September 2010 The Supplement Sheet

NONPROFIT DOES NOT MEAN NONTAXABLE[1]

NOT ALL OWNERS ASSOCIATIONS ARE TREATED THE SAME

A nonprofit organization, whether incorporated or unincorporated, does not render automatic tax exempt status. In fact, neither a nonprofit owners association, nor a nonprofit unincorporated owners association, is a tax exempt entity under IRC § 501(c):

It has always been the Internal Revenue Service's position that a typical condominium association cannot qualify for tax-exempt status. In a 1974 Revenue Ruling, the Service stated that "since the organization's activities are for the private benefit of its members, it cannot be said to be operated exclusively for the promotion of social welfare. Accordingly, it does not qualify for exemption from federal income tax under Section 501(c)(4) of the Code". Rev. Rul. 74-17, 1974 CB 130.

In 1976, Congress made certain changes to the Code to allow an owners association, whether incorporated or unincorporated, to be treated in a different manner than traditional corporations or unincorporated organizations taxed as corporations under IRC § 7701. These changes are in IRC § 528. And, because corporate status in general was such a highly litigated area of the law, the Treasury finally implemented simplified rules. Hence, *after* January 1, 1997, unincorporated entities and associations which are not tax exempt may generally elect tax treatment as either a corporation or a partnership. These are known as "check the box" rules which are routine.

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Unfortunately, Congress only saw fit to carve out tax-exempt treatment for residential owners associations which are neither incorporated or unincorporated. Incorporated or unincorporated owners associations formed to provide for the maintenance of common areas of commercial or industrial common interest developments do not qualify for tax exempt status under IRC § 528. Treas. Regs. § 1.528-1(a). Further, it appears that these same commercial or industrial owners associations, whether incorporated or unincorporated, do not qualify for tax exempt treatment under the California Revenue and Taxation Code. 63 Op. Atty. Gen. Cal. 147. Most other jurisdictions follow the same.

1. Association Business

The primary purpose of an owners association is to maintain and manage the common areas of a common interest development. This purpose will remain as long as there is a common interest development, i.e., individual units owned by individual owners sharing an undivided interest in the common area.

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2. Association Income

Regardless of whether an owners association is incorporated or unincorporated, residential or commercial, income is generally comprised of assessments, fees, fines and bank account interest. IRC § 61(a). Expenses, such as payment of utility bills, cleaning personnel, and gardeners, offset income. IRC §§ 162(a) and 512(a). Simply put, any amount remaining at the end of the taxable year is considered profits and, absent tax-exempt treatment, it is taxable income.

3. Zeroing Out Income

There are two methods accepted by the Service for minimizing tax liability on excess assessments for federal income tax purposes.

The first method accepted by the Service is to return the excess assessments to the members of the owners association. This election must be made by the end of the taxable year. Rev. Rul. 70-604, 1970 CB 9. Further, the owners association must hold an annual vote of the members to determine whether to refund excess assessments in order to exclude the excess assessments from the owners association taxable income for that particular year. TAM 9539001. It should be noted that any amount returned to the members may not be taken as a business deduction by the individual owners of commercial or industrial condominiums for the year in which excess assessments are returned.

The second method accepted by the Service is to "roll-over" or apply excess assessments to the next year's assessments. The amount of excess assessments that are to be applied to the subsequent tax year should be documented on Schedule M-1 of the owners association's federal income tax return. Rev. Rul. 70-604, 1970 CB 9. Again, the owners association must hold an annual vote of the members to determine whether to apply excess assessments to the next year's assessments in order to exclude the excess assessments from the owners association's taxable income. TAM 9539001. Moreover, the application of excess assessments may be rolled over for one year only. FASM 99-ARD-077-4.

In the past, many tax practitioners and owners associations elected a third option which was to transfer the excess assessments to reserve accounts for capital improvements. The Service, consistent with all of the rulings that exist on this particular issue, stated in a 1999 Field Service Advice Memorandum that this is an "inappropriate, unacceptable practice". FASM 99-ARD-007-4. The Memorandum advises field agents to "readjust" the owners association income on this issue as the assessments were billed as operating funds and they may not be re-characterized after the fact as capital assessments.

a. Replacement Reserves

Broadly speaking, replacement reserves may be excluded from taxable income of the owners association. On the other hand, the Service seems to have created three categories of reserves:

Category #1. If the reserve is set aside for the purchase of new assets or creation of an improvement, the assessment is treated as a capital contribution and it is not treated as taxable income by the owners association if the members were billed for that specific purpose. Of utmost importance is that (i) the members must approve the funding as a special assessment, (ii) the reserve portion must be separately stated, and (iii) the funds cannot be held in the general operating account. TAM 9539001.

Category #2. If the reserve is set aside for a major repair or replacement of a structural component, the owners association holds the reserve as agent for its members and the assessment will not be treated as taxable income. Rev. Rul. 74-563, 1974 CB 38, Rev. Rul. 75-371, 1975 CB 52, *Washington Athletic Club v. US,* 614 F.2d 670 (9th Cir. 1980). Again, the members (i) must approve the funding as a special assessment, (ii) the reserve portion must be separately stated, and (iii) the funds cannot be held in the general operating fund. TAM 9539001. Further, since the association is acting as an agent of the members, any interest earned while holding the funds should probably be taxed pro rata to the members. Rev. Rul. 75-370, 1975 CB 25.

Category #3. If the reserve is for routine maintenance such as painting or replacement of dead landscaping, the reserve will be treated in the same manner as periodic maintenance payments as this is considered one of the features fro which the owners association was formed.

In conclusion, excess assessments received by an owners association is income to that owners association if it does not qualify for tax exempt treatment. Commercial and industrial owners associations, whether incorporated or unincorporated, do not qualify for tax exempt treatment under the Code. As a result, excess assessments at the end of the year are taxable income to a commercial or an industrial owners association unless they are zeroed out.

There are only two methods to zero out excess income: (a) return the excess assessments to the members before the end of the year resulting in no excess income, yet diminishing the members' deductions for income tax purposes or (b) apply the excess assessment to the following year's assessments. Both methods require a vote of the membership.

Excess assessments, or taxable income, cannot be zeroed out by transferring them to a reserve account as this is merely re-characterization of the assessments which is not acceptable to the Service. Conversely, if a special assessment is charged for either a capital improvement or a major repair/ replacement of a structural component, and if the members approve the special assessment, reserve the portion as separately stated, and do not hold funds in the general operating account, the funds held in the special assessment account will not be taxable income.

This supplement sheet is written by Corinne A. Tampas, Esq., who is solely responsible for its content. It is written for informational purposes only and shall not be construed as the giving of legal advice, nor shall it be the basis for forming an attorney-client relationship.

Comments are welcome and will be published in the next issue of A More Definitive Statement™ as space permits. You may contact Ms. Tampas via her email address**: yourauthority@gmail.com**

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