Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
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In Re:

Refer Reply To:
CC:CORP:B02 – PLR-113131-03
Date:
June 16, 2003

Taxpayer =

State =

Date 1 =

Dear :

This is in response to your request for rulings dated October 9, 2002. In particular, you requested rulings regarding I.R.C. §§ 118 and 216. By letter dated May 9, 2003, you withdrew your request for a ruling under § 216. Accordingly, this letter addresses only whether the Special Assessments described below qualify as contributions to capital under § 118(a).

The facts submitted provide that Taxpayer is a State non-stock, non-profit membership corporation, subject to taxation under § 277. Taxpayer's members have the right to vote for Taxpayer's board of directors. Each member has one vote per lot. The members are entitled to the liquidation proceeds only in the event the Taxpayer liquidates. The members own the Taxpayer's only equity.

Taxpayer was formed to operate and maintain the common property of a community for its members. Membership is mandatory for all homeowners in the community. Membership is composed solely of the individuals who reside in and upon one of the thirty-eight mobile home lots in the community.

Taxpayer was originally structured as a community where the members owned their homes but rented the land (including the land on which the homes were placed) and the infrastructure of the community from the developer under a long-term lease. Members pay Taxpayer a small monthly fee to cover community maintenance.

Sometime before Date 1, the developer decided to sell the property on which the community was located. Before Date 1, Taxpayer's members voted unanimously to have the Taxpayer purchase the land from the developer. In order to fund the purchase, on or about Date 1, Taxpayer entered into a mortgage and purchased the land from the developer. After the purchase, the members ceased paying rent to the developer. However, in order to pay down the mortgage, the membership unanimously agreed to pay a special assessment (the "Special Assessment") to the Taxpayer for the duration of the mortgage. The members will pay the Special Assessment in addition to their annual membership dues. The funds raised by the Special Assessment will be used exclusively for retiring the mortgage associated with the purchase of the developers land. The Taxpayer deducts the interest and the real estate taxes associated with the real property purchased from the developer.

The Taxpayer requests a ruling that the portion of the payments received from the members allocated to paying the mortgage principal (the "Principal") be considered a capital contribution under § 118.

Section 118(a) provides that in a case of a corporation, gross income does not include any contributions to the capital of the taxpayer.

Section 1.118-1 provides, in part, that if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. Further, the section provides that the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered.

The dominant factor in determining whether the amounts are contributions of capital or payment for goods or services is the motive or purpose and intent in making the contribution. United Grocers, Ltd. v. U.S., 308 F 2d 634 (9th Cir. 1962) Rev. Rul. 75-371, 1975-2 C.B. 52 and Rul. 74-563, 1974-2 C.B. 38. The Board of Trade v. Commissioner, 106 T.C. 369 (1969) set forth a three factor test for determining the existence of an investment motive: (1) whether the fee is earmarked for application to a capital expenditure; (2) whether the payers are the equity owners of the corporation and the payment increases the corporation's equity capital; and (3) whether the members have the opportunity to profit from their investment in the corporation.

To the extent the payments for the Special Assessment are used to pay the principal portion of the mortgage, the Taxpayer satisfies the criteria identified by the court in Board of Trade indicating that the payors had an investment motive. First, the

principal portions of the Special Assessment are specifically allocated to paying for the purchase of the land, a capital asset. The funds are used solely for the mortgage payments. Taxpayer will still collect additional funds to pay for its other expenses.

Second, the payments enhance the member's collective interest in Taxpayer. Although each member's individual interest in Taxpayer does not directly reflect the amount of the Special Assessment paid by such member, member equity is increased by the accumulation of principal. Additionally, the Taxpayer's equity will increase to the extent the land appreciates. As mentioned above, in the event of dissolution of Taxpayer, after provision for creditors and payment of all costs and expenses of the dissolution, members would be entitled to distribution of assets of Taxpayer. See Board of Trade, 106 T.C. at 390; Rev. Rul 75-371, 1975-2 C.B. 52.

Third, the members have the opportunity to profit from their investment when they sell their residence to third parties. The value of their residence will also reflect the value of their interest in Taxpayer because membership in Taxpayer transfers with the residence. As Taxpayer's value increases as it builds equity through appreciation and the accumulation of principal, the member's equity interest increases. See Board of Trade, 106 T.C. at 390; Rev. Rul 75-371, 1975-2 C.B. 52.

We do not believe that the fact that the residents no longer are required to pay rent prevents the payments from being classified as capital contributions. In Eckstein v. U.S., 452 F.2d 1036 (Ct. Cl. 1971), the issue was whether the shareholder/resident was entitled to deduct a pro rata share of the cooperative's mortgage interest and real estate taxes pursuant to § 216. In order to qualify for § 216 treatment, 80 percent of the cooperative's income must have been from the rental of residences. The shareholder/residents in Eckstein signed a "proprietary lease" entitling the shareholder/resident to a specific apartment. The lease provided that the shareholder/resident would pay annual rent calculated as the shareholder/resident's share of the cooperatives' cash requirements, including mortgage interest and amortization payments. Eckstein at 1039. The lease also provided, in part, that the amount allocated for amortization payments or any other mortgage principal payments shall not be income to the cooperative.

The taxpayer in Eckstein, the owner of a unit in the cooperative, argued that the entire amount of the monthly payment should be included in the cooperative's income. The court, however, agreed with the Service that the portion of the rental payments allocated to pay down the mortgage principal constituted a capital contribution and was not included in the cooperative's income.

In reaching this result, the court in Eckstein addressed the shareholder/resident's

argument that the shareholders/residents monthly rental payment constituted a “bargain purchase” that prohibited capital contribution treatment. The court rejected this argument by stating that based on the legislative purpose and history of housing cooperatives, the corporate entity should be ignored and the stockholders should be treated as if they were the owners for purposes of determining whether there was a “bargain purchase.” The court determined that the decisions in cases of other types of membership cooperatives or corporations were not relevant due to the special nature of the relationship between a housing cooperative and its shareholders under the tax statutes.

Although the Taxpayer in this case does not qualify as a cooperative, we believe the same rationale should apply for purposes of determining whether a payment qualifies as a § 118(a) nontaxable capital contribution. This is a unique situation, similar to cooperatives, because the members own their dwelling unit but not the underlying real estate. Instead, the members own the land collectively through their ownership interest in the taxpayer. The fact that the Taxpayer does not qualify as a cooperative for purposes of § 216 does not change the nature of the relationship. In Eckstein, the court applied the tax policy behind cooperatives even though as a result of the application the corporation did not qualify as a cooperative.

Accordingly, based on the facts above and the information provided, we rule as follows:

> The portion of the Special Assessment received from the members allocated to paying the Principal will be considered a capital contribution under § 118 and therefore will be excluded from Taxpayer's gross income under § 61(a).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed regarding the application of §§ 216, 277 or any other Code provision.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Allison G. Burns

Alison G. Burns
Acting Assistant to the Chief, Branch 2
Office of Associate Chief Counsel
(Corporate)

cc: