STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
WEATHERFIELD PARK III HOMEOWNERS' ASSOCIATION, INC.	:	DETERMINATION DTA NO. 817614
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1994, 1995 and 1996.	:	

Petitioner, Weatherfield Park III Homeowners' Association, Inc., c/o Joseph Guy, Treasurer, 42 Springfield Drive, Voorheesville, New York 12186-9322, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1994, 1995 and 1996.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on August 17, 2000 at 9:30 A.M., which date began the six-month period for the issuance of this determination. Petitioner appeared by Joseph Guy, Treasurer. The Division of Taxation appeared by Barbara G. Billet, Esq. (Kathleen Chase, Esq., of counsel).

ISSUE

Whether petitioner is a corporation not subject to tax pursuant to 20 NYCRR 1-3.4(b)(6) and thereby entitled to a refund of taxes paid for the years 1994, 1995 and 1996.

FINDINGS OF FACT

1. Petitioner, Weatherfield Park III Homeowners' Association, Inc. (the "Association"), was incorporated on September 29, 1989 as a not-for-profit corporation under section 102(a)(5) of the Not-For-Profit Corporation Law. The Association's Certificate of Incorporation states that petitioner was formed "to provide for maintenance, preservation and architectural control" of the third phase of the Weatherfield subdivision located on Springfield Drive and Upper Wedgewood Road, Town of Guilderland, County of Albany and State of New York as well as "to promote the health, safety and welfare of the residents" of such subdivision. The Weatherfield subdivision consists of approximately 300 townhouse and single-family residences, including the 48 single-family residences located in the third phase.

2. The real property at issue was originally owned by Weatherfield Property, Inc., the sponsor of the subdivision. Weatherfield Property, Inc. conveyed to the Association certain common areas including two berms, a large grassy area in the middle of the third phase of the subdivision containing two ponds, and wooded areas on both sides of the subdivision. The sponsor attached to the lots of the subdivision certain covenants, easements and restrictions contained in a Declaration of Covenants, Easements and Restrictions dated July 9, 1991, which included the following:

> (a) No dwelling, building, fence, garage or other structure shall be erected, altered or moved on the lots until the design and location is approved in writing by the Association.
>
> (b) The Association may direct an owner of a lot to remove dead, diseased or insect infested bushes, trees or other vegetation from his lot. If the owner fails to comply with this request within 30 days, the Association may remove the vegetation at the sole cost to the owner.

(c) Trucks, vans, camper trailers, boats, motorcycles and commercial and recreational vehicles shall be kept garaged overnight.

(d) Only "umbrella" type clotheslines may be erected in the rear of any lot in the subdivision.

(e) The lots may be used for private residence purposes and only one residence may be erected on each lot and occupied by not more than one family.

(f) There shall not be erected or carried on or upon any lot any saloon, manufacturing establishment, stable, kennel, cattle yard, hog pen, chicken coop or privy vault nor shall any horse, cattle, hog, chicken or livestock be kept or maintained thereon.

(g) All front light, outside mail and paper box stands shall be in conformity with the style designated by the Association.

(h) No lawn ornaments, stone or concrete objects, statues or religious fixtures may be erected on any lot without the prior written approval of the Association.

(i) All exterior surfaces of structures on the lots requiring periodic painting, cleaning, washing or other maintenance is to be given such attention regularly and thoroughly so as to maintain a neat and clean appearance at all times. The color, design or components of a principal exterior building material, a principal exterior building element, a fence or any structure on a lot may not be changed unless the owner has received prior written approval of the Association.

3. Attached to the Declaration of Covenants, Easements and Restrictions as an exhibit are the by-laws of the Association. The by-laws contain the following definitions:

a. Common areas - areas of undeveloped land owned by the Association and reserved for the common use and enjoyment of the members (owners of lots in phase III of the subdivision) of the Association.

> b. Association charges - charges allocated and assessed by the Board of Directors to the owners and upon the lots in accordance with their Association interests, necessary to operate and maintain the common areas and meet Association expenses.
>
> c. Association expenses - all costs and expenses to be incurred by the Association pursuant to the Declaration in connection with the operation and maintenance of Association property and enforcing owner's obligations under the Declaration.

The by-laws further provide that the Board of Directors of the phase III subdivision shall have the power to maintain the common areas, contract for maintenance of the common areas, collect and enforce payment of all charges and assessments pursuant to the terms of the Declaration and enforce the Declaration and any easements and deed restrictions placed on the lots in the subdivision.

