[COMMITTEE PRINT]

INCOME TAX RETURN PREPARERS, ASSESSMENTS IN CASE OF MATHEMATICAL OR CLERICAL ERRORS, CERTAIN WITHHOLDING TAX PROVISIONS, DECLARATORY JUDGMENTS IN THE CASE OF TAX-EXEMPT ORGANIZATIONS, AND TAX-EXEMPT STATUS OF CONDOMINIUMS AND HOMEOWNER ASSOCIATIONS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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CONTENTS

A. INCOME TAX RETURN PREPARERS

Present Law

The Internal Revenue Code presently contains few provisions which affect the conduct of persons who prepare the tax returns of other persons for a fee. The tax return forms generally require that any person preparing a return for another person sign the return, but the law provides for no penalty in cases of failure to sign. No other provisions in the Code require an income tax return preparer to disclose to the IRS whether he is in the business of preparing returns or what returns he has prepared.

In addition, most penalties prescribed by present law for improperly prepared returns relate to improper preparation by the taxpayer himself and not by a preparer. Taxpayers may be subject to criminal fraud penalties of up to $10,000 in fines and imprisonment for not more than five years for willful attempts to evade tax (sec. 7201). Taxpayers are also subject to civil fraud penalties of up to 50 percent of the amount of any underpayment of tax (sec. 6653), and additional penalties for negligence or for intentional disregard of rules and regulations in an amount equal to 5 percent of any underpayment of tax.

By contrast, persons who prepare returns of others for a fee are subject only to criminal fraud penalties for willfully aiding or assisting in the preparation of a fraudulent return, which crime can be punished by fines of up to $5,000 and imprisonment for not more than 3 years. Tax return preparers are, however, subject to criminal penalties for unlawfully disclosing or otherwise using information disclosed to him in connection with the preparation of a return.

Problem

The past few years has seen a substantial increase in the number of persons whose business is to prepare income tax returns for individuals and families of average income. The Internal Revenue Service estimates that for the year 1972, 35 million taxpayers, or one-half of all those who filed income tax returns, sought some form of professional or commercial tax advice in preparing their returns. The Internal Revenue Service also estimates that in 1972 approximately 250,000 persons were engaged in the business of preparing income tax returns.

The rapid growth of the business of professional and commercial preparation of tax returns has led to a number of problems for the Internal Revenue Service. Some abuses have arisen in the preparation of returns for wage earners at the cost of a relatively small fee. In some of these cases, return preparers have made guarantees that individuals will obtain a refund because of the tax expertise of the preparer. In other cases, return preparers have suggested that a taxpayer sign a blank return (i.e., before it is prepared) in which case the taxpayer would not look at the return, let alone review it, before it is filed. In some of these cases, the preparer either claimed fictitious deductions or increased the number of exemptions claimed in order to achieve the desired refund or tax liability which was promised to the taxpayer.

In 1972 and again in 1973 the IRS conducted surveys of preparers suspected to be engaging in these types of conduct. For 1972 the IRS discovered that about 60 percent of the returns surveyed (or over 3,000 returns) showed significant fraud potential. In the 1973 survey, 22.3 percent of the returns prepared (or 1,112 returns) showed fraud potential. The sizable number of returns with fraud potential resulted in part because the IRS focused on preparers suspected of improper conduct. Nonetheless, the surveys indicate that a significant number of preparers in those years had engaged in abusive practices.

Under present law, it is difficult for the IRS to detect any individual case of improper preparation since the tax preparer may not sign the return. Thus, the IRS has no way of knowing whether the return was prepared by the taxpayer or by a preparer who may be engaging in abusive practices involving a number of returns.

Furthermore, even if the IRS can trace the improper preparation of tax returns to an individual tax return preparer, the only sanction available against such preparers are the criminal penalties of the Code. Such criminal penalties are often inappropriate, cumbersome, and an ineffective deterrent given the costs and length of time involved in trying these cases in court. Because these criminal penalties are difficut to apply, the IRS under present law generally proceeds against only the most flagrantly fraudulent cases involving income tax return preparers.

