G. SOCIAL WELFARE: WHAT DOES IT MEAN? HOW MUCH PRIVATE BENEFIT IS PERMISSIBLE? WHAT IS A COMMUNITY?

1. Introduction

IRC 501(c)(4) provides, in part, for the exemption from federal income taxation of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.[1] Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations states that an organization will be considered to be operated exclusively for social welfare purposes if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community, i.e. primarily for the purpose of bringing about civic betterments and social improvements. An organization is not operated exclusively for the promotion of social welfare within the meaning of section 501(c)(4) if its primary activity is carrying on a business with the general public in a manner similar to organizations that are operated for profit. Treas. Reg. Section 1.501(c)(4)-1(a)(2)(ii).

Organizations or civic leagues not organized for profit but operated exclusively for the promotion of social welfare were first exempted from federal income tax by the Revenue Act of 1913. The Committee Reports are deficient in offering any reasoning behind the inclusion of this particular exemption.

There is no official Congressional or Service pronouncement construing the terms "civic league" or "social welfare" as embodied in section 501(c)(4). However, In United States v. Pickwick Electric Membership Corp., 158 F. 2d 272 (6 Cir. 1946), the Court stated that a civic organization is described as embodying "the ideas of citizens of a community cooperating to promote the common good and general welfare of the community." In C.I.R. v. Lake Forest, Inc., 305 F. 2d 814 (4 Cir. 1962), the court described a civic organization as being "a movement of citizenry or the community," whereas the court in Erie Endowment v. United States, 316 F. 2d 151 (1963), while acknowledging the difficult task in arriving at a specific definition of "civic organization," stated that "the organization must be a community movement designed to accomplish community ends."

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[1] IRC 501(c)(4) also provides for exemption of local associations of employees. This topic, however, will focus only on the social welfare aspects of 501(c)(4).

Webster's New World Dictionary defines the term "social welfare" as "any service or activity designed to promote the welfare of the community and the individual, as through counseling services, health clinics, recreation halls and playgrounds ..." This definition is in alignment with the broad concept of "social welfare" as provided in section 1.501(c)(4)-(a)(2)(i) of the Income Tax Regulations. Additionally, the court in Commissioner v. Lake Forest, Inc., stated that "In short, 'social welfare' is the well-being of persons as a community."

The terms "civic organization" and "social welfare" appear to be defined by authorities in terms of "community", an equally evasive concept which will be discussed at length later in this article in the context of Homeowners' Associations. Because "social welfare" is a vague and elusive term, it has been broadly interpreted by the courts and the Service.

Organizations exempt under section 501(c)(4) are generally described in one of the following categories:

1. Nonprofit organizations that traditionally have been labeled in common parlance as social welfare organizations;

2. Organizations that may be performing some type of public or community benefit but whose principal feature is lack of any private benefit or profit;

3. Organizations that would qualify for exemption under section 501(c)(3) but for a defect in their organizational instruments or if they were not "action organizations."

Therefore, although social welfare generally denotes benefits to the community, beyond that there is disagreement as to a working definition of the term. In practice, section 501(c)(4) has been used by both the courts and the Service as a haven for organizations that lack the accepted essential characteristics of a taxable entity, but elude classification under other subparagraphs of 501(c).

2. Overlapping Relationship between Section 501(c)(4) and Other Tax Exempt Sections of the Code.

Because statutory history is lacking, with respect to the origins of section 501(c)(4), and statutory language is scant and couched in seemingly subjective terminology, the regulations' drafters and the courts have lacked clear guidance in

this area. The predictable result has been a lack of uniformity in judicial decisions that contributes to more confusion and still more lack of uniformity. As a result, judicial inconsistency becomes both the cause for and effect of confusion under IRC 501(c)(4).

The concepts of social welfare and community benefits are present, to some extent, in virtually all other subparagraphs of section 501(c), perhaps most notably in (c)(3), (c)(5), (c)(6), (c)(7), (c)(8), (c)(9), (c)(12), (c)(17), and (c)(21). Consequently, the opportunities for confusion under section 501(c)(4) are compounded by the apparent overlap among these provisions. This overlap is less evident or important where the language of the subparagraph is precise, as is the case with 501(c)(17), or where there are few benefits to be gained by preferring one exempting provision over another. For these reasons it is the 501(c)(3)/(c)(4) overlap that is the greatest source of difficulty for the Service. This conflict and a few of the other overlapping subparagraphs of 501(c) are discussed below.

a. Section 501(c)(3).

The concepts of "social welfare" under section 501(c)(4) and "charity" under section 501(c)(3) are not mutually exclusive. Section 1.501(c)(4)-1(a)(2) of the regulations states that a social welfare organization that meets the definition of "charitable" in section 1.501(c)(3)-1(a)(2) and is not an "action" organization can qualify for exemption under section 501(c)(3). Conversely, section 1.501(c)(3)-1(c)(3)(v) of the regulations states that an "action" organization may qualify for exemption under section 501(c)(4) where it otherwise qualifies under section 501(c)(3). As a general rule, all organizations exempt under section 501(c)(3) could also qualify under section 501(c)(4), though the reverse is not true.[2] See Rev. Rul. 80-108, 1980-16 IRB 8, where the Service ruled that an organization that otherwise qualifies for exemption under both section 501(c)(3) and 501(c)(4) but fails to file notice required by section 508(a) within the requisite 15 month period, may apply for and obtain exemption under section 501(c)(4) from the date of its formation to the date its exemption under section 501(c)(3) becomes effective. The effect of these rulings is to point out the nexus between "social welfare" and "charitable". The Service in Rev. Rul. 74-361, 1974-2 C.B. 159 recognized that an organization organized and operated to provide fire, ambulance, and rescue

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[2] See section 504. The regulations are in the process of being revised as part of 501(h) and 4911 regulations project.

services to a community qualifies for exemption as a charitable organization.[3] However, the Service also stated that:

> Because the activities of this organization may also be regarded as promoting the common good and general welfare of the community, the organization could have applied for and received a ruling recognizing its exemption from Federal income tax as a social welfare organization described in section 501(c)(4) of the Code.[4]

One of the major distinctions between section 501(c)(3) and 501(c)(4) organizations is the amount of activity that may be devoted to nonexempt purposes. The regulations under IRC 501(c)(3) provide that an organization will be regarded as operated "exclusively" for one or more exempt purposes only if it engages "primarily" in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). Section 1.501(c)(3)-1(c)(1). (It is important to recognize that activities and purposes are two different things, but that activities may well be indicative of purposes.) An organization is not so operated if more than an "insubstantial" part of the activities is not in furtherance of an exempt purpose. As the Supreme Court put it in Better Business Bureau v. United States, 326 U.S. 279, 66 S. Ct. 112, 90 L. Ed. 67 "...the presence of a single [non-charitable] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [charitable] purposes."

For example, the regulations under section 501(c)(3) contain a prohibition against substantially engaging in legislative activities. No similar type of provision

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[3] See also Monterey Public Parking Corp. v. United States, 321 F. Supp. 972, 975 (N.D. Cal. 1970), where the court stated that "... the distinction between [section 501(c)(3) and section 501(c)(4)] is more apparent than real."

[4] Compare this ruling with Rev. Rul. 66-179, 1966-1 C.B. 139, which holds that slight differences in operation could cause essentially similar organizations to fall into different categories of exemption. Rev. Rul. 74-361 was probably the first instance where the Service publicly conceded that the subparagraphs of 501(c) are not necessarily mutually exclusive.

is contained in section 501(c)(4), and a 501(c)(4) organization may engage in germane legislative activities as its sole activity. See Rev. Rul. 67-293, 1967-2 C.B. 185, and discussion in 1978 EOATRI Textbook. Neither does the statute expressly prohibit participation in political campaigns on behalf of a candidate, as does section 501(c)(3). Section 1.501(c)(4)-1(a)(2)(ii). However, the regulations under section 501(c)(4) do state that:

> "An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the community ... The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club ... or is carrying on a business with the general public in a manner similar to organizations which are operated for profit." (Emphasis added) Section 1.501(c)(4)-1(a)(ii) of the regulations.

