community ASSOCIATIONS INSTITUTE

April 15, 2015

**The Honorable Orrin G. Hatch**
*Chairman*
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

**The Honorable Ron Wyden**
*Ranking Member*
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

**Transmitted via Electronic Mail (business@finance.senate.gov) and (individual@finance.senate.gov )**

***RE: Tax Reform Considerations for Community Associations***

Dear Chairman Hatch and Ranking Member Wyden,

On behalf of the 33,000 members of Community Associations Institute[1] (CAI), I am pleased to submit comments regarding the taxation of community associations in an effort to provide information to best overhaul the nation's flawed tax code to make it simpler, fairer, and more efficient. Thank you for seeking public comment to share with your working groups as you embark upon this monumental task.

[1] CAI is the only international organization dedicated to fostering competent, well-governed community associations that are home to approximately one in every five American households. For more than 40 years, CAI has been the leader in providing education and resources to the volunteer homeowners who govern community associations and the professionals who support them. CAI's members include community association volunteer leaders, professional managers, community management firms and other professionals and companies that provide products and services to associations.

6402 Arlington Blvd.
Suite 500
Falls Church, VA 22042

888.224.4321
www.caionline.org

**Summary of Recommendations**

- CAI members urge the Senate Finance Committee to make the following three changes to the **business tax code** in order to create a fairer taxing model for community associations:
    1. *Clarify that community associations qualify for tax-exempt status under Internal Revenue Code (IRC) Section 501(c)(4) as a "social welfare"[2] organization.*
    2. *Clarify IRC Section 118 to provide that unused insurance deductible funds are a capital item and not taxable income.*
    3. *Clarify the application of Subchapter T (IRC Sections 1381-1388) to establish interest income from reserves as a patronage dividend [3]activity and not subject to taxation for all community associations; including condominiums, housing cooperatives, and homeowners associations.*

- CAI members urge the Senate Finance Committee to make the following change to the ***personal tax code*** in order to create a fairer taxing model for homeowners living in community associations:
    1. *Require the Internal Revenue Service (IRS) to allow homeowners living in a community associations to deduct community association assessment expenses from their annual individual personal tax obligation.*

**Overview of Community Associations**

Community associations—often referred to as homeowners associations, planned communities, condominiums or housing cooperatives—are an important component of the housing market with a unique legal structure and owner obligations. Local municipalities often mandate any new housing development be organized as a community association; as such local municipalities transfer the obligation of municipal services to community associations and homeowners living in these communities bear the expense and relieve the municipalities of infrastructure development and maintenance expenses. Community associations are generally predicated on density, marketability, proximity to employers, and access to education, health and other community services. There are more than 330,000 community associations, accounting for more than 26 million housing units nationwide. More than 65 million people in America live in community associations, and these numbers will continue to grow as the community association model of housing provides services that normally would be provided by

---

[2] Treasury Regulation 1.501(c)(4) - Describes "Social Welfare" Organizations. Appendix 5k. Describing social welfare organizations as in general. An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.

[3] Definition of 'Patronage Dividend' – A dividend or distribution that a co-operative pays to its members or investors. Patronage dividends are given based on a proportion of profit made by the business. Once this amount is figured out the dividend is calculated according to how much each member has used the co-op's services. Tax rules view these profits essentially as an overcharge, which can be returned to patrons and deducted from the co-op's taxable income.

municipalities to residential communities, thereby meeting vital housing needs and alleviating strain on state and local government budgets.[4]

Virtually every community association has a governing board elected by homeowners. While community managers and other professionals often provide critical support to associations, it is volunteers—elected by their neighbors—who ultimately are responsible for preserving the community, meeting the expectations of neighbors, protecting property values and enforcing the association's governing documents, including the obligation to pay assessments.

Community association homeowners are required by contract with their deed-restricted community to pay assessments that fund substantial infrastructure, municipal-like services and recreational facilities, in addition to basic maintenance and repair of buildings. Infrastructure may include facilities such as storm water control and retention basins, streets, conservation of wetlands and other protected areas, and erosion control. Municipal-like services may include telecommunications wiring, refuse collection, street and walkway maintenance and lighting, and snow removal. Larger planned communities and condominiums may be responsible for water supply and waste water treatment. Such infrastructure and recreational facilities traditionally were provided by local government, but the growth of community associations has seen a transfer of these responsibilities from the public sector to private communities.

