M E M O R A N D U M

TO : FILE

FROM : ALDEN E. DANNER, ET AL.

DATE : MARCH 4, 1982

RE : ODD FELLOWS SIERRA RECREATION ASSOCIATION FILE: RDD-15076

I. INTRODUCTION

This memorandum outlines a skeleton plan and summarizes initial research for the above organization. It also poses several questions we need answered by the client.

The memorandum assumes that the association owns the common areas, including those suitable for timber operations. It also assumes the association's regular members do not want associate members to share in whatever bounty is available.

Our review of documents and the personal inquiries that we have made indicate that the property owned by the association was acquired in the late 1940's, a portion of it has been subdivided, that the covenants, conditions, and restrictions (CC&R's) on the land expired in 1975, that the association is a nonprofit corporation which holds an exemption from state income tax but does not hold an exemption from federal income tax, but that the association has been filing federal income tax returns on forms which are supposed to be used by tax exempt organizations.

II. PLAN OUTLINE

1. Change the present organization of the association into two associations, one owning the recreational and other common areas and the other representing the lot owners.

a. The entity owning the recreational and other common areas may be organized either as a profit making corporation or a nonprofit corporation.

(1) If the current general members wish to distribute earnings from the profitable activities on the land to themselves from time to time, a profit corporation will be required. If this is done, several questions arise:

(a) Will all regular members become stockholders, or just those entitled to the association's assets on dissolution.

(b) Will there be any restriction on the transferability of the stock, such as limiting sales/transfer to lot owners?

(c) Will the new corporation's shareholders have a right of first refusal if a shareholder wants to transfer his stock?

(d) Will shares be issued according to the number of memberships held or number of lots owned?

(e) Will the corporation be allowed to issue additional shares and, if so, will the shareholders have preemptive rights?

(f) Are the expected after-tax benefits to the shareholders sufficient to justify all the expense involved?

(2) If current periodic distributions of profit are not required, then it should be possible to continue the corporation as a nonprofit corporation. The members of the corporation are entitled to its net assets or the proceeds of its assets upon its dissolution, if that should ever occur. However, we recommend that such nonprofit corporation be significantly reorganized from the form of the present nonprofit corporation to eliminate the class of associate members and to better define the rights of regular members. In addition to the applicable inquiries listed above, the following additional inquiries are applicable to the nonprofit corporation concept:

(a) Is membership transferable?

(b) If not, since it is a property right of value, what happens to the membership in case of the divorce of a member or the death of a member?

2. Incorporate the lot owners into a nonprofit, tax-exempt homeowners' association. In order that the association will be composed of all present and future lot owners, it will be necessary to adopt and record new CC&R's. All current lot owners will have to sign such CC&R's. In this area, certain questions are raised:

a. Will there be more than one class of members? If so, what are the criteria for membership?

b. What are the restrictions on membership transferability? (Note: The present bylaws prohibit transfer/assignment of memberships. The bylaws are unclear, however, on what happens when a member seels his lot. To be qualified as a member, one need only "purchase" a lot. I read this provision (Section 2.02) to mean that one remains a member even after he sells his lot. Memberships are limited, however, to 366 (Section 2.06).)

3. Grant the Homeowners' Association a license to use the common areas in the subdivided portion of the property and the recreational areas. Several questions arise with respect to this approach:

a. What will be the cost and duration of the license?

b. Who will have responsibility for maintaining the recreational areas and the common areas in the subdivided portion of the property?

c. Will the license include the right to build on/improve the subject property?

III.IS THE LAND SUBJECT TO A TRUST?

One area which will have to be explored throughly is whether the land held by the association is subject to a trust imposed by law due to the circumstances in which the land was received by the association or held by the association since its receipt. This will require legal research after the facts are ascertained. Facts to be ascertained concern the circumstances around the acquisition of the land and what members and associate members have been told over the years about the land.

IV. CORPORATE LAW ANALYSIS

The present association is classified by the California Secretary of State as a nonprofit, mutual benefit corporation. Since

it is nonprofit, distributions are prohibited except on dissolution. California Corporations Code § 7411 (unless otherwise indicated, all code sections cited hereafter shall refer to the corporations code). A "distribution" is defined in Section 5049 as a distribution of any gains, profits, or dividends "to members as such."

A nonprofit mutual benefit corporation may amend its articles to change its status to a business corporation. Section 7813.5. The amendment requires both board and member approval (i.e., the affirmative vote of those at a meeting and voting and at least a majority of the quorum). Section 7812.

If a mutual benefit corporation changes its status to a business corporation, it becomes subject to state franchise tax upon filing the Certificate of Amendment. Section 7813.5(e). Since filng the amendment amounts to a reincorporation, the Secretary of State requires payment of the $200 minimum franchise tax at the time of filing.

It therefore appears clear from a corporate law standpoint that the corporation may change its status from a nonprofit, mutual benefit corporation to a business corporation. Associate members conceivably may challenge, however, the regular members' right to pass the necessary enabling amendments to the articles without their approval. Section 7813(e) supports such a view, providing in part that, a "class" of "members" must approve amendments to the articles if the amendments would effect a cancellation of the memberships of such class.

It does not appear, however, that the association's associate members are true members under the code. Section 5056 defines a "member" as one who pursuant to the articles or bylaws: (1) has the right to vote on directors, on the disposition of the corporation's assets, or on mergers/dissolution; or (2) is designated as a member and, under a specific provision of the articles or bylaws, has the right to vote on changes to the articles or bylaws. The association's associate members meet neither of these tests.

Lot. ass. of more than. on lots will be paid on all assesmt.

