Should Internal Revenue Code Section 277 Be Applied to Cooperative Housing Organizations?

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by

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As a result of the enactment of the Tax Reform Act of 1986, the taxable income of corporations is currently subject to taxation at rates of near historic heights. While corporations are anxious to lessen their tax burdens, the Internal Revenue Service (IRS) has demonstrated an increased conviction to assuring that corporations shoulder their fair share of income taxes. Cooperative housing organizations treated as corporations for income tax purposes have not been immune (nor should they be) to this stance. With accelerating frequency, the IRS has construed the deduction restrictions of Internal Revenue Code (IRC) section 277 as applicable to cooperative housing corporations. The direct results to those cooperatives have been a rise in

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3 IRC section 216 provides the means by which a tenant-stockholder of a cooperative housing corporation, as defined in subsection (b), is essentially equated with the owner of a single family dwelling. That provision entitles the tenant-stockholder to deduct his pro rata share of real estate taxes and mortgage interest paid by the corporation on behalf of the tenant-stockholders.
4 One recent amendment to IRC section 216 produces exceptionally generous results for cooperative housing corporations in particular circumstances. Where a cooperative housing corporation distributes a cooperative apartment unit to a tenant-stockholder in exchange for his stock in the corporation and the tenant-stockholder qualifies for the nonrecognition rollover rules of section 1034(f), the general gain/loss recognition rule frequently applicable to other corporations as a result of the repeal of the General Utilities doctrine will not apply. The cooperative housing corporation will be exempt from recognition of gain or loss under section 216(e), as amended by the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, 102 Stat. 3342 (1988) (and is retroactive to the effective date of the Tax Reform Act of 1986): This provision should facilitate conversions of cooperative housing corporations into condominiums by allowing the tenant-stockholder who qualifies under the residential rollover rules of section 1034 to exchange his interest in the cooperative for a qualifying residential interest in a condominium.
5 Although the committee reports explaining the adoption of Internal Revenue Code section 277 do not clearly indicate that the provision is intended to apply to multiple housing corporations, its applicability was assumed by the Senate Finance Committee in 1976 at the time of amendment of IRC section 216. S. Rep. No. 938, 94th Cong., 2d Sess. (1976) explained:

The Committee does not believe that a clarification of the rules relating to the cooperative housing corporation’s ability to take depreciation deductions with respect to property leased

87
their taxable income and an accompanying increase in their corporate tax liability.\(^4\)

Whether IRC section 277 should be applied to cooperative housing corporations is the subject addressed by this article. First, the article explores the terms of the statute and Congress' intent in adopting it. In doing so, the article assesses the functions of cooperative housing organizations and the connections that such organizations and section 277 have with other federal tax provisions. Finally, the article considers whether the application of IRC section 277 to cooperative housing corporations is fair.

**THE TERMS OF IRC SECTION 277 AND THE CONGRESSIONAL INTENT**

The language of IRC section 277 provides that it is applicable to "a social club or other membership organization which is not tax-exempt and which is operated primarily to furnish services or goods to members."\(^5\) For these nonexempt organi-

to tenant-stockholders will create tax avoidance possibilities because the provisions of existing law (sec. 277) generally prevent non-exempt membership organizations from offsetting non-member income with losses from dealings with members at 397-398; 1976-3 C.B. 435-36 (vol. 3).

Yet, one commentator recently stated that at the time of enactment of the Tax Reform Act of 1986, Congress seemed uncertain as to the applicability of section 277 to cooperative housing corporations. He suggested that the language of Section 644(e) of the Tax Reform Act of 1986 specifically excluded two housing cooperatives from the reach of section 277 and that Congress indicated that no inference is to be made "that a change in law is intended with respect to the treatment of deductions under section 277 ... with respect to cooperative housing corporations and any determination of such issue shall be made as if such provision had not been enacted." R. Siegler, *Cooperatives and Condominiums*, 201 N.Y.L.J. 3, (January 4, 1989).

\(^4\) IRC section 277 is a deduction deferral provision; it is not a deduction disallowance statute. The statute incorporates language which allows carryover and subsequent use of excess temporarily disallowed deductions. See infra note 5.

\(^5\) Internal Revenue Code section 277 was enacted into law by section 121 of the Tax Reform Act of 1969, 83 Stat. 537 (1969). It provides:

**SECTION 277. DEDUCTIONS INCURRED BY CERTAIN MEMBERSHIP ORGANIZATIONS IN TRANSACTIONS WITH MEMBERS**

(a) **GENERAL RULE.**--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 this section applies for the taxable year.

(b) **EXCEPTIONS.**--Subsection (a) shall not apply to any organization--

(1) which for the taxable year is subject to taxation under subchapter H or L,

(2) which has made an election before October 9, 1969, under section 456(c) or which is affiliated
COOPERATIVE HOUSING ORGANIZATIONS

zations, "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 directly derived during such year from members or from transactions with members...."6 Deductions attributable to expenditures associated with membership functions cannot be used to reduce income derived from non-membership sources. Thus, the clear purpose of this statute is to prevent taxable social clubs and membership organizations from avoiding current taxation on income produced from non-membership sources. It prevents the organization from operating its membership functions at a loss and then utilizing such loss to offset income derived from non-membership sources.7 This restricted use of losses operates to prevent the organization from reducing its current taxable income and its concomitant tax liability.

This function of section 277 readily suggests the reason that the IRS attempts to apply the statute to cooperative housing organizations. The language of section 277 reveals that the provision is triggered only if three attributes are present. First, there must be a nonexempt for-profit or not-for-profit social club or membership organization. Second, the organization must be "operated primarily to furnish services or goods to [its] members." Third, in a taxable year, expenses attributable to furnishing services, insurance, goods or other items of value to members must exceed "income derived during such year from members or transactions with members ...." Each of these three components must exist for section 277 to operate with respect to a cooperative housing organization.

