

1965

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Andrew C. Ries

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## Recommended Citation

Quarterly, Vol. 11, no. 3 (1965, September), p. 18-19, 45-46

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# CONDOMINIUMS

by Andrew Ries

*Andrew C. Ries, manager in the tax department of our St. Louis office, is a member of the American Institute of CPAs, Missouri Society of CPAs, and the Missouri Bar Association. He is a member of the Legislative Committee of the Missouri Society; chairman of the Legislative Committee, St. Louis Chapter; and member, Mid-America Tax Conference Committee, St. Louis Chapter. In the past he has served as a member of Council and chairman of Federal Taxation Committee of the Missouri Society and as chairman, Federal Taxation Committee and Legislative Committee, St. Louis Chapter.*

*Mr. Ries received a BA in 1950 and a LLB in 1952 from St. Louis University. He was one of five students of a graduating class of 1500 who received an Outstanding Senior Award. In 1958, after six-years' employment with a local CPA firm, Mr. Ries joined TRB&S.*



A real estate concept as old as Rome is the newest vogue in residential investment for thousands of American home owners, apartment dwellers and builders. Differing in many respects from the co-op, the condominium offers unusual features including certain tax advantages equal to those for a single residence owner.

The word "condominium" has a Latin derivation reflecting its birth in Roman times. It means control to-

gether or joint ownership. It begins with the traditional idea in the United States of vertical ownership applied to the parts of a condominium common to all tenant owners: lobbies, elevators, stairways, sidewalks, swimming pools. Then, it adds the idea of horizontal ownership which deals with the apartment units themselves.

Historically, the condominium form of ownership originated in Roman times and has been used for centuries



in many parts of Europe. Although it has been used also in Latin America for years, it was not until the 1950s that condominiums commanded attention in the United States.

In 1958, Puerto Rico passed what it called the "Horizontal Property Act." A few of the states passed statutes similar to that of Puerto Rico. However, no more than passing interest was given to the condominium concept until the Federal Government provided the incentive in 1961 by amending the National Housing Act with the addition of Section 234.

This section authorized the Federal Housing Authority to insure mortgages and deeds of trust covering individual condominium units. Regulations have subsequently been issued and a model statute has been drafted for use by state legislatures. Stimulated by the availability of FHA insurance, all states except Maine, New Hampshire and Vermont have passed condominium acts, most of them based upon the FHA model statute.

Procedures under a typical condominium act would begin with the preparing, signing and filing of a declaration of record by the owners. This declaration, the essential instrument by which the property is made subject to the act, contains three basic parts.

First, it gives the legal descriptions of the land on which the buildings are located, of each unit usually identified by floor and number and of common areas such as patio or parking location. Then, it shows the value of the entire property and of each unit as well as the percentage of ownership of common elements. Finally, it encompasses other provisions such as voting power on repairs, rebuilding or sale in event of destruction of the property.

Following the declaration comes the filing of record of both a three-dimensional plot from which the individual units and common elements can be identified and the by-laws governing the operation of the unit. Upon completion of all these steps, all units involved may be transferred in fee simple title, leased, rented, mortgaged and dealt with as any other real property.

The co-operative apartment, or co-op, is distinguishable from the condominium in four respects:

1. Ownership. In a condominium the tenant actually owns the portion of the building he occupies, a *unit*. The tenant in a co-op is not an owner of the space he occupies, but is a shareholder with an arrangement which gives him a lease on a specific apartment.
2. Maintenance costs and taxes. All costs are spread ratably by the co-op, while the condominium owner pays only the expenses relating to the common ele-

ments of the building and the land. Maintenance costs and taxes are handled individually by each condominium owner only for his unit.

3. Financing. The co-op is financed by one mortgage on the entire property; in a condominium, there may be as many mortgages as there are units.
4. Disposition. The co-op owner can usually sublease with the permission of the corporation [and he can also sell his shares to another person approved by the corporation. If no buyer is found, he can surrender his shares to the corporation, which will relieve him of any personal responsibility for obligations of the co-op.] A condominium owner is, however, responsible personally for his mortgage, if any, and for his portion of the common element expenses. The condominium owner has, of course, much more latitude in selling his unit.