V. REAL PROPERTY LAW ANALYSIS

The preparation of CC&R's, a separate homeowners' association in corporate form, and agreements between the two corporations are legal documentation but do not present any significant legal issues at this time. A number of decisions with respect to the contents of the CC&R's and corporation bylaws will have to be made at a future time if this organizational route is taken.

VI. TAX ANALYSIS

A. Comments on the Present Status

The present tax status of the association is confusing. The Internal Revenue Service issued a ruling in 1955 that the association was exempt from taxation under Internal Revenue Code § 501(c)(4) [Civic Leagues, Social Welfare Organizations, or local associations of employees]. It seems to me, however, that qualification under Internal Revenue Code § 501(c)(7) [Social Clubs] or Internal Revenue Code § 528 (homeowners' associations] would be more appropriate.

At any rate, the association's 1975 returns were audited, and the IRS reported in August, 1978, thatthe association was functioning in furtherance of its exempt status under Internal Revenue Code § 501(c)(4), but that it was subject to a tax on its unrelated business income under Internal Revenue Coee § 512a(1). One month later, however, the IRS informed the association that because it was not operating within the scope of 501(c)(4), its exemption had been revoked effective for the 1976 fiscal year.

Cecil Walton, who has been preparing the association's returns and who is described as one familiar with the negotiations with the IRS, advised however, that the association had been exempt not under 501(c)(4), but rather 501(c)(3) as a religious organization. He said the exemption was lost because nothing religious was going on.

When the exemption was lost, we believe the association should have begun filing returns on Form 1120 (Corporation Income Tax Return). Instead, it began filing Form 990-T (Exempt Organizations Business INcome Tax Return), used when an exempt organization has unrelated trade or business income. In completing this form, it

included proceeds from the assessment of members as income. The IRS apparently never has questioned this practice, but if the wrong forms have indeed been filed, I doubt that the statute of limitations has started.

The state franchise tax situation is equally muddled. The association apparently has been declared exempt under Rev. & Tax Code § 23701g [Social and Recreational Organizations, analogous to Internal Revenue Code § 501(c)(4)] by the Franchise Tax Board, and it consistently has been filing Form 199 (Exempt Organization Annual Information Return). It did not report the loss of the federal exempt status to the Franchise Tax Board, nor has it filed Form 109, used to report unrelated taxable business income to the state. Moreover, it has stated on the annual Form 199 filings that the association is filing a federal form 990, not Form 990-T. Thus, the Franchise Tax Board has not been tipped off either that the federal exemption has been lost or that the association is paying a tax on its unrelated business income.

Mr. Walton said the association decided to "take a chance" with the state, especially since the tax due would be minimal if they got caught. Since the tax is minimal, however, why not just pay it?

In short, we believe the association's tax reporting procedures need correction.

B. Comments on the Plan

Changing the status of the present association to a business corporation would be merely a change in form and not a taxable event. The IRS presently treats the association as a taxable corporation, and when the "new" sharehodlers start receiving dividends, they will be taxed in the usual manner.

On the other hand, the IRS might claim that an exchange has taken place or that a taxable reorganization has occurred. Although this seems farfetched, perhaps the prudent course would be to get an advance ruling.

We looked into the area of what the new shareholders' tax basis in their stock would be, but the best we could come up with was Revenue Ruling 55-737, which involved a distribution on dissolution of an athletic club. The IRS there held that a member's basis included his initial membership fee but not his annual dues.

With respect to the new homeowners' association, it will be organized as a nonprofit mutual benefit corporation exempt from tax under Internal Revenue Code § 528 and the analogous State Revenue and Taxation Code section. We do not foresee any problems with this at this time.

VII. SECURITIES ANALYSIS

At some point between the time the association was formed and its proposed transmutation to a profit corporation, if that is to occur, securities must be issued. Among the issues are these:

1. Is an association membership a security, and have securities therefore already been issued?

a. If so, was the issuance pursuant to federal and state exemptions?

(1) If so, do the applicable exemptions impose any restrictions on the securities that might block the plan?

(2) If not, can members rescind and obtain past dues/assessments?

b. If so, will the change in statuts of the association be a "reissuance" subject to registration and qualification absent an exemption?

(1) If so, what exemptions are available and what restrictions will they impose on the stock?

2. If securities have not been issued, what exemptions, if any, are available?

The answers to the above questions will take considerable more research. At this point, the law can be summarized as follows:

1. The Federal nonprofit corporation exemption is in Section 3(a)(4) of the 1933 Act, which exempts securities of an issuer "organized and operated exclusively for religious, educational,

benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of thenet earnings of which enures to the benefit of any person, private stockholder, or individual." In a 1972 ruling, however, the SEC stated that issuers of interests in recreational real estate cannot use the 3(a)(4) exemption because the exemption does not apply to entities organized for "social and recreational" purposes.

2. The State nonprofit corporation exemption is in Section 25100j, which exempts any security "except evidence of indebtedness of an issuer organized exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of any private shareholder or individual. . . ." In Opinion 67/97c, however, the Commissioner ruled that a country club membership assignable only to the buyer of a member's house or to the club is a security constituting an interest in real estate, exempt from registration under Section 25100f, but subject to qualification with the Real Estate Commissioner.

3. There do not appear to be any available California exemptions if the issuance of shares by the new organization requires qualification. The Commissioner therefore will impose her fair, just and equitable standards, which probably will require the association to include all regular members in the organization, not just those regular members who would be entitled to distributions on dissolution.

4. The Federal Intrastate Offering Exemption is unavailable since a few regular members live outside California.

5. It is uncertain whether the Federal Private Placement Exemption is available, although the large number of issuees by itself does not destroy the exemption. If shares are issued pursuant to the exemption, they apparently will be restricted.