MEMORANDUM

TO: REVIEW STAFF

DATE: 12/21/83

FROM: DIANA J. LEE/JEAN GALLANCY djl | JG

RE: IRC SECTION 277

It has been brought to our attention that a number of cooperatives are now being audited by IRS to determine any tax liability because of IRC Section 277. That section concerns membership organizations which operate primarily to furnish services to its members. It is unclear whether a cooperative which is a business corporation under the Business Corporation Law would fall within the section. Arguably it could. The section does not allow non-member income to be offset by housing-related expenses in determining taxable income. Non-member income could include reserve fund contributions, interest on reserve funds, commercial income, etc. In the past it was assumed that this income was offset by the operating expenses of the coop and therefore the coop was subject to no or minimal income tax.

Section 277 and its impact on the taxable income of a coop should be discussed in all income tax opinions. This applies to plans not yet accepted and amendments to plans which may result in a new tax opinion.

See copy of Section 277 attached and a recent article from the BNA Housing Reporter.

D.J.L./J.G.

program of a national political convention.

Subsec. (d). Pub.L. 93-443 redesignated former subsec. (d) as (c).

1968 Amendment. Subsec. (c), Pub.L. 90-364 added subsec. (c). Former subsec. (c) redesignated (d).

Subsec. (d), Pub.L. 90-364 redesignated former subsec. (c) as (d).

Effective Date of 1974 Amendment. Amendment by Pub.L. 93-443 applicable with respect to taxable years beginning after Dec. 31, 1974, see section 410(c)(1) of Pub.L. 93-443, set out as an Effective Date of 1974 Amendment note under section 431 of Title 2, The Congress.

Effective Date of 1968 Amendment. Pub.L. 90-364, § 108(b) provided that: "The amendments made by subsection (a) shall apply with respect to amounts paid or incurred on or after January 1, 1968."

Effective Date. Pub.L. 89-368, § 301(c), provided that: "The amendments made by subsections (a) and (b) [adding this section] shall apply to taxable years beginning after December 31, 1965, but only with respect to amounts paid or incurred after the date of the enactment of this Act [Mar. 15, 1966]."

Program Advertising for Presidential and Vice-Presidential Nominating Conventions. Pub.L. 93-625, § 10(g), Jan. 3, 1975, 88 Stat. 2119, repealed Pub.L. 90-346, June 18, 1968, 82 Stat. 183, providing for advertising in a convention program of a national political convention, applicable with respect to amounts paid or incurred on or after Jan. 1, 1968.

Legislative History: For legislative history and purpose of Pub.L. 89-368, see 1966 U.S.Code Cong. and Adm.News, p. 1933. See, also, Pub.L. 90-364, 1968 U.S. Code Cong. and Adm.News, p. 2341; Pub.L. 93-443, 1974 U.S.Code Cong. and Adm.News, p. 5587.

Library References

Internal Revenue ⟹741.

C.J.S. Internal Revenue § 368.

§ 277. Deductions incurred by certain membership organizations in transactions with members

(a) General rule.—In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year. The deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which this section applies for the taxable year.

(b) Exceptions.—Subsection (a) shall not apply to any organization—

(1) which for the taxable year is subject to taxation under subchapter H or L,

(2) which has made an election before October 9, 1969, under section 456(c) or which is affiliated with such an organization, or

(3) which for each day of any taxable year is a national securities exchange subject to regulation under the Securities Exchange Act of 1934 or a contract market subject to regulation under the Commodity Exchange Act.

Added Pub.L. 91-172, Title I, § 121(b)(3)(A), Dec. 30, 1969, 83 Stat. 540, and amended Pub.L. 94-568, § 1(c), Oct. 20, 1976, 90 Stat. 2697.

Historical Note

References in Text. The Securities Exchange Act of 1934, referred to in subsec. (b)(3), is Act June 6, 1934, c. 404, 48 Stat. 881, which is classified principally to chapter 2B (section 78a et seq.) of Title 15, Commerce and Trade. For complete classification of this Act to the Code, see section 78a of Title 15, and Tables volume.