It can therefore be argued that the "primary" test, as employed in section 501(c)(4), may permit an organization lawfully to participate or intervene in political campaigns on behalf of or in opposition to campaigns for public office so long as its primary activities remain the promotion of social welfare. See Rev. Rul. 67-293, 1967-2 C.B. 185. See, generally, the section on Lobbying and Political Activities in this issue and 1980 EOATRI topic on political activities.

An organization exempt under section 501(c)(4) may often be presumed to have compromised. That is, such an organization may have settled for the somewhat less favorable status of 501(c)(4) as opposed to 501(c)(3) (lack of deductible contributions and reduced postage rates) in return for the somewhat greater freedom of action that 501(c)(4) status affords.

However, an organization formed prior to October 9, 1969, cannot avoid classification as a private foundation subject to Chapter 42 excise taxes by applying for exemption under section 501(c)(4). Such organizations are not subject to the section 508(a) notice and application requirement for exempt status under section 501(c)(3). Therefore, under section 509, pre-1969 organizations, not within any of the statutorily excepted classes of organizations, could be exempt under

section 501(c)(3) even if they had not made application under that section so long as they are literally described under section 501(c)(3). The private foundation rules under section 509 would then apply.[5] See Rev. Rul. 73-504, 1973-2 C.B. 190.

Despite some amount of overlapping between sections 501(c)(3) and (c)(4), there are substantial distinctions between the two subsections. Section 501(c)(4) contains no provision requiring that organizations meet the organizational tests similar to the ones contained in section 501(c)(3) for proper purposes or dissolution clauses.

The Service has attempted to argue, albeit unsuccessfully, that the distribution by a 501(c)(4) organization of its assets to its members upon dissolution would constitute a form of inurement or private benefit which would defeat exempt status. See Mill Lane Club, Inc., 23 T.C. 433 (1954), acq. C.B. 1955-1, 5. This contention is based on the concept that an irrevocable dedication of assets to public purposes is as much an essential element of social welfare in 501(c)(4) as it is for charitable property in 501(c)(3).

The courts have for the most part rejected this argument because the dissolution of social welfare groups is largely dictated by state law relating to dissolution of membership organizations. But see Consumer - Farmer Milk Cooperative, Inc. 13 T.C. 150 (1949), aff'd 186 F. 2d 68 (2d Cir. 1950), cert. den. 341 U.S. 931 (1951) where one of the grounds cited by the Tax Court in denying exemption under 501(c)(4) was that on dissolution any surplus could be distributed to its members.

Although distribution of its assets to members upon dissolution by a 501(c)(4) organization may in some instances be a form of inurement, absent legislative action in this area, it may be permissible.

The most important tax difference between classification as a section 501(c)(4) and a section 501(c)(3) organization is that contributions to section

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[5] There is a question concerning whether organizations other than trusts formed after October 9, 1969, that could clearly qualify under 501(c)(3) could avoid private foundation classification by applying for exemption under section 501(c)(4). The Service has not yet answered this question.

501(c)(4) organizations are not deductible under 170(c).[6] An exception is that they are deductible when the contributions are deemed to be for the use of a political subdivision for exclusively public purposes. See section 170(c)(1) and Rev. Rul. 71-47, 1971-1 C.B. 92.

The principal advantage to classification as a social welfare organization, where the issue of deductibility of charitable contributions, lower postal rates, and liability for FICA or FUTA taxes are not at issue, is that such organizations are not held to the strict standards required of charitable organizations under section 501(c)(3). For example, a lobbying organization may not wish to be held to 501(c)(3) restrictions, even with the liberalized provisions under 501(h) and 4911. Before 1970 exemption under section 501(c)(4) presented an additional attraction: the unrelated business income tax rules did not apply.[7]

b. Section 501(c)(6):

Section 501(c)(6) of the Code exempts:

> Business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(6) of the Regulations provides in part that:

> A business league is an association of persons having some business interest the purposes of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.

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[6] Contributions could be deductible under section 162. See EOATRI 1978 section on Lobbying and 501(c)(4)'s.

[7] This advantage was not necessarily significant since it was interpreted as meaning that 501(c)(4) organizations would not engage in a substantial amount of unrelated business activity.

> It is an organization of the same general class as a member of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.

There are substantial differences between the requirements for achieving exemption under section 501(c)(4) and 501(c)(6). There are fundamental philosophical distinctions between the two subparagraphs. Section 501(c)(4) organizations have essentially altrustic motivations while 501(c)(6) organizations are usually formed by businessmen to improve their own financial situations. Where an organization benefits individual members or the community as a whole, it will not be exempt under section 501(c)(6) since its activities will not further any common business interest. In Rev. Rul. 74-308, 1974-2 C.B. 168, an organization was denied exemption under section 501(c)(6) where it operated a referral service. The organization was viewed as performing particular services for individual persons by providing, as a convenience to the businesses and persons listed, clients who would pay for the services performed.

Additionally, a 501(c)(6) organization is typically funded through membership dues whereas a 501(c)(4) organization generally receives its support from public sources. Although these types of support typify these organizations, they bear no direct relationship to the qualification for exemption under each provision.

c. Section 501(c)(7)

Section 501(c)(7) provides that a club organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes is exempt from federal income tax, provided no part of its net earnings inures to the benefit of any private shareholder.

Rev. Rul. 66-179, 1966-1 C.B. 139, discusses the various subsections of the Code under which garden clubs may qualify for exemption. The ruling states that under certain circumstances organizations, including but not limited to garden clubs, may be exempt under section 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(7). In comparing sections 501(c)(4) and 501(c)(7) the principal distinguishing factor appears to be the extent to which an organization engages in social activities for its

members. In section 501(c)(4) an organization must serve community interests while, by definition, an organization exempt under 501(c)(7) serves the private interests of its members. The ruling states that, "In general, social activities for the benefit, pleasure, and recreation of members do not preclude exemption under section 501(c)(4) of the Code." However, section 1.501(c)(4)-1(a)(2)(ii) of the regulations provides that an organization will not qualify for exemption as a civic organization described in section 501(c)(4) of the Code if its primary activity is the operation of a social club. Community Women's Clubs are good examples of the types of entities which engage in some social activities but are primarily engaged in social welfare or charitable activities. Many such clubs can be recognized as exempt under section 501(c)(4).

However, in certain instances an organization more appropriately described under section 501(c)(7) may apply for exemption under 501(c)(4) to escape the restrictive provisions under section 512(a)(3). Where a 501(c)(7) organization derives income from nonmember sources, such amounts are taxed as unrelated business income (unless they are set aside for 170(c)(4) purposes.) However, funds from nonmember sources will not be subject to UBIT where those funds are substantially related to a 501(c)(4)'s exempt purposes. The existence of these special taxing provisions under 512(a)(3) makes it all the more important to assure that these organizations are appropriately categorized.

Rev. Rul. 66-179

Situations under which garden clubs may qualify for exemption from Federal income tax under section 501 of the Internal Revenue Code of 1954.

Depending upon its form of organization and method of operation an organization commonly referred to as a "garden club" may qualify for exemption from Federal income tax as a charitable or educational organization described in section 501(c)(3) of the Internal Revenue Code of 1954, a civic organization described in section 501(c)(4), a horticultural organization described in section 501(c)(5), or a social club described in section 501(c)(7) of the Code. The proper classifications for exemption are illustrated by the four situations set out below.

Situation 1.--Garden club qualifying under section 501(c)(3) of the Code.

The organization was incorporated as a nonprofit organization for the purposes of instructing the public on horticultural subjects and stimulating interest in the beautification of the geographic area. In furtherance of these purposes, the organization (1) maintains and operates a free library of materials on horticulture and allied subjects, (2) instructs the public on correct gardening procedures and conservation of trees and plants by means of radio, television, and lecture programs, (3) holds public flower shows of a noncommercial nature at which new varieties of plants and flowers are exhibited, (4) makes awards to children for achievements in gardening, (5) encourages roadside beautification and civic planting, and (6) makes awards for civic achievement in conservation and horticulture.