Non-Exempt "Social Club" or "Membership Organization"

Although a cooperative housing organization may serve a social function, it does not constitute a "social club" within the meaning utilized by the Internal Revenue Code.8 Unfortunately, the term "membership organization" is not defined

6 By its terms, section 277 does not apply to credits. Rather, it addresses only deductions. See, Priv. Ltr. Rul. 79-38-010 (June 12, 1979).
7 In a sense, IRC section 277 operates in a similar fashion to section 469. Both provisions limit the losses allowed to reduce taxable income in the current year. The former provision restricts the types of losses that can offset income derived from members or transactions with members. The latter statute limits the type and amount of losses that may be utilized to offset active income; passive activity losses may offset active income only in certain circumstances and not in excess of a specified amount. Moreover, both statutes specifically provide for a suspension of the temporarily disallowed "excess" losses and for the utilization of such losses in a subsequent year.
8 It has been suggested that cooperative housing organizations have a social function in that:
A large number of people or families are living in close proximity. Means must be provided for the formulation of rules of conduct amenable to all, for the assessment and collection of routine expenses of operation, and for the selection of new members into the family of cooperative apartment owners when one member desires to sell or dispose of his apartment [footnote deleted]. The selection of new members is
in section 277 nor does that statute refer to any other provision for guidance. The

term appears in section 456, which is concerned with the taxable year for which

prepaid income of certain membership organizations is included in gross income. In

that context, section 456(e)(3) defines "membership organization" to mean

a corporation, association, federation, or other organization—

(A) Organized without capital stock of any kind; and

(B) No part of the earnings of which is distributable to any member.

Cooperative housing organizations may be formed under one of several

forms. Some cooperative housing organizations assume a trust form of existence.

Other cooperatives are formed under co-ownership plans based upon joint tenancy

or tenancy-in-common. Most cooperative housing organizations are created as cor-

porations under state laws which require the issuance of capital stock and proprietary

leases to the stockholder-tenant. The resultant question that one must consider is

whether the section 456 definition of "membership organization" should be

construed narrowly and adopted for purposes of section 277. The response must be

in the negative. Otherwise, there could be no uniformity in the treatment of the

various legal forms of cooperative housing organizations for purposes of section

277. Nonstock cooperative housing organizations would be subject to section 277

while cooperative housing corporations based on capital stock would be immune to

it. This answer is supported by previously proposed and withdrawn Treasury

regulations which did not rely upon the narrow definition of "membership organi-

sation not only from the standpoint of social amiability, but also from that of economic ability to share

in the joint cost of operation.


9 Membership in a stock cooperative results from the purchase of at least one share of stock of the cooperative

organization and from the shareholder's accepting any other responsibilities required by the association's

rules. Membership in a nonstock cooperative results from application to the association by each member and

acceptance of the applicant by the association upon his agreement to meet all association rules and

requirements. Stock and nonstock cooperatives commonly require their members to agree to utilize

exclusively the services of the cooperative for the functions it is able to perform.

10 Depending on state law, a cooperative housing corporation is formed under the general corporation laws,

non-profit corporation statutes, or special laws dedicated to cooperative associations, such as the Uniform

Common Interest Ownership Act.

In general, a cooperative housing corporation is created by a promoter who wishes to sell, build or

purchase a building. The cooperative housing corporation, which issues stock of a total par value equal to

the purchase price of the building, purchases the building. The corporate stock is allocated to the various

apartment units in accordance with their relative values. A proprietary lease is issued to each shareholder-

cooprator and entitles the cooperator to occupy a selected apartment unit upon payment of a maintenance

fee (which resembles a rental payment of a tenant). 15A Am. Jur.2d, Condominiums and Co-operative

Apartments, section 62; Powell, supra at 781. IRC section 216 recognizes this structure. Its purpose is to

enable stockholder-tenants, who are not actually real property owners, to receive the same tax advantages

that owners of single family dwellings receive—e.g. deductibility of real estate taxes and mortgage interest

allocable to the apartment unit. IRC section 216 sets forth a number of specific requirements that must be

met by the cooperative housing corporation in order for the stockholder-tenant to be entitled to this favorable

treatment. Among the conditions that must be satisfied is that only one class of stock may be issued by the

cooperative housing corporation. See Miller, Cooperative Housing Corporation Stock: The "One and Only"


allowed the issuance of membership certificates rather than stock by the cooperative housing organization.
Those proposed regulations indicated that it was "immaterial" whether the "organization is incorporated or unincorporated or is regarded as a profit or a nonprofit corporation under applicable State law." Thus, it is clear that regardless of the legal form of a cooperative housing organization, it should be considered a "membership organization" within the meaning intended by section 277.

"Operated Primarily to Furnish Services or Goods to Members"

The language of section 277 clearly states that it affects only membership organizations "operated primarily to furnish services or goods to members." The difficulty is raised by the adjective "primarily." Do cooperative housing organizations operate primarily to furnish services or goods to members? Or, do these organizations have another primary function? If the first question can be answered in the affirmative, then the second attribute required for application of section 277 exists. If the response to that question is in the negative, then should this constitute a fatal blow to the application of section 277 to cooperative housing organizations? A review of the underlying purpose of cooperatives in general and cooperative housing organizations specifically should provide insights to enable an appropriate response.

1. Underlying Purpose of Cooperatives

Cooperatives have existed since the nineteenth century as operative business enterprises. The early American economy was based primarily on agriculture; this cultivated the creation of the agricultural producer cooperative. Since the early days, the economic base of our country has broadened substantially. That expansion has generated a growing list of cooperative organizations. Among the cooperative enterprises that operate currently, we find agricultural producer cooperatives, utility cooperatives, marketing cooperatives, production supply cooperatives, service cooperatives, credit cooperatives, health care cooperatives, housing cooperatives, consumer cooperatives, and many more.

The dramatic expansion of the types of cooperative organizations attests to its usefulness as a form of doing business. Cooperatives exist to help members serve themselves. Israel Packel, a noted authority on cooperatives, described a coopera-

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11 On May 6, 1972, the Treasury issued proposed regulations for section 277. Proposed Treasury Regulation section 1.277-1(b)(1) was withdrawn in December, 1986 as a result of the discontinuation of 133 regulations projects necessitated by the demands resulting from the Tax Reform Act of 1986.

