The Taxability of Condominium Owners' Associations

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INTRODUCTION

In light of rapidly rising land values and soaring building material prices and construction costs, the condominium concept of home ownership has become extremely popular in recent years. In the condominium, the unit owners individually own only the air space constituting their living unit. As tenants in common with all other unit owners they share the property underlying the project, including common walls, roofs, hallways, sidewalks, green areas, recreational facilities,¹ and, in some cases, garages. Thus, by

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¹ A typical statutory definition of a condominium is California’s:

A condominium is an 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 in addition a separate interest in other portions of such real property. CAL. CIV. CODE § 783 (West Supp. 1974).

This definition is amplified by statutory provisions specifying the scope of a condominium grant:

Unless otherwise expressly provided in the deeds, declaration
combining and eliminating for each living unit some of the incidents of single-family home construction and ownership, the condominium project utilizes more efficiently and economically land and building materials than does a single-family home development consisting of an equal number of living units.

Further, the condominium concept is well-suited to currently evolving flexible life styles. The condominium owner can enjoy all the benefits of home ownership, often in a grand fashion, without having to shoulder many of the burdensome chores of home maintenance, such as weeding, watering, mowing, raking lawns and gardens, trimming trees and bushes, and painting exterior walls. A condominium owners' association performs these tasks for the condominium owner, thus freeing him to pursue more leisure time activities than his homeowner counterpart.2

of restrictions or plan, the incidents of a condominium grant are as follows:

(a) The boundaries of the unit granted are the interior surfaces of the perimeter walls, floors, ceilings, windows and doors thereof, and the unit includes both the portions of the building so described and the airspace so encompassed. The following are not part of the unit: bearing walls, columns, floors, roofs, foundations, elevator equipment and shafts, central heating, central refrigeration and central airconditioning equipment, reservoirs, tanks, pumps and other central services, pipes, ducts, flues, chutes, conduits, wires and other utility installations, wherever located, except the outlets thereof when located within the unit. In interpreting deeds and plans the existing physical boundaries of the unit or of a unit reconstructed in substantial accordance with the original plans thereof shall be conclusively presumed to be its boundaries rather than the metes and bounds expressed in the deed or plan, regardless of settling or lateral movement of the building and regardless of minor variance between boundaries shown on the plan or in the deed and those of the building.

(b) The common areas are owned by the owners of the units as tenants in common, in equal shares, one for each unit.

(c) A nonexclusive easement for ingress, egress and support through the common areas is appurtenant to each unit and the common areas are subject to such easements.

(d) Each condominium owner shall have the exclusive right to paint, repaint, tile, wax, paper or otherwise refinish and decorate the inner surfaces of the walls, ceilings, floors, windows and doors bounding his own unit.

Id. § 1353.

2. Some type of management body for the condominium project is usually required by statute, see e.g., Id. § 1355(a), and its chief responsibility is the management and maintenance of the common elements. Id. §§ 1356(b)-(9). Through an owners' association each owner has some control, by his vote, over the maintenance, management, and improvement of
This increased freedom is not without its price, however. Each owner must pay to the association a monthly assessment equal to his pro rata share of the expenses which will be incurred by the association in maintaining the common elements. The association then uses the funds so obtained to discharge the unit owner’s domestic responsibilities. The difference, if any, between assessments and expenditures constitutes net income to the association. Whether and to what extent the association will be taxed on this income is a matter of considerable debate. The law on the subject is sparse, and the tax status of the homeowners’ association is in flux, with congressional legislation on the matter pending. This article will attempt to provide some suggestions, but few answers, to those charged with the responsibility of counseling condominium owners’ associations on tax matters.

The Association as a Taxable Entity

The Incorporated Association

Few difficulties arise in characterizing an incorporated association for tax purposes. It is a corporation and must be taxed as such. Its members should be taxed as shareholders on any distributions or constructive dividends they receive.

The Unincorporated Association

In categorizing the unincorporated association for tax purposes, difficulties arise because of the uncertain nature of the organization. Depending upon the characteristics of each particular unin-
corporated association, it may be taxed as a trust, a partnership
or as an association taxable as a corporation. In an attempt to
provide guidelines for determining when an organization shall be
characterized as an association and thus taxed as a corporation, the
regulations set forth six characteristics of the pure corporation:
associates, an objective to carry on business and divide profits,
continuity of life, centralization of management, limited liability,
and free transferability of interests. "Whether a particular or-
ganization is to be classified as an association must be determined
by taking into account the presence or absence of each of these
characteristics."  

The regulations do not specify how many of these traits an en-
tity must display in order to be classified as an association. Nor
do they indicate whether particular characteristics are to be
weighted more heavily in determining an organization’s tax
status. With predictable ambiguity, the regulations state only that
an organization will be treated as an association if its “corporate
characteristics are such that it more nearly resembles a corporation
than a partnership or trust."  