Membership in the organization is open to the public and consists primarily of amateur gardeners and others not professionally or commercially connected with horticulture. The organization's funds are derived from donations and membership dues, fees, and assessments. No part of its net earnings inures to the benefit of any officer or member.

Section 501(c)(3) of the Code provides that an organization organized and operated exclusively for charitable or educational purposes is exempt from Federal income tax, provided no part of its net earnings inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations defines the term "charitable" to include the advancement of education and the promotion of social welfare by organization designed to combat community deterioration.

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term "educational" as relating to (a) the instruction or training of the individual for the purpose of improving or developing his capabilities or (b) the instruction of the public on subjects useful to the individual and beneficial to the community. An example in this section states that an organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs, may be an educational organization.

This organization is organized and, in carrying out its purposes in the manner described above, is operated exclusively for charitable and educational purposes. Accordingly, the organization qualifies for exemption under section 501(c)(3) of the Code.

Situation 2.--Garden club qualifying under section 501(c)(4) of the Code.

The facts are the same as in Situation 1 except that a substantial part of the organization's activities, but not its primary activity, consists of social functions for the benefit, pleasure, and recreation of its members.

Section 501(c)(4) of the Code provides that a civic organization not organized for profit but operated exclusively for the promotion of social welfare is exempt from Federal income tax.

Section 1.501(c)(4)-1 of the regulations states that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated to bring about civic betterment and social improvements.

In general, social activities for the benefit, pleasure, and recreation of members do not preclude exemption under section 501(c)(4) of the Code. However, section 1.501(c)(4)-1(a)(2)(ii) of the regulations provides that an organization will not qualify for exemption as a civic organization described in section 501(c)(4) of the Code if its primary activity is the operation of a social club.

The facts in this Situation are distinguishable from those in Situation 1 in that the instant organization conducts substantial social functions not in furtherance of any of the purposes specified in section 501(c)(3) of the Code. Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will not be regarded as "operated exclusively" for one or more exempt purposes described in section 501(c)(3) of the Code if more than an insubstantial part of its activities is not in furtherance of a 501(c)(3) purpose. Accordingly, the organization does not qualify for exemption under section 501(c)(3) of the Code.

However this organization, in carrying out its purposes in the manner described above, is being operated primarily to bring about civic betterment and social improvements. The social functions for the benefit, pleasure, and recreation of the members do not constitute its primary activity. Accordingly, the organization qualifies for exemption under section 501(c)(4) of the Code.

Situation 3.--Garden club qualifying under section 501(c)(5) of the Code.

This organization was incorporated as a nonprofit organization for the purposes of bettering the conditions of persons engaged in horticultural pursuits and improving the grade of their products. In furtherance of these purposes, the organization (1) publishes a monthly trade journal, (2) reports periodically to its members any new developments in horticultural products, and (3) encourages the development of better horticultural products through a system of awards. The membership of the organization is mainly composed of individuals and firms engaged in the business of horticulture and related fields. No part of its net earnings inures to the benefit of any officer or member.

Section 501(c)(5) of the Code provides that a horticultural organization is exempt from Federal income tax.

Section 1.501(c)(5)-1 of the regulations provides that organizations contemplated by section 501(c)(5) of the Code are those which have no net earnings inuring to the benefit of any member, and have as their objectives the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

This organization, in carrying out its purposes in the manner described above, is being operated to improve the conditions of its members and the grade of their products and to develop a higher degree of efficiency in their occupations. Accordingly, the organization qualifies for exemption under section 501(c)(5) of the Code.

Situation 4.--Garden club qualifying under section 501(c)(7) of the Code.

The organization was incorporated by amateur gardeners to promote their common interest in gardening. The organization (1) holds flower shows and exhibits to display members' achievements in home gardening, (2) schedules weekly meetings devoted primarily to informal social hours during which matters related to gardening are discussed, and (3) issues a publication containing news about members' social activities and achievements in home gardening. Its funds are derived from membership dues, fees, and assessments. No part of the net earnings of the organization inures to the benefit of any officer or member.

> Section 501(c)(7) of the Code provides that a club organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes is exempt from Federal income tax, provided no part of its net earnings inures to the benefit of any private shareholder.
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> This organization, in carrying out its purposes in the manner described above, is being operated exclusively for pleasure and recreation of its members. Accordingly, it qualifies for exemption under section 501(c)(7) of the Code.

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3. Private Benefit v. Community Benefit

a. In General

In determining whether an organization is properly described as operated for "social welfare" purposes, the crucial factors to consider are the type of benefits provided and the class of eligible recipients. Although the regulations do not specifically prohibit private benefit or inurement, such a prohibition is a logical extension of the general requirement that social welfare is for the benefit of the general community as a whole and that 501(c)(4) organizations must be operated exclusively to promote social welfare.

Certain social welfare organizations serve only the community as a whole (pure public benefit) while others benefit a particular group of people but still primarily serve community interests. In instances where an organization limits its benefits to members, the organization is generally considered not to be operated for social welfare purposes. However, this presumption (inference) may be overcome.

There are a number of published rulings illustrative of the distinction between organizations that serve the community and those that serve only their members or some other restricted class.

In Rev. Rul. 78-69, 1978-1 C.B. 156, the Service concludes that providing rush-hour bus service to members of the general public on a "first-come, first-served" basis constitutes a social welfare activity where all passengers are charged the same rate. The ruling concludes that providing to all members of the community on an equal basis a useful service that is not commercially available and is subsidized by governmental financial assistance is a 501(c)(4) activity. See

also Rev. Rul. 78-429, 1978-2 C.B. 178, where an organization was found to be exempt under section 501(c)(4) because it met a community need by operating an airport not otherwise available to the rural communities of the area. The organizations in both rulings were viewed as responsive to the needs of the community through the supervision and control exercised by the citizenry. However, see Rev. Rul. 55-311, 1955-1 C.B. 72, where providing bus service for a local association of employees, the membership of which is limited to employees of a particular corporation, is not a social welfare activity.

Also illustrative of the distinction between "pure" public benefit and private benefit is a comparison between Rev. Rul. 54-394, 1954-2 C.B. 131 which concludes that an organization is not exempt under section 501(c)(4) where it provides television reception on a cooperative basis and Rev. Rul. 62-167, 1962-2 C.B. 142 in which an organization retransmitting television signals for the benefit of the entire community qualifies as a social welfare organization.

These rulings represent the more obvious conclusions concerning exemption as social welfare organizations. Those organizations that enable all persons in the vacinity in which they operate to avail themselves of their services will generally qualify for exemption. However, where an organization restricts its services to fee-paying members, social welfare intent may not be present. See also Rev. Rul. 80-206, I.R.B. 1980-31, 11, which states that an organization formed to promote the legal rights of all tenants in a particular community qualifies as a social welfare organization. Compare Rev. Rul. 73-306, 1973-2 C.B. 179, which denies exemption to a similar organization formed to protect the rights of tenants in one particular rental complex.

Also indicative of the prevailing view of the Service is Rev. Rul. 66-148, 1966-1 C.B. 143, which provides that an organization formed to establish and maintain a system for the storage and distribution of water is exempt under section 501(c)(4). Although it was a membership organization, its activities resulted in an increase in the level of underground water, which benefited the entire community, irrespective of membership.

Therefore, where the services furnished by an organization are beneficial to the community and available to all members of the community on an equal basis, irrespective of membership, a social welfare objective will generally be found to exist. However, where an organization limits its services and benefits to its members, the organization is not ordinarily operated exclusively for the promotion of social welfare within the meaning of section 501(c)(4). For example, in New

York State Association of Real Estate Boards Group Insurance Fund, 54 T.C. 1325 (1970), the Tax Court concluded that an organization offering group life insurance to members of a real estate association lacks "the requisite civic concern to constitute social welfare."

