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FEDERAL INCOME TAX CONSEQUENCES FOR CONDOMINIUM HOMEOWNERS: A REQUEST FOR EQUITABLE TAX TREATMENT

INTRODUCTION

The purpose of this comment is to examine the application of the federal income tax laws to condominium homeowners. The introduction briefly summarizes the history of the condominium and the advantages of condominium ownership. Particular attention then will be focused upon the incorporated condominium homeowners association. The pivotal question to be explored is whether or not a condominium owner receives equitable treatment under the present structure of federal taxation in relation to the owner of the traditional single family dwelling. An analysis of the alternative tax planning devices utilized to minimize the tax burdens of a condominium owner may be one solution to the problem and this alternative will be explored. Special legislation for the condominium homeowners association is another possible solution and pending legislative proposals will be examined.

The condominium is a relatively recent phenomenon in California.

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1. A condominium homeowners association is the group which manages the common areas of the condominium project.

2. The various terms describing the components of a condominium project will be defined for the purposes of this paper. According to the California Civil Code, a condominium is:

   [A]n estate in real property consisting of an undivided interest in common in a portion of a parcel of real property together with a separate interest in space in a residential, industrial or commercial building on such real property, such as an apartment, office or store. A condominium may include portions of such real property.

   Such estate may, with respect to the duration of its enjoyment be either (1) an estate of inheritance or perpetual estate, (2) an estate for life, or (3) an estate of years, such as a leasehold or subleasehold.

   CAL. CIV. CODE § 783 (West Supp. 1974). This comment confines its discussion to residential condominiums not purchased for profit, and emphasizes the tax treatment of the condominium management corporation. California Jurisprudence defines a condominium project as "the entire parcel of real property including both the common areas with the ownership as tenants in common and the individual units with the title being separate and in fee simple." 12 CAL. JUR. 3d, Condominiums and Co-operative Apartments §§ 7, 11 (1974). A common area is defined as "that portion of the real property which is owned by all the unit owners as tenants in common." Id. §§ 7, 11. A unit is defined as the interest in the residential building which is owned separately and individually by the condominium owners." Id. § 7.
far as Roman days, and even to the era of the ancient Hebrews in the fifth century B.C., convincing documentation first shows its existence in Europe in the early Middle Ages. In more modern times, interest in this type of property arrangement developed first in large American population centers where individual houses were impractical as well as expensive. Developers first began constructing condominiums in the Washington, D.C. area and in Florida. In both places, inflation was causing the cost of labor, land and building materials to soar. Since construction costs were increasing at a more rapid pace than the possible return from rental payments on an apartment building complex, the condominium became an increasingly attractive prospect, promising a greater margin of profit for the developer. In California, developers began construction of the condominium on a large scale in the early 1960's.

Both federal and state legislation encouraged the emergence of the condominium as a viable form of property ownership. Section 1715(y) of the National Housing Act authorized FHA insurance to guarantee the mortgages of the individual condominium owner's interest. The Regulations accompanying Section 1715 (y) state its purpose as follows:

To provide an additional means of increasing the supply of privately owned dwelling units where under the laws of the State, in which property is located, property title and ownership are established with respect to a one-family unit which is a part of a multifamily project.

California passed its own enabling legislation for condominium ownership in 1963. This statute, called the Horizontal Property Act, recognized this new concept of home ownership and established appropriate regulations in the public interest. The California Act includes guidelines for the grant or master deed for condominium transfers. According to section 1353 of the California Civil Code, this document contains the following inci-

7. See Borgwardt, supra note 3.
9. Id.
dents of ownership: a statement of the boundaries of each unit; a provision for a nonexclusive easement for ingress, egress and support through the common areas for each unit; a statement that the common areas are owned by the owners of the units as tenants in common, in equal shares one for each unit; and the rights of each unit owner to refinish and decorate the inner surfaces of his own unit. It is possible to alter these provisions by the deed, declaration of restrictions, or the general plan. Further, the owner of the project must record a declaration of covenants, conditions and restrictions, referred to as the CC and R's, which may be enforced by any unit owner in the project. These restrictions may provide for insurance coverage of the common areas, as well as for their maintenance and general upkeep. Usually, the restrictions also include provisions for a management structure for the common area and those specific powers necessary to enable the management to govern and perform its duties effectively. The Act contains provisions for the enforcement of the payment of monthly dues and other amounts assessed against the units by permitting the homeowners association to record a lien against the delinquent condominium unit and even to foreclose on the unit. The Act also provides that the homeowners association may record a lien against the unit when the unit owner has failed to meet his fractional share of obligations incurred for labor and materials for the common areas.

The California Real Estate regulations also provide guidelines for the condominium developer. Section 2792.8 of these regulations suggests matters that should be included in the instruments for the management, regulation and control of the condominium project. Generally, the developer is required to post a security bond to assure the availability of funds for the ownership, operation and maintenance of the common areas during the start-up period, although alternative plans may be accepted. Section 2792.10 sets forth the general policies that the real estate commissioner should follow in evaluating condominium developments.