The abuses described above primarily involved "commercial" tax preparers (i.e., individuals often without formal training engaged in the seasonal business of preparing tax returns) rather than "professional" tax preparers, such as lawyers and certified public accountants. Yet it is difficult to single out any group alone for special regulation. At the request of the Joint Committee on Internal Revenue Taxation the General Accounting Office has been conducting a study of tax return preparation by all types of tax return preparers. The GAO report, which the staff has recently received in draft form, indicates that commecial preparers on the average have not had a significantly greater tendency to make mistakes in preparing returns than do other types of preparers. For example, the GAO studied the 22,000 tax returns which were audited in depth for the year 1971 under the IRS Taxpayer Compliance Measurement Project and discovered that for all returns (excluding 1040A short form returns) with adjusted gross incomes of $10,000 and under and for nonbusiness returns of adjusted gross income between $10,000 and $50,000, the percentage of tax adjustment determined from the IRS audits averaged 10.9 percent for returns prepared by commercial preparers and 10.2 percent for returns prepared by professional preparers. Other parts of the study also indicate that commercial preparers are not more likely to make more or larger mistakes on the returns they prepare than are professional preparers. This result occurs probably because most commercial prepares are generally involved only with those returns which are relatively simple to prepare, while professional preparers are generally involved in more complex returns. It should be noted in this regard that these errors do not necessarily result from the types of abuses referred to above but many result from differences of interpretation or other similar mistakes. In these cases where the IRS determines that certain return preparers have made erroneous interpretations of the tax law, regulation of all preparers would allow the IRS to correct these errors on all the returns prepared by that preparer. The fact that all types of preparers are about equally likely to make errors in preparing tax returns has led the GAO to recommend that any regulation of tax return preparers apply equally to all preparers.

Alternative Approaches

1974 committee bill

Last year the committee agreed to a series of provisions dealing with tax return preparers which are designed to assist the Internal Revenue Service in its auditing procedures. The draft report by GAO recommends the adoption of the 1974 committee provisions as useful aids to the IRS in identifying tax return preparers and the returns they prepared and in taking any corrective action which may be required against specific individual preparers.

Tax return preparers who would be covered by these provisions are those persons who prepare, directly or through employees, a return or claim for refund for compensation. These rules were not to apply to persons who render mere mechanical or processing assistance, regular employees who prepare returns of their employer as a usual incident of employment, fiduciaries who prepare returns for trusts or estates, or partners who prepare returns for partnerships.

The provisions agreed to by the committee which were to apply to tax return preparers are as follows:

1. Each prepared return, statement or other document must contain the identification number of the return preparer and other data sufficient to identify the preparer. A $25 penalty is provided for each failure to comply, if without reasonable cause.

2. Each preparer must furnish to taxpayers a copy of the return or claim for refund prepared by the tax return preparer at the time the return is given to the taxpayer for his signature. A $25 penalty is provided for failure to comply, if without reasonable cause.

3. Each return preparer or every person employing a tax return preparer must file an annual report with the IRS listing the name, address, identification number, and place of work of each preparer they employ. This report is to be filed by July 31 for a 12-month period ending June 30. Failure to comply without reasonable cause would result in a $100 penalty for each failure to file an annual return and a $5 penalty for each failure to include a name, identification number and place of work in the annual report. These penalties are not to exceed $20,000 for a 12-month period.

4. Each return preparer or employer of return preparers must retain for three years either a list of taxpayers for whom returns were prepared or copies of their returns and claims for refunds. A $50 penalty is provided for each failure to retain a copy of a return or to list a taxpayer for whom a return was prepared, up to a maximum of $25,000 for all returns in a year.

5. Penalties are also provided for negligence or fraud on the part of the tax return preparer. A $100 penalty is provided for negligent

or intentional disregard of Internal Revenue Service rules or regulations by a tax return preparer. A $500 penalty is provided for a willful attempt to evade, defeat or understate any tax by a tax return preparer. A separate penalty may be imposed for each return or claim for refund. The penalties are specific amounts rather than a percentage of understatement of tax (as is the case under present law with respect to negligence or fraud on the part of a taxpayer) in order to avoid the necessity of determining a taxpayer's exact tax liability in a proceeding against the preparer. With respect to all the penalty provisions, the period of limitations for assessing penalties would be three years from the filing date of the return or claim for refund, except that penalties for a willful attempt to evade, defeat, or understate any tax could be imposed at any time.

6. In order to prohibit a tax return preparer from continuing to prepare returns when it is determined that he has engaged in improper conduct with respect to the preparation of tax returns, an injunctive proceeding could be brought against such a preparer. The grounds for such action may include (1) engaging in conduct subject to penalties, (2) misrepresenting qualifications (including eligibility to practice before the Internal Revenue Service), (3) guaranteeing the payment of a tax refund, or (4) engaging in other similar conduct that substantially interferes with the proper administration of internal revenue laws. A tax return preparer who files a bond of $50,000 to guarantee payment of further penalties would not be subject to an injunctive proceeding for penalty-type conduct.