12 Proposed Treasury Regulation section 1.277-1(b)(1) expanded the definition of membership organizations to include those that "primarily" furnished "services, facilities or goods to members." It is clear that a cooperative housing organization would fall within the reach of this definition. However, these proposed regulations were withdrawn in December, 1986, and therefore, they cannot be given any weight. (See supra, note 10.) Moreover, was the expanded definition inappropriate in that Congress had not provided in section 277 a specific delegation of authority to the Treasury to define the terms?


A cooperative is owned and controlled by its members on a substantially equal basis and the cooperative renders services for or on behalf of those members. It is operated for the mutual help of all members. The cooperative is created by its members "to provide themselves with goods and services or to produce and dispose of the products of their labor."\(^{17}\)

A cooperative can be categorized functionally as either a producer cooperative or as a consumer cooperative.\(^{18}\) A producer cooperative benefits members in their capacity as producers; the cooperative processes and sells goods produced by its members. A consumer cooperative operates "for the benefit of the members in their capacity as individual consumers."\(^{19}\) The consumer cooperative acts as the agent for its aggregate membership to obtain goods or services at more economical rates and in a more efficient manner than each member individually could secure the goods and services.

A cooperative housing corporation is a consumer-type cooperative.\(^{20}\) The

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\(^{15}\) Israel Packel, *What is a Cooperative?*, 14* TEMPLE L.Q. *60, 61 (1939).

\(^{16}\) *Id.* at 61. Packel wrote that the cooperative organization is characterized by one or more of the following attributes: (1) each member has substantially equal control over management of the enterprise; (2) each member has a substantially equal ownership interest; (3) membership is limited to persons who will avail themselves of the services supplied by the association; (4) prohibited or limited transfer of ownership interest; (5) capital investment which receives no return or a limited return; (6) economic benefits which pass to the members on a substantially equal basis or on the basis of their patronage of the association; (7) continuity of the association even upon the death, bankruptcy or withdrawal of one or more of its members; and (8) services of the organization supplied primarily for the use of the members. I. Packel, *supra.* note 14, at 3-4; I. Packel, *supra.* note 15, at 61.


There is a clear and basic difference between a cooperative organization and a for-profit corporation built on capital stock.

In a cooperative, all the members assume, in a broad sense, the economic risk. By pooling their resources together, be it labor, capital, or goods, the members form a single entity that is better able to purchase, market, or provide services for the members as a group than each member could accomplish individually. The members do not contemplate a return for the undertaking of this risk (footnote omitted). Rather, any excess receipts attributable to the activities of the organization are to be returned to the member-patron in proportion to such member's support of the cooperative relative to the participation of all members in the association (footnote omitted).

*Note, Cotter & Co. v. United States: The Federal Circuit Finds the Meaning of Subchapter T to be Less Than Cooperative, 47 OHIO STATE L.J. 565, 568-569 (1986).*

Comparatively, a for-profit corporation is founded on the earning capacity of the invested capital. It is operated for the shareholders who expect to have a voice in the enterprise based upon the capital that each has invested. The investment, which in the hands of the shareholders is represented by capital stock, is the foundation for the control, administration and distribution of corporate income and gains.

\(^{18}\) Puget Sound Plywood, 44 T.C. at 309.

\(^{19}\) *Id.*

\(^{20}\) The origins of housing cooperative organizations can be traced to the early 1900's. Finnish artisans in 1918
COOPERATIVE HOUSING ORGANIZATIONS

cooperative housing organization functions as the agent for its members in "obtaining the security of home ownership without many of its inconveniences. [f.n. deleted.]"\(^{21}\) For example, the cooperative housing organization can arrange for and manage building and grounds maintenance on a regular schedule without the members' involvement on a daily basis. Members additionally "have learned that elimination of the landlord's profit and some of his expenses may make a cooperative apartment more economical than ordinary renting [f.n. deleted]."\(^{22}\) Moreover, cooperatives often enable members to obtain an interest in and access to facilities, such as tennis courts, golf course, a spa, and a swimming pool, that as individuals they might otherwise be unable to afford. All of these advantages are augmented by beneficial federal tax laws which treat most cooperative members as real property owners for purposes of allowing them to deduct their ratable share of real estate and mortgage interest on the building.\(^{23}\) As one treatise states:

From the purchaser's viewpoint, there are four principal advantages of buying a cooperative apartment: [f.n. deleted]

1. The acquisition of a type of ownership in his home and living quarters with the accompanying psychological and economic satisfactions of pride, security, and savings in the form of investment assets;
2. The savings enjoyed through the economic principle of cooperation, by which the high cost of the apartment site and the cost of property maintenance is shared ratably among the apartment owners;
3. The ability to take advantage of the same deductions which are applicable to individual homeowners under the present income tax laws; and
4. The minimization of the risk of personal liability of the coope-

formed the Finnish Home Building Association in Brooklyn, New York. World War I brought a housing shortage which stimulated a market for cooperative apartments. In 1926, organized labor became interested in cooperative housing for the purpose of "economy and good living." Abrahamsen, supra. note 12, at 30; Powell, supra. note 7 at 764-765; McCullough, Cooperative Apartments in Illinois, 26 Chicago-Kent L. Rev. 303, 304 (1948); Note, Cooperative Apartment Housing, 61 Harvard L. Rev. 1407 (1948).