12. Id.
13. Id.
14. Id. § 1355.
15. Id.
16. Id.
17. Id. § 1356.
18. Id. § 1357.
19. CAL. ADM. CODE, tit. 10, § 2792.8 (1971). See also CAL. BUS. & PROF. CODE §§ 11,000.1-11,023 (West Supp. 1974) which also regulate the building and sale of condominium developments.
20. Id.
21. Id. § 2792.9.
projects and in issuing an informational public report. Each prospective purchaser of a condominium must be afforded an opportunity to read this public report and must acknowledge having done so in writing before signing a sales contract.

ADVANTAGES OF OWNING A CONDOMINIUM

The residential condominium enables more people to live in a smaller area than if each home were a detached unit resting on an individual plot of land, in the traditional American pattern. While condominium development is a more efficient and economical approach to the problem of housing, it does not diminish the high value that our society places on individual homeownership. The purchaser of a condominium acquires two real property tenancies at once: an undivided interest in common in certain jointly owned areas and a separate and individual title to his unit. Each unit owner procures his own financing for the unit and is individually liable for the mortgage upon it. He does not assume any responsibility for his neighbors' payments on their units, and his interest will not be jeopardized should the other unit owners default on their mortgages.

The buyer of a condominium pays one fourth to one half a percentage point more for his mortgage than a comparable purchaser of a detached dwelling unit. Yet, it is still possible for the condominium owner to pay less for the same amount of living space than if he were to purchase a detached single family dwelling. In all likelihood, less land will have been utilized than in the individual tract plan, and the construction costs will have been lower due to the extensive use of similar materials on the same site and to the use of common features such as shared walls and walkways.

Planning common area facilities for group use is another cost-reducing factor. The unit owner may avail himself of attractive and expensive recreational facilities, such as swimming pools, tennis courts, and golf courses, which he would not be able to afford or to finance on an individual basis. In addition, the condominium owner normally bears no responsibility for exterior maintenance and upkeep; thus, theoretically he has more time available for leisure activities than the owner of a detached single

22. Id. § 2792.10.
23. Id. § 2795.
26. See Condo's Very Special Problems: how to spot, solve—and avoid—them in the first place, 46 HOUSE & HOME 67 (Sept. 1974) [hereinafter cited as Special Problems].
dwelling who is normally personally responsible for the exterior maintenance of his home.

The condominium buyer may also find that the cost of his housing is lower than that of the apartment renter. His monthly payment includes items which are tax deductible, and the portion of his monthly payment which constitutes principal contributes to the building of equity in his investment. An apartment dweller, who pays rent, has no investment and acquires no equity. A further advantage in condominium ownership is the realization of appreciation in the investment, a premium which the apartment dweller does not enjoy. Although a condominium buyer pays real estate commissions and mortgage and interest expenses, these costs usually are more than offset by the appreciation of his property. The apartment renter must include the landlord's profit in his monthly payment without any compensating financial benefit to balance this cost factor.

Lastly, the condominium owner enjoys the pride and security of ownership and has a legal voice in the management of the project. Although compulsory membership may, at a glance, appear to be detrimental, through the vehicle of the management association the unit owner may vote and participate in the decision-making process affecting the common areas and may be elected to the board of directors of the association.

**Tax Advantages**

The Internal Revenue Code also provides federal income tax deductions for the condominium owner. If the unit is his personal residence, several tax deductions are available: (1) a deduction for interest paid on the unit mortgage; (2) a deduction for property taxes paid on the unit; (3) a deduction for certain casualty losses; (4) a possible deferral of gain from the sale of the unit.

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27. See notes 30-32 and accompanying text infra.
29. See Special Problems, supra note 26 at 74-83.
30. INT. REV. CODE OF 1954, § 163(a) provides: "General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year of indebtedness." See Rev. Rul. 31, 1964-1 CUM. BULL. 300, 302, which specifically provides that interest on a condominium mortgage may be deducted on an itemized return.
31. INT. REV. CODE OF 1954, § 164(a) provides in part:
   General Rule.—Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) State and local, and foreign, real property taxes.
   See Rev. Rul. 31, 1964-1 CUM. BULL. 300, 302, which specifically provides that taxes on the condominium interest may be deducted on an itemized return.
32. INT. REV. CODE OF 1954, § 165 provides in part:
   (a) General Rule.—There shall be allowed as a deduction any loss sus-
if the owner reinvests this gain in another personal residence within one year.\textsuperscript{33} If the unit owner is over 65, he may take advantage of special internal revenue code provisions for the sale of a residence by a senior citizen.\textsuperscript{34} If the property is converted to rental use, a deduction for depreciation of the unit is allowed.\textsuperscript{35}

**THE COMMON AREA AND INCOME TAX CONSEQUENCES**

**Organization of the Common Area**

The common area is usually managed and maintained by an organization whose members are the unit owners. The need to limit liability for tort claims arising from accidents in the common area, as well as to minimize other forms of liability such as actions for breach of contract or breach of the equitable servitudes contained in the master deed, is the key factor in choosing the form of the organization. If the unit owners form a partnership, each owner will be personally liable on all of the contracts entered into by the partnership as well as for accidents which result from negligent conditions, such as broken glass or defective equipment, found in the common area.\textsuperscript{36}

If the condominium owners form an unincorporated association during the taxable year and not compensated for by insurance or otherwise.

\textsuperscript{33} See Rev. Rul. 31, 1964-1 Cum. Bull. 330, which provides that section 1034 applies to the purchase or sale of a condominium.