7. The Internal Revenue Service would be authorized to provide the names, addresses, and taxpayer identifying numbers of preparers to State authorities charged with enforcing State provisions regulating tax return preparers.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

B. ASSESSMENT IN CASE OF MATHEMATICAL OR CLERICAL ERROR

General

A determination by the Internal Revenue Service that correction of a mathematical error appearing on the taxpayer's return results in increased tax liability, does not entitle the taxpayer to a deficiency notice. As a result, the taxpayer cannot appeal such a determination to the United States Tax Court. The Service can assess the amount it believes is due and proceed to collection. Taxpayers have maintained that the Service has used this summary procedure in cases where it is not authorized by the statute; the Service maintains that it properly uses this procedure in categories of cases where most taxpayers do not dispute the Service's conclusions, thereby substantially reducing administrative and other costs.

Present Law

Under present law, if the Internal Revenue Service determines that a taxpayer has made a mathematical error on his return of any income, estate, or gift tax, or of any tax imposed under the private foundations provisions (chapter 42) or under the provisions relating to qualified pension, etc., plans (chapter 43), the Service may correct the error, and, if an underpayment of tax results from the correction, assess the additional tax without being subject to the restrictions which apply generally to assessment (sec. 6213(b)(1)). In the case of a mathematical error, the Service is not required to send a notice of deficiency to the taxpayer before assessing the additional tax. Nor do the time restrictions on assessment apply. The taxpayer also has no right to file a petition with the Tax Court based on a mathematical error.

Where the Service determines that a mathematical error has been made and, as a result, the taxpayer owes additional tax, an assessment is summarily made and a mathematical error notice explaining the error is sent to the taxpayer. Before the Service begins procedures to collect the additional tax due on account of the apparent error, the Service's policy is to permit the taxpayer to explain why he believes there is no error. If the taxpayer substantiates his claim, the Service's policy is to abate any assessment which it may have made or refund any additional tax which the taxpayer may have paid. Under present law, however, a taxpayer has no right to claim abatement of any income, estate, or gift tax (sec. 6404(b)).

The term "mathematical error" is not defined in the Internal Revenue Code or in the Treasury Regulations. In processing returns, however, the Service has interpreted the term to include several types of error which are broader in nature than literal errors of arithmetic. The Service's position is that mathematical error includes the following: errors in arithmetic (such as $2+2=5$); errors in transporting amounts correctly calculated on a schedule, form, or another page of Form 1040 to either page 1 or page 2 of Form 1040; missing schedules, forms, or other substantiating information required for inclusion with Form 1040; inconsistent entries and computations (such as cases where total exemptions claimed do not agree with the total used in computing the tax); and errors where the entry exceeds a numerical or percentage limitation (such as a standard deduction claimed in excess of the maximum allowed by the Code).

However, court opinions have generally limited the scope of the term "mathematical error" to arithmetic errors involving numbers which are themselves correct.

Problem

The Service is concerned that a narrow reading of its statutory authority under the "mathematical error" provisions would result in its not being able to use the expedited mathematical error procedure in significant numbers of instances where taxpayers are not likely to dispute the Service's determination. The Service points out that the deficiency notice procedure is considerably more costly than the mathetical error procedure, both in terms of personnel and processing costs and in terms of the cost to the Government of delays in collection of taxes. On the other hand, there also is concern that the Service should not be able to proceed summarily where the taxpayer believes that the Service has erred in its determination.

Alternative Approaches

1974 committee bill

The 1974 committee bill would have expanded the area in which the Service is permitted to use the summary procedures, but also would have provided taxpayers with methods for requiring abatement of any assessments made under these summary procedures.

The 1974 bill provided that the summary procedure could be used in the following five categories of "mathematical or clerical errors": (A) an error in addition, subtraction, multiplication, or division shown on the return; (B) an incorrect use of any table provided by the Internal Revenue Service with respect to the return if that incorrect use is apparent from the existence of other information on that return; (C) an entry on the return of an item which is inconsistent with another entry of the same or another item on that return; (D) an omission of information required to be supplied on the return in order to substantiate an entry on that return; and (E) an entry on the return of a deduction or credit in an amount which exceeds a statutory limit expressed as a specific dollar amount, or as a percentage, ratio, or fraction, if the items entering into the application of the limit appear on that return.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

The bill also provided that, when the Service sends the taxpayer a notice that he or she has made a mathematical or clerical error, the taxpayer would have 90 days to request in writing the abatement of any summary assessment which has been made or would be made based on the asserted error. Within 60 days after the taxpayer has responded, the Service is required to either abate any such assessment or to send the taxpayer a further explanation of the reasons for the Service's determination that there has been an error. If, within 30 days thereafter, the taxpayer confirms his or her original abatement request, then the Service must abate any such assessment.

