Internal Revenue Service

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:BR05 – PLR-115017-03
Date:
May 28, 2004

In Re:

LEGEND:

A =

Company C =
State Y =
Years:
1 =
2 =
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Amounts:
x (%) =
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Dear :

This is in response to your letter and submissions of February 11, 2003, submitted on behalf of a number of condominium associations (Associations), including Association A, (the “Taxpayer” herein) in which you requested certain rulings regarding

the proper federal income tax treatment under various provisions of the Internal Revenue Code of 1986 attendant the receipt by A of certain settlement proceeds received from Company C and other, related entities, in connection with the settlement of certain claims for damages resulting from an earthquake, as further discussed below. We are pleased to address your concerns.

The information submitted indicates that each of the Associations on whose behalf rulings are requested is a non-profit mutual benefit corporation under the State Y corporation law, formed for the purposes of preserving and maintaining the common areas of the condominiums owned by its members (the "Owners"). With respect to the Year 3 calendar tax year, each Association will file a federal return of income tax (Form 1120) as a membership organization under section 277 of the Internal Revenue Code, and will not elect to file Forms 1120-H to be treated as an exempt homeowner's association under section 528 of the Code. (Some Associations have made elections to be so treated from time to time in the past.)

The membership of each Association is comprised of all the Owners of condominiums which are managed and operated by each Association; all of the condominiums and common areas associated therewith are managed as "senior citizen's communities" under State Y civil law. Each Owner owns a separate "freehold estate" consisting of the area or space contained within, and including, the exterior walls, roof, and floor slab of the residential building structure. Each Owner's purchase also includes an undivided interest in the land and other common elements appurtenant to the units. Together, the Associations requesting the subject rulings herein manage y buildings, containing z condominium units. None of the Associations owns any interest in the buildings or the condominiums or the common areas which the Associations manage or operate.

Pursuant to the covenants, conditions and restrictions (CCRs) governing each condominium project for which an Association was created to manage and operate, the Associations have the responsibility to manage and maintain all of the common areas, and to keep each project in a first-class condition and in a good state of repair. Each Association is also authorized to make general and special assessments against the Owners (and the units) to provide funds to pay for maintenance expenses (including real estate taxes and the costs of maintaining insurance) and capital improvements to the common areas. Bylaws specifically require that all maintenance expenses of the common areas and the performance by the Associations of all duties and powers be paid for out of assessments made to Owners. Thus, each Association is supported by periodic assessments against the Owners, and any unpaid assessments constitute a lien on the individual property of the Owner.

All funds collected by Associations from Owners are deposited into either a general maintenance "current maintenance and operating account," or a "deferred capital maintenance and replacement account," and upon the sale or transfer of any unit by an Owner, the Owner's interests in the trust funds are automatically deemed to be

transferred to the new Owner. Pursuant to the CCRs, each Association is required to maintain liability and hazard insurance with respect to the project it manages. Any insurance proceeds received by any Association is required to be held by such Association as trustee for the benefit of the Owners, and may only be used to repair the property if the destruction constitutes a partial destruction and the proceeds are sufficient in amount to pay the costs of repair.

In accordance with the CCRs, the Associations acquired from Company C in Year 1 a "condominium association master policy" insuring, among other things, against earthquake damages (the "Policy"). In Year 2, the condominiums and common areas managed and operated by the Associations suffered severe damages as a result of the "Earthquake." Company C paid the amount of $n to all of the Associations at issue herein (and 2 other related Associations not parties to this ruling request) in Year 3, for damages. The Associations believed that Company C was obligated to pay substantially more under the Policy than was tendered, and in order to pursue their claims, engaged law firms to file suit against Company C on behalf of their members. Under the laws of State Y, which permits such suits, a lawsuit was filed against Company C on behalf of the members of the suing Associations, to recover damages as to the common areas and the separate interests of their members, as their representatives. The suit alleged that Company C was in breach of contract, breached its duty of good faith and fair dealing, committed fraud, and violated provisions of State Y's business and professional codes.

In Year 4, Company C and the suing Associations entered into an out-of-court settlement. Pursuant to the Settlement Agreement, Company C paid to all the suing Associations an additional amount of $o. All payments by Company C to the suing Associations were made solely to recompense the suing Associations for actual damages sustained to the common areas in connection with Earthquake. In addition, Company C paid directly to the retained law firms representing the suing Associations an additional amount for attorney's fees in the sum of $p. Lastly, Company C paid the additional amount of $q to a professional organization that performed geotechnical analysis, etc., in connection with the preparation and analysis of reports relating to the damages sustained to the subject properties. The insurance proceeds are sufficient in amount to pay for the costs to repair all of the damages caused by Earthquake, and each Association has a fiduciary obligation to expend the insurance proceeds collected for the limited purpose of repairing the property, and can not otherwise receive any benefit from the recovered funds.