Even though it exhibits many of the qualities of a trust, the con-
dominium owners' association probably could not be classified as
a trust under the Code.  

6. Treas. Reg. § 301.7701-2(a) (1) (1974); see Morrissey v. Comm’r,
296 U.S. 344 (1935); Anderson, Tax Aspects at 91.
8. Id.
9. The owners' association, like the trust, generally has centralized man-
agement, continuity of life, and free transferability of interests. And since
it usually lacks a profit motive, the owners' association is more akin to a
trust than to a partnership or a corporation. See Id. § 301.7701-2(a) (2).
In fact, the regulations' general description of a “trust” could readily be
applied to the typical condominium owners' association. The regulations
state:

Generally speaking, an arrangement will be treated as a trust
under the Internal Revenue Code if it can be shown that the pur-
pose of the arrangement is to vest in trustees responsibility for the
protection and conservation of property for beneficiaries who can-
not share in the discharge of this responsibility and, therefore, are
not associates in a joint enterprise for the conduct of business for
profit.

Id. § 301.7701-4(a).

Cutting against the argument that an owners’ association is a trust is the
statement in the regulations which limits a “trust” to “an arrangement cre-
ated either by a will or by an inter vivos declaration whereby trustees take
around whether the organization should be taxed as a partnership or as an association taxable as a corporation. This determination will depend upon whether the organization "has more corporate characteristics than noncorporate characteristics."10

By definition, the owners' association has associates. Since this factor is also common to a partnership, it is disregarded in determining whether the association will be taxed as a corporation or as a partnership.11

Condominium owners acting collectively to maintain and manage commonly owned property generally lack a profit motive.12 Like any homeowners, their primary goal is to prevent the deterioration of their homes and their amenities. Many commentators feel that, absent a profit motive, an owners' association can be taxed neither as a corporation nor as a partnership.13 Indeed, there is language in the regulations susceptible to this interpretation.14 According to property for the purpose of protecting or conserving it for the beneficiaries." 10. Treas. Reg. § 301.7701-2(a) (3) (1974); Anderson at 228.
12. Anderson at 225; Brauer at 198.
13. See, e.g., ROHAN § 15.04(1); Anderson at 225; Anderson, Tax Aspects at 90; Brauer at 199; U. FLA. L. Rev., supra note 4, at 533. But see Krasnoweicki, supra note 4, at 843.
14. The regulations state:

Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association.

This language could be construed to mean that absent "an objective to carry on business for joint profit" an organization could not be classified as a corporation or partnership, for it then would lack an "essential characteristic" of either of these entities as defined by the regulations. However, another equally acceptable interpretation of this language is that absent a joint or corporate profit motive, co-owners developing property for their individual profit will not be taxed as a corporation.

The language quoted above should not be read to preclude taxation of an owners' association as a corporation simply because it lacks a profit motive. The disputed phrase is apparently meant only to highlight the differ-
to this view, an association which is not engaged in any profit ori-
tented activities would not be treated as an entity for tax purposes. Members of the association would be taxed as individuals on any income distributed to them by or through the association.\textsuperscript{15}

This view appears to be contrary to the basic orientation of the definitional section of the regulations because it emphasizes the existence of only one corporate characteristic in ascertaining the tax status of the owners’ association. A contrary view, and that which is apparently contemplated by the regulations, is that the presence or absence of a profit motive is only one factor to be weighed with all others in determining whether the owners’ association will be taxed as a corporation. Under this approach to the categorization problem, an owners’ association that lacks a profit motive could nevertheless be classified as an association taxable as a corporation if it possesses sufficient other corporate characteristics.

Of course, if the unincorporated association carries on some type of business activity, it will be treated as either a partnership or an association.\textsuperscript{16} Whether an association with or without a business

\textsuperscript{15} Brauer at 199.

\textsuperscript{16} Treas. Reg. §§ 301.7701-2(a) (2), (3) (1974); ROHAN § 15.05; Anderson, Tax Aspects at 90-91. No firm opinion can be ventured on the question whether an association would be treated as a partnership if it lacked a business purpose and enough other corporate characteristics to warrant classification as an association taxable as a corporation. The regulations state that a partnership includes any “unincorporated organization through . . . which any . . . venture is carried on . . . and which is not a corporation” under the Code. Treas. Reg. § 301.7701-3(a) (1974).

Maintenance and management of the common elements of a condominium project would presumably constitute a “venture” carried on by the owners’ association. There is no requirement that the venture in which the organization is engaged be profit oriented. In the next breath, however, the regulations indicate that “[m]ere co-ownership of property which is main-
tained, kept in repair, and rented or leased does not constitute a partner-
ship.” Id.