The problem of private benefit appears to be prevalent in the area of cooperative service arrangements. In Rev. Rul. 73-349, 1973-2 C.B. 179, exemption was denied to a self help cooperative organization that engaged in quantity food purchasing activities to achieve the lowest possible prices for its members. In denying exemption as a social welfare organization, the Service stressed that the organization was formed and operated for the economic benefit or convenience of its members, thus lacking the necessary elements embodied in section 501(c)(4). In Rev. Rul. 78-132, 1978-1 C.B. 157 the Service once again denied exemption under section 501(c)(4) based upon the rationale and principles employed in Rev. Rul. 73-349. The Service ruled that a cooperative formed to organize the exchange of personal services among its members only incidentally benefited the community as a whole while primarily benefiting its individual members.

In Contracting Plumbers Cooperative Restoration Corp. v. United States, 72-2 U.S.T.C. Paragraph 9731 (E.D.N.Y. 1972), reversed 488 F. 2d 684 (2nd Cir. 1974), the court considered the issue of whether an organization whose purpose was to insure the efficient repair of "cuts" in city streets resulting from its members plumbing activities for which they were liable was exempt as both a "civic organization" under section 501(c)(4) and a "business league" under section 501(c)(6). In reversing the lower court's determination and denying exemption under both Code sections the Circuit Court focused on four factors that demonstrated the substantial private benefit present. The fact that each member enjoyed substantial economic benefits precisely to the extent that the organization's restoration services were used and paid for by the member was viewed by the court as a strong indication of private benefit.

An opposite result was reached in Rev. Rul. 79-316, 1979-2 C.B. 228, where the Service found that a membership organization formed to prevent and to clean up oil spills within a port city area qualified for exemption as a social welfare organization. The organization, like the one in Contracting Plumbers, was required under state law to clean up spills of all but identified nonmembers. The organization, however, unlike the one in Contracting Plumbers cleaned up the spills of members and nonmembers on an equal basis and for a fee equal to the cost of labor, supplies, and equipment used in the cleanup. The equal availability of

services to members and non-members alike established that the organization's activities only incidentally benefited its members.

An organization seeking exemption under section 501(c)(4) may place restrictions on the availability of its benefits, but only when those restrictions are functionally related to its exempt purpose. An example might be where an organization restricts its benefits to individuals comprising a recognized charitable class. A problem arises when the restrictions imposed bear no relationship to the fulfillment of the organization's social welfare aspirations.

Where an organization limits benefits to its members, one must carefully scrutinize all the surrounding facts and circumstances. A social welfare organization necessarily benefits private individuals in the process of benefiting the community as a whole; however, even when benefits are confined to a particular group of individuals the general community may derive substantial benefit. Similarly, an organization that benefits a large number of people will not necessarily be organized for social welfare purposes within the meaning of section 501(c)(4) of the Code. This is illustrative of the theory that raw numbers are not necessarily determinative of social welfare objectives. The court in C.I.R. v. Lake Forest, Inc. stated that:

> Size of membership in ratio to local population is not controlling on whether an organization is "civic" or "social." The number affected is not the criterion. A private project may touch an appreciable segment of the people or a large physical area and yet, for want of of the considerations mentioned, not be converted into a civic or social undertaking. Classification as "civic" or "social" depends upon the character - as public or private - of the benefits bestowed, of the beneficiary, and of the benefactor.

The issue to be resolved then is whether the organization's activities result in so much private benefit as to preclude it from qualifying as a social welfare organization. The test in resolving this question with respect to exemption under section 501(c)(4) is "primarily", which, as used in the regulation, means that some amount of private benefit may be permissible so long as the organization's activities remain "primarily" social welfare.

In Rev. Rul. 57-297, 1957-2 C.B. 307, the Service ruled that an organization formed to secure positions of employment for its members qualified for exemption under section 501(c)(4) but not under 501(c)(3).[8] Membership was limited to persons over a stated age who formerly held positions of administrative responsibility. The ruling offers no explanation with respect to the Service's finding regarding the issue under section 501(c)(4). This ruling may be contrary to the spirit and legal precedents in the area of social welfare organizations. See Consumer-Farmer Milk Cooperative, supra, and Contracting Plumbers Cooperative Restoration Corporation, supra. The organization's activities approximate those of a commercial employment agency and clearly substantial benefit its members. Any benefit to the community appears to be insignificant. Rev. Rul. 57-297 appears to be in conflict with current Service position. The Service is presently considering its position in this area.

The Service, in Rev. Rul. 78-86, 1978-1 C.B. 152, has refused to acquiesce in the decision rendered in Monterey Public Parking Corporation v. United States, 481 F. 2d 175 (9th Cir. 1973), affirming the decision of the District Court for the Northern District of California, 321 F. Supp. 972 (N.D. Cal. 1970) in which a corporation formed to provide a downtown parking facility in Monterey was found to qualify for exemption from federal income tax under section 501(c)(3) and 501(c)(4) of the Code. The corporation was formed by merchants to alleviate a lack of parking space in the central business district of Monterey. The participating merchants established a validation stamp system to provide parking to its customers at a reduced rate. The government asserted that the primary purpose of the corporation was to encourage public patronization of those businesses participating in the parking validation stamp system. This fact, it argued, evidenced a direct private benefit to the participating merchants. The Court agreed that the organizer/merchants were benefited but found such benefits indistinguishable from the benefits accorded to the community as a whole. The court expressed its belief that any increase in profits by the organizer/merchants attributable to the new parking system was a benefit shared equally by all the merchants in the downtown area of Monterey. However, where a similar type of organization provides free parking to all patrons in a business area without aid of a validation stamp system,

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[8] Exemption was denied under 501(c)(3) because the organization was viewed as serving private interests by primarily operating an employment service and providing employment and business opportunities for its members

the question of private benefit may not be at issue. See Rev. Rul. 69-90, 1969-1 C.B. 63 which only addressed the question of deductibility under section 170 of the Code. The Service is currently considering the issue concerning exemption under section 501(c)(4).

The courts once again, in Eden Hall Farm v. United States, 389 F. Supp. 858 (W.D. Pa 1975), utilized a broader interpretation of the term "social welfare" than did the Service. In Eden Hall, the district court found an organization to qualify for exemption under section 501(c)(4) where it provided recreational facilities to the employees of selected corporations. The Service argued unsuccessfully that by restricting its facilities on a broader basis than that required to fulfill its social welfare objectives, the organization was operating for the benefit of selected private groups rather than primarily benefiting the common good and general welfare of the community.

In disposing of the Service's objections, the court in Eden Hall noted that although the organization had apparently been established as a recreation center for women employees of the Heinz Company, there was "no evidence of domination, control or management by the Heinz Company." The court, in finding the restrictive access policy not damaging to the issue of exemption, stated that:

> It is apparent from the evidence that the invitational process was used as a mechanism or device to extend the use of the facilities to groups who were screened in the first instance by virtue of employment, and, secondly, apparently employment at specific neighboring companies and institutions whose employment practices were known to the trustees and whose employment practices met with the approval of the trustees.

Although the government argued that Eden Hall served private interests, the court found it served a broad community need:

> Considering all of the evidence, Eden Hall Farm is an institution which has served a broad community need in the sense that Congress intended, that is, that when one segment or slice of the community, in this case thousands of working women of the Pittsburgh and Allegheny County area, are served, then the community as a whole benefits.