21 61 Harvard L. Rev. at 4107.
22 \textit{Id.}
23 IRC section 216. \textit{See also}, 15A Am. Jur. 2d, section 62 at 894-895, which states:

A co-operative corporation is not a business corporation in the ordinary contemplation. It is a vehicle for the common ownership of property, to enable the occupants, the stockholders of the cooperative, to own, manage, and operate residential apartments without anyone profiting therefrom (footnote omitted). The cooperative plan is sui generis: there are elements of ownership, as well as stock and leasehold rights. The primary interest of every stockholder in such a corporation is the long term proprietary lease and the stock is incidental to such purpose and affords merely the practical means of combining an ownership interest with the method of sharing proportionately the assessments for maintenance and taxes (footnote omitted). While it is true that the occupants pay monthly maintenance charges in much the same manner as tenants pay rent (footnote omitted), they have a substantial capital investment and a direct interest in the financial stability, character, reputation, and personal conduct of the other stockholder-occupants of the premises, and if there is a failure to pay maintenance charges by one, the others must carry the burden (footnote omitted).
tive members.\textsuperscript{24}  

Clearly the fundamental functions of a cooperative housing organization include furnishing facilities and services to members on an economical and efficient basis. Whether one function -- furnishing services as opposed to facilities to members on an economical and efficient basis -- can be considered primary or foremost is difficult to conclude. It seems as if one would need to split hairs to make such an evaluation. It is logical that these fundamental functions are the cornerstones of cooperative housing organizations; without them cooperative housing corporations would not exist. This should suffice to bring cooperative housing organizations within the section 277 phraseology which is the second component of section 277 -- the "membership organization ... is operated primarily to furnish services or goods to members."

\textit{Deductions Attributable to Member Related Expenses Allowed to the Extent of Income Derived "from Members or Transactions with Members"}

The third, and final, attribute required in order to trigger the limitation of section 277 -- that "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..." -- has proved controversial over the past few years with respect to cooperative housing organizations. The controversy stems from conflicting interpretations of terms. The focus has been on what constitutes "income derived ... from members or transactions with members" (hereinafter also referred to as "membership income"). Attention converges on this phraseology because it is an essential function in the equation that operates the restriction and sanction of section 277. If the membership organization has income from sources other than from members or from transactions with members (hereinafter also referred to as "nonmembership income"), that income may not be reduced by deductions attributable to member related expenses.\textsuperscript{25} Only income derived from members or transactions with members may be offset by deductions attributable to member related expenses.

While this controversial topic has been addressed by the IRS in several private letter rulings,\textsuperscript{26} there is only one reported case that attempts to interpret this section 277 language.\textsuperscript{27} The recently litigated case involving this issue is Concord Consumers Housing Cooperative v. Commissioner, supra note 3. This case was discussed in court conference and a majority and concurring opinion were rendered.

\textsuperscript{25} The statute clearly provides for suspension and carryover of deductions attributable to member related expenses which are disallowed as a result of insufficient income from members or transactions with members. Section 277 in relevant part states: "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."
\textsuperscript{27} Concord Consumers Housing Cooperative v. Commissioner, supra note 3. This case was discussed in court conference and a majority and concurring opinion were rendered.
ers Housing Cooperative v. Commissioner. Petitioner, a nonprofit, nonstock corporation was organized exclusively to provide housing facilities for low and moderate income persons and to furnish "such social, recreational, commercial and communal facilities as may be incidental or appurtenant thereto and, in general, to carry on any business in connection therewith and incidental thereto ...." The parties to the case stipulated that petitioner was "incorporated on January 16, 1970 as a cooperative housing corporation." The issue was whether interest earned on two reserve accounts and on one escrow account maintained by the petitioner corporation as required under regulatory agreements with the Federal Housing Administration (FHA) and the Michigan State Housing Development Authority (MSHDA) constituted income "derived . . . from members or transactions with members" within the meaning of section 277. In accordance with the regulatory agreements with the FHA, which were required in order for petitioner to obtain special mortgages and mortgage insurance from the FHA and MSDHA, petitioner maintained a replacement reserve fund and a general operating reserve fund.

The purpose of the replacement reserve fund was to make funds available for petitioner for replacement of mechanical equipment and structural elements of the 391 apartment units and for other items of expense not specifically included in petitioner’s annual budget with the FHA. The replacement reserve was funded monthly by petitioner in various amounts as specified in the regulatory agreements. This replacement reserve was managed and controlled by MSDHA, as mortgagee. The funds in this reserve could be in the form of cash or United States obligations; interest earned on the funds was credited to petitioner’s replacement service account from which appropriate bills could be paid.

Petitioner’s second reserve fund, the general operating reserve fund, was funded monthly by petitioner as required by the regulatory agreements. Petitioner was required to contribute a monthly amount not less than three percent of the monthly amounts otherwise chargeable to the 391 members (apartment residents) under their occupancy agreements. This amount approximated $65,000 annually. The purpose of the general operating reserve fund was to provide a measure of financial stability during periods of special stress and to satisfy deficiencies resulting from delinquent member payments. Additionally, the fund was to be used for various contingencies, including to repurchase membership certificates of withdrawing members. As with the replacement reserve fund, the general operating

28 *Id.*
29 *Id.* at 107. The Tax Court describes the Concord Consumers Housing Cooperative as having numerous functions but does not categorize them as to primary or subordinate in nature.
30 *Id.* at 106, n. 3. The Tax Court specifically noted that "petitioner has not contended that it is a 'cooperative housing corporation' within the meaning of section 216, and the record does not contain the facts necessary for us to determine whether, during the years before the Court, petitioner satisfied the statutory requirements of section 216(b)(1) and the pertinent regulations." *Id.* The Court continued its discussion by indicating that it attached no significance to whether the organization was a cooperative housing corporation within the meaning of section 216(b)(1) nor to whether the organization operated on a cooperative basis within the meaning of section 1381(a)(2).
reserve fund could contain only cash or United States obligations; interest earned on
the funds was to be used to pay petitioner's management company fee and any excess
was to be credited to the reserve account.

The escrow account required by the regulatory agreements arose as a result of
the method required to assure payment of the mortgage, real estate taxes, and
insurance premiums. Petitioner's management company made mortgage payments
to MSDHA and a portion of each mortgage payment was placed in a mortgage
escrow account established and maintained by MSDHA for its payment of peti-
tioner's real estate taxes and insurance premiums. The mortgage escrow account
was an interest bearing account, and all interest was credited to the account and used
only for payment of taxes and insurance premiums.