Thus, it appears that the distinguishing element of a partnership for tax
purpose possesses enough corporate characteristics to warrant treatment as an association taxable as a corporation must be determined on an individual basis. Some guidelines for making this determination follow.

The association might have the right to expel a unit owner for engaging in activities contrary to the declaration of restrictions.\textsuperscript{17} Although under ordinary circumstances no individual owner can sue for partition of the project, the unit owners may be able to demand partition if the common elements are substantially damaged or destroyed.\textsuperscript{18} If either of these conditions exist, the association would lack the corporate characteristic of continuity of life.\textsuperscript{19}

Commonly, a board of directors or similar governing body manages the association. Rarely are management decisions subject to the approval of all condominium owners. Therefore, most owners' associations will have centralized management.\textsuperscript{20} If, however, the governing body is empowered to perform only ministerial acts on behalf of and with the consent of the unit owners, centralized management would not exist.\textsuperscript{21} The problem then becomes one of defining "ministerial acts." Presumably, selection of gardeners, pool maintenance contractors, and refuse disposal services would constitute ministerial acts.\textsuperscript{22} Decisions of this nature are generally made by the governing body of the association without the approval of the unit owners. Decisions of major significance, such as

\textsuperscript{17} Treas. Reg. § 301.7701-2 (b) (1) (1974); ROHAN § 15.05 (1); Anderson at 226; U. Fla. L. Rev., supra note 4, at 534. Anderson advocates providing in the declaration of restrictions or master deed that any member of the association may be expelled for cause as a means of negating the corporate characteristic of continuity of life. Anderson at 226. Not only would this type of provision aid in preventing the association from being taxed as a corporation, it would also give the association an effective means of controlling the activities of intransigent or unruly owners.

\textsuperscript{18} See CAL. Civ. Code § 1355 (b) (9) (West Supp. 1974); ROHAN § 15.05 (1); Anderson at 226; Anderson, Tax Aspects at 91-92.

\textsuperscript{19} ROHAN § 15.05 (1); Anderson at 226; Anderson, Tax Aspects at 91-92.

\textsuperscript{20} ROHAN § 15.05 (4); Anderson, Tax Aspects at 92.

\textsuperscript{21} Treas. Reg. § 301.7701-2 (c) (3) (1974); Anderson at 227; Anderson, Tax Aspects at 92.

\textsuperscript{22} Anderson at 227; Anderson, Tax Aspects at 92.
whether to make a capital improvement or enter into a long-term maintenance and management contract, generally require the concur-
currence of the unit owners.\textsuperscript{23} Therefore, it could reasonably be argued that the typical condominium owners’ association does not have centralized management.\textsuperscript{24}

Members of an unincorporated owners’ association are bound as principals on any authorized contracts entered into by the govern-
ing body of the association.\textsuperscript{25} As tenants in common of the common areas, the condominium owners are also personally liable for any torts occurring in those areas.\textsuperscript{26} Thus, the unincorporated association would apparently lack the corporate characteristic of limited liability.\textsuperscript{27}

In some condominium developments, the transferability of a liv-
ing unit is restricted in some fashion, for example, by a right of first refusal on behalf of the association.\textsuperscript{28} The existence of this type of limited restraint on alienation does not negate the corporate characteristic of free transferability of interests, but it does diminish its importance in determining the tax status of a particular entity.\textsuperscript{29} Of course, if no such restraints on the alienation of a condominium exist, the unit owner’s interest in the association would be freely transferable.\textsuperscript{30}

If the association carries on business for profit and partnership characteristics outweigh corporate characteristics, the association would only have to file a partnership informational return.\textsuperscript{31}

\textbf{Income of the Association}

\textit{Assessments of Unit Owners}

Assessments on unit owners are generally of two types—regular

\begin{itemize}
\item \textsuperscript{23} See note 22 supra.
\item \textsuperscript{24} Id. But see ROHAN \S 15.05(4) (suggesting that even if day-to-day decisions made by authorized management group and others are subject to owner approval, the Internal Revenue Service will still assert existence of centralized management).
\item \textsuperscript{25} Anderson, Tax Aspects at 93.
\item \textsuperscript{26} Id.
\item \textsuperscript{27} Id.; Treas. Reg. \S 301.7701-2(d)(1) (1974).
\item \textsuperscript{28} Anderson, Tax Aspects at 93; Browder, Restraints on the Alienation of Condominium Units: The Right of First Refusal, 1970 U. ILL. L.F. 231.
\item \textsuperscript{29} Treas. Reg. \S 301.7701-2(e)(2) (1974); ROHAN \S 15.05(3); Anderson at 227.
\item \textsuperscript{30} Treas. Reg. \S 301.7701-2(e)(1) (1974).
\item \textsuperscript{31} ROHAN \S 15.04(1).
\end{itemize}
Regular assessments are used to defray the daily costs of maintaining and operating the common elements and related facilities and are collected on a monthly basis. Special assessments, by contrast, are used to construct new capital improvements in the condominium project and can usually be charged to the unit owners only if a majority of them approve the assessment.