4. The two ponds that are incorporated in the common areas are also a part of the storm water system of the Town of Guilderland. The ponds accept the storm water off-flow from the streets and regulate out-flow into designated wetlands further downstream. These ponds are maintained by both the Association and the Town of Guilderland. The creation of the ponds was a prerequisite to the building development as a means of dealing with storm water run-off. Near the ponds is a plot of land owned by the Town of Guilderland upon which is located a pump station which services the public water supply for the development.

5. In response to petitioner's Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code ("IRC"), Form 1024, the Internal Revenue Service advised petitioner that in order for a homeowners' association to qualify, the organization is prohibited from conducting any activities related to the enforcement of private property maintenance. All documentation, such as by-laws and covenants, would have to be amended to eliminate any such references. The Internal Revenue Service suggested that, as an alternative to exemption under section 501(c)(4), petitioner could file Form 1120-H within the provisions of

IRC § 528. Section 528, entitled "Certain homeowners associations," exempts from taxable income amounts received as membership dues, fees or assessments from the owners of real property located in the subdivision covered by the association. Wanting to avoid the expense and trouble of amending its by-laws and covenants, petitioner opted to file as a homeowners' association with the Internal Revenue Service pursuant to section 528 of the Code.

6. For each of the years at issue, petitioner filed with the Division of Taxation ("Division") a General Business Corporation Franchise Tax Return, Form CT-4, indicating and remitting tax due of $366.00, $349.00 and $448.00 for the years 1994, 1995 and 1996, respectively. On December 31, 1997, petitioner filed three claims for credit or refund of corporation tax paid, Form CT-8, for the years 1994, 1995 and 1996 requesting refunds of $366.00, $481.84[1] and $448.00, respectively. The basis of the claims for refund is that petitioner is a not-for-profit corporation, effectively exempt from Federal taxation, and therefore is not subject to New York State corporation franchise taxes.

7. The Division denied petitioner's refund claims in a letter dated March 4, 1998. The Division explained that:

> it has consistently interpreted the dues collected by homeowners' associations for management of common property, as an "inurement of net earnings" benefitting their membership and therefore subjecting the associations to New York State (NYS) franchise tax.

The Division further explained that a homeowners' association, as that phrase is described in section 528 of the IRC, is included within the Federal definition of a corporation (IRC § 7701[a][3]), and thus is a corporation for New York State tax purposes. The letter concluded

[1]Petitioner's return for the year 1995 was filed late, subjecting petitioner to late penalty and interest, which brought its total payment to $481.84.

that petitioner must establish Federal tax-exempt status in order to be considered exempt from taxation for New York State purposes.

CONCLUSIONS OF LAW

A. Tax Law § 209(1) imposes a franchise tax on business corporations, as follows:

> [f]or the privilege of exercising its corporate franchise, or of doing business, or of employing capital, or of owning or leasing property in this state in a corporate or organized capacity, or of maintaining an office in this state, for all or any part of each of its fiscal or calendar years, every domestic or foreign corporation, except corporations specified in subdivision four of this section, shall annually pay a franchise tax, upon the basis of its entire net income base, or upon such other basis as may be applicable as hereinafter provided, for such fiscal or calendar year or part thereof, on a report which shall be filed . . . .

The term "corporation " is defined in section 208(1) of the Tax Law and section 7701(a)(3) of the Internal Revenue Code to include an association. Thus, a homeowners' association formed under the Not-For-Profit Corporation Law is a "corporation" that falls within the provisions of Tax Law § 208(1).

B. The Business Corporation Franchise Tax Regulations (20 NYCRR 1-3.4[b]) provide an exemption from tax for:

> (6) corporations organized other than for profit which do not have stock or shares or certificates for stock or for shares and which are operated on a nonprofit basis no part of the net earnings of which inures to the benefit of any officer, director, or member, including Not-For-Profit Corporations and Religious Corporations.

The issue to be decided in this matter is whether any of the net earnings of petitioner inure to the benefit of its members.

C. Petitioner's reliance on ***Rancho Santa Fe Association v. United States of America*** (589 F Supp 54, 84-2 US Tax Cas ¶ 9536) and ***Flat Top Lake Association, Inc. v. United States of America*** (868 F2d 108, 89-1 US Tax Cas ¶ 9180) is misplaced. Both cases involve a homeowners' association's request for tax-exempt status as a social welfare organization

pursuant to Internal Revenue Code § 501(c)(4). Section 501(c)(4) provides a tax exemption for "civic leagues or organizations not organized for profit, but operated exclusively for the promotion of social welfare . . . ." In an effort to determine the meaning of the term "social welfare," the Internal Revenue Service promulgated a regulation at 26 CFR 1.501(c)(4)-1 which defined a social welfare organization as one "primarily engaged in promoting in some way, the common good and general welfare of the community." The ***Rancho Santa Fe*** and ***Flat Top Lake*** cases turned on the question of whether the particular association constituted a "community" for section 501(c)(4) purposes. The issue of whether the income of the association inured to the benefit of any of its members was not addressed in either case. However, in reviewing the case law and the statute, it is determined that petitioner would not qualify for tax exempt status under Internal Revenue Code § 501(c)(4).