The Owners will not have the right to receive or withdraw any payments received, any amounts deposited, or any interest earned on the settlement proceeds paid to any of the Associations. The Owners will not have the right to draw upon the funds, or to receive a credit of any of the interest upon disposition of their units (although an Owner's share of the proceeds held by an Association is automatically transferred to a purchaser of the unit). Some of the funds received by each Association will be spent to repair existing damage to the properties, some funds will be distributed to members to

reimburse them for actual expenditures made directly by them to fix damages attributable to Earthquake, and the balance of funds will be set aside in a separate account irrevocably dedicated to repairing and replacing common property. None of the funds will be commingled with general assessment funds, and they will be disbursed only for capital repairs, correction of remaining damage, and payment of extraordinary capital expenses. None of the funds may be expended to pay for ordinary maintenance expenses.

Owner's casualty loss occurred in Year 2, and recovery of the proceeds at issue herein did not occur until Year 4. During the intervening eight years, Owners made substantial repairs and improvements to their properties, increasing the bases in their units over that at the time of the earthquake damage. As indicated above, the Associations will distribute portions of the proceeds to reimburse owners for such repairs.

The settlement proceeds, including amounts $p and $q, were received by or on behalf of the Owners in several payments and at various dates in Year 4. It is represented that settlement proceeds allocable to each Owner at the time a payment was received did not exceed the tax basis of the Owner in his or her condominium unit, i.e., that Owners did not at any time recover proceeds in excess of such Owner's then current tax basis in his or her condominium unit.

Section 61 of the Internal Revenue Code provides that, except as otherwise provided in subtitle A (relating to income taxes), gross income means all income from whatever source derived.

Section 1016(a)(1) of the Code provides that proper adjustment shall be made to the basis of property for expenditures, receipts, losses, or other items properly chargeable to capital account.

Section 277(a) provides that in the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade shows which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year. The deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall not be allowed to any organization to which section 277 applies for the taxable year.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in

section 1011 for determining gain. Section 1011(a) provides generally that the adjusted basis for determining gain from the sale or other disposition of property is the basis determined under section 1012 (cost), adjusted as provided in section 1016. Under section 1016, basis is adjusted by expenditures, receipts, losses, and other items properly chargeable to capital account. Under section 1001(c), the entire amount of gain must be recognized, except as otherwise provided.

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, and, during the period specified in section 1033(a)(2)(B), the taxpayer purchases property similar or related in service or use to the converted property, at the election of the taxpayer, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property. Section 1.1033(a)-3 provides, generally, that the provisions of section 1033 apply in the case of property used by the taxpayer as his or her principal residence.

Section 1033(a)(2)(B) provides that the replacement period referred to in subparagraph (A) is the period beginning with the date of the disposition of the converted property, and ending two years after the close of the first taxable year in which any part of the gain upon the conversion is realized (or such later date as the Secretary may designate upon application of the taxpayer).

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

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

Similarly, in Rev. Rul. 75-370, 1975-2 C.B. 25, special assessments collected by a nonexempt condominium management corporation from its unit owner-stockholders and accumulated in a separate bank account for replacement of the roof and elevators

in the condominium were held not to be includible in the corporation's gross income. Rev. Rul. 75-370 indicates that the corporation receives no benefit from the funds. The corporation also had the duty to expend the funds collected in the manner approved by its unit owner-stockholders. The relationship between the corporation and its unit-owner stockholders insofar as the special assessments are concerned is one of agent and principal.

In this case, the Associations, including Association A, brought the claims for damages against Company C for breach of contract/fraud, etc., on behalf of the unit owners of the subject condominiums. The proceeds from settling the lawsuit represent amounts necessary to repair or restore the subject properties that Company C agreed to pay by reason of such damage, but failed to honor. Therefore, the Associations did not receive the settlement proceeds on their own behalf, but rather as agent for the unit owners. Accordingly, receipt of the settlement funds is not income or a return of capital to the Association(s).

The settlement funds also are not income to the unit owners, but instead represent a return of capital to each unit owner to the extent each unit owner's portion of the recovery does not exceed that owner's basis in his or her property interest. Consequently, the unit owners must reduce their bases in their property interests by an amount equal to their proportionate share of the recovery attributable to the common areas and his or her unit. To the extent that portions of the recovery relate to individual units, the owners of those units must reduce their bases by the amount of the recovery attributable to their individual units.