1. Regular Assessments

Often, the regular assessment consists of two components. A portion of the regular assessment is expended currently for general operation and maintenance of the common elements. With the remainder of the regular assessment, a reserve fund for replacement of the common elements is established. The initial question is whether the association will be taxed on either or both of these elements of the assessments. Preliminarily, however, it must be determined whether assessments or portions of them constitute gross income to the association. There are two views under which they might be found not to be includable in the association's gross income.

   a. Contribution to Capital.

   It has been suggested that all assessments should be viewed as a contribution to capital and thus not includable in gross income under section 118 of the Code. There is, however, only a glimmer of authority for this proposition. In United Grocers, Ltd. v. United States, a case holding contrary to this view, a retail grocers cooperative collected from its members dues which it treated as contributions to capital and excluded from gross income. The Internal Revenue Service contended that the "dues" were actually payments received by the cooperative for rendering services to its members. In holding the dues to be includable in gross income, the Ninth Circuit stressed that the intent of the member making the contribution was a dominant factor in determining whether the dues were capital contributions or payments for services.

   Viewing the components of the homeowners' association assessments in the light of this rationale yields divergent results depend-

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32. See authorities cited notes 33–43 infra and accompanying text.
33. As to any condominium unit mortgages purchased by either the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association, the seller of the mortgages must warrant that there exists an adequate reserve fund for replacement of the common elements.
34. Brauer at 209.
36. 308 F.2d 634 (9th Cir. 1962).
ing upon which component is analyzed. The unit owners intend that the association will use a portion of the assessments it collects to provide them with maintenance and landscaping services. Accordingly, the portion of the assessment so used should be viewed as includable in the association's gross income. The portion of the assessments used to establish a reserve fund is intended to be used for the replacement of capital assets of the association. Therefore, that portion of the assessments earmarked as reserves for replacement of the common elements should be characterized as a capital contribution and should not be included in gross income.37

b. Trust Fund Theory.

Assessments may also be excludable from the association's gross income under a trust fund theory. If the use of the assessments is narrowly restricted, the association could be viewed as holding those funds "in a trustee or custodial capacity, to be expended solely for the prescribed purpose."38 Although no case or revenue ruling has condoned the application of this concept to the condominium owners' association, cases involving conventional corporations in analogous situations lend support to this theory.

In Seven-Up Co.,39 the parent company received from individual bottlers contributions for an advertising fund. This money was

37. See Lake Petersburg Ass'n v. Comm'r, 33 T.C.M. 259, 267 (1974); Rev. Rul. 74-563, 1974 INT. REV. BULL. No. 47, at 6. There is a statement in Revenue Ruling 74-563 that suggests the possibility of excluding as a contribution to capital all assessments from the association's gross income. The ruling indicates that if "the motive or purpose for paying the... assessment is enhancement of the homeowner's proprietary interest," then the assessment may be viewed as a capital contribution. At first blush, it might appear that this language would allow treating all assessments as a capital contribution, for the primary motive for paying the assessment is arguably enhancement of the homeowner's proprietary interest.

A closer reading of the ruling reveals that enhancement of the homeowner's proprietary interest, i.e., his residence, is the key concept. The bulk of the regular assessments is devoted to maintaining rather than enhancing the homeowner's proprietary interest by providing the homeowner with landscaping, maintenance, and janitorial services. Only those portions of the assessments used to make capital improvements or repairs in the nature of capital improvements actually enhance the homeowner's proprietary interest, and only those portions of the assessments should be viewed as capital contributions.


utilized by Seven-Up only for the exclusive purpose of financing a national advertising campaign. Expenditures for the campaign were not deducted by Seven-Up from its gross income. The court held that Seven-Up acted only "[a]s custodian of the funds and agent for the bottlers." Therefore, the bottlers' contributions were not gross income to Seven-Up.

The portion of an assessment used to establish a reserve fund would appear to be excludable from the association's gross income under the Seven-Up Co. rationale. The use of any such fund should be restricted to only the replacement of the association's capital assets, i.e., the common elements and related facilities. Additionally, the reserves should be kept segregated from the association's operating funds to insure that they are not used for general purposes.

