Some Income Tax Consequences of Condominium

William Simmons
SOME INCOME TAX CONSEQUENCES OF CONDOMINIUM

By William Simmons*

The question of income taxation of the condominium must be considered under two main headings: (1) income taxation of the unit owner, and (2) income taxation of the condominium as an organization. ¹

Income Taxation of the Unit Owner

The advantage of the condominium is said to be "home ownership." ² In this respect, the unit owner in a condominium will be concerned with four items of federal income taxation: (1) nonrecognition of gain on the sale of residence; (2) deductions allowed for uninsured casualty loss; (3) deductions allowed for local property taxes; (4) deductions allowed for depreciation of the unit if it is rented or leased.

The purchase or sale of a unit in the condominium should qualify for the nonrecognition of gain on the sale or exchange of a residence.³ Assuming that the unit is used as a residence and that the owner has a legal title to it in fee, any transfer should qualify as a purchase or sale within the meaning of the Internal Revenue Code. Such treatment is afforded tenant-stockholders of a cooperative housing corporation.⁴

The Internal Revenue Code allows an individual to deduct uninsured losses of property not connected with a trade or business if the loss arises from fire, storm, or other casualty.⁵ The condominium unit owner who has a title in fee simple should be able to take this property loss deduction. But the tenant-stockholder in a cooperative housing corporation is not allowed this deduction, probably because the corporation can take it and the loss then would be passed to the tenant as a shareholder in the corporation. So, if the unit owner has only a leasehold title it would seem that he would be in the same position as the tenant-stockholder and probably not be allowed the deduction, the lessor being the one who would take it.

If the unit owners are assessed individually for their local property

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¹ For one further tax consideration for the unit owner, which is connected with taxation of the condominium, see text at notes 59-61 infra.
⁵ Int. Rev. Code of 1954 § 165(c) (3).
taxes, there should be no question about allowing deductions for them since the Code allows a deduction for taxes paid within the taxable year, with exceptions not here involved. Furthermore, the deduction should be allowed even if such taxes are not separately assessed and the management (hereinafter called the board of governors) must pay them for the entire building, as may be the case in California. This is because the board of governors can in turn pass on the tax to the unit owner according to his pre-determined share. One way to insure that this deduction will be allowed is to have enabling legislation provide for separate assessment.

If the condominium unit owners are not the owners in fee simple of the land on which the building is built, but have only a long term lease, the following problem may arise. Treasury Regulations prescribe that deductions for local taxes may be taken only by the person on whom they are imposed. Thus, as fee owner of the land a lessor is usually assessed and not the lessee. And so, even if the lessor requires the lessee to pay the taxes, only the lessor can take them as a deduction. But under California law, land and improvements are assessed separately. Since the greater portion of the local property taxes will be imposed upon the building, it follows that the unit owners, either individually or collectively, will be responsible for the larger part of the taxes and may therefore take them as a deduction. The lessor of the land is still the only one permitted to take the deduction for taxes on the land, and so if the unit owners under their lease must pay all property taxes they will not be able to deduct the amount of tax which was imposed on the land.

The final income tax consideration for the unit owner is the taking of depreciation as a deduction when he rents or leases his unit. The Code provides that the deduction is allowable for exhaustion, wear and tear of property that is held for the production of income. Accordingly, the unit owner should be allowed this deduction. The Commissioner previously denied this deduction to the tenant-stockholder.

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6 INT. REV. CODE OF 1954 § 164(a), 164(b).
7 37 CAL. OPS. ATT'Y GEN. 223 (1961).
8 Borland v. Commissioner, 123 F.2d 358 (7th Cir. 1941).
11 Caroline T. Kissel, 15 B.T.A. 1270 (1929).
12 CAL. REV. & T. CODE § 607.
13 INT. REV. CODE OF 1954 § 167(a) (2).
of a cooperative housing corporation but the Revenue Act of 1962 specifically gives it to him.\textsuperscript{15}

Thus the taxation of the unit owner in a condominium should be straightforward,\textsuperscript{16} especially if he has title in fee simple to his unit. This title will give him the argument that he should be allowed the same deductions that are allowed to one who owns a lot with a house on it.