\textsuperscript{34} INT. REV. CODE of 1954, § 121. This section includes the following limitations: if the adjusted sales price exceeds $20,000, that portion of the gain which bears the same ratio to the total amount of such gain as $20,000 bears to such adjusted sales price shall be exempt from gain. Further, the taxpayer must have owned and used this property in aggregate periods of five or more years in the eight years preceding the sale. Only one such sale or exchange is allowed.

\textsuperscript{35} INT. REV. CODE of 1954, § 167(a) provides:

General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income.

\textsuperscript{36} See CAL. CORP. CODE § 15013 (West 1973).

Where, by any lawful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his copartners, loss or injury is caused to any person, not being a partner in the partnership, or any penalty is incurred, the partnership is liable therefor to the same extent as the partner so acting or omitting to act.

See also Id. § 15015.

All partners are liable (a) Jointly and severally for everything chargeable to the partnership under sections 15013 and 15014, (b) Jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.
tion, the issue of liability becomes less clear. Such an association is definitely liable on contracts and in tort to a person who is not a member of the association. In *White v. Cox*, the California Court of Appeal held that a person who is a member of the unincorporated association could bring an action against the association for damages caused by negligent maintenance of the common areas. The court based its decision on the concept that the unincorporated association of unit owners was a separate entity, and that the unit owners did not directly control the activities of the management body set up to handle the common affairs of the condominium owners. This case does not resolve the question of whether and to what extent the individual unit owners are personally liable to an accident victim. In his concurring opinion, Justice Roth noted:

The ownership of the common areas in the condominium project is vested in the individual unit owners as tenants in common.

Thus, even though, as the majority holds, the association may be sued in its separate name, it is apparent that the legal owners of the common area are not immunized from liability by virtue of the mere existence of the association.

After analyzing the present law in California, the justice concluded:

The absence of an express statutory scheme for the redistribution of tort liability, such as those found in Alaska, Massachusetts and Washington legislation, is ample warning that the problem of protecting the individual unit owner from tort liability, which it should be noted may exceed the value of his unit . . . is yet an open question in California.

Thus, Justice Roth foresaw the possibility that co-owners of the common area might be personally liable for money judgments and other judgments rendered against the association in their status as tenants in common.

37. *Id.* § 24001 (West Supp. 1974).
39. *Id.* at 829-30, 95 Cal. Rptr. at 262.
40. *Id.* at 830, 95 Cal. Rptr. at 262-63.
41. *Id.* at 832, 95 Cal. Rptr. at 264. See *Cal. Civ. Code* § 1353(b) (West Supp. 1974).
42. 17 Cal. App. 3d at 832, 95 Cal. Rptr. at 264.
43. *Id.* at 833, 95 Cal. Rptr. at 265. The concurring opinion refers to Cal-
To avoid such liability, the safest course for condominium homeowners to pursue is to incorporate the management association as a non-profit corporation which does not issue any shares. This format effectively insures limited liability, since the debts of the corporation are its own and not those of the shareholders.\textsuperscript{44}

The condominium management corporation is the prevailing type of condominium homeowners organization in California. For example, the Executive Council of Homeowners of San Jose, California is an organization of one hundred and fifty member homeowners associations, all of which are incorporated.\textsuperscript{45} The president of this group estimates that of the more than 100,000 condominiums and planned unit development units in Northern California, approximately 90 percent of these units belong to a management corporation, rather than an unincorporated association.\textsuperscript{46}

Provisions for a corporate management form should be contained in the condominium declaration or master deed.\textsuperscript{47} If these provisions are not so included, an existing condominium organization can convert to the corporate form by amendment of the C, C and R's with the unanimous consent of the unit owners.\textsuperscript{48} As a matter of general practice, the developer transfers title to the common areas to a professional management corporation and takes in return enough of the title to the common areas in the corporation to represent the total interest allotted to all of the units. The developer owns title to each unit and all interests, including voting rights, in the management corporation. As each unit is conveyed, the developer also simultaneously conveys part of his interest in the management association.\textsuperscript{49} When all of the

\textsuperscript{44} See M. LATIN, THE LAW OF CORPORATIONS 65 (1971) states that:

\ldots [a] corporation is a legal unit separate from its shareholders, whose property is its own and whose contracts are personal to itself, whose corporate debts do not charge its shareholders personally, but must be collected from the corporation, whose torts committed by its employees within the course of their employment or by its agents within the scope of their authority are chargeable to the corporation and not to its shareholders, and whose suits must be brought in the corporate name, is one of the conveniences which dictates that corporate rights and liabilities are not to be confused with those of even sole shareholders.

\textsuperscript{45} Interview with Douglas Christison, President, Executive Council of Home Owners, in Santa Clara, California, Jan. 14, 1975.

\textsuperscript{46} Id.

\textsuperscript{47} See CAL. CIV. CODE § 1355(a) (West Supp. 1974).

\textsuperscript{48} See Id. § 1351.

\textsuperscript{49} Interview with Douglas Christison, President, Executive Council of
units are sold, all of the interests in the common area will have been transferred to the unit owners who will then own the common area corporation.  