For taxable year ending March 31, 1977, the replacement reserve earned
interest of $7991, the general operating reserve had a deficit of $602 and the
mortgage escrow account had interest of $7792. For taxable year ending March 31,
1978, the replacement reserve earned interest of $8016, the general operating reserve
had interest of $4432, and the mortgage escrow account earned interest of $6876.
For taxable year ending March 31, 1976, a breakdown of the interest earned on each
account was unavailable. Petitioner reported the interest earned on all three accounts
as part of its gross income, and reported deductions which produced substantial
losses in each year. For 1976 and 1977, petitioner did not specifically allocate any
of the deductions to the interest income, but for 1978 it did make a specific allocation.

The Commissioner determined that for purposes of section 277 the interest
earned during each year on the replacement reserve fund, the general operating
reserve fund, and the mortgage escrow account constituted income from sources
other than from members or transactions with members. Relying on this determina-
tion the Commissioner in his notice of deficiency increased petitioner's taxable in-
come for each year. The Commissioner explained that the interest constituted invest-
ment income and should be characterized as income from a source other than
members. It followed that pursuant to section 277 the interest income could not be
offset by deductions for expenses attributable to providing facilities and services to
members.

The majority opinion for the Tax Court interpreted narrowly the section 277
phraseology "income derived . . . from members or transactions with members." Based
upon the historic connection between section 277 and section 512, the
majority declined to treat the interest earned on the escrow and reserve accounts as
falling within the section 277 meaning of "income derived . . . from members or
transactions with members." It held that the interest was income generated by an
investment and that it was of no consequence that the investment was involuntary

31 Id.; see also supra note 27.
The majority characterized the investment income as non-membership in source. Consequently, the deductions of Concord Consumers Housing Cooperative attributable to membership related expenses exceeded all income from members or transactions with members. This triggered the deduction restriction and sanction of section 277. In coming to its conclusion, the majority specifically refused to explore the interrelationship of section 277 with Subchapter T, which applies to cooperatives generally. The majority therefore did not address whether its decision would have stood under analysis of Subchapter T.

The remainder of this portion of the article focuses on the connection between section 277 and section 512 and upon the commonality of and links between those statutes and Subchapter T for purposes of cooperative housing organizations. Through the following discussion it will be revealed why the final holding of the Tax Court would not have been secure had the Court chosen to analyze the relevance of Subchapter T.

1. Connection Between Section 277 and Section 512

Subtitle A of Part III of the Internal Revenue Code (sections 511 through 515) was adopted to assure that a tax-exempt organization's income attributable to its exempt function would escape taxation while the portion of its income generated by non-exempt functions would be subject to taxation. For purposes of section 512, "exempt function income" is the amount received by the organization from members in exchange for the organization's goods or services. "Exempt function income" of a tax-exempt organization by definition is not subject to taxation. By contrast, section 511 imposes the corporate income tax on that portion of the tax-exempt organization's income known as "unrelated business taxable income."

32 Id. at 118. Moreover, the majority for the Tax Court stated that Congress did not intend investment income to go untaxed. Id. at 118-121. 33 Id. at 123, n. 17. Subchapter T has been held to apply specifically to cooperative housing organizations. See, Concord Village, Inc. v. Commissioner, 89 T.C. 105 (1987); Park Place, Inv. v. Commissioner, 57 T.C. 767 (1972).

In a concurring opinion, Judge Korner, joined by Judges Whitaker, Hamblen, Jacobs, Wright, Parr and Williams reflected on the applicability of Subchapter T. In relevant part, the concurrence stated:

The application of Subchapter T to this case, however, is a different matter. If this petitioner was being operated on a cooperative basis, within the meaning of section 1381(a)(2), then the provisions of Subchapter T attach, and petitioner's liability is to be determined under those provisions as a matter of law. The application of Subchapter T is not elective on the part of either petitioner or respondent. Neither party can avoid the application of the correct law to the facts of the case by failing to plead or argue it. That is the province of the Court (Citation omitted). We have previously held that low income nonprofit housing corporations, which concededly were cooperatives, are governed by Subchapter T, and that those Code provisions preempt other more general Code provisions which otherwise might be applicable (Citation omitted) (emphasis in original).

The issue in Concord Consumers Housing Cooperative involved the appropriate categorization of income. No refunds were made to cooperative members. Therefore, Subchapter T would not have affected the taxpayer's tax liability as a matter of law. The applicability of Subchapter T would have remained in the form of definition guidance and its similarity to section 277.

Pursuant to section 512(a), as amended in 1969, "unrelated business income" is essentially the organization's gross income as reduced by exempt function income. "Unrelated business income" has been interpreted to mean income generated either by (1) a regularly carried on trade or business that is not substantially related to the organization's tax-exempt purpose, or (2) investment or other nonmember source regardless of its relation to the exempt purpose of the organization. Unrelated business income may be reduced by allowable deductions attributable to the carrying on of such business or investment, and the resulting net income is known as "unrelated business taxable income." Thus, the 1969 amendments to section 512 ensured that virtually all tax-exempt organizations would be taxed at corporate income tax rates on their "unrelated business taxable income"; only "exempt function income" could escape taxation. Moreover, the modified statutory language clarified that an exempt organization may not reduce its unrelated business taxable income by claiming deductions for the costs of providing goods and services to members.

By its terms, section 512 did not reach taxable social clubs and membership organizations. Yet, Congress was aware that such taxable organizations were sheltering non-membership income by claiming offsetting deductions attributable to the costs of providing goods and services to members. It expressed concern that the divergence in the tax treatment of the tax-exempt and the taxable social clubs and membership organizations was inequitable. Congress indicated that without a specific statute to address the treatment of investment and nonmember income of non-exempt membership organizations, the tax-exempt organizations governed by section 512 might attempt to avoid the statute's effect "in treating investment income and income received from nonmembers as unrelated business income by giving up their exempt status and deducting the cost of providing services for members against this income." In an effort to foreclose such a potentially troublesome maneuver, Congress enacted IRC section 277. Congress stated that its intent in adopting section 277 was "to prevent [taxable] membership organizations from escaping tax on business or investment income by using this income to serve its members at less than cost and then deducting this book loss." "[Income from sources other than members may not be reduced, in determining taxable income, by losses arising from dealings with members." The clear import of section 277 is to disallow the deductibility of certain expenditures.