The Service in Rev. Rul. 80-205, 1980-31, I.R.B. 10 has stated its intention not to follow Eden Hall Farm. It stated that "there is no requirement that a section 501(c)(4) organization provide equal benefits to every member of the community," because certain limitations on the equal availability of benefits are "inherent in the activities that are undertaken to promote social welfare... In [Eden Hall], however, the organization imposed limitations on the use of its facility other than those that were inherent in the nature of the facility. By restricting use of the facility to employees of selected corporations and their guests, the organization is primarily benefiting a private group rather than primarily benefiting the common good and general welfare of the community." We believe the rationale of Rev. Rul. 80-205 may be the most accurate summation to date of Service philosophy with regard to 501(c)(4) status for organizations that necessarily limit their facilities and benefits to less than an entire community.

b. Homeowners' Associations/A Definition of "Community"

Where benefits are limited to its members, an organization must demonstrate clearly that making its services available only to a particular group benefits the community as a whole in order for the organization to be exempt under Section 501(c)(4). The leading case in the area of homeowners' associations is Commissioner v. Lake Forest, Inc., 305 F. 2d 814 (1962), which arose under the predecessor to section 501(c)(4). The case involved a nonprofit membership housing cooperative that provided low cost housing to its members. In denying exemption, the court stated that the organization was not organized exclusively for the promotion of social welfare because, although its activities were available to all citizens eligible for membership, "its contribution is neither to the public at large nor of a public character." The court looked to the benefits provided and not to the number of persons who received benefits through membership. Compare the decision in Lake Forest with that in Garden Homes Co. v. Commissioner, 64 F. 2d 593 (7th Cir. 1933), which held that a housing project formed and controlled by the local government qualified for exemption.

The position of the Internal Revenue Service with respect to exemption under section 501(c)(4) for homeowners' associations is contained in a number of revenue rulings. The principal nonqualifying factor is the private benefit that appears to be inherent in the basic nature and composition of these types of organizations.

In Rev. Rul. 69-280, 1969-1 C.B. 152, the Service held that an organization formed to provide maintenance of exterior walls and roofs of homeowner members in a development is not exempt as a social welfare organization. In denying exemption under Section 501(c)(4), the Service noted a similarity of facts and circumstances as those present in Lake Forest, Inc. The Service viewed this type of organization as lacking the essential ingredients for 501(c)(4) exemption by operating for the economic benefit or convenience of its members.

The Service then issued Rev. Rul. 72-102, 1972-1 C.B. 149 which appeared, at first blush, to provide homeowners' associations with guidance by enumerating tangible standards upon which exemption would be based. The Service, here, considered whether a finding of exemption could be sustained for a homeowners' association formed by a developer to administer and enforce covenants for preserving the architecture and appearance of a housing development, and to own and maintain common green areas, streets and sidewalks for the use of the development residents. The organization was supported by membership dues and assessments with membership required of all homeowners. The Service noted that "For the purposes of section 501(c)(4) of the Code, a neighborhood precinct, subdivision or housing development may constitute a community." Although the Service recognized that there existed some amount of private benefit to the developer and individual residents, it was labeled as being incidental to the benefit provided to the community as a whole. In granting exemption the Service distinguished its ruling in Rev. Rul. 69-280 because that organization was operated primarily and directly for the benefit of individual members.

In Rev. Rul. 74-17, 1974-1 C.B. 130 the Service distinguished its treatment of homeowners' associations, as reflected in Rev. Rul. 72-102, from condominium associations. In denying exemption, the Service noted that the substantial distinction existing between the legal nature and structure of homeowners' associations and condominium associations justifies different treatment, on issues of exemption. Although similar services are provided by the two types of associations, the revenue ruling noted that:

> "By virtue of the essential nature and structure of a condominium system of ownership, the rights, duties, privileges, and immunities of the members of an association of unit owners in a condominium property derive from and are established by, statutory and contractual provisions and are inextricably and compulsorily tied to the owner's acquisition and

> enjoyment of his property in the condominium. In addition, condominium ownership necessarily involves ownership in common by all condominium unit owners of a great many so-called common areas, the maintenance and care of which necessarily constitutes the provision of private benefits for the unit owners."

With the publication of Rev. Rul. 72-102, it became apparent that the vague concept of "social welfare" was being defined in terms of an equally uncertain term, "community." Rev. Rul. 72-102 was apparently misconstrued by homeowners' associations as applying to associations with membership restricted to housing developments. The original intent of the Service, to provide clarification to an otherwise clouded area of exemption, was apparently not served by the issuance of Rev. Rul. 72-102.

Following its unsuccessful efforts, to clarify this problem the Service published Rev. Rul. 74-99, 1974-1, C.B. 131, to modify Rev. Rul. 72-102. This new ruling provided that a homeowners' association, to qualify for exemption under section 501(c)(4), (1) must serve a "community" which bears a reasonably recognizable relationship to an area ordinarily identified as governmental; (2) must not conduct activities directed to the exterior maintenance of private residences, and (3) the common areas or facilities it owns and maintains must be for the use and enjoyment of the general public. The ruling indicates that an association of homeowners that enforces covenants and owns and maintains common areas and streets is presumed to be organized and operated primarily for the benefit of its members, unless it overcomes this "prima facie" presumption by satisfying the three preceding elements.

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26 CFR 1.501(c)(4)-1: Civic organizations and local associations of employees. (Also Section 170; 1.170-2.)

A nonprofit organization formed to preserve the appearance of a housing development and to maintain streets, sidewalks, and common areas for use of the residents is exempt under section 501(c)(4); however, contributions to the organization are not deductible under section 170 of the Code; Revenue Ruling 69-280 distinguished.

Rev. Rul. 72-102

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(4) of the Internal Revenue Code of 1954.

The organization is a membership organization that was formed by a developer and is operated to administer and enforce covenants for preserving the architecture and appearance of a housing development, and to own and maintain common green areas, streets, and sidewalks for the use of all development residents. Prospective home buyers are advised that membership in the organization is required of all owners of real property within the housing development. The organization is supported by annual assessments and member contributions. Its activities are for the common benefit of the whole development rather than for individual residents or the developer.

Section 501(c)(4) of the Code provides for exemption from Federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

For the purposes of section 501(c)(4) of the Code, a neighborhood, precinct, subdivision, or housing development may constitute a community. For example, exempt civic leagues in urban areas have traditionally represented neighborhoods or other subparts of much larger political units. By administering and enforcing covenants, and owning and maintaining certain non-residential, non-commercial properties of the type normally owned and maintained by municipal governments, this organization is serving the common good and the general welfare of the people of the entire development. Even though the organization was established by the developer and its existence may have aided him in selling housing units, any benefits to the developer are merely incidental. Also, even though the activities of the organization serve to preserve and protect property values in the community, these benefits that accrue to the property owner-members are likewise incidental to the goal to which the organization's activities

are directed, the common good of the community. Therefore, it is held that the organization is exempt from Federal income tax under section 501(c)(4) of the Code. Contributions to it are not deductible by donors under the provisions of section 170(c)(2) of the Code.

Revenue Ruling 69-280, C.B. 1969-1, 152, which holds that a non-profit organization formed to provide maintenance of exterior walls and roofs of members' homes in a development is not exempt under section 501(c)(4) of the Code, is distinguished because that organization was operated primarily and directly for the benefit of individual members rather than for the community as a whole.

Rev. Rul. 74-99 specifically expands and clarifies the definition of "community" contained in Rev. Rul. 72-102. It states that a "community 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..." The ruling continues by stating that although an exact definition of the parameters of a "community" is not possible, "the term as used in [section 501(c)(4)] 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." There is no minimum size.

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26 CFR 1.501(c)(4)-1: Civic organizations and local associations of employees.

Homeowners association, preserving appearance and maintaining common areas. A homeowners association, to qualify for exemption under section 501(c)(4) of the Code, (1) must serve a "community" which bears a reasonable recognizable relationship to an area ordinarily identified as governmental, (2) it must not conduct activities directed to the exterior maintenance of private residences, and (3) the common areas or facilities it owns and maintains must be for the use and enjoyment of the general public; Rev. Rul. 72-102 modified.

Rev. Rul. 74-99

The Internal Revenue Service has been requested to clarify the circumstances in which an organization similar to the

homeowners' association described in Rev. Rul. 72-102, 1972-1 C.B. 149, may qualify for exemption under section 501(c)(4) of the Internal Revenue Code of 1954.

The characteristics of the organization of homeowners described in Rev. Rul. 72-102 are generally typical of many such organizations formed in recent years that seek exemption under section 501(c)(4) of the Code and may be summarized as follows: The organization is formed by a commercial real estate developer as an integral part of a plan for the development of a subdivision. Membership in the association is required of all purchasers of lots in the development. Membership is open only to the developer (at least for such time as he owns property in the development) and those who purchase lots. The organization is supported by periodic assessments against the members and an unpaid assessment constitutes a lien on the property of the homeowner-member. The stated purposes of the organization are, generally speaking, to administer and enforce covenants for preserving the architecture and appearance of the given real estate development, and to own and maintain common green areas, streets, and sidewalks.