\textbf{Income Taxation of the Condominium as an Organization}

In contrast to the simple tax problems of the unit owner, the taxation of the condominium as an organization may be quite complex. It may be asked, “But the condominium has no income; what could be more simple?” This may be true if the condominium is solely a residential project, but the concept involves high-rise structures in the center of our metropolitan areas, and also commercial and industrial projects.\textsuperscript{17} The chief complicating factor in any of these condominiums is that the owners may own the ground floor as tenants in common and rent or lease this area for commercial purposes; or they may need to buy a unit under a first refusal option in order to keep out an undesirable tenant, and this unit most likely would be rented or leased. Income from such commonly owned areas constitutes taxable income, but is it income to mere tenants in common? Or will the unit owners be treated as partners, or as shareholders in a corporation?

There is one tax problem that any condominium must consider whether it rents commonly owned areas or not. Assume that the board of governors has found that at the end of the year its expenses did not consume the total assessments that it has levied on the unit owners and that consequently the condominium has a surplus. Although this surplus would be applied against the next year’s expenses, in a similar situation such an excess in a cooperative housing corporation was said to be taxable.\textsuperscript{18} A simple solution is to make certain that the board of governors must return any excess money to the unit owners at the end


\textsuperscript{16}See 50 Calif. L. Rev. 299, 332-34.


\textsuperscript{18}Rev. Rul. 56-255, 1956-1 Cum. Bull. 58: “[W]here the excess of predetermined charges at the end of any year is not used to reduce carrying charges until a subsequent year or years, such excess constitutes income to the corporation subject to Federal income taxes in the year in which received.” This Ruling is entirely inconsistent with long-established Treasury practice of permitting other types of non-exempt cooperatives to exclude patronage dividends, refunds, or rebates from gross income, as long as there is pre-existing liability for such payments. See CCH 1963 Stand. Fed. Tax Rep. ¶ 273.05.
of the year. Another possible solution is to side-step the problem by depositing the funds in an agency account, the agency revocable on thirty days notice. Thus the agent would hold an undivided interest in the account for each contributor, and if he should leave he would be entitled to immediate repayment of his excess deposits.\(^9\)

In determining the question of taxation of the condominium deriving income from rentals of commonly owned areas, the classification of the organization as a business enterprise is critical. This classification, being solely for tax purposes,\(^{20}\) is not controlled by the name given to the organization by its members or the designation given it under local law.\(^{21}\) However local law is applied “in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets.”\(^{22}\)

The condominium will come within one of three tax classifications: a “co-ownership” arrangement, a partnership, or an association taxable as a corporation. Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business enterprises, the absence of either of these characteristics will cause the organization to be a co-ownership arrangement and not a partnership or an association i.e., taxable as a corporation.\(^{23}\)

The requirement that there must be associates merely means that there must be more than one person in the organization.\(^{24}\) Clearly condominiums have associates — the individual owners organized to protect their common interests and to maintain the building.\(^{25}\)

**Business Objective?**

Does the condominium which rents or leases commonly owned areas have an “objective to carry on business and divide the gains therefrom?” The Treasury Regulations make no attempt to define this term. It seems clear from the cases that co-tenants of real property who rent such property, while they have a profit motive do not neces-

\(^{19}\) See Mobile Bar Pilots’ Ass’n v. Commissioner, 97 F.2d 695 (5th Cir. 1938); Topeka Insurors, 12 T.C. 428 (1949); Farmers Coop. Co., 33 T.C. 266 (1959), reversed on other issues, 288 F.2d 315 (8th Cir. 1961).

\(^{20}\) Treas. Reg. § 301.7701-1(b) (1960).

\(^{21}\) Treas. Reg. § 301.7701-1(c) (1960).

\(^{22}\) Ibid.

\(^{23}\) Ibid. § 301.7701-2(a) (2) (1960).


\(^{25}\) That the courts will endeavor to find associates, see Central Republic Bank & Trust Co., 34 B.T.A. 391 (1936), where the sole beneficiary of a trust was found to be an associate with others who had provided money for the trust res, but were not named as beneficiaries.
sarily have an objective to carry on business, at least for the purpose of the Code section here in question. On the other hand, where the purpose of the organization is to own, manage, lease, and sell real property there is such an objective. It is not determinative that there is only one piece of property, that no land has been bought and sold, or that the dealings are confined to real property.