However, under that bill, any such mandatory abatement would not by itself obligate the Service to credit or refund any overpayment of tax that would have resulted from the abatement.

C. WITHHOLDING TAX PROVISIONS

1. Withholding State and City Income Taxes From the Compensation of Members of the National Guard or the Ready Reserve

Present Law

Under present law, the Secretary of the Treasury is required to enter into agreements with States and cities to withhold State and city income taxes from the compensation of Federal employees. The agreement, however, may not apply to pay for service as a member of the Armed Forces.

Problem

In the case of members of the National Guard or Ready Reserve who are serving in this status within the State of which they are a resident, the inability of the Federal Government to withhold State income tax from their compensation often means they are faced either with large lump-sum payments at the time of filing or they must make a declaration of estimated tax and pay the tax quarterly. This is the same problem which led to the adoption of the Federal withholding of State income tax provision in the first instance. The prohibition against withholding of tax from payment for services as members of the Armed Forces was intended to exclude from withholding military personnel stationed in a State when they would not be subject to the State income because of their nonresident status. This concern, however, does not apply to National Guardsmen or Reservists serving in their own State or on regular training with their own unit and the exception need not apply.

Alternative Approaches

1974 committee bill

The committee last year extended the provision under present law requiring the Treasury to enter into agreements with States and cities to withhold income taxes from Federal employees to members of the National Guard and Ready Reserve when they are paid for performing regular training.

Mr. Ullman

His proposal is the same as the 1974 committee bill.

2. Voluntary Withholding of State Income Tax in the Case of Certain Legislative Officers and Employees

Present Law

Under present law the Secretary of the Treasury is required to enter into agreements with States that the Federal Government will withhold the State's income taxes from the compensation of Federal employees. Present law does not, however, permit the paying officers of the House of Representatives to enter into such agreements with respect to Members of Congress and congressional employees.

Problem

The absence of withholding for Members of Congress and congressional employees has meant that many of them are required either to use the declaration and payment of estimated tax system for their respective States or pay substantial lump sum amounts at the time of filing. This creates unnecessary inconvenience and occasionally hardship. In addition, legislative employees who are residents of the District of Columbia, Maryland, or Virginia are treated differently from other Government employees employed by the Executive Branch.

Alternative Approaches

1974 committee bill

The committee last year agreed to permit the paying officers of the House of Representatives to enter into agreements with requesting States to withhold State income tax from any members or employees of the House who request it.

Mr. Ullman

His proposal is the same as the 1974 committee bill.

3. Withholding of Agricultural Wages

Present Law

Taxpayers generally are withheld for individual income taxes when the income earned each pay period would produce enough gross income during the year to be taxable. The income levels at which taxpayers become taxable vary with their individual circumstances. Individuals who are employed only part of the year generally apply for refunds of withheld taxes when the withholding has been greater than their tax liability. Alternatively, each taxpayer may file a statement with his employer which states he was nontaxable in the preceding year and expects to be nontaxable in the current year.

These provisions do not apply to agricultural wages which are exempt from compulsory withholding. This then places agricultural wage workers in a position where they may be required to make substantial final tax payments when filing the tax return for the year. In order to relieve some of this burden, Congress provided in the Tax Reform Act of 1969 that Federal income tax was allowed to be voluntarily withheld from agricultural wages when both employer and employee agree to do so. In addition, agricultural wage employees may file a quarterly statement of estimated income tax. The voluntary withholding system was enacted in 1969 because there was concern about the overwithholding of part-time agricultural employees who would have to file for refunds.

Problem

The Joint Committee on Internal Revenue Taxation has requested and authorized the General Accounting Office to act as its agent in performing specified reviews of the operations, policies, and procedures of the Internal Revenue Service in its administration of the tax laws. During the preliminary phase of its review of IRS audit procedures (which had been specifically requested by the Joint Committee in June 1973), the GAO found that both the IRS and taxpayers employed in agriculture faced problems regarding the reporting of income and the payment of income taxes. Since agricultural employees generally do not pay income taxes on a pay-as-you-earn basis, the GAO investigated how much use was being made of the voluntary withholding system enacted in the Tax Reform Act of 1969 and the declaration of estimated income tax provisions by agricultural employees.

