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Potential Federal Tax Trap: Condominium and Homeowner Associations

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General Rule of Taxability

The IRS recently reiterated its longstanding position that when a condominium or homeowner association's collected assessments exceed its operating expenses, the difference is taxable income. Associations that have formally chosen to pursue an exemption under (a) IRS Code 501(c)(4) – general public benefit exemption; (b) IRS Code 501(c)(7) – recreational facility exemption or (c) IRS Code 528 as a "qualified homeowner's association" agreeing to annually file an 1120H federal income tax return and pay a 30% tax rate on their non-assessment receipts are exempt from this taxation rule. This issue has been a frequent subject of revenue rulings addressing situations when an association must recognize taxable income.

The general rule is simple: any assessments collected during the current year must be used for that year's operating expenses. Any excess assessments collected are taxable income and subject to federal income tax. Currently, associations are taxed at a 15% tax rate for its first $50,000 in 2013 taxable income.

Capital Assessment Exception

A significant exception to this general rule of taxability exists for those special assessments collected for the replacement of specific capital assets. These funds are considered by the IRS to be the member's contribution to the member's capital and as such are not considered income. However, to qualify for this non-recognition of taxation, two tests must be met:

- The special assessment must be **to replace a capital asset**; and
- These assessments must be maintained in a **segregated capital assessment bank account**.

First, the association must understand that not all special assessments qualify for this tax-free treatment. Only special assessments collected and maintained for the sole purpose of the replacement of capital assets qualify. The IRS specifically has indicated that the replacement of capital assets such as roofs, elevators and outdoor furniture

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qualifies. The IRS also has indicated that special assessments for purposes other than the replacement of capital assets, such as reserve accounts, contingency funds or major maintenance projects (i.e. painting), do not qualify. Associations are urged to consult with their tax advisors to determine if specific projects qualify as replacement of capital assets.

Second, these special capital assessments must be maintained in a separate bank account. The IRS has made clear that even though the association documentation (declarations, by-laws, code of regulations, etc.) differentiate between operating assessments and special capital assessments, the formalities required by the IRS must be followed. Similarly, a comingled account with separate account reporting is not sufficient. Simply stated, if the special capital assessments are not maintained in a dedicated separate bank account, those funds will be considered income and subject to taxation.

Annual Vote Exception

Presumably recognizing the potential hardship and disservice this rule could impose on an association, the IRS has recognized a procedure which could avoid the taxation of all excess assessments.

As long as the members of the association have an affirmative vote at the end of each and every year to elect whether the association is to (a) refund to the members all excess assessments or (b) carry the excess assessments over to the next year to be used for the next year's operating expenses, the excess assessments will not be considered taxable income. The IRS has taken the position that by holding this vote, the association has legally returned the excess assessments to its members.

Reviewing this potential tax trap for condominium/homeowner associations is an excellent opportunity to remind both associations and their members that an association is considered a separate legal entity and has its own rights and obligations which are separate and distinct from the rights and obligations of its members. Consequently, it is critical to assure that the association is properly protected in both its decisions and in the assets it owns. This requires the vigilant monitoring and review of the association's policies, actions and, particularly, its insurance coverage.

If you have any questions regarding this or any other condominium or homeowner association issue, please directly contact either Stephen A. Roepke in our Findlay office, Gene R. Abercrombie in our Toledo office or visit our website at www.eastmansmith.com