The Commodity Exchange Act, referred to in subsec. (b)(3), is Act Sept. 21, 1922, c. 369, 42 Stat. 998, which is classified generally to chapter 1 (section 1 et seq.) of Title 7, Agriculture. For complete classification of this Act to the Code, see Tables volume.

1976 Amendment. Subsec. (a). Pub.L. 94-568 provided that the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which this section applies for the taxable year.

Effective Date of 1976 Amendment. Amendment by Pub.L. 94-568 applicable to taxable years beginning after Oct. 20, 1976, see section 1(d) of Pub.L. 94-568, set out as an Effective Date of 1976 Amendments note under section 501 of this title.

Effective Date. Section applicable to taxable years beginning after Dec. 31, 1970, see section 121(g) of Pub.L. 91-172, set out as an Effective Date of 1969 Amendment note under section 511 of this title.

Legislative History. For legislative history and purpose of Pub.L. 91-172, see 1969 U.S.Code Cong. and Adm.News, pp. 1645, 1727, 1939, 2103, 2400. See, also, Pub.L. 94-568, 1976 U.S.Code Cong. and Adm.News, p. 6051.

Library References

Internal Revenue ⟹566.1.

C.J.S. Internal Revenue § 256 et seq.

§ 278. Capital expenditures incurred in planting and developing citrus and almond groves; certain capital expenditures of farming syndicates

(a) General rule.—Except as provided in subsection (c), any amount (allowable as a deduction without regard to this section), which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof), and which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted, shall be charged to capital account. For purposes of the preceding sentence, the portion of a citrus or almond grove planted in one taxable year shall be treated separately from the portion of such grove planted in another taxable year.

(b) Farming syndicates.—Except as provided in subsection (c), in the case of any farming syndicate (as defined in section 464(c))

the housing authority gets a fee of 1.5 points on each house sale, which averages about $35,000, she said.

In connection with this program, the PHA made some loans directly, using the proceeds of a tax-exempt loan from a local lender. The marketing and financing activities under inclusionary zoning generate sporadic income, however, she cautioned.

The multifamily developments also are subject to the 15 percent quota, which the PHA uses as an outlet for its Section 8 certificate holders. But for those apartments set-aside under the low-income quota but not rented under Section 8, the PHA will find eligible tenants, verify their incomes and rents for county purposes, and charge a fee for this service.

The zoning law also allows a builder to contribute to the PHA in lieu of directly providing low-income units. Through this mechanism, the authority was given outright one townhouse in a market-rate development, from which it now gets regular income.

Management Business

Much of the PHA's apartment management business also comes through a local government regulation, which had required recipients of community development grants for housing to submit project management plans. For small developers, the PHA was suggested as a resource to develop such plans and afterwards often became the management agent, James related.

Most of the units it manages are Section 8-assisted or in the same building as other Section 8 units, and James said the PHA gets on average 7 percent of monthly rent for its rent-up, collection, and maintenance services on over 150 units.

Another way in which the city has generated business for the PHA is to use the authority's staff for early development work on a limited equity co-op. The PHA at this stage is under contract to seek out a suitable building for conversion.

James noted that having a very progressive local government was a big help in keeping up interest in new development options for low-income housing.

Floating tax-exempt bonds has also been a "big money maker" for the authority in its role as administrator, she added, and Santa Cruz is now working on its first "80/20" bond-financed project (a market-rent project with 20 percent low-income units).

BUSINESS AND FINANCE

INCREASING COMPLEXITY OF CO-OP FINANCING SEEN RAISING PROSPECT FOR TAX CHANGES

Experts in the field of cooperative housing taxation agree that major changes in the application of tax laws to co-ops, and perhaps changes in the laws themselves, lie just ahead.