D. As previously mentioned, the courts' analysis of a homeowners' association request for tax-exempt status under IRC § 501(c)(4) centers on establishing a working definition of the term "social welfare." The Internal Revenue Service's regulation at 26 CFR 1.501 (c)(4)-1 attempted to clarify the term "social welfare" by insisting that the organization promote the general welfare of the "community." The court in ***Flat Top Lake*** was of the opinion that the regulation did little to clarify the meaning as "it merely substitutes one amorphous term (*i.e.* 'community') for another ('social welfare')" (***Flat Top Lake Association, Inc. v. United States of America***, ***supra***).

In 1972, the Internal Revenue Service recognized that "a neighborhood, precinct, subdivision, or housing development may constitute a community" for purposes of section 501(c)(4) (***see***, Rev Rul 72-102, 1972-1 CB 149). Due to the large number of claims for exemption filed by homeowners' associations following the issuance of this revenue ruling, the

Internal Revenue Service attempted to clarify its determination. In Rev Rul 74-99, 1974-1 CB 131, the Internal Revenue Service stated:

> A community within the meaning of section 501(c)(4) of the Code and the regulations is not simply an aggregation of homeowners bound together in a structured unit formed as an integral part of a plan for the development of a real estate subdivision and the sale and purchase of homes therein. Although an exact delineation of the boundaries of a "community" contemplated by section 501(c)(4) is not possible, the term as used in that section has traditionally been construed as having reference to a geographical unit bearing a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district thereof.

The Internal Revenue Service concluded in the revenue ruling that, to qualify for the section 501(c)(4) exemption, a homeowners' association (1) must serve a "community" which bears a reasonably, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit, (2) must not conduct activities directed to the exterior maintenance of any private residence and (3) the common areas or facilities that the homeowners' association owns and maintains must be for the use and enjoyment of the general public.

In 1976 Congress amended the IRC to create a tax exemption specifically for homeowners' associations (Tax Reform Act of 1976, Pub L 94-455, 90 US Stat 1520, § 2101.). Section 528 exempts from the taxable income of homeowners' associations amounts received as membership dues, fees or assessments from the owners of real property located in the subdivision covered by the association. Petitioner opted to file under section 528 instead of section 501(c)(4) because its by-laws and declaration provided for the Association to maintain the common areas and enforce the restrictions and covenants, provisions which the Internal Revenue Service advised petitioner would preclude its tax-exempt status under section 501(c)(4).

The ***Rancho Santa Fe*** case provides some guidance in determining whether a particular subdivision constitutes a "community" for purposes of the social welfare exemption. In that case

the association consisted of 3,000 members who owned 5,600 acres with the association owning an additional 600 acres outright. Of the 600 acres, 300 were used as parks and open space, 165 acres were improved as playgrounds, athletic fields, hiking trails and a community clubhouse and the remaining 135 acres comprised a golf course and tennis courts. All but the golf course and tennis courts were available to the general public on an unrestricted basis. The golf course and tennis courts were available to all members of the association and were available to the general public when it was using the inn located in Rancho Santa Fe. The homeowners' association oversaw the governance of the property within the development by enforcing the covenants and setting up various boards, including a planning board, a park board, a health board, a library board and a recreation board. It provided private security protection by way of the Rancho Santa Fe patrol. The association functioned as a liaison between the community and larger governmental entities on issues such as maintenance of the rights-of-way and the sanitation system. The association also served the community in loaning out its facilities free of charge to various public service organizations as well as to the schools.

The court concluded that Rancho Santa Fe as a community constituted an independent community within the meaning of section 501(c)(4). Significant to its decision was the size of the housing development, its independent location separated geographically from the central area of San Diego, of which it is a sub-part, the fact that it had its own post office and zip code, and the performance by the Rancho Santa Fe association of numerous governmental functions, including overseeing parks, athletic fields and a library. In contrast, the Weatherfield Association is only 48 single-family residences and the third phase of a larger 300 townhouse and single-family residence subdivision. It does not have its own post office or zip code, does not oversee parks, playgrounds and athletic fields or perform other governmental functions and

is not geographically separate from the Town of Guilderland or even phases I and II of the Weatherfield subdivision. It is the more typical and ordinary residential grouping of tract homes making up a portion of the larger subdivision of Weatherfield which is included in the Town of Guilderland. In short, it is not an independent community within the meaning and intent of section 501(c)(4) of the IRC, and would not qualify for the social welfare exemption provided by such section. IRC § 501(c)(4) also requires that no part of the net earnings of the entity inure to the benefit of any member, a requirement not met by petitioner, as will be discussed.

