COOPERATIVES AND CONDOMINIUMS

Tax Treatment of Condominiums—Under and Outside IRC §528

Condominium unit-owners typically manage their property through a homeowners association, which collects regular assessments from all unit-owners to maintain and improve the association’s property. Whereas individual homeowners who set aside funds to maintain and improve their own homes will not incur any tax liability, a condominium association that collects assessments from unit-owners for the same purposes may have such assessments treated as taxable income. To correct this anomaly and to encourage condominium property improvement and maintenance, in 1976 Congress added §528 to the Internal Revenue Code (IRC)—to exempt from income tax dues, fees, and assessments collected by a qualified homeowners association and used for the maintenance and improvement of association property. Condominium associations or their boards of managers, as well as residential real estate management and timeshare associations, are eligible for this favorable tax treatment, from which housing cooperatives are excluded.1

This column discusses the conditions that a condominium association must meet in order to qualify as a homeowners association under IRC §528, the tax-motivated reasons why a condominium association or board may choose not to elect §528 treatment, and what the tax consequences may be for a condominium association or board electing to be outside of (or not eligible for) the benefits of §528—at the federal, New York State and New York City levels. Importantly, given the pros and cons of electing §528 tax status, including the possibility of individual unit-owner tax liability, and the difficulty of revoking such status after a §528 election has been made, the board of managers of a condominium association should seek advice based on the association’s unique circumstances from a knowledgeable tax advisor prior to determining whether to elect IRC §528 tax treatment.

Eligibility

To qualify as a homeowners association under §528, a condominium association must satisfy six conditions. First, the condominium must be organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property.2 Second, at least 60 percent of the condominium association’s gross income for the taxable year must consist of dues, fees, or assessments from the residential unit-owners of the condominium.3 Third, at least 90 percent of the condominium association’s expenditures for the taxable year must consist of dues, fees, or assessments from the residential unit-owners of the condominium.4 Fourth, at least 85 percent of the condominium’s total square footage must be used for residential purposes, which includes spaces such as laundry areas, swimming pools, tennis courts, storage rooms, and areas used by maintenance personnel.5 Fifth, no part of the condominium association’s net earnings may inure to the benefit of any private individual or shareholder.6 Sixth, the association must elect §528 treatment by filing Form 1120–H; a separate election must be made for each taxable year.7

As a qualifying homeowners association, the dues, fees, or assessments collected from unit-owners by the condominium association are not included in its gross income.8 The federal tax rate on such homeowners associations is a flat 30 percent,9 whereas the typical federal corporate tax rate ranges from 15 percent to 35 percent depending on the amount of the entity’s taxable income.10 Thus, although the corporate tax rate may be lower than the 30 percent flat tax rate under §528 (if the entity’s taxable income is below a certain threshold), a condominium association qualifying under §528 may exclude dues, fees, and assessments from its gross income, a benefit that is not afforded corporations.

Not Electing §528 Treatment

Even if a condominium association satisfies the eligibility requirements of IRC §528, there may be tax reasons for not electing treatment under this provision. If it elects §528 treatment, the condominium association’s tax rate would be a flat 30 percent, regardless of its income for that taxable year. In other words, the condominium would not be eligible to be taxed at a lower federal corporate tax bracket.11 For example, if the condominium’s income is $50,000 or less in a given year, the applicable federal corporate tax rate would be 15 percent; income of $75,000 would be taxed at a combined rate of 15 percent on the first $50,000 of income and 34 percent on the balance.

As a qualifying homeowners association, the condominium association would also not be entitled to an investment credit,12 a credit which rewards property owners for engaging in certain activities, such as the use of clean...
energy.13 In addition, the condominium would not be entitled to a net operating loss deduction,14 or other corporate deductions, such as write-offs for organizational expenditures.15

Once a condominium association elects to be treated under §528, it is bound by that election for the taxable year and can only revoke its election with the consent of the Commissioner of the Internal Revenue Service (IRS).16 The IRS does not automatically grant requests to revoke the election of §528 status. For example, in a 1983 Revenue Ruling, the IRS permitted a condominium association to revoke its §528 election only because the condominium was given inadequate tax advice by a professional tax advisor.17

The condominium had a net operating loss from a prior tax year that could not be utilized under §528, but could have been claimed if §528 had not been elected and a corporate tax return (Form 1120) had instead been filed. Noting the tax advisor’s error, the condominium’s due diligence and prompt action in seeking relief from the IRS for the error, and its stated intent to file a “proper” (Form 1120) federal tax return if permitted to do so, the IRS relieved the condominium of its §528 election.