**THE IRS POSITION ON THE TAXATION OF THE MANAGEMENT CORPORATION**

Members who are unit owners usually are assessed monthly dues to cover various current expenditures and to provide for future needs of the common area. The dues which are paid to the management corporation are considered income to the corporation. The amount designated by the corporation for current expenses, such as landscape and pool maintenance contracts, utility service, casualty insurance for the common areas, and the general costs of repairs, administration and operation, may be deducted as trade or business expenses. Reserve amounts for future needs may escape taxation under Internal Revenue Code section 118, which states that contributions to capital are not taxable income to the corporation. Treasury Regulations help to define the exclusions under Code section 118.

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50. Interview with Mr. John D. Schuhmann, Administrator of Cal-West, a developer of large condominium complexes, in Santa Clara, California, Oct. 13, 1974.


52. Id. § 162.

53. Id. § 118.

54. Treas. Reg. § 1.118 (1956) provides in part:

Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus ac-
However, if the IRS and the courts hold that section 118 is not applicable to condominium management corporations and if the management saves part of the assessments for future repairs, the IRS might well argue that the accumulated funds will be taxed as income to the corporation in the year of receipt. The effect of such a position would be to subject the owner to a double taxation. Presumably, the owner paid tax on his earnings, and, through the vehicle of the management corporation, his portion of the dues which are held in reserve will be subject to a second tax. This tax will deplete the reserves of the corporation, and the condominium owner will have to pay more than the actual cost for the long-term upkeep of the common areas. In contrast, a homeowner who sets aside money in a savings account to put a new roof on his house in twenty years is not taxed on the principal being saved. Possibly, the private homeowner is paying less for his repairs since his fund is not depleted by tax.

Another problem confronting the management corporation, is the taxation of investment income derived from these accumulated funds. In the average condominium management corporation, the only investment income will be interest on deposits in savings accounts. According to Internal Revenue Code section 277, this investment income cannot be offset by deductible operating expenses. Thus, this limitation means that it is possible for a condominium management corporation to incur a net operating loss while paying tax on its investment income, since only ordinary income can offset expenses.

Finally, the condominium homeowner may be subject to a third tax when the actual repair or improvement is made. Internal Revenue Code section 301 explains the concept of constructive dividend, which generates a taxable event for the unit owner when money or property is distributed to him in his capacity as a shareholder or member of the management corporation. For example, a condominium management corporation may utilize its accumulated reserves and the interest earned from these funds to improve the common area by installing tennis courts. If there

See notes 106-114 and accompanying text infra.

55. INT. REV. CODE of 1954, § 277.
56. Id. § 301.

This section covers distributions of stock made to a shareholder with respect to its stock. In the Minnequa University Club, P-H 1971 TAX CT. REP. & MEM. DEC. ¶ 71,305, the court stated: "While petitioner is a nonstock corporation, its members are its only owners and must be put in the shoes of stockholders."
are fifty units in the project, then each unit owner owns a 1/50th interest as a tenant in common of tennis courts. Thus, a $20,000 tennis court project would benefit a unit owner to the extent of 1/50th of its value, or $400. By applying the constructive dividend theory to this situation, a unit owner would realize $400 in income in the year the courts were completed.\textsuperscript{57}

**Depreciation**

Internal Revenue Code section 167 states: 

\begin{quote}
[T]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of (1) property used in a trade or business, (2) property held for the production of income.\textsuperscript{58}
\end{quote}

The question of whether a condominium management corporation may deduct depreciation for its improvements in the common area is unresolved. In order to claim depreciation, a corporation must own the property on which the deduction is sought.\textsuperscript{59} Applying this rule in the context of the condominium, the corporation would not be entitled to a depreciation deduction on this property since the facilities and the common area are owned by the unit owners as tenants in common.\textsuperscript{60} This reasoning raises a serious question as to the legal feasibility of a condominium management corporation's reducing its income through a charge for depreciation.\textsuperscript{61} If the depreciation deduction is unavailable to the corporation, a fortiori, it would not be available to the unit owners. In a hypothetical project with fifty units,\textsuperscript{62} the unit owner could not deduct 1/50th of the annual depreciation of the common facilities, since he could not meet the tests of Internal Revenue Code section 162, namely, that the property be used in a trade or business or be held for the production of income.\textsuperscript{63}

**TAX PLANNING FOR THE CONDOMINIUM MANAGEMENT CORPORATION**

**Tax Exempt Status**

The condominium management association might seek a solution to the double taxation problem by applying for tax ex-


\textsuperscript{58} INT. REV. CODE of 1954, § 167(a).

\textsuperscript{59} Helvering v. Lazarus & Co., 308 U.S. 252 (1939). If the management corporation were to have title to the assets of the common areas, a depreciation deduction would be available to offset taxable income.

\textsuperscript{60} Brauder, *supra* note 57, at 200.

\textsuperscript{61} P. ROHAN & M. RESKIN, CONDOMINIUM LAW AND PRACTICE ¶ 15.06 (3) (1974).

\textsuperscript{62} See note 57 and accompanying text *supra*.