Aspects to be considered from the viewpoint of the builder are the same as in any other type of family residence, namely, market appeal and financing. Builders favoring condominiums conclude there is a favorable market. A close view of factors involved reveals the reasons for their conclusion:

1. Rising land costs. Rapidly rising land costs in suburban areas make it possible to offer larger living area for the same price by more concentrated use of land in a condominium project. The advantage of having a location closer to the center of the metropolitan area is also achieved.
2. Desire for more leisure time. Market surveys indicate that young executives are working longer hours under greater pressure than ever before. As a result, they are interested in their leisure time being uninhibited by the chores connected with single family home ownership.
3. Senior citizens. Many couples as they advance in age are unable or unwilling to wash windows, shovel snow, cut grass and do other chores connected with single residences, and yet are unwilling to pay rent by moving into a rented apartment.
4. Population explosion. Population surveys indicate that there will be a greater number of persons reaching voting age in the next ten years than at any other time in our history. Condominium proponents contend that these young couples will not be able to afford the two cars necessary in suburbia or the down payment for the type of home to which they were accustomed.
5. Status search. Apartment dwellers may qualify for

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William J. Simpson is a member of the Subcommittee of the Tax Conference, Harrisburg, Pennsylvania.

**Portland**—Lee Schmidt was elected secretary of the Oregon Society of CPAs. Mr. Schmidt was re-elected treasurer of the Portland Retail Controllers' Group.

**Rochester**—Gail Brown was elected president of the National Society of Accountants for Cooperatives at the annual meeting in San Francisco, California.

**St. Louis**—Ken Bauer was elected president of the St. Louis Chapter of the Missouri Society of CPAs.

**San Diego**—Glen A. Olsen was appointed chairman of the Management Services Committee of the California Society of CPAs.

**San Francisco**—The San Francisco Chapter of CPAs announces the following appointments: Education Standards and Student Relations, Jim Loebbecke; Cooperation with Credit Grantors, Richard Nishkian; Savings and Loan, Robert Riss; Accounting and Auditing Procedures, David Moxley; Taxation, Robert Estes and Robert Bean; Public Relations, William King.

Thomas Wall was appointed director for a two-year term of office in the San Francisco Chapter of CPAs and to the Trial Board of Northern California Chapter of CPAs. Mr. Wall serves on a joint committee on auditing and examination principles and procedures of the Savings and Loan Industry which is comprised of five CPA members and five officers of savings and loan associations. Members of state and federal regulatory agencies meet with the committee in an advisory capacity.

Gene Englund has been appointed chairman of the Committee on Educational Standards and Student Relations of the San Francisco Chapter of CPAs.

Richard Nishkian was appointed to the California State Committee on Cooperation with Credit Grantors.

**Seattle**—Stanley M. Bray has been appointed placement director of the Seattle Chapter, National Association of Accountants.

Michael P. Curtis is a member of the Arrangements Committee for the Northwest Graduate Study Conference at Ocean Shores, September 9-11.

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the status of being home owners by living in a condominium project.

In financing condominium projects, the prospective builders face more serious problems. Since the condominium concept is new in this country, lenders still prefer to invest in conventional multi-family rental projects. Also, strict requirements must be met before the FHA insurance endorsement can be made. They include securing a feasibility report from the FHA, obtaining commitments for both a multi-family rental unit and a condominium, constructing the project, selling the units and then applying for the final insurance endorsement.

Most important is the sale of the units. The FHA requires that 80 per cent be sold before the condominium commitment becomes effective. Because of this, at least that percentage of sales is essential to insure total financing and to avoid secondary financing or ownership of a portion of the unit by the builder. It may be necessary to escrow down payments and defer closing until a condominium project is assured. Conventional financing is the means most builders are using to circumvent this problem.