35 The Tax Court discussed the reason for characterizing investment income as "unrelated business income" in Concord Consumers Housing Cooperative, 89 T.C. at 118-20.
37 H. REP. No. 413, 91st Cong., supra note 36, 1969-3 C.B. at 232; see also S. REP. No. 552, 91st Cong., supra note 36.
Section 512 and section 277 were enacted to prevent virtually comparable abuses by similar tax-exempt and taxable organizations. Section 512 achieves this goal by focusing on definitions of types of income while section 277 accomplishes the task by temporarily disallowing certain deductions which are characterized with reference to categories of income.

2. Connection Between Section 277 and Subchapter T

If the Tax Court had explored Subchapter T, would the Court have held that the interest earned by the cooperative housing corporation on its escrow and reserve accounts was not "income derived... from members or transactions with members" and could not be reduced by deductions attributable to "furnishing services, insurance, goods or other items of value to members"? The answer lies in a determination of the similarity of purpose of Subchapter T to that of section 277. Like section 277, Subchapter T applies to cooperative organizations, including cooperative housing organizations, and is intended to establish parameters for taxing income derived from members of the cooperative and income generated by other sources.

Cooperatives have been considered unique entities for income tax purposes since shortly after enactment of the Sixteenth Amendment to the United States Constitution. Special income tax treatment for selected cooperatives formally was introduced into the federal tax laws with the Revenue Act of 1916. The 1916 Act exempted from income tax "farmers", fruit growers or like association[s]" that acted as sales agents to market produce of its members at cost (i.e. producer associations). The Revenue Act of 1921 expanded the 1916 exemption to include agricultural associations that acted as the agent for members to purchase supplies and equipment at cost (i.e. consumer associations). The 1921 Act specifically allowed the cooperative agricultural associations to exclude from gross income amounts refunded to member-patrons which resulted from overcharges directly attributable to the cooperative associations' selling or purchasing transactions made on behalf of their members. In other words, the savings that a cooperative realized as a result of volume sales or purchases made on behalf of its members were returned to its members based on their proportionate shares of usage of the cooperative's services.

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40 See supra note 33. See also Concord Village, Inc. v. Commissioner, 89 T.C. 105 (1987); Park Place, Inc. v. Commissioner, 57 T.C. 767 (1972).

41 The Sixteenth Amendment to the United States Constitution was passed in 1913 and allowed Congress to "lay and collect taxes on income, from whatever source derived...." In the Revenue Act of 1913, ch. 16, 38 Stat. 114 (1913), Congress exempted from taxation "agricultural and horticultural organizations" without specifying the applicability of this exemption to cooperatives.


43 Revenue Act of 1921, ch. 136, section 231, 42 Stat. 253 (1921).
The statute required:

that there be a direct functional relationship between the activity undertaken by the cooperative and the member patron in order to qualify the repayment of the overcharge as patronage dividend. . . . Absent this direct relationship between the cooperative and member patron, the association would no longer be functioning either as a sales agent or a purchasing agent for the member. Therefore, any income to the cooperative which was derived from activities not directly related to business done with or for member patrons would not be derived from the basic functional activities of the cooperative and thus would not be patronage sourced. As a result, such income would not qualify for the exemption provided under section 231(11) [of the Revenue Act of 1921].

The Revenue Act of 1926 continued the dependence of the income tax exemption upon the direct relationship between the cooperative and its activity undertaken on behalf of its members. The Revenue Act of 1934 recodified the prior tax statute, and for the first time, the Revenue Act of 1951 expressly recognized that both exempt and nonexempt cooperative associations were entitled to reduce patronage sourced gross income by "patronage dividends" which arose from its business activities and which were refunded to its member-patrons. In trade-off, member-patrons were to be taxed on the receipt of the patronage dividends. This tax structure was adopted by sections 521 and 522 of the Internal Revenue Code of 1954. However, soon after enactment of the 1954 Code, the inadequacy of these statutes became apparent. A loophole enabled both the cooperative and its member-patrons to avoid the income tax liability attributable to the patronage dividend. Congress responded in part by restating the prior law and in other part by tightening its language. The outcome was the 1962 codification of Subchapter T. The interaction of the provisions of Subchapter T is described in the following paragraphs.

44 Ohio St. L. J. at 572.
45 Revenue Act of 1926, ch. 27, section 231(12) pt. 2, 44 Stat. 40-41 (1926) allowed the income tax exemption to the cooperative association only if a consumer cooperative association limited the amount of its dealings with nonmembers to fifteen percent of its total business or if a producer cooperative association limited the amount of its dealings with nonmembers to fifty percent of its total business.
48 Patronage sourced gross income was essentially income derived from transactions "in furtherance of" and "ordinarily and necessarily incidental to" the basic functions of the cooperative. See language of Section 314 of the Revenue Act of 1951 S.Bil 892, introduced by Senator Williams of Delaware, 97 Cong. Rec. 1317 (1951).
50 Several cases demonstrated that both the cooperative and the patron-members could avoid tax on the patronage income. See, e.g. Commissioner v. Carpenter, 219 F.2d 635 (5th Cir. 1955); Long Poultry Farms, Inv. v. Commissioner, 249 F.2d 726 (4th Cir. 1957).
51 See discussion in Coastal Chemical Corp. v. U.S., 546 F.2d 110, 117 (5th Cir. 1977).
1383, 1385 and 1388) prevented double income tax avoidance; no longer could both the cooperative and the member-patrons undeservingly benefit. The current Internal Revenue Code of 1986 adopted the provisions of Subchapter T intact.