The trust fund theory is inapplicable to those assessments which constitute the bulk of the association's income, viz., regular assessments and those special assessments used only for minor repairs. These funds must be available to meet general expenses, and their use cannot be restricted sufficiently to bring them within the confines of the trust fund concept. Thus, under the trust fund theory, this portion of the funds derived from assessments would be includable in the gross income of the association.

c. Excess General Assessments.

In many projects the assessments are used only to defray current general expenses and no portion of the assessment fund is set aside as reserves. As previously discussed, in other projects the total assessments levied on the owners include such a general assessment. Under either the capital contribution concept or trust fund theory these general assessments are includable in the association's gross income.

In most situations, however, deductions for reasonable and necessary expenditures incurred in managing and maintaining the common elements would minimize the association's taxable assessment income. However, to the extent that there is any excess of assessments over expenses, the association would have taxable income. The Internal Revenue Service, in a ruling that apparently embodies a blend of the trust fund and capital contribution theories, has ruled that taxation on these overassessments may be avoided. If these overassessments are either returned to the unit owners or

40. 14 T.C. at 978.
41. See note 33 supra and accompanying text.
applied against the following year's assessments, the association is not taxed on the excess "since such excess, in effect, has been returned to the stockholder-owners." Thus, by segregating and restricting the use of a reserve fund, thereby excluding it from gross income under the trust fund theory, and by returning any excess general assessments to the unit owners, the association can minimize, if not eliminate, its taxable assessment income.

2. Special Assessments

Special assessments generally can only be imposed upon unit owners if a majority of the membership of the association approves the assessment. Usually, these assessments are to be used only for the construction of new capital improvements or the rendition of extensive repairs to existing capital improvements. Because the use of these funds is restricted, they should be viewed as held by the association in a custodial or trustee capacity and they should not be chargeable to the association as income.

Investment Income from Reserve Accounts

Unless the reserves for the replacement of common elements are kept in noninterest bearing accounts, they will earn interest which will be includable in the association's gross income. In addition, this income cannot be offset by deductions for expenses incurred by the association in managing and maintaining the common elements. Under section 277 of the Code, the expenses incurred by a membership organization in furnishing services to its members can be deducted only against income derived from its members. Thus, the investment income of the association could be reduced only by expenses, if any, made in connection with the generation of that income, such as a management fee or similar charge paid by the association. Except for this type of deduction, investment income is fully includable in the association's gross income.

44. INT. REV. CODE OF 1954, § 277.
45. See Treas. Reg. § 1.277 (1974); Krasnoweicki, supra note 4, at 345.
Additionally, the disposition of this investment income can create tax problems for the condominium owners. If the money is distributed to the owners, it will constitute a dividend to the extent of the association’s earnings and profits.\textsuperscript{46} The unit owners will be found to have received a constructive dividend to the same extent if the investment income is used to defray expenses properly chargeable to them.\textsuperscript{47}

\textit{Fees for Using Common Elements}

In some condominium projects, fees are charged for the use of such common facilities as swimming pools, tennis courts, and parking spaces. When these fees are obtained from unit owners who are members of the association, they constitute gross income to the association, but the expenses of maintaining and managing the facilities can be deducted. Fees paid by nonmembers to use these common facilities are also included in the association’s gross income; however, because of the strictures of section 277, that portion of the total expenses that was incurred in operating and maintaining the facilities for the benefit of members cannot be deducted from the income obtained from nonmembers.\textsuperscript{48} Here, again, the members will face the same dividend problems mentioned above if income from nonmembers is distributed to them or used to defray expenses properly allocable to them.\textsuperscript{49}

\textit{Rent from Leasing Common Areas}

Associations which lease common elements have gross income in the form of rent. If the property is leased only to members of the association, all maintenance and operational expenses attributable to it can be deducted from the income so derived. Rental income received from nonmembers of the association could be offset only by maintenance and operating expenses attributable to the property that generated such revenue.\textsuperscript{50} Thus, for example, if a condominium owners’ association leases a portion of the common area to a small shop, only the expenses of maintaining the property on which the shop is located can be deducted from the rental income received from the shop.

Use of this rental income to make distributions to members or

\textsuperscript{46} \textit{Int. Rev. Code of 1954}, §§ 301, 316.
\textsuperscript{47} \textit{Anderson} at 229; \textit{Brauer} at 201.
\textsuperscript{48} \textit{Int. Rev. Code of 1954}, § 277; \textit{Brauer} at 213; \textit{Krasnoweicki, supra note 4}, at 345.
\textsuperscript{49} See authorities cited notes 46 & 47 \textit{supra} and accompanying text.
\textsuperscript{50} \textit{Int. Rev. Code of 1954}, § 277; \textit{Krasnoweicki, supra note 4}, at 345.
to pay expenses which members would otherwise have to pay, creates the same dividend difficulties mentioned above.51

**Deductions from the Association's Income**

**Expenses of Operating and Maintaining the Common Elements**

Subject to the limitations imposed by section 277 on the deductibility of expenses from "investment" income noted previously, the association may deduct from its gross income the ordinary and necessary expenses of operating, managing, and maintaining the common elements.52 Customarily, the unit owners, who are tenants in common as to the common elements, deduct from their incomes interest and taxes attributable to the common elements.53 Of course, if the association owns these common elements and pays interest and taxes thereon, these expenditures can also be deducted from the association's gross income.