\textsuperscript{63} INT. REV. CODE of 1954, § 167(a).
empt status under Internal Revenue Code section 501, which lists nineteen types of organizations exempt from taxation.\textsuperscript{64} Section 501(c)(4) of the Code describes a civic league or non-profit organization operated exclusively to promote the social welfare as one type of tax exempt organization.\textsuperscript{65}

However, the Internal Revenue Service has specifically ruled that a condominium housing association does not qualify for exemption under section 501(c)(4).\textsuperscript{66} In support of the government position, the ruling cites Commissioner v. Lake Forest, Inc.,\textsuperscript{67} a case in which the court of appeals held that a cooperative housing corporation was not exempt as a social welfare organization under section 501(c)(4) of the Code, since its activities were of an economically beneficial and private nature.\textsuperscript{68} The circumstances in Lake Forest are somewhat similar to those in the typical condominium management association, since the case involved a cooperative which purchased a housing project and then sold homes to its members. In the Lake Forest case, the court held that the corporation was not a municipal or civic organization operating for the common good.\textsuperscript{69} In the Lake Forest arrangement, the unit owners, a private group, received benefits of a personal nature, and the court was unwilling to stretch the concept of the social welfare organization to include the notion that painting one's own house was of benefit to the entire community.\textsuperscript{70}

Revenue Ruling 74-17\textsuperscript{71} cites Revenue Ruling 65-201,\textsuperscript{72} which stated that a cooperative organization operating and maintaining a housing development, housing facilities, and maintenance services on a cooperative basis for the personal benefit of the tenant owners was not exempt under section 501(c)(12)\textsuperscript{73} or any other provision of the Internal Revenue Code.\textsuperscript{74} This ruling also refers to Revenue Ruling 69-280,\textsuperscript{75} which specifically held that a nonprofit organization formed to provide maintenance of the exterior walls and roofs of the members' homes in a development was not exempt under section 501(c)(4). This rul-

\textsuperscript{64} Id. § 501.
\textsuperscript{65} Id. § 501(c)(4).
\textsuperscript{66} Rev. Rul. 17, 1974 INT. REV. BULL. No. 2, at 11.
\textsuperscript{67} 305 F.2d 814 (4th Cir. 1962).
\textsuperscript{68} Rev. Rul. 17, 1974 INT. REV. BULL. No. 2, at 12.
\textsuperscript{69} Id.
\textsuperscript{70} Id.
\textsuperscript{71} Id.
\textsuperscript{72} Rev. Rul. 201, 1965-2 CUM. BULL. 170.
\textsuperscript{73} INT. REV. CODE of 1954(c)(12). "Benevolent life insurance associations of a purely local character, mutual or cooperative telephone companies or like organizations . . . ."
\textsuperscript{74} Rev. Rul. 17, 1974 INT. REV. BULL. No. 2, at 12.
\textsuperscript{75} Rev. Rul. 280, 1964-1 CUM. BULL. 152.
ing stated that the organization merely performed services which otherwise would have to be provided by the members.\textsuperscript{76}

Revenue Ruling 74-17\textsuperscript{77} emphasized that the rights, privileges, duties and immunities of the members of an association of unit owners of condominium properties are of a contractual and statutory nature. For example, in California membership in a condominium management association may be made compulsory by the C, C and R's.\textsuperscript{78} Thus, it is clear that membership often is a term of the sales contract, and the only way to become a member is to purchase a condominium unit. The ruling states:

Condominium ownership necessarily involves ownership in common . . . of . . . common areas, the maintenance and care of which necessarily constitutes the provision of private benefits for the unit owners.\textsuperscript{79}

Revenue Ruling 74-99 struck a similar blow to the various attempts by condominium management corporations to qualify for an exemption under Internal Revenue Code section 501(c)(4).\textsuperscript{80} The ruling deals with the following fact situation: An organization is formed by a real estate developer as part of the project plan of a sub-division. Membership is required of all purchasers of lots in the development. The organization is supported by assessments of the homeowner members, and its stated purpose is to preserve a pleasing outward appearance of the development and to maintain carefully the assets of the common areas. These requirements and goals are incorporated into written documents that accompany the sale and the purchase of the property.\textsuperscript{81} Based on these facts, the ruling stated that

\[\textit{[t]he \textit{prima facie} presumption is that these organizations are essentially and primarily formed and operated for the individual business or personal benefit of their members and do not qualify for exemption under 501(c)(4) of the Code.}\textsuperscript{82}

Revenue Ruling 74-99 places limits on an otherwise favorable stance assumed by the Internal Revenue Service regarding the tax treatment of condominium management associations, as stated in Revenue Ruling 72-102.\textsuperscript{83} The fact situation in this ruling is quite similar to the one described in Revenue Ruling 74-