A sample study of returns filed in four IRS districts were undertaken. The results showed that less than 10 percent of the agricultural employers in these districts were withholding income tax on agricultural wages. It was also indicated that about 75 percent of the agricultural employees in these districts did not have income taxes withheld.

In addition, a sample of the employees of agricultural employers who did not withhold income tax showed that many of them: (1) were not filing income tax returns (about 38 percent of the sample); (2) were not reporting all or part of their agricultural wages (one out of eight of those filing a tax return); or (3) were not paying tax due when filing their returns (a tax delinquency rate of 26 percent). In addition, the lack of mandatory withholding and lack of use of the estimated tax provision have resulted in many agricultural workers facing the problem of making relatively large tax payments in relation to current income when they file their returns (averaging about three weeks' wages). This has led to tax delinquency difficulties for the taxpayers and tax collection problems for the IRS.

Alternative Approaches

General Accounting Office

In its report to the Joint Committee on Internal Revenue Taxation on March 26, 1975, the General Accounting Office recommended mandatory tax withholding for agricultural employees. To avoid unnecessary burdens on those agricultural employers who only occasionally hire agricultural employees, the GAO suggested that the provision include criteria similar to those now applicable to payment of social security taxes by agricultural employers. Such criteria would require mandatory withholding by employers who either have paid one or more agricultural employees $150 in cash wages in a year or have one or more agricultural employees who have worked 20 or more days during the year for cash wages.

Mr. Ullman

His proposal is the same as the GAO recommendation.

4. Withholding Tax on Certain Gambling Winnings

Present Law

Under present law, withholding on racetrack winnings is not required although payouts to winners of the daily double, Exacta, Perfecta and similar type pools are reportable on form 1099 information returns if the payout is based on betting odds of 300 to one or higher. In addition, Nevada gambling casinos are required to report certain large winnings from Keno and bingo games on forms 1099 to the Internal Revenue Service depending on the price of ticket paid as well as the amount won.

Problem

Although most wagering transactions have no tax significance since the majority of bettors end up the year with no net wagering gains, the special types of wagers mentioned above represent unique and occasional windfalls that generally produce a significant tax liability. Even with the information reporting requirements, many taxpayers did not report these winnings on their income tax returns. One source of this nonreporting of income is, for example, the use of the so-called "10 percenters" at the racetrack. A 10 percenter is a person hired by the winner to cash his ticket for 10 percent of the winnings and provides fictitious identification so that the reporting on 1099 is provided in a name other than that of the actual winner. These 10 percenters themselves seldom pay any income tax either by filing no tax return or claiming sufficient offsetting losses.

Alternative Approaches

1974 committee bill

Last year the committee replaced the information reporting requirement with a provision for withholding on certain winnings at a 20-percent withholding rate. The person making the payment of winnings subject to withholding would be required to deduct and withhold from the payment 20 percent of such payment. The withholding would be based on the entire payment rather than the amount of the winnings for ease of compliance. The winnings subject to withholding under the committee bill were the proceeds of $100 or more from wagers in sweepstakes, wagering pools, or lotteries (whether or not conducted by a State or agency or instrumentality of a State). In the case of winnings other than those mentioned above, withholding was to be required on payments of $600 or more from the wagering transaction if the amount of such proceeds was at least 300 times as large as the amount wagered. The person who was to receive the payment of winnings subject to withholding would be required to furnish the payor with the name, address and taxpayer identification number of the person receiving the payment and of each person entitled to any portion of such payment, under penalty of perjury.

Mr. Ullman

His proposal is the same as the 1974 committee bill.

D. DECLARATORY JUDGMENT AS TO TAX-EXEMPT STATUS AS CHARITABLE, ETC., ORGANIZATION

General

If an organization seeks to be recognized as a "charitable" organization, exempt from Federal income tax and eligible to receive tax-deductible contributions, it either must receive recognition of this favored tax status from the Internal Revenue Service or must prepare to resolve any dispute with the Service in the courts. In general, it cannot initiate a court suit to resolve such a dispute unless the Service has determined by a "notice of deficiency" that the organization must pay a tax, or the organization has itself paid a tax and sues for a refund. In additon to the delays inherent in any judicial proceeding, such an organization also suffers the often-extensive delay that occurs between the time the dispute arises with the Service and the time that a judicial proceeding can begin. In many cases, this "limbo" period spells the end of the organization, both because of the organization's potential tax liability which accrues during this period, and also because typically it cannot receive public financial support during this time.