**Depreciation on Common Elements**

Whether the condominium owners' association is entitled to deduct from its income the depreciation on the common elements is a matter upon which there is considerable disagreement. Naturally, if the association owns the common elements, it can deduct depreciation on them from any income which they might generate.54 In most condominium owners' associations, however, the unit owners own undivided interests in the common elements, with the association merely managing and maintaining these areas. The association would thus be ineligible for the depreciation deduction. As owners of the common elements, the unit owners presumably are allowed to deduct, from their aliquot share of the income produced by the common elements, depreciation attributable to their proportionate interest in the common elements. But by the time this in-

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51. See authorities cited notes 46 and 47 supra and accompanying text.
52. INT. REV. CODE OF 1954, § 162; Brauer at 199.
54. INT. REV. CODE OF 1954, § 167. In a planned unit development, the association usually owns the common elements, and it would therefore be able to take the depreciation deduction. The new Federal Home Mortgage Loan Corporation warranty provisions applicable to planned unit developments require that the owners' association take title to the common elements.
come reached the unit owners it already would have been taxed at the association level where it would not have had the shelter of the depreciation deduction. In any event, it is not even clear that the unit owners are entitled to a depreciation deduction on the common elements. It could be argued persuasively that the owners hold the common elements for their personal use rather than for the production of income and therefore could not claim the depreciation on that property.\textsuperscript{56}

Thus, the depreciation deduction on the common elements may be in limbo, with neither the association nor the unit owners entitled to it.\textsuperscript{56} Some commentators have proposed solutions to this problem while others have simply ignored it.\textsuperscript{57} Until there is some definitive ruling on the matter, perhaps the simplest course to follow is for the unit owners to take the depreciation deduction on the common area. As owners of that property they logically should be allowed the deduction, and they could reasonably be viewed as holding the common elements for the production of the income through the actions of the association as their agent.

**Exemptions**

**Section 501(c)(4)**

Section 501(c)(4) of the Code\textsuperscript{58} and the accompanying regula-

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\textsuperscript{55} Rohan \S 15.06(3); Brauer, supra note 2, at 200. But see Anderson, Tax Aspects, supra note 4, at 95-98.

\textsuperscript{56} Rohan \S 15.06(3); Anderson, Tax Aspects at 95; Brauer at 200.

\textsuperscript{57} The solution proposed by most authorities is to have the unit owners lease their undivided interests in the common elements to the association. The unit owners, whose property would then be used for the production of income, could take the deduction for depreciation on the common elements. The income of the association could be offset by the rental payments, and the association's taxable income could be reduced to nearly nothing. Additionally, the rental paid could be set at an amount which would equal each owner's depreciation deduction, thus minimizing, if not eliminating, the individual owner's taxable rental income. See Rohan \S 15.06(2); Anderson at 229-30; Anderson, Tax Aspects at 97-98; Note, 23 Vand. L. Rev. 321 (1970). But see Brauer at 200.

Anderson states that if the association is treated as a corporation for taxation it should be treated as a corporation for all purposes, including \S 351. Accordingly, under Anderson's analysis, the beneficial interests of the unit owners in the association would be the equivalent of stock which each owner would be deemed to have received in exchange for the transfer to the association of his interest in the common area. Thus, the association would become the owner of the common area for purposes of deducting depreciation. Anderson at 96 n.38. Of course, if this view is taken, the owners would not be entitled to deductions for depreciation, interest, taxes or maintenance expenses attributable to their aliquot share of the common area. Further, such a result might obligate the association to pay interest and taxes on the common area.