The foregoing format is spelled out in written documents which form a part of, and are inextricably tied to, enforceable contracts for the sale and purchase of private property. In the light of this combination of factors, the *prima facie* presumption is that these organizations are essentially and primarily formed and operated for the individual business or personal benefit of their members, and, as such, do not qualify for exemption under section 501(c)(4) of the Code. However, an organization of this kind may in certain circumstances overcome the presumption and qualify for recognition of exemption under section 501(c)(4).

Thus, notwithstanding the combination of characteristics which the organization in Rev. Rul. 72-102 has in common with many other homeowners' associations, it was considered to have established its qualification for recognition of exemption as an organization described in section 501(c)(4) of the Code. In reaching this conclusion Rev. Rul. 72-102 reads, in part, as follows: "For the purposes of section 501(c)(4) of the Code, a neighborhood, precinct, subdivision, or housing development may constitute a community. For example, exempt civic leagues in urban areas have traditionally represented neighborhoods or other subparts of much larger political units. By administering and enforcing covenants, and owning and maintaining certain non-residential, non-commercial properties of the type normally owned and maintained by municipal governments, this organization is

serving the common good and the general welfare of the people of the entire development."

Increasing experience with homeowners' associations of this general kind has demonstrated, however, that the Revenue Ruling does not delineate the bases for the favorable holding in the case clearly enough to prevent misconceptions as to its scope. Specific questions have been raised as to (1) the scope of the term "community" as used in the ruling; (2) whether an organization whose program includes activities devoted to exterior maintenance of private residences comes within the ambit of the ruling; and (3) the interpretation of the phrase "non-residential, non-commercial properties of the type normally owned and maintained by municipal governments."

One misconception generated by Rev. Rul. 72-102 is that the ruling appears unqualifiedly to equate a housing development with the term "community" within the meaning of section 501(c)(4) of the Code, thereby giving rise to the implication that any housing development may qualify as a community for exemption purposes regardless of any other attendant facts and circumstances in the case. Rev. Rul. 72-102 is hereby modified to reject its apparent acceptance of such a narrow definition of "community" for purposes of section 501(c)(4).

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.

A second feature of Rev. Rul. 72-102 that has been subject to misinterpretation is whether, consistent with the position taken in the Revenue Ruling, an organization whose program includes, but is not limited to, activities directed to exterior maintenance of private residences may qualify for recognition of exemption under section 501(c)(4) of the Code. In the given facts in the Revenue Ruling there was no mention of any exterior maintenance activity. One of the stated purposes of the organization in Rev. Rul. 72-102, however, is to enforce covenants for preserving the architecture

and appearance of a housing development. It has been contended that exterior maintenance activities may properly be justified and subsumed under that purpose.

Given the combination of factors discussed above surrounding the formation and operation of this type of homeowners organization, the exterior maintenance activities reinforce the *prima facie* presumption that the organization is operated essentially for private benefit. See Rev. Rul. 69-280, 1969-1 C.B. 152, in which exemption of an organization formed to provide maintenance of exterior walls and roofs of members' home is denied under section 501(c)(4) of the Code. See also Rev. Rul. 74-17, page 130, relating denial of exemption under section 501(c)(4) of an organization formed by unit owners in a condominium housing project to provide for the management, maintenance and care of all the areas and elements in the project that are owned in common by the unit owners.

Another aspect of Rev. Rul. 72-102 that has given rise to some misconception of the ruling's scope involves interpretation of the phrase "non-residential, non-commercial properties of the type normally owned and maintained by municipal government" in determining what kinds of common areas or facilities an exempt homeowners' association may own and maintain. The Revenue Ruling in reciting the areas and facilities owned and maintained by the organization speaks only of "common green areas, streets, and sidewalks." The Revenue Ruling was, by the quoted phrases, designed to indicate that the only areas and facilities encompassed were those traditionally recognized and accepted as being of direct governmental concern in the exercise of the powers and duties entrusted to governments to regulate community health, safety, and welfare. Thus, the Revenue Ruling was intended only to approve ownership and maintenance by a homeowners' association of such areas as roadways and parklands, sidewalks and street lights, access to, or the use and enjoyment of which is extended to members of the general public, as distinguished from controlled use or access restricted to the members of the homeowners' association, as appropriate and consistent with exemption for the association. Rev. Rul. 72-102 is modified accordingly.

Although an association may not benefit a "community", within the meaning of Rev. Rul. 74-99, it may well still qualify for exemption under section 501(c)(4). If the association's activities are not limited to its members, but are directed to a

broader audience, i.e. the general public, it can qualify for exemption. This view is reflected in Rev. Rul. 75-286, 1975-2 C.B. 210, where the Service ruled that an organization formed by the residents of a city block to preserve and beautify that block could qualify as exempt under section 501(c)(4). Although membership was restricted to residents of the block, owners of property or individuals doing business there, the activities improved public property. The fact that the members were at the same time enhancing the value of their privately owned properties was viewed as insignificant in recognizing the association's exemption under section 501(c)(4), but it was the ruination of its exemption under section 501(c)(3). It may be inferred from the language of this ruling that the fact that the regulations under 501(c)(3) contain a specific restriction on operations to benefit private interests, while the regulations under 501(c)(4) do not, was determinative as to denial under the former and approval under the latter. Although the ruling denied exemption under section 501(c)(3) because the organization failed to benefit a sufficiently broad segment of the public to be charitable, and served private interests to a degree impermissible under that section, the beautification and preservation of a single city block was found to promote the general welfare of the people of the community as a whole within the contemplation of 501(c)(4).

Rev. Rul. 80-63, 1980-10 IRB 7, clarifies Rev. Rul. 74-99 by providing responses to certain questions concerning whether the conduct of various activities will jeopardize the exempt status of an otherwise qualifying homeowners' association. The ruling responds in the negative to the questions of whether a homeowners' association, which represents an area that is not a "community" qualifies for exemption under section 501(c)(4) where it restricts the use of its recreational or its parking facilities to its members. From this ruling it would appear reasonable to conclude that exemption as a social welfare organization will not be jeopardized where the association represents an area that is a "community" and restricts access to certain of its facilities to members. However, where this restriction extends beyond recreational or parking facilities and the organization engages in a policy of total restriction, we may have a different issue. The issue arising therefrom may not be whether this type of restrictive access is permissible under Rev. Rul. 74-99 or Rev. Rul. 80-63, but rather whether restrictions to this extent negate a finding that the association is a "community." The Service is considering this question.

Section 501.--Exemption from Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(c)(4)-1: Civic organizations and local associations of employees. (Also 1.501(c)(7)-1.)

Homeowners' associations. Answers are provided to specific questions as to whether the conduct of certain activities will affect the exempt status under section 501(c)(4) of the Code of otherwise qualifying homeowners' associations; Rev. Rul. 74-99 clarified.

Rev. Rul. 80-63

The Internal Revenue Service has received several inquiries asking whether the conduct of certain activities will affect the exempt status under section 501(c)(4) of the Internal Revenue Code of otherwise qualified homeowners' associations.

Section 501(c)(4) of the Code provides for exemption from federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated for the purpose of bringing about civic betterments and social improvements.

Rev. Rul. 72-102, 1972-1 C.B. 149, holds that certain nonprofit organizations of a type usually called homeowners' associations, which are formed to administer and enforce covenants for preserving the architecture and appearance of a housing development and to maintain streets, sidewalks, and other non-residential, non-commercial properties in the development of the type normally owned and maintained by a municipal government, may qualify for exemption under section 501(c)(4) of the Code.

