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HOA Industry News, Articles, and Links

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### Have a great Independence Day weekend!

In observance of the upcoming holiday, we're keeping this newsletter brief. The main things for you to know are:

- enjoy your long weekend
- have that backyard bar-b-q with hot dogs and hamburgers
- enjoy the fireworks display

And, back to work next week



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### Unit Owners Tax Basis in Condo Associations

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### New Cases Added:

Autumn Ridge Homeowners Association v. Occhipinto

Bailey v. Stonecrest Condominium Association

Battram v. Emerald Bay Community Association

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### HOA Pulse

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# Unit Owners Tax Basis in Condo Associations

By: Gary A. Porter, CPA

Condominium owners get an increase in the tax basis of their homes based upon the reserve contributions they have paid into their association over the years. This can save tax dollars on the sale of the unit, and homeowners should be aware of this benefit. The question for most people is "How do I calculate my increase in tax basis from reserve contributions?"

Most associations have a reserve program, even if they don't conduct formal reserve studies and many homeowners are now becoming aware that a portion of the dues they pay are for "reserves" or the major repair and replacement fund. The purpose of the reserve fund is to provide monies for the ultimate major repair or replacement of the common areas of the association which include such items as roofing, fencing, streets, tennis courts, swimming pools, etc. It is well established that at the association level these items are of a capital nature under Internal Revenue Code Section 118 as modified by Revenue Rulings 74-563, 75-370 and 75-371. There are several rulings in this area that pertain to the association's point of view.

However, like many areas of association tax law, there is nothing directly on point that reflects the unit owners' point of view on the basis additions. We have to rely on a patch-work of various code sections, regulations and revenue rulings to attempt to find an answer to this question. While it seems clear that the items are capital in nature and may be added to the unit owners basis, the key question is when does this basis addition take place? Is it when the unit owner is assessed the funds? Or is it when the association expends the monies? The answer to this question and the timing of the expenditures can have very significant impact on the individual unit owner. To adequately assess this we must look at each of the citations related to this issue (see next page for analysis of applicable tax law).

The only logical conclusion that can be reached at this time is that a unit owners basis will include any capital assessments paid by the unit owner to the association whether the association has expended such funds or not. We will probably have to wait for a contested court case or specific ruling on this area to get a more strongly supported answer than we have at this time. However, existing evidence does support the conclusion reached above.

The unit owner is generally able to obtain this information from the association simply by reviewing the association budget for each fiscal year. The unit owner should remember, however, that not all reserves may qualify as "capital" in nature. The Internal Revenue Service has defined in Revenue Rulings 75-370 and 75-371 that painting and contingency reserve additions specifically do not qualify as capital in nature.

Assume homeowner pays \$250,000 for a condominium unit and incurs closing costs of \$1,000. In subsequent years, homeowner directly expends \$2,500 for interior improvements, and pays capital (reserve or repair and replacement fund) assessments of \$400 per year for 4 years. Homeowner's tax basis in residence is calculated as:

Cost - Purchase Price	\$ 250,000
Closing Costs	4,000
Direct Improvements	2,500
Capital Assessments (4 @ \$600)	2,400
Total Basis	<hr/> \$ 259,900

The basis has been increased by an additional \$2,400 simply by considering the capital assessments. Assuming a 40% combined Federal and State tax rate, this will save homeowner \$960 in taxes on the gain on sale of residence. While not a fortune, it is definitely worth the extra effort.



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## Tax Basis—continued

### Applicable Tax Law

IRC Sec. 1034 which relates to computation of gain or loss on sale of a personal residence provides that "in determining the taxpayers cost of purchasing a residence, there shall be included only so much of his costs as attributable to the acquisition, construction, reconstruction and the improvements made which are properly chargeable to capital account...".

IRC Sec. 1012 relating to the basis of property, states that "the basis of the property shall be the cost of such property...".

IRC Sec. 1016(a)(1), relating to Adjustments To Basis states that "General Rule-Proper adjustment in respect of the property shall in all cases be made-for expenditures, receipts, losses, or other items, properly chargeable to capital account...".

IRS Regulation 1.1016-2 states that "the unadjusted basis must be adjusted upward to include any expenditure or other item properly included in the capital account".

C.W. Robinson, 32 TCM 1130, DEC.32,199(M), TC Memo.1973-242, concerns the basis of the sale of a lot. It was held that the basis of the property sold did not include special assessments paid to a country club that adjoined the lots. The key issue in this case, however was that the ownership of the property did not carry with it the membership of the club. What this case implies is that there is a basis in the membership club that is separate from the basis in the lot.

T.R. Ettig, 55 TCM 720, DEC.44,736(N), TC Memo.1988-182, allowed taxpayer to claim as basis additions certain improvements to a co-owned condominium unit. This case addressed only such amounts directly expended by the taxpayer for improvements made by himself; it did not address improvements that may have been included in assessments paid by taxpayer to the association.

Internal Revenue Service Revenue Ruling 81-152, deals with a developer litigation lawsuit on a construction defects case and tax treatment to the association of the amount of monies received. This ruling held that the amounts received were not income to the association but constituted a return of capital to the individual unit owners.