\textsuperscript{58} Int. Rev. Code of 1954, \S 501(c)(4).
tions\textsuperscript{59} exempt from federal taxation nonprofit organizations “operated exclusively for the promotion of social welfare.”\textsuperscript{60} Whether the activities of a homeowners' association promote the “social welfare” has been the subject of several recent revenue rulings. What these rulings generally indicate is that the typical condominium owners' association will not qualify for the 501(c)(4) exemption.\textsuperscript{61}

In the typical condominium, the association maintains the common elements, including exterior walls and roofs of individual units, sidewalks, parking areas and recreational facilities. The upkeep of these common elements would be the responsibility of each owner as a tenant in common but for the activities of the association. The Internal Revenue Service has ruled that the association's maintenance and care of the common elements confers a direct private benefit on the unit owners which disqualifies the association for the 501(c)(4) exemption.\textsuperscript{62}

If the association owns and maintains only the common green areas, streets and sidewalks and does not perform any repair or maintenance on the owners' units, the 501(c)(4) exemption may be available to it.\textsuperscript{63}

\textit{Section 501(c)(7)}

Although not truly a “club,” the condominium owners' association may nevertheless qualify for exemption under section 501(c)(7) of the Code as a “[c]lub organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes.”\textsuperscript{64}

\textsuperscript{60} Int. Rev. Code of 1954, § 501(c)(4); Treas. Reg. § 1.501(c)(4)-1(a)(1).
\textsuperscript{62} Rev. Rul. 17, 1974-1 Cum. Bull. 130. Of course, the activities of the association confer a benefit on the unit owners in the same way that the activities of any homeowner who maintains or improves his property is benefited. That is exactly what it is supposed to do. To withhold exemption from taxation on that ground seems to be counter-productive. The condominium owner would be better off if the association performed no maintenance on the buildings. In fact, he would be much better off in a single family home.
\textsuperscript{63} Rev. Rul. 102, 1972-1 Cum. Bull. 149.
\textsuperscript{64} Int. Rev. Code of 1954, § 501(c)(7).
If the association’s activities are narrowly confined to providing and maintaining recreational facilities for its members, the Internal Revenue Service has indicated that the 501(c)(7) exemption will be available to it. Maintenance of the other common elements of the condominium project—exterior walls, roofs, and sidewalks—could, however, result in disqualification for the exemption. Yet arguably, this type of activity would be “other nonprofitable purposes” in which the association could engage without jeopardizing its exempt status. The regulations indicate that the 501(c)(7) exemption is generally extended “to social and recreational clubs.” It is unclear whether or not this language is meant to restrict the range of permissible activities in which an exempt organization may engage. However, it appears that it is only a guideline for those who might apply for the exemption. If so, that language would not preclude the availability of the exemption for an owners’ association that maintains common elements which include recreational and social facilities.

The association will not be granted an exemption if any of its net earnings inures to the benefit of any member. The association which has net earnings and either distributes them to its members or uses them to pay costs for which the owners would otherwise be liable, will not be exempt under this section. If, however, the net earnings are held in reserve accounts to be used only for common element capital improvements or replacements, no private member would receive the benefit of the association’s net earnings. All members would benefit equally in the aggregate and the association would therefore qualify for the 501(c)(7) exemption.

Of course, if the association is organized and operated for busi-

69. Of course, overassessments which might be returned to the unit owners do not constitute gross income to the association. Therefore, the distribution to the owners of overassessments would not impair the association’s otherwise exempt status.
70. It is doubtful that an ordinary association would accumulate more than the $100,000.00 allowance under the accumulated earnings provisions of the Code. Int. Rev. Code of 1954, § 535(c)(2). If it did, however, accumulate in excess of $100,000.00, it would be difficult to justify such an accumulation as necessary for the reasonable needs of the business. Id. § 535(c)(1). Any such excess would be taxed at the exorbitant rates specified in § 531 of the Code.
ness purposes, the 501(c)(7) exemption will not be granted. Accordingly, the association which makes its recreational facilities available to the public, charging a fee for their use, would not be exempt. Similarly, an association which sells or leases real property would be ineligible for the exemption.

Although qualification for the 501(c)(7) exemption is fraught with contingencies and uncertainties, it is a potential alternative to taxability for the owners' association. Because it is neither difficult nor expensive to seek the exemption it should be considered for the typical owners' association, the activities of which are limited to providing and maintaining recreational facilities and other common areas for the benefit of its members.

Congressional Legislation

A rash of bills was introduced in the 93d Congress, each of which would provide owners' associations with exemption from federal taxation. Typical of much of this proposed legislation is H.R.

