with respect to reserve funds.

To the extent these items are properly considered capital improvement projects,[(4)] the payments destined for such designated reserves may be excluded from gross income as capital contributions. Section 118 of the Internal Revenue Code and section 1.118–1 of the regulations provide that in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer corporation in the form of money or property. The exclusion, however, does not apply to any money or property transferred to the corporation in consideration for goods or services rendered. In *United Grocers, Ltd. v. United States*, 308 F.2d 634 (9th Cir. 1962), the court stated that the dominant factor in determining whether amounts were contributions to capital or payments for goods or services was the motive or purpose and intent in making the contribution.

The Service has recognized certain arrangements wherein payments to a housing association will not be included in income of the recipient on the basis that the payments are either contributions to capital or the corporation is a mere agent for the members for those specific funds. Rev. Rul. 74-563, 1974-2 C.B. 38 concerned a special assessment agreed to by the homeowner-members of a condominium to fund a special account for paving a parking lot. The assessments were considered contributions to capital pursuant to section 118. A similar result was reached in Rev. Rul. 75-371, 1975-2 C.B. 52, involving special assessments for outdoor furniture surrounding a swimming pool. The agency theory was employed in Rev. Rul. 75-370, 1975-2 C.B. 25, to exclude from gross income special assessments to replace the roof and elevators located in the common elements of a condominium.

In each of these revenue rulings, the recited facts, taken collectively, were sufficient to demonstrate that an intent or purpose existed to make a capital contribution to the corporation or create an agency relationship as to those funds. Among the circumstances were the facts that the members themselves dictated specific sums for a designated purpose, the collection of those amounts was by special assessment, and the funds were deposited in separate bank accounts clearly segregated from any operating funds. [g] None of these facts are present here. The taxpayer and/or its managing company made the call on the need, timing, and amount of the payments; the sums collected were part and parcel of the continuing maintenance fees paid for services rendered or to be rendered; and the resulting reserve funds were ledger entries, not separately maintained bank accounts.[(5)] [f]

The facts justifying the conclusion that a capital contribution occurred, of course, will vary from case to case and no single factor is necessarily controlling. However, where the corporation in question is organized and operated solely or primarily to provide services to those parties making the payments, it is particularly difficult to avoid the conclusion that the payments were for services. For example, in *Washington Athletic Club v. United States*, 614 F.2d 670 (9th Cir. 1980), a nonprofit membership organization assessed their members a surcharge, payable as part of their annual dues, which was allocated to a capital improvement fund. The monies were deposited in separate savings accounts and commercial paper, and expended only on capital improvements. Yet, the court found the surcharge amounts were taxable income since the payers received no entitlement of an investment nature or greater rights on liquidation of the association. See also *American Medical Association v. United States*, 887 F.2d 760, 773-775 (7th Cir. 1989).

Considering all the circumstances of payment in this case, we do not find sufficient evidence to conclude that any portions of the member assessments, paid primarily for an array of services with respect to their units, constitute a contribution to capital of the corporation or were paid under conditions creating a principal-agent relationship for the amounts assigned to reserve accounts. Consequently, the reserve account portions of the assessments are properly included in gross income when received and Rev. Proc. 71-21 is not available to the taxpayer for these taxable years.

CONCLUSIONS [h]

1. Amount received as annual assessments from taxpayer's members in excess of annual expenses are includible in taxable income.

2. Prepaid member assessments collected in one year but allocable to the next budget year are includible in gross income in the year of receipt.

3. Member assessments allocated to various repair and replacement reserve accounts are includible in gross income in the year of receipt.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

IRS Notes:

(1) Article I of the Declaration of Condominium includes the units in the concept of "Limited Common Elements."

(2) It is our understanding that time-share projects were not in existence in 1970.

(3) **The revenue ruling clearly contemplates an annual choice by the member-payers on the subject.** Whether this is accomplished at an annual meeting or in some other fashion is not significant.

(4) We express no opinion, nor have we been asked to do so, as to which reserve accounts, if any, represent funds of a capital nature.

(5) Taxpayer astutely notes that commingling of funds occurred in Rev. Rul. 74-321, 1974-2 C.B. 16, which applied the agency theory to premiums paid by patrons of a farm production credit association for a group life insurance policy. That case, of course, did not involve payments to a servicing corporation maintaining the payers' assets where a higher standard is required. Furthermore, the payments were made strictly on an individual basis for those choosing insurance coverage.

Notes:

[a] The scope of activities issue with respect to Rev. Rul. 70-604 (Appendix 6H) has potentially broad-based implications. This TAM implies that *any* association, not just a time-share association, that has activities beyond those of simply maintaining the common areas of the association may not use Rev. Rul. 70-604.

[b] This ruling reiterates the necessity of an *annual* election by the *members* to invoke the benefits of Rev. Rul. 70-604 (Appendix 6H).

[c] As indicated in the Notes to Rev. Rul. 70-604 and in *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*, it is absolutely *critical* to follow the literal procedural provisions of Rev. Rul. 70-604 (Appendix 6H).

[d] This sentence is the first and only clear statement by the IRS that language in an association's controlling documents that is roughly equivalent to the wording of Rev. Rul. 70-604 (Appendix 6H) *would not* substitute for strict compliance with the provisions of the revenue ruling, primarily because of the lack of an *annual election* by the members. This supports the authors' consistent position as stated in section 503 of *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*.

[e] This is the portion of Rev. Proc. 71-21 (Appendix 9A) that destroys the subject taxpayer's argument for treating dues paid in advance as "prepaid assessments" rather than including them in income when received. If the taxpayer had prevailed on the reserve issue, it likely would have prevailed on the prepaid assessment issue. However, because reserve assessments were considered by the IRS to be "fees for services" rather than "capital contributions" and because the reason for collecting those amounts was to pay for future years' maintenance, the one succeeding year test of Rev. Proc. 71-21 was violated. (See also Note [f]).

[f] The taxpayer failed to maintain separate bank accounts for capital reserves, which is probably the most important of all factors in documenting a taxpayer's *intent* when establishing reserves. Other important factors are: accounting separately for funds, budgeting for reserve funds, having a reserve study to support the purpose and nature of amounts collected, and clearly distinguishing reserve transactions from operating transactions on the tax return.

Also note that reserve bank accounts should contain only amounts set aside for *capital* purposes. Any *noncapital* reserve amounts collected (such as for painting or contingency purposes) should be placed in separate noncapital reserve bank accounts. Placing them in the same bank accounts with capital reserves would be considered by the IRS a commingling of cash that would taint *all* of the reserves.

[g] This ruling restates the circumstances necessary to support the treatment of reserve assessments as capital contributions as: (a) the members themselves dictated specific sums for a designated purpose, (b) the collection of those amounts was by special assessment, and (c) the funds were deposited in *separate bank accounts* clearly segregated from any operating funds.

[h] If an association wants to change its method of accounting to conform to the conclusions reached by the IRS, it must file Form 3115. Since Rev. Proc. 97-27 eliminated the provision that such changes must be made within 180 days of the beginning of the year, an association may now change its accounting method for a year *at any time* within that year.

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