Discussions at the annual meeting of the Cooperative League of the U.S.A. (CLUSA) on October 25-26 focused most sharply on the tax status of the "non-member" income co-ops earn from commercial rents and interest on reserves, and on the difficulties in qualifying as co-ops under Internal Revenue Code Section 216, which is a key to co-ops' abilities to pass through tax deductions to members.

Eligibility under Section 216 has been a problem for cooperatives with the potential for high commercial rent revenue. Because they have to keep non-member income down to 20 percent of total revenues, New York City co-ops have often had to charge below-market commercial rents. A second type of 216 problem is its requirement that the value of shareholders' stock be proportional to their share of total co-op equity, a condition which may not be met by limited equity co-ops, judging by a recent IRS private letter ruling.

The importance and level of interest in resolving such issues have been elevated recently because of the increasing complexity of cooperative housing finance, explained Matthew B. Slepin, CLUSA housing vice president. "In these days when bond counsel are becoming involved (when co-ops seek tax-exempt bond financing) and FNMA (Federal National Mortgage Association) is looking at co-op loan (purchases), meeting the letter of the law on Section 216 will mean a lot more than in the past," he noted.

These issues have also come to the fore because of increasing IRS audit activities, questioning certain co-ops' tax practices, and because congressional tax-writing committees are dissatisfied with the current co-op tax law.

Growing Tension

"After 42 years without very major problems, there is a growing tension between taxing authorities and the cooperative community," asserted Dennis B. Drapkin, Washington, D.C., attorney and tax specialist. While Section 216 may have been suitable for cooperatives for much of the last four decades, the roundtable participants agreed that it is now inappropriate in many ways for today's co-ops.

The restrictions on outside income imposed by Section 216, plus the IRS audits now under way which focus on the taxation of member versus non-member income, "really say something has to happen" to change the law, he stated.

"The 80/20 situation (limiting non-member income to 20 percent of a co-op's total) is close to intolerable for the co-op community," he said. Once Congress is pressured into considering loosening this requirement, "that will open up (discussion of) all the areas of taxation of co-ops," perhaps with action as early as 1984, Drapkin predicted.

Revise 80/20 Test

The present statutory provision restricting non-member income to 20 percent of a co-op's total should be changed to a less strict requirement, co-op advocates argued, perhaps by simply mandating that housing must be the corporation's principal purpose. This would enable co-ops to maximize

their earnings from any rental space, as long as housing remained the major use of space or source of income.

At a minimum, the participants asserted, the application of the 80/20 test should be modified. Currently, any co-op exceeding the 20 percent non-member income quota is completely ineligible for 216 pass-throughs to its members, but under a liberalized revision of the Code, this "cliff" could be converted to a "rolling slope." Then pass-through deductions would be reduced once the 20 percent limit is exceeded without jeopardizing the co-op members' basic right to tax deductions.

A second major issue in revamping the tax law, from the perspective of the co-op community, is the status of non-member income. Recent IRS audits, some of which are still not completed but are under review in Washington, have led some co-ops to begin to segregate non-member income from shareholder income for tax purposes. The corporation incurs a tax liability on the former even if housing-related deductions might be available to shelter it, under this interpretation. Such a segregation of income sources is suggested under Section 277 of the Code, which governs membership organizations in general.

If and when co-op tax law is rewritten, Drapkin and others agreed that co-ops likely will be liable for some tax on their non-member income. This feature of tax law affects nearly every co-op in the nation, as long as it has capital reserves earning interest. In contrast, the 20 percent non-member income limit is of concern primarily to New York City co-ops with commercial rental potential.

An underlying issue on the classification of co-op income is the possibility of two levels of taxation, both at the corporate and individual levels, if the net earnings are deemed to be a dividend to each individual shareholder as well as income to the corporation. Avoiding this scenario will be high on the list of co-op goals in any reworking of the Code.