\begin{itemize}
\item \textsuperscript{76} Rev. Rul. 280, 1969-1 CUM. BULL. 152.
\item \textsuperscript{77} Rev. Rul. 17, 1974 INT. REV. BULL. No. 2, at 12.
\item \textsuperscript{78} CAL. CIV. CODE § 1355 (West Supp. 1974). See note 14 and accompanying text \textit{supra}.
\item \textsuperscript{79} Rev. Rul. 17, 1974 INT. REV. BULL. No. 2, at 12.
\item \textsuperscript{80} Rev. Rul. 99, 1974 INT. REV. BULL. No. 9, at 11.
\item \textsuperscript{81} \textit{Id.} See also CAL. CIV. CODE § 1355 (West Supp. 1974) contained in note 16 and accompanying text \textit{supra}.
\item \textsuperscript{82} Rev. Rul. 99, 1974 INT. REV. BULL. No. 2 at 12.
\item \textsuperscript{83} Rev. Rul. 102, 1972-1 CUM. BULL. 149.
\end{itemize}
The organization seeking section 501(c)(4) status was a nonprofit homeowners association charged with maintaining the common areas of the development for the benefit of all the members. Membership was required of all purchasers in the development and dues were assessed annually. In analyzing these facts, the Service stated that an organization operated exclusively for the promotion of the social welfare may include one whose purpose is to promote civic and social improvements for the general welfare of the community. In Revenue Ruling 72-102 the Service reasoned that a sub-division or a housing development may constitute a "community" within the definition of section 501(c)(4). Revenue Ruling 74-99 clearly states that condominium development, unlike a subdivision or housing development, does not qualify for a tax exemption under section 501(c)(4).

Revenue Ruling 72-102 distinguished Revenue Ruling 69-280 on the grounds that the homeowners association's purpose in Ruling 69-280 was to provide a benefit to its individual members by maintaining the exterior of their homes, whereas the association in Revenue Ruling 72-102 proposed that the community as a whole, and not just the unit owners, were benefited when the organization performed its duties of maintaining the common area.

The structure and purpose of these associations of individual tract homeowners are similar in many ways to the average condominium management corporation. The management corporation performs a dual function by providing direct benefits to the individual units as well as servicing the common areas for the general welfare of the entire condominium project. If Revenue Ruling 72-102 were still in force without qualification, a condominium management corporation might well divide the corporation into two organizations—one charged with providing direct services to the individual units and the other charged with the care and maintenance of the common area. The corporation charged only with the upkeep of the common areas would then fit the fact pattern described in Revenue Ruling 72-102.

However, Revenue Ruling 74-99 clearly rejects defining "community" to include a housing development, on the ground that such an interpretation is too narrow. The ruling states:

84. See notes 80-82 and accompanying text, supra.
85. Rev. Rul. 102, 1972-1 CUM. BULL. 149.
86. Id.
87. Id.
90. Rev. Rul. 102, 1972-1 CUM. BULL. 149, 150.
A community within the meaning of section 501(c)(4) of the Code and the Regulations is not simply an aggregation of homeowners bound together in a structured unit formed as an integral part of a plan for the development of a real estate subdivision . . . .92

This ruling also clarifies the position of the Service that, if one of the activities of a neighborhood homeowners association is the exterior maintenance of the individual units, then this type of activity further substantiates the initial presumption that the organization is operated essentially for the private benefit of its members.93 Lastly, the ruling distinguishes between common areas such as roadways and parks, which are accessible to and used by the general public, and those common areas which are used only by the members of the homeowners association.94 Again, in this context, it should be noted that the average condominium management corporation provides services to both types of common areas; there are facilities which are available to the general public as well as those areas which are restricted to the sole use of the unit owners.

An alternative exemption is available under Internal Revenue Code section 501(c)(7) which covers “[c]lubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder . . . .”95 In Revenue Ruling 69-281,6 the Internal Revenue Service ruled that an association providing recreational facilities for homeowners in a particular housing development may be exempt under section 501(c)(7). It is unlikely, however, that a condominium management corporation could qualify as a social club. Even though it provides a countryclub-like atmosphere and facilities for its members, it also provides distinctly personal services.97 One example of the personal benefits which inure to the individual unit owner would be the repair of his roof and exterior walls.98 Analogously, an

92. Id.
93. Id.
94. Id.
95. INT. REV. CODE of 1954, § 501(c)(7).
96. 1969-1 CUM. BULL. 155.
98. See Art. IV of the Articles of Incorporation of the Vineyards of Saratoga (California), filed Nov. 6, 1970. This article contains general provisions for the benefits of unit owners.

ARTICLE IV

This Association does not contemplate pecuniary gain or profit to the members thereof, and the specific primary purposes for which it is formed are to provide for the management, maintenance, preservation and architectural control of a condominium housing complex, consisting of the Common Areas of one or more Condominium Project, pursuant to Section 1355 of Title 6 of the Civil Code of the State of California
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automobile club was denied an exemption as a social club because its principal activity was the rendering of personal automobile service and there was not a sufficient amount of social contact among the members.\(^9\)

The Strategy of Revenue Ruling 70-604

Revenue Ruling 70-604\(^{100}\) approves a formula for avoiding the tax on accumulated income of the corporation. The ruling concerned a condominium management corporation whose stated purpose was to maintain and operate the common elements of the condominium property. In addition, its by-laws did not authorize it to engage in any other activity.\(^{101}\) In the hypothetical situation discussed in the ruling, the members of the management association voted at their annual meeting to return any excess income to themselves or to apply the excess to the following year's assessments.\(^{102}\) The ruling states that this excess over and above expenses is not taxable income to the corporation, since it has, in effect, been returned to the unit owners.\(^{103}\) This arrangement solves the immediate problem of paying tax in the present year, but it does not provide any solution to the problem of the need to accumulate income for large and costly repairs and capital improvements in the future.