The Supreme Court has held that declaratory judgments, which in many other areas are available to resolve disputes before the interests of the parties are substantially impaired, are not available in these cases.

Present Law

Under the Internal Revenue Code, an organization that meets the requirements of section 501(c)(3) of the Code [1] is exempt from tax on its income.[2]

In general, a domestic organization which is exempt under section 501(c)(3) is also eligible to receive deductible charitable contributions (sec. 170(c)(2)).

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[1] "SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

"(a) Exemption From Taxation.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * * * * * *

"(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

* * * * * * *

"(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of candidate for public office."

[2] Such an organization is, nevertheless, subject to tax on its "unrelated business taxable income" (sec. 511 *et seq.*, and, if it is a private foundation, is also subject to tax on its "net investment income" (sec. 4940); however, it is not subject to Federal income tax on its related business income. The tax on private foundations' investment income is at the rate of 4 percent, compared to the rates applicable to taxable corporations (up to 48 percent) and taxable trusts (up to 70 percent).

If such an organization is a private foundation (defined in sec. 509), then it is subject to a series of restrictions on its activities (sec. 4941 *et seq.*), as well as a tax on its investment income (see footnote 2 above). Also, if it is classified as a private foundation (other than an operating foundation (sec. 4942(j)(3)), its status as a charitable contribution donee is in some respects significantly less favorable than if it were not so classified (compare sec. 509(a) with sec. 170(b)(1)).

Although the tax status of an organization generally does not depend on the Internal Revenue Service's position as to the organization, as a practical matter, most organizations hoping to qualify for exempt status find it imperative to obtain a favorable ruling letter from the Service and to be listed in the Service's "blue book" (Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1954, Publication 78). A ruling letter and listing in the blue book assure potential donors in advance that contributions to the organization will qualify as charitable deductions under section 170(c)(2); in general, potential donors may rely upon these indicia even though the organization may not in fact be qualified under the statute for this treatment at the time of the gift.[3]

In two cases decided in 1974 (*Bob Jones University* v. *Simon*, 416 U.S. 725, and *Alexander* v. "*Americans United*" *Inc.*, 416 U.S. 752), the Supreme Court held that an organization could not obtain the assistance of the courts to restrain the Internal Revenue Service from withdrawing a favorable ruling letter or withdrawing its listing in the blue book. In effect, this means that a judicial determination as to the organization's status cannot be had by the organization or its contributors, except in the context of a suit to redetermine a tax deficiency or to determine eligibility for a refund of taxes.

By the time the Supreme Court issued its opinions in *Bob Jones* and *Americans United*, both Houses of Congress had already passed versions of what became the Employee Retirement Income Security Act of 1974 (Public Law 93-406). Each House's version of the bill included provisions for declaratory judgments as to the tax-qualified status of employee retirement plans. This ultimately became section 1041 of that Act, which added section 7476 to the Internal Revenue Code.

Under that provision, the Tax Court has been given jurisdiction to hear declaratory judgment suits as to the tax qualification of an employee retirement plan (pension, profit sharing, stock bonus, etc.), so that the plan's status can be tested without the necessity of the Service issuing a notice of deficiency or a taxpayer suing for a refund of taxes.

Problem

In *Bob Jones University* v. *Simon*, the Supreme Court summarized the problems faced by an organization seeking to establish its charitable tax-exempt status. The Court noted that, as it interpreted present law,

> "Congress has imposed an especially harsh regime on §501(c)(3) organizations threatened with loss of tax-exempt status and with withdrawal of advance assurance of deductibility of

[3] See Rev. Proc. 72-39, 1972-2 C.B. 818, for the Service's position on the extent to which contributors may rely on the listing of an organization in the blue book.

> contributions. * * * The degree of bureaucratic control that, practically speaking, has been placed in the Service over those in petitioner's position [i.e., the position of Bob Jones University] is susceptible to abuse, regardless of how conscientiously the Service may attempt to carry out its responsibilities. Specific treatment of not-for-profit organizations to allow them to seek preenforcement review may well merit consideration." [4]

The opinion then suggested that this is an appropriate matter for the Congress to consider.[5]

In order to provide an effective appeal from an Internal Revenue Service determination that an organization is not exempt from tax, or is not an eligible donee for charitable contributions, or is a private foundation (an operating foundation or a nonoperating foundation), it has been urged that there be access to the courts through some declaratory judgment procedure.

