MEMORANDUM

TO: REVIEW STAFF

FROM: DIANA J. LEE/JEAN GALLANCY

RE: IRC SECTION 277

DATE: 12/21/83

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.
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 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.

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. Stepin, 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.
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 the CLUSA discussion noted that it may be fairly

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 subscription rates. According to Patrick Clancy, the Washington, D.C., attorney who represents the co-op near Columbia, Md., this is getting support from many sponsors of the demonstration program.

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 credit would be a onetime payment to the lender to cover the discount on a belowmarket-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 $150 million, or $20 million per year. Housing agencies, in a 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 expensive 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, 1988.

Support for Program

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