Rev. Rul. 74-99, 1974-1 C.B. 131, modified Rev. Rul. 72-102, to make clear that a homeowners' association of the kind

described in Rev. Rul. 72-102 must, in addition to otherwise qualifying for exemption under section 501(c)(4) of the Code, satisfy the following requirements: (1) It must engage in activities that confer benefit on a community comprising a geographical unit which bears a reasonably recognizable relationship to an area ordinarily identified as a governmental subdivision or a unit or district thereof; (2) It must not conduct activities directed to the exterior maintenance of private residences; and (3) It owns and maintains only common areas or facilities such as roadways and parklands, sidewalks and street lights, access to, or the use and enjoyment of which is extended to members of the general public and is not restricted to members of the homeowners' association.

Specific questions that have been raised and their answers are as follows:

Question 1.

Does Rev. Rul. 74-99 contemplate that the term "community" for purposes of section 501(c)(4) of the Code embraces a minimum area or a certain number of homeowners?

Answer:

No. Rev. Rul. 74-99 states that it was not possible to formulate a precise definition of the term "community". The ruling merely indicates what the term is generally understood to mean. Whether a particular homeowners' association meets the requirements of conferring benefit on a community must be determined according to the facts and circumstances of the individual case. Thus, although the area represented by an association may not be a community within the meaning of that term as contemplated by Rev. Rul. 74-99, if the association's activities benefit a community, it may still qualify for exemption. For instance, if the association owns and maintains common areas and facilities for the use and enjoyment of the general public as distinguished from areas and facilities whose use and enjoyment is controlled and restricted to members of the association then it may satisfy the requirement of serving a community.

Question 2.

May a homeowners' association, which represents an area that is not a community, qualify for exemption under section 501(c)(4) of the Code if it restricts the use of its recreational

facilities, such as swimming pools, tennis courts, and picnic areas, to members of the association?

Answer:

No. Rev. Rul. 74-99 points out that the use and enjoyment of the common areas owned and maintained by a homeowners' association must be extended to members of the general public, as distinguished from controlled use or access restricted to the members of the association. For purposes of Rev. Rul. 74-99, recreational facilities are included in the definition of "common areas".

Question 3.

Can a homeowners' association establish a separate organization to own and maintain recreational facilities and restrict their use to members of the association?

Answer:

Yes. An affiliated recreational organization that is operated totally separate from the homeowners' association may be exempt. See Rev. Rul. 69-281, 1969-1 C.B. 155, which holds that a social club providing exclusive and automatic membership to homeowners in a housing development, with no part of its earnings inuring to the benefit of any member, may qualify for exemption under section 501(c)(7) of the Code.

Question 4.

Can an exempt homeowners' association own and maintain parking facilities only for its members if it represents an area that is not a community?

Answer:

No. By providing these facilities only for the use of its members the association is operating for the private benefit of its members, and not for the promotion of social welfare within the meaning of section 501(c)(4) of the Code.

Rev. Rul. 74-99 is clarified.

Alternatives -

A homeowners' association whose primary function is to own and maintain certain recreational areas and facilities may opt for exemption as a social club under section 501(c)(7) rather than under section 501(c)(4). This alternative may prove to be desirable where the association seeks to restrict use of its facilities to members, offers incidental community benefits and has little or no nonmember income which is subject to tax under section 512(a)(3). Rev. Rul. 69-281, 1969-1 C.B. 155, and Rev. Rul. 80-63 provide the authority for this position. As noted in Rev. Rul. 75-494, 1975-2 C.B. 214, a homeowners' association may not qualify under section 501(c)(7) if it owns and maintains residential properties which are not a part of its social facilities, administers and enforces covenants for preserving the architecture and appearance of the housing development, or provides the development with fire and police protection.

Therefore, a homeowners's association that does not qualify for exemption under section 501(c)(4) may qualify under section 501(c)(7) where it provides only qualifying social and recreational activities.

Prior to the Tax Reform Act of 1976, the only manner in which a homeowners' association could qualify as an organization exempt from federal income tax was under either section 501(c)(4) or section 501(c)(7). The Tax Reform Act of 1976 enacted section 528 to provide that a homeowners' association is taxable only to the extent provided in the section. Section 528 exempts from income tax any dues and assessments received by a qualified homeowners' association which are paid by property owners who are members of the association, where the assessments are used for the maintenance and improvement of association property. Thus, all homeowners' associations described therein may be granted a sort of quasi-exempt status by virtue of their own election.[9]

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[9] Legislation has been introduced and at this writing is pending before the State Finance Committee that would lower the tax rate for cooperatives under section 528 from 46 percent to 30 percent. See section 106 of H.R. 7956. Passage of this section would make the election under 528 more favorable than it is at present.

Section 528 defines a "homeowners' association" as an organization which is a condominium management association or a residential real estate management association if:

1. It is organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property,

2. It elects to have the section apply for the taxable year,

3. No part of the net earnings of the association inures to any private shareholder or individual,

4. 60 percent or more of the association's gross income consists solely of amounts received as membership dues, fees, assessments from owners of residential units or residences or residential lots (exempt function income), and

5. 90 percent or more of the association's expenditures for the taxable year are expenditures for the acquisition, construction, management, maintenance, and care of association property.

The legislative history of Section 528 reveals that Congress recognized the difficulty in most homeowners' associations meeting the requirements of Rev. Rul. 74-99. Section 528 reflects Congress' view that it is not appropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity. House Report No. 94-658; 94th Congress, 2d Session; H.R. 10612 (November 12, 1975). (Reproduced in 1979-3 (Vol. 1) C.B. 373).

Conclusion:

Homeowners' associations with the general characteristics of the organization described in Rev. Rul. 72-102 must overcome the prima facie presumption that they are essentially and primarily formed and operated for the personal benefit of their members. This can be accomplished by a showing that the organization represents an area that is a "community" and that by benefiting its members it benefits the community as a whole. In such a case the homeowners' association can restrict access to certain of its facilities. If this presumption is not overcome, the organization does not qualify for exemption under 501(c)(4).

However, an association does not necessarily need to be a "community" to enable it to be classified as a social welfare organization. An association of residents and property owners may be exempt under section 501(c)(4) where its activities are directed not to its members but flow to the general public as described in Rev. Rul. 75-286.

c. HMO'S and Mutual Benefit Associations -

The Service's position is that mutual, self-interest organizations, whose income is used to provide benefits to their members, do not qualify for exemption under section 501(c)(4). See Rev. Rul. 75-199, 1975-1 C.B. 160. however, the Service has recognized exemption for certain organizations that directly benefit only a small number of individuals. The test that apparently has been applied focuses on the community benefits to be derived from the organization's activities and not on the number of persons actually benefited. Similarly, because the Service looks to the community benefits and not to the number of persons receiving those benefits, an organization should not be exempt under section 501(c)(4) merely because its membership accounts for a large percentage of the total population of a certain community. See C.I.R. v. Lake Forest.

At one time it was argued that the source of funds used by mutual benefit societies was a significant factor in determining whether recognition of exemption was justified. Organizations which derived a substantial amount of their working capital from nonmember sources were viewed as being organized for profit.

An organization that otherwise qualifies as a social welfare organization will not be disqualified under Code Section 501(c)(4) on the sole basis that it receives a substantial portion of its income from nonmember sources. For example, a war veterans post was permitted to derive a substantial portion of its funds from weekly bingo games open to the general public (Rev. Rul. 68-45, 1968-1 C.B. 259) and the conduct of a concession at a lake resort by a War Veteran's Association, an activity ordinarily engaged in for profit the operation of which yielded a major portion of its income, was held not to jeopardize its Code Section 501(c)(4) status. (Rev. Rul. 68-455, 1968-2 C.B. 215). This position was maintained despite a finding that a portion of such income was utilized for other than social welfare purposes.[10]

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[10] However, it may not be well to place too much emphasis on these rulings. Government policy has traditionally been liberal with veteran's associations.

It would therefore appear that Code Section 501(c)(4) qualification is contingent upon the continued existence of the promotion of social welfare as the organization's primary purpose, notwithstanding the fact that it derives a major portion of its income from the conduct of activities open to the general public. See Rev. Rul. 68-455, 1968-2 C.B. 215.