Capital Contributions and Accumulated Income

According to Internal Revenue Code section 118: "Gross income to a corporation does not include any contribution to the capital of the taxpayer."\(^{104}\) Income Tax Ruling 1302\(^{105}\) declared that any excess assessment over actual costs for maintenance and interest in a homeowners association would be considered income to the association. However, Revenue Ruling 71-498\(^{106}\) held that Income Tax Ruling 1302 would no longer be determinative for

on certain real property located in Santa Clara County, to own, manage and maintain certain Community Facilities related thereto, and to promote the health, safety and welfare of the residents within such housing development and any additions thereto as may hereafter be brought within the jurisdiction of this Association for this purpose.

See also note 49 supra.

101. Id.
102. Id.
103. Id.
104. INT. REV. CODE of 1954, § 118.
105. I.T. 1302, I-1 CUM. BULL. 193 (1922).
future transactions. In another opinion, Revenue Ruling 57-375,\textsuperscript{107} the IRS indicated that dues accumulated in a special reserve account to pay interest and principal on a mortgage held by the homeowners association is not excludable under section 118. The Service reasoned that these payments were not really voluntary, since they were used to discharge the homeowner’s personal liability on the mortgage. This fact situation described in Ruling 57-375 is not analogous to one involving the reserves for capital expenditures accrued by a condominium management corporation, since the unit owners would not be personally liable for the debts incurred for maintaining the common areas by the corporation.\textsuperscript{108}

In support of the tax treatment of accumulated income of the corporation as a capital contribution, membership interests can be compared to stock holdings, particularly where payments are recorded in corporate books and identified with specific capital assets.\textsuperscript{109} When stock is issued to a shareholder on the receipt of money or other property, the corporation does not recognize taxable income.\textsuperscript{110} The problem of accumulated income might be dealt with under an approach similar to the treatment of a stock issuance, rather than under a capital improvement theory. Although the unit owners do not own stock in the management corporation, that portion of their assessments held in reserve for the future needs of the common area resembles the funds paid to a corporation by shareholders in return for stock. If the IRS allows the usual corporation to receive funds paid for stock without recognizing any taxable income, it should follow that a management corporation could receive similar contributions from the unit owners without recognizing taxable income.

Generally, the Internal Revenue Service and the courts have tended to rule against the taxpayer by refusing to allow membership assessments to be treated as capital contributions.\textsuperscript{111} How-


\textsuperscript{108} See note 44 and accompanying text supra.

\textsuperscript{109} Snowling, \textit{supra} note 97, at 129.

\textsuperscript{110} INT. REV. CODE of 1954, § 1032.

\textsuperscript{111} Snowling, \textit{supra} note 97, at 129. \textit{But cf.} Rev. Rul. 47, 1974 INT. REV. BULL. No. 47, at 6, which held that a special assessment collected by a homeowners association from its members and set aside for paving a community parking area constitutes a contribution to capital under section 118. Also some taxpayers have used an accounting method to defer income reporting. A group of United States Supreme Court decisions, Automobile Club of Michigan v. Commissioner of Int. Rev., 353 U.S. 180 (1957), American Auto. Ass'n v. United States, 367 U.S. 687 (1961), and Schlude v. Commissioner of Int. Rev., 372 U.S. 128 (1963) (involving dancing lesson contracts), stated that the Commissioner did not abuse his discretion in rejecting a deferral of income where the time and extent of performance of future services were uncertain. However, in Antrell Co. v. Commissioner of Int. Rev., 400 F.2d 981 (1968), the court of appeals departed from
ever, two recent Tax Court memorandum decisions have accepted the taxpayer's arguments that the assessments were capital contributions. In *The Minnequa University Club,* the deciding factor for the taxpayer was that the special assessments were kept in a separate bank account and that the funds were specifically earmarked on the club's books for purchasing and replacing certain assets. In *Lake Petersburg Association,* the court treated lot assessments paid by members for the privilege of leasing property as capital contributions, although part of the amount was held in reserve for future capital improvements. Nevertheless, the applicability of section 118 to the accumulated funds of the condominium management corporation is an unsettled issue to date.

**The Trust Fund Concept**

Another possible tax planning alternative is for the condominium management corporation to set up a trust fund with definite restrictions on the use of these funds. The management corporation can argue that as a trustee, it does not hold the amount received from the members under a claim of right. The money which is held in trust does not constitute gross income to the corporation in this situation. Rather, the corporation acts as an agent for the payors, the unit owners, and exerts no active control over the funds. The Internal Revenue Service position seems to be that a trust will not be taxed on accumulated income as long as the trustee's powers are merely ministerial. A more simplified approach is to deposit any funds that exceed the annual expenditures of the management corporation in savings accounts.

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113. Id. at 1310.
116. Id.
117. Id.

> One which a person performs in a given state of facts in a prescribed manner in obedience to the mandate of legal authority, without regard to or the exercise of his own judgment upon the propriety of the act being done.

*Black's Law Dictionary* 1148 (4th ed. 1968). This definition may be compared to the definition of management: "Government, control, superintendent, physical or manual handling or guidance; act of managing by direction or regulation or administration. . . ." *Id.* at 1112.
of the individual unit owners, with the corporation acting as agent or trustee of the funds. The separate accounts prevent any possibility of the commingling of these funds with the operating funds of the management corporation.