Amounts distributed to the unit owners from the settlement amount in the year the Association(s) receive the settlement are not taxable to the unit owners provided that the Association(s) do not distribute any part of the interest earned on the settlement funds and the unit owners do not receive distributions in excess of their adjusted bases. To the extent the Association(s) use or retain the funds for repairs and restorations, the funds represent a capital assessment of the unit owners. Consequently, the unit owners shall increase their bases in their respective property interests by their proportionate share of the amounts used or retained by the Association(s) to repair and restore the common areas of the property. To the extent a unit owner's individual unit requires separate repair or restoration, that unit owner shall increase his or her basis by the amounts used or retained by the Association to make repairs to his or her individual unit.

Amounts distributed to the unit owners from the settlement account in years subsequent to the year the Association(s) receive the settlement funds also are not taxable to the unit owners provided that the Association(s) do not distribute any of the interest earned on the settlement funds and the unit owners do not receive distributions in excess of their bases. The unit owners may increase their bases to the extent they use the funds to make capital improvements to their units.

As indicated, the character of settlement proceeds is generally determined based upon the origin and nature of the claim giving rise to the lawsuit or settlement. The instant case involves the Owner's recovery of capital for damages resulting from Earthquake damage to non-business property, i.e., their condominium units and common areas. Accordingly, the recovery proceeds are generally to be treated as a recovery of basis to the Owners in their units.

Costs incurred in the recovery of the insurance proceeds in the present case (including amounts $p and $q) constitute capital expenditures. Such expenditures must generally be capitalized rather than deducted or expensed. See, for example, Jasko v. Commissioner, 107 T.C. 30 (1996). Payment of such capital expenditures properly increases basis, while the recovery of reimbursements respecting such expenses generally decreases basis, thus serving in effect to offset such additions. Thus, to the extent basis is not exceeded, the portion of recovery proceeds allocable to such expenses is neither includible in the gross incomes of the Owners, nor deductible by them as a business or other expense. In the instant case, it is represented that each Owner's proportionate share of the settlement proceeds did not exceed the Owner's basis in his or her unit at the time of its recovery, and that no gain was thus realized. (If net proceeds attributable to an owner were to exceed the Owner's then current tax basis, the provisions of section 1033(a)(2)(A) would apply to govern the recognition of any gain.)

Based on the above analyses, we conclude as follows:

1. The proceeds received in settlement of the subject suit(s) by the Associations (including Association A) to recover for damages resulting from the Earthquake, and all other amounts paid by Company C in relation to such settlement (e.g., including engineering and attorney's fees) are not includible in the Associations' (including specifically Association A's) gross income. The recovery is received by the Association(s) not in its own capacity as plaintiff, but as agent(s) on behalf of and for the Owners.

2. The proceeds received in settlement of the suit(s) by the Associations (including Association A) against Company C are not income to the Owners but are treated as a recovery of basis of the Owners. Each Owner must reduce his or her basis in the units by his or her proportionate share of the recovery attributable to the common area and his or her unit. The Owners must increase his or her basis in the unit by his or her proportionate share of the amounts used or retained by the Association(s) for the repair or restoration of the common area or his or her unit plus the amounts expended by the Owners to repair damages to his or her unit resulting from the Earthquake.

3. Under the circumstances described, any excess funds from the settlement held and retained by the Association(s) in a reserve for future capital improvements are not taxable income to the Association(s).

4. Under the circumstances described, amounts of the gross settlement proceeds paid for legal and engineering expenses, including specifically amounts $p and $q, are not income to the Owners, and give rise to no net increase or decrease to the tax basis of the Owners in their condominiums.

Final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by adoption of final regulations, to the extent the regulations are inconsistent with any conclusions in this ruling. See section 12.04 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1. However, when the criteria in section 12.06 of Rev. Proc. 2004-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

This letter ruling is based on facts and representations provided by the Taxpayer and its authorized representatives, and is limited to the matters specifically addressed. No opinion is expressed as to the tax treatment of the transactions considered herein under the provisions of any other sections of the Code or regulations which may be applicable thereto, or the tax treatment of any conditions existing at the time of, or effects resulting from, such transactions which are not specifically addressed herein.

Because it could help resolve federal tax issues, a copy of this letter should be maintained with A's permanent records.

Pursuant to a power of attorney on file with this office, the ORIGINAL of this letter ruling is being sent to the Taxpayer's authorized representative, and copies are being furnished to the Taxpayer.

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

Associate Chief Counsel
(Income Tax & Accounting)

/s/ William A. Jackson

By _____
William A. Jackson
Chief, Branch 5

Enclosures:
Copy of this letter
Copy for section 6110 purposes