**<u>Community Associations as Social Welfare Organizations</u>**

Under state law, community associations are typically organized as non-profit corporations. However, community associations often do not qualify for IRS tax-exempt determination due to the improper application by IRS of IRC Section 501(c)(4).

IRS consistently adopts positions contrary to this narrow section of tax law in the course of tax audits and the exemption application process. IRS written training materials and in-house training courses exhibit a bias against homeowners associations attempting to qualify under this Section by addressing only one of the three methods in which an association may qualify for exemption.

Treasury Regulations establish that the association must "serve a community" (a term that is not defined in the Code or subsequent rulings) in order to qualify as a social welfare organization under IRC Section 501(c)(4). The IRS has a single interpretation of this, which is that the association must grant unrestricted access to the public to all association owned and maintained amenities. This is the only position presented in IRS training material and training programs. Unfortunately, that position ignores other following factors established in court cases and various revenue rulings where an association may restrict access:

- The association itself may constitute a "community"; and

[4] Foundation for Community Association Research, *Statistical Review 2013.*

• The association may occupy a geographic area generally recognized as a governmental entity.

Because IRS recognizes only the unrestricted access test in its written internal training material, IRS agents routinely inform associations that they may not qualify if they restrict access of the general public to any association facilities. IRS training materials attempt to establish a "bright line" test where none exists. This biased training material is not in accordance with law or the IRS's own revenue rulings, and has resulted in significantly raising the cost to associations attempting to gain exempt status by forcing many of them into an expensive appeals process.

***CAI members urge the Senate Finance Committee to clarify community associations qualify for tax-exempt status under IRC Section 501(c)(4) as a "social welfare" organization.***

**Unused Insurance Deductible Funds as a Capital Item**

Insurance of common property is one of the most important responsibilities for community associations. Insurance requirements are established by state statute and regulation, federal law, and association governing documents. Most community associations require four types of insurance coverages to protect their exposure to loss: property insurance (including the buildings, land and other real property owned by the community association as well as personal property); liability insurance; income protection insurance; and personnel risk insurance. As a best practice – and a requirement for qualifications of mortgage backing by the Federal Housing Administration, Fannie Mae, and Freddie Mac, community associations must budget for insurance deductibles. The dollar amount of the insurance deductibles for community associations, especially condominiums, has increased tremendously. Deductibles that were once between \$1,000 and \$5,000 are now between \$5,000 and \$25,000.

If an association is eligible to file IRS Form 1120-H, then maintaining insurance deductibles as an expense line item does not pose a direct federal income tax problem. This is because the revenue collected to fund the line item deductible, by definition, would come from exempt function income. The association would have no federal income tax liability for the insurance deductible line item even if there was no draw down on that line item during the tax year. Nevertheless, below points to the problem that the IRS would treat this line item as an expense and not as capital item.

If an association has to file IRS Form 1120, then the treatment of the insurance deductible as an expense line in the event that the association did not have any insured losses would mean that the association would have excess income at the end of the year. Absent any other deductions, the association might have to pay federal income tax on the unspent insurance deductible line item. Under IRS Form 1120, the association would be eligible to use Revenue Ruling 70-604, but that would defeat the purpose of building up an insurance deductible fund, especially if the association had some type of catastrophe insurance with a percentage deductible base on total insured values.

A *Property Insurance Deductible Fund* can meet the interpretation of a Capital Item under IRC 118, because the monies held would be used to restore the property of the association. Under IRC Section 118, contributions to capital are not taxable income; therefore, funds collected in assessments (or otherwise) and used for items in a Reserve Fund should not treated as taxable income to the association.

***CAI members urge the Senate Finance Committee to clarify IRC Section 118 that unused insurance deductible funds are a capital item and not taxable income. This will create an incentive for community associations to budget for full insurance deductibles and create a more financially stable community association.***

**Interest Income from Community Association Reserves Considered as Patronage Activity**[5]

Subchapter T was added to the Internal Revenue Code in 1962 to recognize a special type of entity; not a for-profit organization, not an exempt nonprofit organization, but something in between; an organization formed primarily by a group of individuals or companies known as patrons to conduct business amongst themselves without profit motive. The organizations were given the label of "cooperative organizations."