This revenue ruling is consistent with several others citations in this same area, however this ruling went further and stated that "the money received from the builder is not income to the individual unit owners, but instead represents a return of capital to each unit owner to the extent the recovery does not exceed that owners bases in his or her property interest in the condominium development...requiring the individual unit owner to reduce their bases in their respective property interest in the condominium development is consistent with the congressional purpose in enacting Section 528 of the code. The essential purpose of Section 528 is to provide homeowners associations with the same tax treatment as individual homeowners...". The most important aspect of this revenue ruling however, is that in the last paragraph Internal Revenue Services stated,

"To the extent capital assessments are, or have been made against the unit owners for the purpose of making the necessary repairs or replacements, or the association retains the amounts recovered in the suit against the builder and uses them for capital repairs, replacement or improvements, the unit owners bases, under Section 1016, will be increased". This is the clearest statement that exists on this issue and very directly states that if a capital assessment is made by the association the unit owner bases will be increased. This does not indicate that the association must have expended such monies for the actual major repair or replacement of the common areas. This also makes sense when contrasted to the Robinson case, as homeowners association the association membership runs with the property or unit; it is not a separate membership interest that may be transferred without the underlying transfer of the real estate.

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Article Title	Article Summary	State
<a href="#">Anxious residents wait, help</a>	Team effort was evident in the sweat Sunday in Wynstone, a private gated community with fewer than 200 homes near McCook Lake in Union County.	South Dakota
<a href="#">5 Tips for the first-time homebuyer</a>	Major changes in <a href="#">mortgage</a> lending and housing markets have created a new world for first-time homebuyers.	National
<a href="#">With HOA collection bill dead, language revived in another bill</a>	A portion of a homeowner association bill languishing in committee got re-born in a bit of last-minute legislative maneuvering.	Nevada
<a href="#">Sign ordinance 'may open up a can of worms'</a>	A hospice house and their neighboring homeowners association may cause more trouble throughout their city over sign ordinance violations	Florida
<a href="#">Judge backs homeowner in S. Phila. Pool dispute</a>	A judge ruled in favor of a family whose HOA was trying to get them to fill in their pool	Pennsylvania
<a href="#">State revokes permit for high-rise development on North Bergen waterfront</a>	A lawsuit by an environmental group and a homeowner's association appears to have been successful in stopping a proposed high-rise development on one of the last parcels of undeveloped land on the Hudson River -- at least, for now.	New York
<a href="#">OpenBand seeks dismissal of HOA's federal lawsuit</a>	Southern Walk HOA files suit charging that the exclusive contract for telecommunications services is illegal.	Virginia
<a href="#">Major Nevada bill on HOA collection fees dies in 11th hour, but battle still rages in courts</a>	Largest HOA bill of the Nevada legislative session has been postponed to a later agenda	Nevada
<a href="#">Edmond homeowner doesn't like Covell Road widening project</a>	HOA Treasurer is pressured to resign for disagreeing with city and other board members about a road widening project that would occur behind her home.	Oklahoma
<a href="#">Boardwalk builds, boosts community</a>	Children of HOA raised money to build a boardwalk for neighbors to get to lakeside waterfront	Michigan
<a href="#">Questions, debate still cloud Jetton Road pedestrian lights</a>	The board of the Peninsula Property Owners Association plans to pursue its request for the town to help pay for lighting along Jetton Road, after clarifying that the association wants less expensive safety lighting for pedestrians, not	North Carolina
<a href="#">Take LOUD out of lake parties</a>	HOA wants boat parties to be shut down for loud music laced with profanities	North Carolina
<a href="#">Dr. Brad Watson: The importance of knowing your HOA's conditions</a>	It is important to review and have knowledge of your CC&R's before purchasing your property	California

Article Title	Article Summary	State
<a href="#"><u>Broward considers suing over-55 Coconut Creek condo community</u></a>	50 year old disabled man who lived with his grandmother in an over-55 community until she recently passed away, is now being harassed by community leaders who want him to leave	Florida
<a href="#"><u>Law lets condo owner fly flag with pride</u></a>	Governor signed a bill into law that gives renters and condo owners the right to fly the American flag outside their home	NH
<a href="#"><u>Investor spiffs up run-down Wellington condos, but prices some residents out</u></a>	Owners and realtors have complained that an association has increased dues while blocking new buyers so it can snap up units for itself	Florida
<a href="#"><u>Townhouse, condo, co-op, conversion. Huh?</u></a>	Townhouse, Condo, Co-op, Conversion ... What's the difference?	California
<a href="#"><u>Side Streets: Judge rules large Kissing Camels homeowners group can't just absorb small neighboring HOA</u></a>	A judge has smacked down one of the most affluent homeowners groups in Colorado Springs in a decision that affects any HOA thinking of trying to absorb a smaller, neighboring association.	Colorado
<a href="#"><u>HOA Adviser: Neighborhood watch program</u></a>	Electric vehicles and neighborhood watch to eliminate crime are addressed	California
<a href="#"><u>Sunshine Law applies to government agencies</u></a>	Q: I was under the impression that Florida's Sunshine Law did not apply to homeowners' association meetings unless the board was performing some governmental function.	Florida
<a href="#"><u>Condo rules for pets are varied</u></a>	Condo law and pet restrictions are the center of this discussion	Washington
<a href="#"><u>Stoneridge developer withdraws support for lease agreement</u></a>	The developer of a subdivision withdrew support from an agreement in which the company would turn over the community center to help homeowners reduce bond debt	Arizona
<a href="#"><u>Any recourse when the homeowners association board is not responsive?</u></a>	Non-responsive board needs to be dealt with. Davis-Stirling Act provides a mechanism for removing and replacing board members who continue to disregard covenants	California



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