The owner of a condominium unit has certain tax advantages equivalent to those of the owner of a single residence:

1. Non-recognition of gain. 1954 Code Section 1034(a) provides for the non-recognition of gain on the sale of a residence if proceeds are reinvested. This makes it possible for older persons over 65 or couples (with at least one spouse over 65), whose families are grown, to sell their single family residence and move into smaller quarters in a condominium project with no tax if all of the proceeds are reinvested. If it is not necessary to reinvest all of the proceeds and a gain has been realized on the sale of the single family residence, an election may be made under Code Section 121. It will make possible exclusion of either all of the gain, if the adjusted sales price is less than \$20,000, or a portion of the gain if the adjusted sales price is more than \$20,000.

Section 1034(f) and 121(d) (3) make the above possibilities available for tenant-stockholders in a co-operative housing corporation provided that it meets the tests of Code Section 216.

2. Deduction for real property taxes and interest paid on mortgage. Code Section 164 permits the deduction for real property taxes and Code Section 163 allows a deduction for the interest paid by either the condominium unit owner or tenant-stockholder of a co-op, provided, again, that the corporation qualifies under Code Section 216.
3. Casualty loss. In the event of partial or total destruction of the premises the tax effect is different as to the unit owner of a condominium and the tenant-stockholder of a cooperative housing corporation. The condominium unit owner is entitled to a casualty loss under Code Section 165(c)(3) except for the first \$100 as provided by the 1964 amendment. The tenant-stockholder, however, has as his only possible deduction a long-term capital loss resulting from a worthless security under Code Section 165(g).
4. Depreciation if rented. Both the unit in a condominium and the portion of the stock in a co-op allocable to a proprietary lease or right of tenancy are eligible for depreciation if the premises are used in the taxpayer's trade or business or for the production of income, as permitted by Code Sections 167(a) and 216(c).

More tax problems arise as to the entity which is created to manage the common elements of the condominium. First, what kind of taxable entity is the management group if unincorporated? A partnership? Or an association taxed as a corporation?

Regardless of the type of entity it may legally be, it is possible for the accumulation of monthly maintenance charges paid by the unit owners to exceed expenses incurred for such purposes in any period. This will certainly be the case if the project is an FHA project since the FHA requires a reserve fund for both replacements and general operations. The problem which then exists is how to avoid paying income tax on any excess of income over expenses or, in the case of the FHA reserves, how to avoid having the amounts paid treated as income under the constructive receipt doctrine.

As to the type of entity which exists if unincorporated, there is considerable doubt. The regulations provide guidelines at 301.7701-2(a)(1) to determine if the organization has more corporate than non-corporate charac-

teristics. In such a case, it will be taxed as a corporation; if not, as a partnership.

The guidelines are:

1. Associates.
2. An objective to carry on business and divide its gains.
3. Continuity of life.
4. Centralization of management.
5. Liability for corporate debts limited to corporate property.
6. Free transferability of interests.

Since 1, 3 and 6 are present as a result of the normal condominium by-laws, and, since attempts to structure the by-laws to eliminate profit motive or centralization of management may be considered self-serving, most organizations may be taxed as corporations.

Most management organizations will incorporate, however, as a matter of course in order to avoid the unlimited liability possible as an unincorporated organization.

With regard to the excess of income received from unit owners over expenses of maintenance and repairs, there seems to be taxable income. There is no specific provision in the code exempting condominium management corporations from taxation. Also, such an entity would not come within any of the tax-exempt organizations included in the provisions of Code Section 501(c). It should be possible, however, to contract to have the organization act as agent for the unit owners in the event of an excess of receipts over expenses. Provision would be made for refund within a short period after the end of the accounting year, and thereby avoid taxable income.

Concerning the amounts to be paid for the funding of reserves as required under an FHA arrangement, it should be possible to arrange for these funds to be put in escrow and thereby not be considered as income until they are released from escrow. Since release would be simultaneous with the necessity for expenditures no income would result.

#### *Conclusion:*

It seems likely that the idea of the condominium will increase in popularity throughout the United States as conventional financing becomes readily available and market appeal intensifies. Some day, residential investors may see the condominium concept of the Romans adopted as an American institution.