E. To be exempt under Business Corporation Franchise Tax Regulation 20 NYCRR 1-3.4(b)(6), a corporation must be organized other than for profit, not have stock or shares, be operated on a not-for-profit basis and have no part of the net earnings inure to the benefit of any member. It is the last of these stated requirements that the Division claims petitioner does not meet. In considering this issue it is important to note that the term "net earnings" includes more than the net profits of an organization as shown on its books or more than the difference between the gross receipts and disbursements (***Northwestern Municipal Assn., Inc. v. United States***, 99 F2d 460, 38-2 US Tax Cas ¶ 9564; ***Northwestern Jobbers' Credit Bureau v. Commissioner***, 37 F2d 880, 2 US Tax Cas ¶ 459). Where a corporation has multiple responsibilities, some of which benefit its members and some of which benefit the general public, the courts will consider which of its activities represent the main purpose of its activities and which are incidental thereto. If its main purpose is to benefit its members, it is not exempt. However, if benefit to the members is secondary and incidental, it is exempt (***Northwestern Municipal Assn., Inc. v. United States***, ***supra***; ***Retailers Credit Assn. v. Commissioner***, 90 F2d 47, 37-1 US Tax Cas ¶ 9291; ***Northwestern Jobbers' Credit Bureau v. Commissioner***, ***supra***; ***Crooks v. Kansas City Hay Dealers' Assn.***, 37 F2d 83).

It is the contention of petitioner that it is involved in several areas which benefit the general public. Petitioner claims that its common areas are used by the public for fishing and the trails in its wooded areas surrounding the development are used to access the forests beyond. Petitioner also claims that its maintenance of the ponds assists the storm water run-off system of the Town of Guilderland. However, these are not the main purposes for which the Association was formed and operates. The certificate of incorporation of the Association states that it was formed to provide for the maintenance, preservation and architectural control of the third phase of the Weatherfield subdivision and to promote the welfare of its residents. The number and specificity of the covenants and restrictions contained in the Declaration of Covenants, Easements and Restrictions indicate the high degree to which the Association exercises control over the development, including maintenance of the common areas. Enforcing the restrictions and maintaining the common areas are the main purposes for which petitioner was formed, and both of these activities directly benefit the Association's property owners. The upkeep of the common areas serves the purpose of preserving the aesthetic nature of the housing development for the use and enjoyment of each association member.

Although the common areas may be used by the general public, the term "common area" is defined in the by-laws of the Association as "undeveloped land owned by the Association and *reserved for the common use and enjoyment of the members (owners of lots in phase III of the subdivision) of the Association* (emphasis added). Neither the declaration nor the by-laws provide for the opening up of the common areas to the general public. Any use by the public of the common areas is incidental to the primary purpose of the Association to maintain and control the subdivision, including the common areas, through the covenants, restrictions and powers granted to it for the benefit of its members. The creation and maintenance of the ponds as part of

the storm water run-off system of the Town of Guilderland was a requirement imposed by the Town as a condition of building the subdivision and simply replaced the existing natural run-off system. The principal end to be achieved by the incorporators was to benefit the owners of the lots of the subdivision, and thus the earnings of petitioner inure to the benefit of its members.

The inurement of any of the earnings to a member constitutes an "inurement of net earnings" for the benefit of such individual (***People of God Community v. Commissioner of Internal Revenue***, 75 TC 127). The conclusion that the earnings of petitioner inured to the benefit of its members is supported by IRC § 528 (c)(1)(d), which defines the term "homeowners' association" and which provides that an association qualifies as a homeowners' association only if:

> no part of the net earnings of such organization inures (other than by acquiring, constructing, or providing management, maintenance, and care of association property, and other than by a rebate of excess membership dues, fees or assessments) to the benefit of any private shareholder or individual . . . .

The provision of management and the maintenance and care of association property constitute an "inurement of net earnings" of the Association to the benefit of its members. Therefore, petitioner does not qualify as a tax-exempt organization pursuant to 20 NYCRR 1-3.4(b) of the Business Corporation Franchise Tax Regulations, and is subject to the franchise tax imposed by Tax Law § 209(1).

F. The petition of Weatherfield Park III Homeowners' Association, Inc. is denied; and the Division of Taxation's refund denial of March 4, 1998 is sustained.

DATED: Troy, New York
February 01, 2001

/s Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE