INTERNAL REVENUE SERVICE

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MAY 27, 1999

Re:
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Legend:

X:
TIN:
Y:
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Z:
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Receiver:
State:
Date 1:
a:
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Dear :

This is in response to your letter of , , submitted on behalf of X and Y (the Associations), Z (a corporation) and Receiver. Those parties seek a ruling that their receipt of proceeds pursuant to the sale of residential and recreational property be treated as a nontaxable event for Federal income tax purposes.

The represented facts are as follows: The Associations are not-for-profit condominium owners associations under State law. The Associations file United States Corporate Income Tax Returns (Forms 1120) as membership organizations under § 277 of the Internal Revenue Code. The Associations have not elected to file United States Income Tax Return for Homeowners Associations

(Forms 1120-H) to be treated as exempt homeowners associations under § 528 of the Code. The respective membership of the Associations is comprised of all the unit owners in X and Y.

Each condominium unit owner purchased a separate "freehold estate" consisting of the area or space contained within, and including, the exterior walls, roof, and floor slab of the residential building structures. Each unit owner's purchase also included an undivided interest in the land and other common elements appurtenant to the units.

The Associations, with two other condominium associations, own Z, a qualified State not-for-profit corporation. Z, in turn, owns a acres of recreational property. The Associations, with the other condominium associations, directly own b acres of residential real estate. Each association has a percentage property interest in the recreational acreage and a corresponding percentage interest in the residential real estate. X owns c percent and Y owns d percent of the residential and recreational acreage. Under State law, the individual unit owners within the Associations own an undivided interest in the residential and recreational acreage based on the percentage of the residential and recreational acreage owned by that unit owner's condominium association.

On Date 1, a hurricane destroyed most of the condominium buildings and common area improvements within the Associations. The Associations' members voted not to rebuild the condominiums and to dissolve the Associations. The unit owners then vacated, and Receiver was appointed to collect insurance proceeds for the common area damage, demolish the remaining damaged structures and ready all the real property for sale. The planned dissolution also includes disposal of the recreational acreage.

Prior to the hurricane, the recreational acres had been leased on a long term lease to the Associations and other condominium associations by the developer. After the hurricane, in order to facilitate the sale of the entire parcel, the Associations together with the other associations voted to buy the recreation property from the developer and terminate the long term lease. The Associations and the other condominium associations formed Z for the sole purpose of purchasing the recreational acreage for the exclusive benefit of the individual unit owners. Z is wholly owned by the associations.

The Associations, Z and their Receiver represent that the title to the recreational property is held by Z as an agent for the exclusive benefit of the individual unit owners. Therefore, Z (a not-for profit corporation) holds only a nominal title to the recreation property and does not have an unrestricted use of the recreation property or any property proceeds. It is represented that, when the condominium associations purchased the recreation land and terminated the lease, each of the individual

unit owners effectually acquired an undivided interest in the newly acquired recreation common property under State law. Sale of the residential and recreational real property is pending.

Section 61(a) provides that, except as otherwise provided in Subtitle A, gross income means all income from whatever source derived.

Section 277(a) provides that 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 §§ 243, 244, and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which § 277 applies for the taxable year.

The character of amounts received as proceeds from a lawsuit or a settlement depends upon the nature of the claim and the actual basis for recovery. If the recovery represents damages for lost income or profits, it is taxable to the recipient as ordinary income. U.S. v. Burke, 504 U.S. 229, 112 S. Ct. 1867 (1992). If, however, the recovery is received as a replacement of capital, it is not taxable to the extent that it does not exceed the taxpayer's basis in the property. Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944); Freeman v. Commissioner, 33 T.C. 323, 327 (1959); Rev. Rul. 81-277, 1981-2 C.B. 14.

In Rev. Rul. 81-152, 1981-1 C.B. 433, a homeowners association instituted an action against the builder of a condominium development for damages arising from construction defects. The facts in Rev. Rul. 81-152 indicate that the funds recovered by the homeowners association in the action against the builder are recovered on behalf of the unit owners. Therefore, the revenue ruling concludes that the homeowners association receives the recovery as agent for the unit owners and, thus, the recovery represents a return of capital for each of the individual unit owners. Accordingly, the revenue ruling holds that the unit owners must reduce their bases in their property interests by their proportionate share of the recovery.

Similarly, in Rev. Rul. 75-370, 1975-2 C.B. 25, special assessments collected by a nonexempt condominium management corporation from its unit owner-stockholders and accumulated in a separate bank account for replacement of the roof and elevators in the condominium were held not to be includible in the corporation's gross income. Rev. Rul. 75-370 indicates that the corporation receives no benefit from the funds. The corporation also had the duty to expend the funds collected in the manner approved by its unit owner-stockholders. The relationship between the corporation and its unit-owner stockholders insofar as the special assessments are concerned is one of agent and principal.

State condominium law provides that condominium property includes an undivided interest in common elements, common surplus, lands, and leaseholds that are subjected to condominium ownership. State law also gives condominium associations the power to acquire title to property or otherwise hold, convey, lease, and mortgage association property for the use and benefit of its members. State law further provides that every instrument creating a condominium must include an undivided share in the common elements appurtenant to each unit stated as percentages or fractions, which, in the aggregate, must equal the whole.

In preparing the residential and recreational properties for sale, the Associations, Z and Receiver were acting as agents on behalf of the unit owners and received no benefit from the sales proceeds. The Associations, Z and Receiver have a duty as agents to distribute the proceeds collected from the sale of the recreation and residential properties to the unit owners.

Based upon the facts surrounding the case and the representations of the Associations, Z and Receiver, we hold that the receipt of proceeds related to the sale of the residential and recreational properties is not a taxable event to the Associations, Z or Receiver.

The Associations, Z and their Receiver should attach a copy of this letter to the respective Federal income tax returns for the year in which the residential and recreational properties are sold.

Except as ruled above, we express or imply no opinion concerning the federal tax consequences of this transactions under the cited provisions of the Code or any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited

as precedent.

In accordance with the Powers of Attorney on file with this office, a copy of this letter is being sent to the Associations, Z and Receiver.

Sincerely,

James C. Gibbons
Assistant to the Chief, Branch 7
Office of the Assistant Chief Counsel
(Passthroughs &and Special Industries)