Through the interaction of section 1382(b) and section 1388, Subchapter T allows a cooperative to reduce income derived from patronage sources by patronage dividends distributed to member-patrons. Pursuant to the statutes, in order to be considered patronage sourced and thus to qualify as patronage source income or as patronage dividends (refunds of savings resulting from economical and efficient business capabilities), it must be connected with "business done with or for patrons." Case law has interpreted this requirement to necessitate a direct or indirect,

53 IRC section 1385 provides that if a cooperative reduces patronage source income by patronage dividends distributed, the recipient-patrons must include the patronage dividends in their gross income.
54 IRC section 1382(b)(1) provides in relevant part:

(b) Patronage Dividends and Per-Unit Retain Allocations.--In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year--

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year;
(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred;

* * *

For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) or (2), be treated in the same manner as an item of gross income and as a deduction therefrom, and in the case of an amount described in paragraph (3) or (4), be treated as a deduction in arriving at gross income.

55 Patronage dividends have been described by one author in nontax terms as follows:

Patronage refunds result because cooperatives, like most other businesses, cannot estimate with certainty their exact operating costs at the time they occur. To be on the safe side, cooperatives therefore seek to operate with sufficient margins to so that their income exceeds their outgo. Patronage refunds also occur when cooperatives are relatively efficient and realize savings after paying going prices for products they market or after charging going prices for the supplies, goods, and services they provide. . . .

Patronage refunds, then, are the "group savings" that are returned to individual patrons in proportion to the business they do with their cooperatives. The technique explains why, in the conventional sense, cooperatives that return patronage refunds to members have no profits as legal business entities.

ABRAHAMSSEN, COOPERATIVE BUSINESS ENTERPRISE at 308 (1976).
56 IRC section 1388(a) states:

(a) Patronage Dividend.--For purposes of this subchapter, the term "patronage dividend" means as amount paid to a patron by an organization to which part I of this subchapter applies--

(1) on the basis of quantity or value of business done with or for such patron,
(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
(3) which is determined by reference to the net earnings of the organization from business
but not incidental, relationship between the activity generating the income and the basic functions for which the cooperative was created on behalf of the cooperators.\(^7\) This nexus is seen in the following test which the IRS originally proposed\(^5\) and a number of courts\(^5\) has adopted:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the . . . activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative’s marketing, purchasing or service activities, the income is from patronage sources. However, if the transaction . . . merely enhances the overall profitability of the cooperative, being merely incidental to the . . . cooperative operation, the income is from nonpatronage sources.\(^6\)

Several courts have viewed this test expansively by focusing attention also on the business and economic conditions necessitating the cooperative to engage in the income-generating activities which were at issue.\(^6\) As one court explained the test:

Considering the income-generating transaction in its relation to all the activity undertaken to fulfill a cooperative function will allow courts to

done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

\(^5\) See Land O’Lakes, Inc. v. U.S., 675 F.2d 988, 993 (8th Cir. 1982) which adopted the test set forth in Rev. Rul. 74-160, 1974-1 C.B. 245. In that case, the Eighth Circuit held that the income earned on bank stock purchased by the dairy cooperative in order to obtain a loan was patronage sourced, “because the transaction actually facilitated the cooperative’s activities by providing financing on terms favorable to the cooperative.” Id. at 993. Yet the Court took a broad approach and implied that because the income was generated by a transaction for which there was a business reason and general business connection to the cooperative’s operations, it was patronage source income.

\(^6\) Rev. Rul. 69-576, 1969-2 C.B. 166; see Rev. Rul. 74-160; Rev. Rul. 75-228, 1975-1 C.B. 278. But see, Treasury Reg. section 1.1382-3(c)(2) which provides that “income from sources other than patronage” means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. Examples cited in the regulations of nonpatronage sourced income blanketly include income derived from the lease of premises, income from investment in securities, and income from the sale or exchange of capital assets. See also Pri. Ltr. Rul. 85-32-004.


\(^6\) Rev. Rul. 69-576.

\(^5\) Cotter and Company v. U.S., 765 F.2d 1102, 1110 (Fed. Cir. 1985); see also Land O’Lakes, Inc. v. U.S., 675 F.2d 988. Clearly, the Federal Circuit attempted to distinguish the cooperative from a for-profit corporation, the latter which has profitability as a primary function. (See discussion supra note 17. In reversing the Claims Court, the Federal Circuit stated that --

Cotter’s transactions here were not merely to gain incidental profits; they resulted from activities integrally intertwined with the cooperative’s functions. The earnings Cotter in this case produced and passed through to its members are patronage dividends. (765 F.2d at 1110).
distinguish from cooperative activity transactions which merely enhance overall profitability in a manner incidental to cooperative function. Such activity is not to receive the benefits of Subchapter T, but other activity, which does directly relate to cooperative function when considered in its actual business environment, cannot properly be considered outside "business done with or for patrons."62

The test, as enhanced, infers that as long as the income in issue is generated from activities that directly or indirectly, but actively, facilitate accomplishment of the cooperative's fundamental functions, it may be characterized as patronage sourced.

If this expanded "motive" test had been applied to the facts of the Concord Consumers Housing Cooperative case, it seems that the income earned on the escrow and reserve accounts would have been categorized as patronage sourced for Subchapter T purposes. There, the cooperative housing organization was required by the federal and state housing authorities to maintain escrow and reserve accounts. As stated in the regulatory agreements, these accounts were a pre-condition to receiving the government backed special financing and mortgage insurance. Only by obtaining the special financing could the cooperative fulfill its basic function of providing housing facilities for low and moderate income persons. The cooperative's establishment of the escrow and reserve accounts was necessitated by economic and business conditions; the accounts facilitated the accomplishment of the basic functions of Concord Consumers Housing Cooperative. The interest income produced by the accounts was not "extrafunctional;" it was not intended to merely generate incidental profits. Rather the interest "resulted from activities integrally intertwined with the cooperative's functions."63

Presuming that the income of a cooperative housing organization is categorized as patronage sourced for Subchapter T purposes, the question arises as to whether that income necessarily also should be characterized as derived from "members or transactions with members" for purposes of section 277. Applying a test of the five senses -- smells like, looks like, tastes like, feels like and sounds like -- the kinship of section 277 and Subchapter T leads to the belief that, absent any consideration of section 512,64 such income, which is substantially and integrally

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62 Cotter and Company v. U.S., 765 F.2d 1102, 1110. In that case, the cooperative was formed by small independent hardware retailers to gain the benefit of economical buying and merchandising through large volume transactions. The cooperative was required to retain substantial funds on hand at times during the year for business reasons. The cooperative decided that rather than allow the funds to lay fallow, it would invest it in interest bearing certificates a deposit and short-term commercial paper. Additionally, excess warehouse space was tented. The issue was whether the interest income and rental income was patronage sourced. The Federal Circuit rejected the direct relationship test which had been used by the Claims Court.