The questions that have been raised include (1) which courts should be given jurisdiction to hear such cases; (2) whether declaratory judgment suits should be available to test other exempt organization questions, such as whether an organization is a social welfare organization under sec. 501(c)(4), a fraternal organization under sec. 501(c)(8), a cemetery company under sec. 501(c)(13), etc.; (3) whether such a proceeding should be available to test revocations of prior favorable Service determinations, as well as initial unfavorable determinations (or refusals to rule); (4) what should be the tax treatment of persons who make contributions to the organization during the pendency of the suit, if it is ultimately determined that the organization was not exempt (i.e., if the court agrees with the Internal Revenue Service); and (5) whether contributors or third parties should be permitted to seek a declaratory judgment that the organization is exempt (despite a Service decision that it is not exempt) or that the organization is not exempt (despite a Service determination that it is exempt).

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[4] The Court's opinion noted that former Internal Revenue Commissioner Thrower had criticized the present system for resolving such disputes between the Service and the organization.

> "This is an extremely unfortunate situation for several reasons. First, it offends my sense of justice for undue delay to be imposed on one who needs a prompt decision. Second, in practical effect it gives a greater finality to IRS decisions than we would want or Congress intended. Third, it inhibits the growth of a body of case law interpretative of the exempt organization provisions that could guide the IRS in its further deliberations." (Thrower, IRS Is Considering Far Reaching Changes in Ruling on Exempt Organizations, 34 Journal of Taxation 168 (1971).)

[5] In a dissenting opinion to *Alexander* v. *"Americans United" Inc.*, the companion case to *Bob Jones University* v. *Simon*, Mr. Justice Blackmun stated that

> "where the philanthropic organization is concerned, there appears to be little to circumscribe the almost unfettered power of the Commissioner.[11] This may be very well so long as one subscribes to the particular brand of social policy the Commissioner happens to be advocating at the time (a social policy the merits of which I make no attempt to evaluate), but applications of our tax laws should not operate in so fickle a fashion. Surely, social policy in the first instance is a matter for legislative concern. To the extent these determinations are reposed in the authority of the Internal Revenue Service, they should have the system of checks and balances provided by judicial review *before* an organization that for years has been favored with an exemption ruling is imperiled by an allegedly unconstitutional change of direction on the part of the Service." (Footnote omitted.)

Alternative Approaches

1974 committee bill

The 1974 committee bill included a provision modeled after the Tax Court declaratory judgment provision in the Employee Retirement Income Security Act of 1974. The committee bill provided for declaratory judgment proceedings only in the United States Tax Court, to bring to bear the expertise and national uniformity of statutory interpretation that would result from making that court the exclusive forum for these suits. The bill authorized suits to be brought by the organization seeking the determination as to its own status, and did not give any rights to contributors or to third parties who wish to defend or attack the organization.[6]

The bill applied to revocations of prior favorable Service determinations, as well as initial unfavorable determinations (or refusals to rule), but limited its application to determinations of whether an organization is exempt as a "charitable organization," whether it is an eligible recipient of deductible charitable contributions, and whether it is a private foundation (and, if so, whether it is an operating foundation).

The committee concluded that the questions that could be resolved under the procedures it provided for generally were the more important questions in the field, and that it was important to provide promptly a mechanism for answering those questions. Examination of the more intricate problems (such as the standing of contributors and of third parties), the committee concluded, could properly be delayed until the Congress could evaluate the working of the declaratory judgment procedure provided under the bill, as well as that enacted under the 1974 pension law.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

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[6] The Supreme Court has implicitly held that under certain circumstances suits can be brought by third parties to restrain the Internal Revenue Service from treating an organization as being exempt. *Coit* v. *Green*, 404 U.S. 997 (1971), affirming *Green* v. *Connally*, 330 F. Supp. (D.C., D.C., 1971), a decision by a special 3-judge district court.