A Treasury Regulation concerning the definition of a partnership says that mere co-ownership of property which is maintained, rented, or leased does not constitute a partnership. But tenants in common may be partners if they “actively carry on a trade [or] business” and divide the profit. For example, a partnership exists if co-owners of an apartment building “lease space and in addition provide services to the occupants” either directly or through an agent. Key words here are “actively” and “in addition provide services.” It seems that “additional services” are such an “activity” that will cause co-owners of an apartment to be carrying on a business. “Services to the occupant” of an apartment building are defined in another Treasury Regulation relating to the self-employment tax. These services are not such things as are normally provided in an apartment building, such as heat, light, collection of trash, or the employment of a janitor, but are such things as are normally provided by hotels — maid service and catering. A luxury residence condominium would thus have to be careful not to provide such services to a tenant of a commonly owned unit.

What other activity may be sufficient to find an objective to carry on a trade or business? A case involving a trust says that while the

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26 Daniel S. W. Kelly, 16 CCH Tax Ct. Mem. 34, 40 (1957); Lena Hahn, 22 T.C. 212 (1954); see Crocker v. Malley, 249 U.S. 223 (1919); Meyers v. Commissioner, 89 F.2d 86 (7th Cir. 1937).

27 “Business” or “objective to carry on business” may be used with different meanings in reference to different Code sections, e.g., Int. Rev. Code of 1954 §§ 162(a), 172(d) (4), 1221, 1231, 1402; see Gilford v. Commissioner, 201 F.2d 735 (2d Cir. 1953).

28 Often the purpose will be derived from the instrument creating the organization, whether the organization actually conducts that business or not. E.g., Morrissey v. Commissioner, 296 U.S. 344 (1935); Rohman v. United States, 275 F.2d 120 (9th Cir. 1960). On the other hand, the actual conduct may control where there is no instrument sufficient for finding the business objective. See Treas. Reg. § 301.7701-1.


30 Title Ins. and Trust Co. v. Commissioner, 100 F.2d 482 (9th Cir. 1938).


33 Treas. Reg. § 301.7701-3 (a) (1960).

mere holding of property and collection of rent do not create sufficient activity, the powers of trustees to lease, to mortgage, and to borrow money are sufficient for the trust to be considered to be doing business. The line seems thin, for certainly tenants in common, all of whom sign any important document, can operate as "actively" as trustees. The distinction might be that there is a predetermined organization in a trust arrangement, but there may be no defined organization when property is held by tenants in common.

Where does the condominium fit in? In the case of a residential condominium clearly the board of governors must not be granted power to provide tenants of commonly owned areas with such services as maid service or some other service beyond the normal operation of an apartment building. The declaration of covenants should clearly state such a limitation.

Considering condominiums generally, it might be considered that the purpose of a condominium is to own, lease and manage the commonly owned property. This seems sufficient under the controlling cases. Certainly the unit owners own the areas and are the lessors; and it would seem that it would be necessary for the board of governors, or its agent, actively to manage at least the commercially used areas if not the commonly owned residence areas. On the other hand it might possibly be argued that the real purpose is not to carry on a business at all, but to so utilize any commonly owned areas to reduce the cost of the operation of the building. This is evident from the fact that the rents and the assessments levied on the unit owners for maintenance of the building are to be put into the same "maintenance" fund. (This procedure is required under existing documents for high-rise condominiums; and it will be of importance in another aspect met with under the heading of "Double Taxation.")

**Partnership or Corporation?**

Assuming that the condominium which rents commonly owned areas has been proved to be a taxable enterprise, is it a partnership or an association taxable as a corporation? The Regulations list six corporate characteristics in determining such an association. But the Regulations say that since associates and an objective to carry on business and divide the gains therefrom are common to both partnerships and associations,

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35 See Crocker v. Mailey, 249 U.S. 223 (1919); Myers v. Commissioner, 89 F.2d 86 (7th Cir. 1937); Blair v. Wilson Syndicate Trust, 39 F.2d 43 (5th Cir. 1930); Caswal Corp. 19 CCH TAX CT. MEM. 757 (1960).

36 Sherman v. Commissioner, 146 F.2d 219 (6th Cir. 1944).

only four characteristics remain to be considered: (1) continuity of life; (2) centralization of management; (3) limited liability; and (4) free transferability of interests. For the organization to be taxed as an association, there must be more corporate characteristics than noncorporate characteristics in an overall sense.

Without question, there seems to be continuity of life. All that is required is that death, bankruptcy, resignation etc. of any member will not cause the dissolution of the organization. Under the condominium concept, the condominium is to last until the building is destroyed, or until dissolution is voted by a specified majority of the unit owners. Further, the declaration of covenants will probably run with the land.