IRC Section 61 states "gross income means all income from whatever source derived" unless specifically exempted by another section of the Code. Congress recognized that no such exemption existed for cooperatives, so enacted Subchapter T that provided for organizations operating on a cooperative basis. Subchapter T exempted the "patronage" income from taxation, and taxed only net "non-patronage" income.

As mentioned earlier, community associations include cooperatives. The common elements of these communities are owned by the community association. Common elements may include roofs, stairways, roads, sidewalks, storm water management systems, parks, pools, club houses, and more. For a community association to plan for the maintenance and repair of the common elements, they undergo a reserve study to analyze the useful life of the common element and the associated replacement costs. A portion of the assessment paid by the homeowner will fund the reserve fund for the community so that capital improvements are budgeted and expected.

The capital reserve account of a community association consists of funds put aside in reserve for replacement of major components of a community's common property. Typically used to replace asphalt paving, concrete sidewalks, roofs, central heating and cooling plants, swimming

---

[5] Definition of 'Patronage Dividend' – A dividend or distribution that a cooperative pays to its members or investors. Patronage dividends are given based on a proportion of profit made by the business. Once this amount is figured out the dividend is calculated according to how much each member has used the cooperative's services. Tax rules view these profits essentially as an overcharge, which can be returned to patrons and deducted from the cooperatives' taxable income.

pools, tennis courts, elevators, and other varied property components. These major replacement items are placed on a replacement reserves scheduled. The schedule is a framework for accumulating and spending the funds for replacing major components of the community. The funds are put aside over a period of time to ensure that adequate amounts are available to replace components when they need to be replaced. The components, cost to replace the components, and the remaining useful lives of the component will determine how much should be in the replacement reserves.

***CAI members urge the Senate Finance Committee to clarify application of Subchapter T (IRC Sections 1381-1388) to establish interest income from reserves as a patronage dividend activity and not subject to taxation for all community associations; including condominiums, housing cooperatives, and homeowners associations.***

**Deduction of Community Association Assessments from Personal Tax Obligation**

Community association operations are funded, almost solely, by assessments paid by homeowners. A community association board of directors develops a budget for the community services and determines the assessment obligated to each homeowner in the community. Homeowners living within the community association are required to pay assessments that provide for the municipal services that were once offered by the local municipality–like refuse removal, street maintenance and more. These homeowners are required to pay local municipality taxes at the same rate as homeowners outside of the association who receive municipally-provided services. This creates an inequity for homeowners living in community associations, because they pay the same local tax as homeowners not living in a community association in addition to assessments; homeowners in associations are being taxed twice. An example of double taxation is refuse removal. A homeowner living in a community association pays assessments which include expenses related to trash removal. The community association removes the trash, but the homeowner also pays taxes to the local municipality. For those not living in the community association, the municipality removes their trash.

***CAI members urge the Senate Finance Committee to create equity for homeowners living in community associations as they pay local taxes without receive the same benefits as homeowners outside of a community association. The IRS should allowing homeowners living in a community association to deduct community association assessments expenses from their annual individual personal tax obligation.***

**Conclusion**

The number of community associations continues to grow at a rapid rate; especially considering that many local municipalities require the organization of a community association for housing development. Local municipalities continue to transfer the obligation of providing municipal services to community associations and homeowners living in these communities bear the expense. Community associations are non-profit organizations and to recognize these nonprofits properly under IRS Tax Code creates financial sustainability in the community association and therefore strength in the overall housing market.

I am pleased to meet with Members of the Committee or staff to further discuss the community association model of housing and why equity in the IRS Tax Code is important. Please contact me or Dawn Bauman, CAI's senior vice president of government and public affairs, at (703) 970-9224, if we may be of any further assistance.

Sincerely,

Thomas M. Skiba

Thomas M. Skiba, CAE
Chief Executive Officer
Community Associations Institute