Organizations that provide benefits solely to their members are not ordinarily properly classified as social welfare organizations. They operate essentially as mutual benefit or cooperative associations that primarily promote and benefit the interests of their members and only incidentally benefit the general community. This position has not always been consistently applied under section 501(c)(4).

In Rev. Rul. 55-495, 1955-2, C.B. 259, the Service held exempt as a social welfare organization a mutual benefit society that provided its members with life, sick, accident and death benefits and derived its income primarily from membership fees. Membership in the organization was restricted to individuals of a particular religious group who were of good moral character and health. Although it appears that benefit was directed to members with only incidental benefit to the general community, the Service ruled that "where any substantial number of people band together in an effort to help ensure that none of their group will become candidates for public assistance, a benefit thereby redounds to the community as a whole."

Rev. Rul. 55-495 has been modified by Rev. Rul. 75-199, 1975-1 C.B. 160 which sought to clarify the Service's position with respect to mutual, self-interest organizations whose income is utilized to provide direct benefits to its members. The organization in this ruling was formed to provide sick benefits for its members and pay death benefits to members' beneficiaries. Membership was restricted to individuals of good moral character and health who belonged to a particular ethnic group and reside in a stated geographical area. The organization's income was primarily derived from membership dues. The Service found the organization to be primarily operated for the benefit of its members with only minor benefit to the community as a whole.

The Service illustrated the distinction between social welfare organizations and mutual benefit societies by comparing Rev. Rul. 54-394 with Rev. Rul. 62-167, both discussed previously. Rev. Rul. 54-394 denied exemption to an organization that operated a closed circuit community antenna television system for its members while Rev. Rul. 62-167 granted exemption to an organization

operating a re-transmission television service available without charge to the entire community. These principles demonstrate the general rule that a social welfare organization may benefit its members so long as the principal beneficiaries remain the community as a whole.

However, the large nonprofit prepaid medical service plans have been an exception to this general rule.[11]

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26 CFR 1.501(c)(4)-1: Civic organizations and local associations of employees. (Also Section 7805; 301.7805-1.)

Mutual sick and death benefits society. A nonprofit organization that restricts its membership to individuals of good moral character and health belonging to a particular ethnic group residing in a stated geographical area and provides sick benefits to members and death benefits to their beneficiaries is not exempt under section 501(c)(4) of the Code for tax years beginning after June 2, 1975; Rev. Rul. 55-495 modified.

Rev. Rul. 75-199

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(4) of the Internal Revenue Code of 1954.

The organization was formed to provide sick benefits for its members and pay death benefits to the beneficiaries of members. Membership is restricted to individuals of good moral character and health who belong to a particular ethnic group and reside in a stated geographical area.

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[11] An additional exception has been certain publicly supported policemen's and firemen's benevolent associations. Because of the hazardous nature of their work and because pension, sick, and death benefits were not provided by the government it was concluded that there was sufficient public benefit to justify exemption under 501(c)(4). However, because most political subdivisions now provide these benefits there may be less justification for continuing exemption for these types of benevolent associations. The Service is considering this issue.

Activities of the organization consist of holding monthly meetings and maintaining an established system for the payment of sick and death benefits. The organization's income is derived principally from membership dues, and is used for the payment of benefits to members and for miscellaneous operating expenses.

Section 501(c)(4) of the Code provides for the exemption from Federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2)(i) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.

A membership organization of the type here described is essentially a mutual, self-interest type of organization. Its income is used to provide direct economic benefits to members and any benefit to the larger community is minor and incidental. Where the benefit from an organization is limited to that organization's members (except for some minor and incidental benefit to the community as a whole), the organization is not operated exclusively for the promotion of social welfare within the meaning of section 501(c)(4) of the Code. See *Consumer-Farmer Milk Cooperative v. Commissioner*, 186 F. 2d 878 (2d Cir. 1950), affirming 13 T.C. 150 (1949) and *New York State Association of Real Estate Boards Group Insurance Fund*, 54 T.C. 1325 (1970).

The distinction between social welfare organizations and mutual benefit societies is illustrated by comparing Rev. Rul. 54-394, 1954-2 C.B. 131, with Rev. Rul. 62-167, 1962-2 C.B. 142. Both rulings consider nonprofit organizations providing television reception in areas not adaptable to ordinary reception. Rev. Rul. 54-394 holds that an organization operating in such an area whose sole activity is providing television reception to its members on a cooperative basis does not qualify as a social welfare organization. On the other hand, Rev. Rul. 62-167 holds that retransmitting television signals to the entire community without charge is a social welfare activity. The first activity is designed to benefit only the organization's members who have contracted to pay

membership fees and monthly maintenance charges while the second is made available to everyone within the area.

Accordingly, since the benefit from the organization in question is for its members and there is only minor and incidental benefit to the community as a whole, the organization does not qualify for exemption from Federal income tax under section 501(c)(4) of the Code.

Rev. Rul. 55-495, 1955-2 C.B. 259, concerns an association whose membership is restricted to individuals who subscribe to a designated religious creed, are of good character and health, and have the ability to earn a livelihood.

Rev. Rul. 55-495 holds that an association that provides life, sick, accident, or other benefits to members or their dependents, but does not operate under the lodge system, or for the exclusive benefit of the members of an organization so operating, is not exempt as a fraternal beneficiary society as described in section 501(c)(8) of the Code. However, it further holds that the association is exempt under section 501(c)(4).

Rev. Rul. 55-495 is hereby modified to remove therefrom the conclusion that the association is exempt under section 501(c)(4) of the Code. However, the holding in Rev. Rul. 55-495 that the association is not exempt under section 501(c)(8) remains in effect.

Under authority granted by section 7805(b) of the Code, this Revenue Ruling will be applied only to taxable years beginning after June 2, 1975, the date of this publication in the Internal Revenue Bulletin.

The first prepaid medical plans were recognized as exempt during the great depression. The Service will not as a rule overturn longstanding positions favorable to a taxpayer where subsequent legislative enactments have failed to do so. This is particularly true where such action could have adverse impact on a large proportion of U.S. citizens. However, the Service is constantly monitoring these areas as to changes in fact patterns and evolution of the law and retains the option to reassess its position as circumstances warrant.

For these reasons, the Service has continued to find prepaid medical service plans exempt under section 501(c)(4), but it appears now that the courts may be willing to broaden the scope of section 501(c)(3) by recognizing exemption under that section to certain prepaid plans. In Sound Health Association v. Commissioner, 71 T.C. 158 (1978), the Service denied exemption to an HMO under the theory that it primarily operated to serve the private interests of its members, but approved exemption under section 501(c)(4).[12]

The Tax Court found the Association's particular form of membership organization provided for an unlimited class of individuals eligible for membership, thus benefiting the community.

In the court's view, although member/contributors receive some type of preferential treatment, private interests are not served where the requirements for membership are so broad as to allow nearly all segments of the interested public to obtain the services at the lower member rate. This led the court to conclude that the organization did not operate for the private benefit of its members.

4. Conclusion:

Attempts to pinpoint a working definition of the basic concepts contained in section 501(c)(4), such as "social welfare" and "community" have thus far had limited success. The "community concept", discussed in Rev. Rul. 74-99 and Rev. Rul. 80-63, may require further clarification with respect to associations that attempt to totally restrict access to their "communities."

Prepaid service arrangements continue to plague the Service as a problem area. Despite the continued enjoyment of exempt status of certain prepaid medical plans, exemption under section 501(c)(4) should not generally be extended to new types of prepaid service arrangements without National Office approval.

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[12] Approving exemption as a social welfare organization but denying it under section 501(c)(3) evidences the fact that an amount of private benefit which will defeat an organization's classification as a charitable organization may not disqualify it from classification as a social welfare organization.

Although the Service has been making an effort to refine and clarify this area, section 501(c)(4) remains in some degree a catch-all for presumptively beneficial nonprofit organizations that resist classification under the other exempting provisions of the Code. Unfortunately, this condition exists because, "social welfare" is inherently an abstruse concept that continues to defy precise definition. Careful case-by-case analyses and close judgments are still required.