74. Treas. Reg. § 1.501(c)(7)-1(b) (1974). An incidental sale of property would not result in forfeiture of the § 501(c)(7) exemption. Id. Thus, an owners' association could sell or purchase, at a foreclosure sale, a condominium upon which unpaid assessments had become a lien without losing the § 501(c)(7) exemption. See Cal. Civ. Code § 1356 (West Supp. 1974).
75. To request an exemption under § 501(c)(7), the taxpayer must file an application on form 1025. For the § 501(c)(4), the application form to be used is 1024.
76. It is important which exemption is obtained. Under § 501(c)(4), there is no tax on unrelated business income of the association. See Int. Rev. Code of 1954, § 512(b)(4); Brauer at 213. Unrelated business income is taxed even though the association is exempt under § 501(c)(7). See Int. Rev. Code of 1954, § 512(a)(3)(A); Brauer at 213.
77. See S. 3663, S. 3786, H.R. 13800, H.R. 14690, H.R. 15166, H.R. 15174, H.R. 15313, H.R. 15367, H.R. 15396, H.R. 16100, H.R. 16377, 93d Cong., 2d Sess. (1974). All of these bills would amend § 501(c) of the Internal Revenue Code to give owners' associations a specific exemption from taxation. Additionally, some of these bills would amend § 512 to ensure that only an association's "membership" income, i.e., assessments, would be immune from taxation. See, e.g., H.R. 15313, 93d Cong., 2d Sess. (1974). For tax purposes, an owners' association would then be treated like a social club exempt under § 501(c)(7) of the Code. See Snowling, Federal Taxation of Homeowners' Associations, 28 Tax Law. 117, 123 (1974); see authorities cited notes 64-76 supra, and accompanying text. As part of the Tax Reduction Act of 1975, the Senate sought to provide an exemption for owners' associations. The conference committee, however, refrained from including
This bill would exempt from federal taxation cooperative housing corporations and condominium owners' associations. It is unclear whether this bill would exempt only associations composed of the owners of true condominiums, in which the residential units consist of only air spaces, or whether it would apply as well to townhouses and planned unit developments in which the unit owners own the lot under their unit as well as the interior walls and air space. Presumably, “condominium” is used in a generic sense in the bill, thus including within the exemption any owners' association formed to manage and maintain a “common interest”, including a condominium, townhouse or planned unit development project. This meaning is not apparent, however, and more definitional language is needed in the bill to delineate the scope of the exemption.

There are three conditions to obtaining the exemption proposed by the bill. First, membership in the organization seeking exemption must be limited to owners of units within the condominium project. In most instances, this condition would be readily met, for membership in the association usually is automatic upon the purchase of a condominium unit and is transferable only upon transfer of the unit.

The second condition of the exemption requires that “no member . . . [be] entitled to receive any distribution” from the association except upon complete or partial liquidation of the organization. Ostensibly, under this requirement the association could discretionarily distribute to the owners any income earned by the association as long as the owners have no right to receive periodic distributions, i.e., dividends. If this reading of the bill is accurate, its passage would alleviate many of the problems alluded to above regarding investment income of the association and dividends to owners.

Alternatively, this provision may envision that the association may make no distribution whatsoever to its members. If this interpretation is correct, then interest earned by the association on reserve accounts for capital improvements and replacements would have to be retained in those accounts in order for the association to qualify for the exemption. The association apparently could use those funds for capital improvements without losing the exemption.

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79. Id. § 20(B)(ii).
80. See authorities cited notes 46 and 47 supra and accompanying text.
But even in that situation, it could be contended that there was a distribution to the members to the extent interest income was used to make such improvements. If such a view were accepted, the exemption would be lost. However, the return to the members of assessments or the application of overassessments to the members' assessments for the following year should be viewed as a return of capital rather than a distribution and, therefore, should not endanger the exemption.81

A final condition to obtaining the exemption is that at least eighty percent of the association's gross income consists of assessments received from unit owners.82 Ordinarily, this provision should create no problem. Large reserve accounts for the replacement of the common elements could, however, generate interest income in excess of twenty percent of the association's gross income. The exemption apparently would be foreclosed if this were the case.

In addition to these conditions, the owners' units must be restricted to residential use in order for the association to be eligible for the exemption.83 Accordingly, the association in a hotel-type condominium project, in which the units are used for both residential and commercial purposes, would not be granted the exemption.

When dealing with the purely residential condominium project, there is good reason to exempt the owners' association from taxation. The ostensible reason for granting tax-exempt status to certain organizations is that they perform socially desirable functions and should not be taxed on the funds they use in the process. The condominium owners' association, by maintaining common green areas and recreational facilities, preserves the quality of the neighborhood or mini-neighborhood which the condominium comprises, and the association's continued care and supervision of the project will prevent it from deteriorating into uninhabitable housing. The single family home dweller, who has essentially the same reasons for maintaining his home as does the condominium owner certainly is not taxed for sprucing up his yard. It seems inequitable to treat the condominium owner differently.

81. See Brauer at 209.
83. Id. § 20(c).
Although not a major deterrent to the proliferation of condominiums, the taxation of condominium owners' associations does nothing to encourage condominium development. With usable urban and suburban land becoming priced beyond the reach of most individuals, and with construction costs rapidly accelerating, the government should attempt to promote means of efficient and economical land use like the condominium.