Is there centralization of management? The Treasury Regulations say that an organization has centralized management if the governing body has continuing exclusive authority to make management decisions. If there are many members, there is more likelihood that there will be centralization of management. Further, the Regulations stipulate that this term means a “concentration of continuing exclusive authority to make independent business decisions . . . which do not require ratification by members of such organization.”

But if the board of governors merely performs ministerial duties as an agent at the direction of principals (unit owners), this corporate characteristic will not be present. In one case the Tax Court noted that each tenant in common signed all contracts for work to be done on the building. And likewise, where the owners of an oil lease had made separate individual agreements with an agent, giving him expressly delegated powers, there was no centralization of management. But where an agent had broad powers, such as the irrevocable authority to extract and sell minerals rather than reserve to the participants the right to their share of the oil and gas lease in place, centralized management existed.

The high-rise condominium would most likely have centralization of management. It is too large to have all unit owners sign contracts

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38 Treas. Reg. § 301.7701-2(a) (2) (1960).
40 Treas. Reg. § 301.7701-2(b) (2) (1960).
42 Treas. Reg. § 301.7701-2(c) (1) (1960).
43 Ibid.
44 Ibid.
45 Ibid.
47 C. A. Everts, 38 B.T.A. 1039 (1938); cf., Mobile Bar Pilots' Ass'n v. Commissioner, 97 F.2d 695 (5th Cir. 1938); Topeka Insurers, 12 T.C. 428 (1949).
or in any other way establish merely an agency relationship with the board of governors. The board, under instruments already drawn up for high-rise condominiums, has power to maintain the common areas, to rent or lease the commonly owned space, to buy a unit on the first refusal option, to ascertain and levy assessments, and to file and foreclose for non-payment of assessments — all without the ratification of the membership at large. The fact that the board is specifically granted these powers under an instrument will be presumptive of centralized management whether the board exercises the powers or not.49

Is there limited liability on the part of the individual owner? The general rule in California is that members of an unincorporated association are liable as principals on all duly authorized contracts made by officers of the association.50 Furthermore, there is joint and several liability on the part of tenants in common.51 As to torts, there also would seem to be unlimited liability, at least where they occurred in the common areas, or were caused by the janitor or other servant.52 Thus there is, under California law, no limited liability on the part of the owners.

The last corporate characteristic is free transferability of interests. The Regulations require that each member have the power, without the consent of other members, to substitute for himself a person who is not a member.53 There seems to be no question but that there is free transferability in a condominium — one can alien his interest as he likes. Should there not be free transferability of interests the whole concept of the condominium would fail. However, an interest which is subject to a first refusal option, while freely transferable, will cause free transferability of interests to be accorded less significance than if such an option were not present.54

In determining whether the condominium will be a partnership or an association taxable as a corporation we have one characteristic which is definitely corporate, continuity of life, and another which is accorded less significance, free transferability of interests in modified form. On the other hand, we have a characteristic which is not corporate, unlimited liability. Thus (remembering that for an organization to be taxable as a corporation it must have more corporate characteristics than noncorporate characteristics) in order for the condominium to

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49 See note 28, supra.
51 Bell v. Adams, 150 Cal. 772, 90 Pac. 118 (1907).
54 Treas. Reg. § 301.7701-2(e) (2) (1960).
be a partnership and not an association, it would appear that it must not have centralization of management. An example given in the Treasury Regulations is in point:65

A group of twenty-five persons forms an organization for the purpose of engaging in real state investment activities. Under their agreement, the organization is to have a life of twenty years, and under the applicable local law, no member has the power to dissolve the organization prior to the expiration of that period. The management of the organization is vested exclusively in an executive committee of five members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Under the applicable local law, each member is personally liable for the obligations of the organization. Every member has the right to transfer his interest to a person who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While the organization does not have the corporate characteristic of limited liability, it does have continuity of life, centralized management, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.

Except for the fact that the organization has the purpose of engaging in real estate activities and that its life is limited to twenty years, the organization described sounds very much like the type of organization found in a large condominium. Thus if the condominium is not to be a corporation it will be because of the preliminary characteristic that it does not have an objective to carry on business and divide the gains therefrom.