E. Tax-Exempt Status of Condominium, Cooperative, and Homeowner Associations

General

In developing a real estate subdivision, a condominium project, or a cooperative housing project, it is common for developers to form owners' associations as an integral part of the overall development. Generally, membership in the association is open only to owners of lots or dwelling units and is normally required as a condition of ownership. These associations are formed to allow individual homeowners, etc. to act together in managing, maintaining, and improving certain areas where they live. The purposes of the organization may include, for example, the administration and enforcement of covenants for preserving the architectural and general appearance of the development, the ownership and management of common areas such as streets, sidewalks, parks, swimming pools, etc., and the exterior maintenance and repair of property owned by its members.

The association is funded by either annual or periodic assessments of the members. Generally, there are two categories of assessments and expenditures made by the association. First, operating assessments are made to administer, manage, maintain, and operate the areas and facilities common to all residential units. This includes the the maintenance of parking areas, hallways, elevators, roofs, exterior of buildings, etc. Second, capital assessments are made to build up reserves for the replacement of equipment and facilities used in common. This includes the equipment and facilities used with respect to swimming pools, tennis courts, clubhouse facilities, etc.

Present Law

Under present law, generally a homeowner association may qualify as an organization exempt from Federal Income Tax (under sec. 501(c)(4) of the Code) only if it meets three requirements (Rev. Rul. 74-99, 1974-1 C.B. 131). First, the homeowner's association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit. Second, it must not conduct activities directed to the exterior maintenance of any private residence. Third, common areas for facilities that the homeowner's association owns and maintains must be for the use and enjoyment of the general public.

If an association is unable to meet these three requirements, it will ordinarily be taxed as a corporation. If an association is taxed as a corporation, generally the excess of current receipts over current expenditures at the end of the year would be taxable to it unless the excess is refunded to the members or applied to the subsequent year's assessments. With respect to assessments for capital improvements, if the assessments are designated to be used solely for the purpose of making capital improvements and if the association homeowners have an equity interest in the association, then the assessments will not be treated as current income to the association but may be treated as contributions to capital.[1] Also, to the extent that the association's accumulated funds earn income, this income is taxable to the association.

Problem

Most homeowners' associations have found it difficult to meet the three requirements set forth in Rev. Rul. 74–99, discussed above, and therefore, do not qualify for tax exemption. To avoid being taxed on the excess of current receipts over current expenditures, the association must refund such excess to the members or apply the excess to the subsequent year's assessments. In addition, it is not clear that assessments earmarked for major repairs and improvements of a member's individual dwelling unit, would not be taxable.

It is argued that it is not appropriate to tax the assessments of an association of homeowners who act together while an individual homeowner acting alone would not be taxed on the same activity. This approach, however, would allow an association to generate a reserve for capital expenditures relating to the exterior maintenance of individual dwelling units without the funds being taxed. In addition, even if the current expenditures and current assessments do not match at the end of the year, the association would not be taxed on assessments received for current maintenance.

Since an individual homeowner would be taxed on income generated by funds accumulated for maintenance or capital purposes, those making this argument agree that income earned on the association's funds should be taxed. In addition, they feel that certain safeguards are appropriate. For example, it is suggested that the association be owned by the members so that they have an equity interest in the assets of the association and that no part of the net earnings of an association may inure to the benefit of any individual or shareholder. However, the exterior maintenance of individual dwelling units would not be considered inurement for purposes of this provision.

Alternative Approaches

1974 committee bill

The committee agreed last year to provide that in the case of homeowner associations, condominium housing associations, and cooperative housing corporations, only the investment income and income derived from a trade or business is to be taxable. A deduction would be allowed for expenses directly attributable to any investment income and any income derived from a trade or business. Assessments for the administration, maintenance and operation of the homeowners association, etc., would not be taxable.

Mr. Ullman

His proposal is the same as that in the 1974 committee bill.

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[1] Rev. Rul. 75–370, 1975–35 I.R.B. 6, indicates that special assessments collected by a nonexempt condominium management association for replacement of the roof and elevators in the condominium are not includible in the association's gross income, and Rev. Rul. 75–371, 1975–35 I.R.B. 7, indicates that special assessments collected by such an association and accumulated for the replacement of personal property used to maintain common areas are contributions to capital.

Mr. Karth

He would agree with the provision in the 1974 committee bill as well as the approach taken in his bill, H.R. 3024.

Mr. Pickle

The proposal would provide that surplus funds in the hands of a cooperative or condominium at the end of the year would not be subject to tax.

Mr. Duncan

The proposal would provide a tax exemption for income of condominiums, homeowner associations, and cooperative housing corporations, as proposed in his bill, H.R. 8666, or the provision agreed to last year in the 1974 committee bill in both cases retroactive to 1974.

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