Proportionality At Issue

Another threat to any co-op's eligibility under Section 216 is the requirement that the value of members' stock be proportionate to their share of the co-op's net equity. A June 30, 1983, IRS private letter ruling disqualified a limited equity cooperative from 216 status as a co-op, based on its flat subscription rate of $500 for shareholders occupying any of its various sized units.

The ruling implied that "there has to be some variation in the value of membership interest depending on what the shareholder is getting," so that at least apartments with different numbers of bedrooms should carry differing subscriptions rates, according to Patrick Clancy, the Washington, D.C., attorney who represents the co-op near Columbia, Md.

The brief IRS ruling did not specify whether proportionality would be tested only at the time a co-op initially is set up or whether the formulas for future sell-outs would also have to maintain proportionality to shares of total equity. Speakers at the CLUSA discussion noted that it may be fairly simple to initially structure prices to be proportional but would be more difficult to maintain this through time if, for example, the relative market values of different size units shifted over time.

The Maryland co-op which sought the letter ruling actually had wanted affirmation of the qualification of a leasehold co-op for Section 103(b) tax-exempt financing. This was indirectly received for this project since the denial of co-op status put it into the rental housing category for tax-exempt financing purposes. That enabled the county to proceed with its bond issue, but prevents any moderate-income tenants in the co-op from claiming tax deductions.

Co-op advocates agreed that this ruling is another sign that Section 216 should be rewritten, even though as a private ruling this IRS opinion does not constitute a legal precedent.

In the tax bill pending before the House which allows tax-exempt financing for limited equity co-ops under the multi-family housing rules (Section 103(b)), co-op representatives are hoping to add a provision stipulating that such co-ops automatically would qualify as cooperatives under Section 216. As the bill was reported by the Ways and Means Committee, in contrast, it would require that limited equity co-ops comply with 216 to get tax-exempt financing (even though deductions under 216 would be denied to their shareholders).

REPORT RECOMMENDS MORTGAGE BOND EXTENSION, DEMONSTRATION PROGRAM FOR ALTERNATIVES

The single family mortgage bond program has effectively promoted homeownership for lower-income families, without major revenue losses to the Treasury or a serious impact on interest rates, according to a new study of the program.

The report, published for the National Center for Policy Alternatives in Washington, D.C., recommends a five-year extension of the mortgage bond program. In addition, it says a simultaneous five-year demonstration program should be implemented for three possible alternatives to tax-exempt mortgage bonds — taxable bonds, mortgage grants, and tax credits.

The taxable bond option would involve a federal subsidy to reduce the effective rate on bonds sold by housing finance agencies, enabling them to offer below-market-rate mortgages to borrowers. The mortgage grant would be a one-time payment to the lender to cover the discount on a below-market-rate loan. The tax credit would be the equivalent to the borrower of a reduced monthly mortgage payment.

Each of the three demonstration programs would have a five-year authorization of $100 million, or $20 million per year. Housing agencies would exchange part of their mortgage bond authority for an equivalent share of the demonstration programs, eliminating any additional cost to the Treasury.

Uniform Reporting Standards

The report also urges Congress to require the Treasury to develop uniform reporting standards for mortgage bond programs, which would include borrower's income and net worth, mortgage rate, price of house, down payment, and monthly payments.

"Targeting single family mortgage revenue bonds funds to low-and moderate-income potential homeowners is the intention of Congress and many supporters of the revenue bond program," the report says. "Creating an extensive and accurate data base on who the actual beneficiaries are of this program is critical to defend it, or to change it if the actual beneficiaries are individuals who have less need of these programs."

The report says the data gathered through this new reporting system, along with information from the three demonstration programs, could be used in determining whether to extend the mortgage program beyond December 31, 1986.

Support for Program

The report uses data on targeting, economic impact, and cost to justify continuation of the mortgage bond program,

Copyright © 1983 by The Bureau of National Affairs, Inc.

0091-5939/83/$0+.60