Double Taxation

If the condominium is found to be taxable as a corporation, then the most serious aspect of the entire problem arises: can the condominium set-off the expenses of operating the building with the income from the rented areas, and if not, would that income be taxed not only as income to the condominium, but also as income to the unit owners in the form of constructive dividends? In *Anaheim Union Water Co.*56 two irrigation corporations (cooperatives which were non-profit, but not tax exempt) sold water to their shareholders. Each also received substantial income from sources other than the water business, namely

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oil leases and rentals. Each fixed its water charges to its shareholders below cost. The remaining cost was met by the income from the oil leases and rentals. Expenses and income were equal, and no profit appeared on the balance sheet. But the Tax Court held that, to the extent that the water costs were in excess of the charges to the shareholders for the water, the expenses were not deductible as "ordinary and necessary" business expenses under section 162 of the 1954 Internal Revenue Code.\(^5\) The court felt that the entire procedure was merely a device to distribute the oil and other unrelated income to the shareholders.\(^5\)

The question of a constructive dividend to the shareholder was not before the court. The Regulations say that one receives income when it is credited to his account.\(^6\) The Tax Court has held that income credited to a taxpayer's account to off-set charges on the account was constructively received and so taxable income.\(^6\) Would not the shareholder in the irrigation corporation be receiving a "credit" on his account to the extent that his share of the water cost was reduced by the income from the unrelated sources?\(^6\)

Compare the procedure in the *Anaheim* case with the procedure likely to be used by a condominium receiving rent from commonly owned areas. The rent would be put into the maintenance fund along with money received from the assessments on the unit owners. Naturally assessments would be reduced according to the amount of the anticipated income from the rentals. The condominium would show no profit, yet the unit owners would be getting a saving in the same way that the shareholders of the irrigation corporations realized a saving. In essence, would not the entire procedure be a device to distribute the "unrelated" income to the unit owners? The analogy is striking.\(^6\)

**California Income Taxation of an Association**

The condominium, not holding a corporation franchise, will not be subject to the California franchise tax,\(^6\) but may be subject to the cor-

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\(^{57}\) *Ibid.* at 1078.

\(^{58}\) *Ibid.*


\(^{62}\) The *Anaheim* case was appealed to the Circuit Court of Appeals, Ninth Circuit, and was argued March 8, 1962, docket no. 17494. No decision had been announced at the time this issue went to press. However, even if it should be reversed, the rule of the case was cited with approval and applied in *Chicago & Western Ind. R.R. v. Commissioner*, 303 F.2d 796 (7th Cir. 1962).

\(^{63}\) 16 CAL. ADM. CODE REG. 23151-23154(a).
poration income tax if it is found to be, under California law, an
association taxable as a corporation. The California Revenue and Taxation Code imposes a 5.5% tax upon the net income (derived from
sources within the state) of such a corporation. It states that for the
purposes of the corporation income tax, "corporation" also includes
associations and Massachusetts trusts. This section is amplified by
Title 18 of the California Administrative Code which says that the
term "association" is not to have a technical meaning but is to include
any organization created for the transaction of designated affairs, the
objectives of which continue though the members change, and the
affairs of which are conducted by a single person, a board or some
other group. Thus it includes any type of organization, regardless
of its designation, which is similar to an ordinary corporation. It
would appear that the definition of a corporation for California taxa-
tion purposes is at least as broad as the one applied in the Internal
Revenue Code.

Another section of the California Code of Revenue and Taxation,
however, allows a deduction in the case of associations organized and
operated on a cooperative or mutual basis, (1) when all income results
from or arises out of business activities for or with their members
carried on by them or their agents, or (2) when done on a non-profit
basis with nonmembers. This section was construed in Appeal of
Retailer's Credit Assn. of Alameda County, the Board of Equalization
saying that the intent of the section appears to authorize the deduction
by a cooperative association of the income received by the association
from members or nonmembers for services rendered to them at the
rates or charges arranged so as to return to the association an amount
approximately equal to the expenses incurred by it in rendering those
services. Following this decision, the condominium should not be taxed
at all in California on its income from rentals or leases.

Conclusion

There should be no federal tax imposed on a condominium if the
owners do not rent commonly owned areas or in any other way carry
on business for profit. This can be prevented only by carefully limit-
ing the power of the board of governors or managing authority. Also all assessments remaining after payment of expenses at the end of the year should be required to be returned to the individual owners.

But assuming that the rule in the *Anaheim* case will be adhered to and that the condominium does rent commonly owned areas, and there is centralized management, as most likely will be the case, then the condominium will be taxed as a corporation and the “profit” from the rentals will be taxed both as corporate profit and as a constructive dividend to the unit owners. As far as state taxation is concerned, there will probably be no taxation on income from commonly owned areas even if these corporate characteristics are found.