**Tax Treatment if Non-Electing**

Absent the application of IRC §528, the tax treatment of condominium associations is unsettled. A 1996 federal district court in California noted that a non-electing condominium association should be treated as a corporation for federal tax purposes,18 but our research has disclosed no other court decisions or determinative IRS rulings on point.

However, the legislative history of IRC §528,19 as well as leading treatises in this area20 generally agree that non-electing or ineligible condominium associations should be taxed as corporations. In addition, an IRS publication specifically addressing the issue of unincorporated condominium associations has also stated that such associations should be treated as corporations for tax purposes.21

An entity classification regime was adopted in regulations issued by the U.S. Treasury Department on Dec. 17, 1996, but there is no authority expressly addressing the application of those entity classification regulations to condominiums.22 However, if the condominium association is properly treated as a separate entity, it may nonetheless elect to classify itself as a corporation under the entity classification regime.23 The condominium would then be considered a separate taxpayer and be subject to corporate tax return filing requirements and federal corporate income tax.

If the condominium association does not file an election to be treated as a corporation under the classification regime and is treated as a partnership, the condominium would not be subject to an entity level tax.24 However, the income and deductions of the partnership should be reflected on the separate income tax returns of each individual unit-owner, pro-rata to their interest in the condominium, in accordance with the provisions of IRC Subchapter K, and the condominium association would be required to file an information return with the IRS.

Similarly, if the board of the condominium association, as agent for the individual unit-owners under the condominium’s by-laws, takes the position that the condominium is not a separate entity and therefore not subject to the entity classification regime, the unit-owners should, in the aggregate, include in their gross income and be taxed on all income earned by the condominium association. This income may include interest or similar income earned from interim investments of the amounts assessed and collected from the unit-owners, reduced by the expenses incurred in earning such income.

**State and City Taxes**

The income tax treatment of a condominium association for New York State and New York City tax purposes is also unclear. The relevant New York State and New York City laws incorporate by reference federal entity classification provisions which, as discussed above, do not specifically address the treatment of condominiums.25 If a condominium is treated as a separate entity that is taxable as a corporation for federal income tax purposes, it appears likely that the condominium would be subject to the New York State Corporation Franchise Tax and the New York City General Corporation Tax.

If the condominium does not constitute an association that is taxable as a corporation for federal income tax purposes, it is still possible, although not certain, that the condominium might be subject to the state corporation franchise tax. Further, in such event, the condominium likely would also be subject to the New York City Unincorporated Business Tax, unless it were eligible for and elected treatment under §528 as a homeowners association.

**Recommendations**

An eligible condominium association must carefully consider whether to elect IRC §528 treatment for a given taxable year. Although dues, fees, and assessments will be excluded from the condominium’s gross income under §528, the condominium will also become ineligible for certain tax credits and deductions. Outside of §528, the tax treatment of condominium associations is unclear under federal, state and city laws.

If the condominium is not treated as a separate entity, individual unit-owners may be taxed on all income earned by the condominium. On the other hand, if the condominium is treated as a separate entity, it may be classified and taxed as a corporation or partnership under the federal classification regime. Given that a condominium can only revoke its §528 election with the consent of the IRS and the unsettled nature of an association’s tax treatment outside of §528, a prudent board should consult with an experienced tax advisor regarding eligibility and the election to be treated under IRC §528, the availability of alternative tax treatment outside §528, and the possibility of tax exposure to individual condominium unit-owners outside of §528.

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1. IRC §528(c).
2. Id.
3. Id.
4. Id.
5. Treas. Reg. §1.528-4(b).
6. IRC §528(c).
8. IRC §528(f).
9. IRC §528(b).
10. IRC §11(b).
11. IRC §528(b).
12. Treas. Reg. §1.528-10(g).
13. IRC §48(a).
14. IRC §528(d).
15. Id.