63 See Cotter and Company, 765 F.2d at 1110.

64 The absence of a consideration of section 512 reflects the Tax Court's stance in Concord Consumer Housing Cooperative v. Commissioner that it need not explore a connection between Subchapter T and section 277. The Tax Court specifically stated: "[W]e have found nothing to indicate that Congress intended that phrase [in section 277: "income derived . . . from members or transactions with members"] to include
related to the basic functions of the cooperative, likely should be considered both patronage sourced and "derived . . . from members or transactions with members." This conclusion is based on the functional similarity of the language, purpose and operation of Subchapter T and section 277. It is clear that under the two sets of provisions, Congress contemplated special income tax advantages exclusively for that portion of the cooperative's operations which promotes its fundamental functions; Congress further intended to deny special treatment where "extrafunctional" activities are involved.

3. Conflicting Analysis

The Tax Court's refusal in the Concord Consumers Housing Cooperative case65 to examine the nexus between section 277 and Subchapter T, resulted in its avoiding conflict. If the relationship of section 277 were analyzed independently with each section 512 and Subchapter T, differing conclusions would be produced as to the proper label to attach to the interest generated by the escrow and reserve accounts.66 Relying upon the historical link between section 277 and section 512, the Tax Court broadly categorized the interest investment income as similar to "unrelated business income" within the meaning of section 512. The Tax Court concluded that because the interest was investment income, it necessarily could not be derived from "members or transactions with members" within the meaning of section 277. The Tax Court chose not to introduce into its decision an important factor: the housing cooperative's motive for deriving interest income. If the Tax Court had considered this factor as pertinent to its decision, it would have been forced to distinguish between pure for-profit investment motive and investment intent necessitated by business reasons. In that event, the Tax Court likely would have realized that the interest income resulted from accounts which were essential for fulfillment of the cooperative's cornerstone functions. The income was more akin to "exempt function income" as defined in section 512 and to "income derived . . . from members or transactions with members" within the meaning of section 277. If this had been the analysis utilized by the Tax Court, there would have been consistency in categorizing the interest income. It would have been treated as "exempt function income,"67 as "patronage sourced income,"68 and as "income all income from sources substantially related to the function of the organization . . . Indeed, the plain language of section 277 precludes us from reaching such a conclusion." See Concord Consumer Housing Cooperative v. Commissioner, 89 T.C. at 121-22.

65 See Concord Consumers Housing Cooperative v. Commissioner, supra note 3.

66 The Tax Court analyzed the facts of the Concord Consumers Housing Cooperative case, and without assessing the impact of Subchapter T, the Court exclusively looked to section 512 for guidance with regard to section 277 definitions. The Court held, as discussed in article pages 5-7, that the interest income in question was like "unrelated business income" and thus was "non-membership" income for section 277 purposes. The author analyzes the same facts and concludes in the article pages 9-12 that under Subchapter T, the interest income would be considered patronage sourced and thus also would be membership income for section 277 purposes. The author's approach is not inconsistent with the concurring opinion in the Concord Consumers Housing Cooperative case. See supra, note 33.

67 See IRC of 1986, sections 511-512.

COOPERATIVE HOUSING ORGANIZATIONS derived from members or transactions with members.\textsuperscript{69} Hence the anomaly would have been eliminated. However, this analytical approach would have forced the court to change its final decision line in the case.

**FAIRNESS OF APPLYING IRC SECTION 277 TO COOPERATIVE HOUSING ORGANIZATIONS**

It has been demonstrated that the three attributes of section 277 may be present and can trigger the application of the statute's restriction and sanction with respect to cooperative housing organizations. But, is it fair to apply section 277 to cooperative housing organizations? Logic supports the application of section 277 to cooperative housing organizations.

The statute applies to most non-exempt membership organizations and does not specifically exempt cooperative housing organizations from its reach. Its purpose is to merely limit the type of deductions with which a membership organization may offset income from membership sources. Expenses associated with "extrafunctional" operations of a membership organization should and can be utilized currently to reduce taxable income generated by "extrafunctional" sources. On the other hand, member-related expenses should not and cannot reduce taxable income realized from "extrafunctional" sources.

The history, purpose, and operation of cooperative housing organizations as well as that of each section 512 and Subchapter T provide convincing support. The monetary and functional foundations of a cooperative housing organization are focused on its members. Its primary funds should be generated by "members or transactions with members" and its expenditures should be dedicated to its cornerstones -- efficiently providing economical housing, ancillary facilities and services to its members. The income taxation structure should and does recognize that no tax advantage or disadvantage should attach to a cooperative housing organization which is designed and is operated exclusively to allow individuals to join together to obtain economical housing and ancillary facilities as well as efficient services attributable to those functions. Yet, in the real world, a cooperative housing organization may not operate solely to further those basic functions. Instead it might also become involved in "extrafunctional" activities and transactions. In that event, the cooperative housing organization may realize income from sources not integrally intertwined with its basic functions; also it may incur expenses for purposes substantially unrelated to or removed from its cornerstones. Where a cooperative housing organization abandons its exclusivity of purpose -- the pursuit of its vital and basic functions -- it should no longer be entitled to a neutral tax position. Income derived from "extrafunctional" sources should be taxable and should not be reduced nor "neutralized" by expenditures attributable to the cooperative housing

\textsuperscript{69} See IRC of 1986, section 277.
organization's basic functions. This is the tax consequence contemplated and advanced by section 277. If section 277 did not exist, income tax abuse likely would be courted and fairness would be undermined.