In both of these situations, the Service contends that the corporation must establish itself as a "true agent."\textsuperscript{119} To determine whether or not the corporation is a true agent, the IRS considers the degree and nature of control exercised by the members as principals, their liability for corporate actions, whether dealings between members and the association should be characterized as sales, and whether there has been an attempt to segregate dealings with individual members.\textsuperscript{120} In \textit{Seven-Up Co.},\textsuperscript{121} Seven-Up bottlers voluntarily agreed to periodic assessments for national advertising to be paid to the Seven-Up Company.\textsuperscript{122} The Service argued that such payments were taxable as income to the company.\textsuperscript{123} The company then persuaded the Tax Court that it merely held these funds in a custodial capacity and was obligated to spend the funds for one specific purpose only, and not for general corporate purposes.\textsuperscript{124} The condominium corporation could also argue that its trust funds were designated for specific projects to benefit individual unit owners and not for corporate purposes.

\textit{Legislation}

The Internal Revenue Code is not designed to accommodate the needs of all special interest groups, nor would it be possible to write the Code in such a way as to anticipate every inequitable situation that might result. Due to the inadequacies in present tax laws, condominium management associations have sought special federal legislation to meet their particular needs and objectives. During the 93rd Congress, several bills were introduced to provide a special tax exemption for condominium management corporations.\textsuperscript{125} One example is H.R. 15174,\textsuperscript{126} which would add a new category, the cooperative housing corporation, to the list of eligible tax exempt organizations.\textsuperscript{127} To qualify for this tax exempt status under the proposed legislation, the organization formed to manage the common areas of a condominium housing

\textsuperscript{119.} Snowling, \textit{supra} note 97 at 125.
\textsuperscript{120.} Id., \textit{citing} National Carbide Corp. v. Commissioner of Int. Rev., 336 U.S. 422, 437 (1948).
\textsuperscript{121.} 14 T.C. 965 (1951).
\textsuperscript{122.} Id. at 969.
\textsuperscript{123.} Id. at 976.
\textsuperscript{124.} Id. at 978.
\textsuperscript{126.} 93d Cong., 2d Sess. (1974).
\textsuperscript{127.} Id.
project would be subject to the following limitations: (1) all members would have to be unit owners; (2) no distributions from the corporation could be received by a member except in the case of a partial or complete liquidation; (3) 80 percent or more of the income of the corporation would have to come from the unit owners themselves; (4) substantially all of the units would have to be used by the owners as personal residences. In its report on the Tax Reform Bill of 1974, the House Ways and Means Committee stated:

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

Thus, passage of some legislation to benefit the condominium management association is expected in the 94th session of the Congress. Hopefully, this anticipated statutory relief will solve many of the planning problems currently confronting the condominium unit owner and his corporation.

CONCLUSION

The current posture of the government towards condominium management corporations does present several inequitable situations for the condominium unit owner. Perhaps the most severe injustices are the taxation of the income of the management corporation accumulated for future needs, and the taxation of the unit owner upon the receipt of a “constructive dividend” for the implementation of any long-range improvements. These unfortunate consequences may be mitigated by various tax planning devices which would utilize and adopt provisions in the present Code, but none of these schemes is ideal nor fully guaranteed to withstand government attack.

The ownership of condominiums will surely increase in our inflationary economy, as fewer people will be able to afford the luxury of owning their own home on a separate lot. The condominum tax...
minimum will provide an attractive intermediate choice between the heavy financial burden of traditional private home ownership and the equally unattractive burden of a leasing or rental contract, which affords no investment opportunities, only if the condominium owner does not have to assume a disproportionate tax burden in relation to these other living arrangements. The present tax status of the condominium owner is not equal to that of the owner of the traditional private home or the renter. The condominium owner's tax burden is undoubtedly greater because of the tax treatment of the common area corporation.

This analysis of the various tax planning devices that may be employed by the condominium management corporation yields no definitive answers to the tax problems of the unit owners. The most realistic solution to the double and triple taxation of the condominium unit owner's contributions to the common areas\textsuperscript{132} is the enactment of federal legislation\textsuperscript{133} to enable the condominium management corporation to qualify as a section 501(c) exempt organization. Statutory relief will insure freedom from IRS attack. However, this legislation should be carefully drafted to provide assistance to the moderate income taxpayer without creating loopholes for flagrant abuses, such as the construction of airports, golf courses and other extravagant luxury facilities, under the umbrella of a tax exemption. The middle class condominium owner deserves to be accorded tax benefits commensurate with those of the traditional owner of a detached dwelling. The average condominium owner, however, does not need a tax subsidy for elaborate countryclub facilities in his common backyard. Neither does the sophisticated and wealthy taxpayer need another loophole to exploit.

The same public policy considerations which have prompted favorable tax benefits for homeowners should be encouraging the growth of condominium ownership. The condominium serves to combine a modified form of private ownership with a more economical and efficient utilization of recreational and living space. The trend toward conservation of resources and community living should be encouraged, not hindered, by our tax policy. The passage of reasonable legislation to permit tax exempt status for condominium management corporations would equalize the tax burden on the condominium homeowner in relation to the traditional homeowner and alleviate the harsh tax consequences with which the condominium unit owner is presently confronted.

Maureen O'Connell

\textsuperscript{132} Id.
\textsuperscript{133} See notes 126-129 and accompanying text supra.