

4-1975

## Tax Forum: The Plight of the Homeowners' Associations

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### Recommended Citation

Kitchen, Mable W. (1975) "Tax Forum: The Plight of the Homeowners' Associations," *Woman C.P.A.*: Vol. 37 : Iss. 2 , Article 10.

Available at: <https://egrove.olemiss.edu/wcpa/vol37/iss2/10>

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# Tax Forum

## The Plight of the Homeowners' Associations

*GUEST WRITER: This column is the work of Stephen D. Higgins, CPA, a tax manager and the director of international tax operations in the Minneapolis, Minnesota, office of Touche Ross & Co.*

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It appears inconceivable that homeowners should have to include in taxable income funds set aside to use for painting the exterior of their houses in the future, but that is essentially the predicament of homeowners belonging to homeowners' associations.

Normally the association is a nonprofit corporation established by homeowners (generally townhouse owners) to provide for the normal maintenance of the grounds such as the mowing of lawns and shoveling of snow and also the maintenance of the exterior of the homes. The association usually makes monthly assessments of its members to cover the above costs and normally accumulates funds for the repainting of the houses rather than making a large assessment at the time of repainting.

Many homeowners' associations had

considered themselves tax-exempt organizations under Section 501(c)(4) of the Internal Revenue Code and had requested and received determination letters to that effect. However, at some point the Internal Revenue Service had a change of heart and in 1974 the Internal Revenue Service formally announced through Revenue Rulings 74-99 and 74-17 that homeowners' associations would not qualify as tax-exempt organizations.

At present the Internal Revenue Service is revoking the exempt status of homeowners' associations in those cases where they had previously issued favorable determination letters) and requiring the homeowners' associations to file corporate income tax returns for prior years.

In filing returns for prior years consideration may be given to excluding the excess of receipts over disbursements from taxable income under the so-called conduit theory. Under this judicially developed theory an entity is not taxable on funds it does not have unfettered control over. Under the governing documents of a homeowners' association, the association is normally restricted in its scope of activity and essentially does act as a conduit to funnel money from its members to independent contractors. However, it now appears that the Internal Revenue Service will not honor this position. In Revenue Rulings 74-318 and 74-319 the Internal Revenue Service withdrew their acquiescences in the leading cases on the conduit theory and substituted nonacquiescences. The Internal Revenue Service further implied that, even if the excess of receipts over disbursements of a

fund could be excluded from taxable income of an entity under the conduit theory, the contributing members of the fund may constitute an association taxable as a corporation and may be taxable on the excess of receipts over disbursements.

It appears that homeowners' associations should consider the following steps of action:

1. If the association has a cumulative excess of receipts over disbursements through the beginning of the year, consideration should be given to curtailing assessments for the year to attempt to create a net operating loss to carry back against prior years' income. Note however that Section 277 may only allow a carry forward of such a loss.
2. Consideration should be given to establishing a separate fund for painting and capital improvements. In connection therewith the governing instruments should provide for annual capital contributions by the members to such fund. There is statutory authority (Section 118) and case history for excluding capital contributions from income and the Internal Revenue Service as informally agreed with this approach in some cases. It recently took this approach in Revenue Ruling 74-563. However, the capital contribution exclusion does not apply to money or property transferred to the corporation for services rendered.

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more frequent basis, so that the intervening processing period for which transactions must be saved can be kept to a minimum. This approach to reconstruction has the disadvantage that the dumping operation itself requires time and, of course, that the reconstruction operation can be time-consuming, since it requires a reexecution of all of the transactions occurring since the preceding dump. Where possible, it is desirable when using the dumping technique to incorporate in the dump operation additional processing benefits. Thus, while dumping records, an edit routine can be executed to perform edit and reasonableness checks on the logical fields within each record in order to determine, where possible, consistency within the records. In addition, inactive or logically deleted records can be recognized, so that file rearrangement and compaction can be obtained as a by-product of the normal dumping procedure.

The third approach, which can be used to good advantage in those instances where a systems failure destroys only a few records rather than the entire data base, is an approach that can be referred to as an audit trail approach. Basically this technique keeps a record of all transactions that occur as well as the contents of each master record both before and after updating by a specific transaction. The audit trail log, or reconstruction log, can be recorded on any medium although the most efficient is some machine-readable medium that can be accessible to the recovery routine. By copying the contents of the data base master record before updating, the full text of the transaction, and then the contents of the data base record after updating, the reconstruction log makes it possible for the recovery routine to determine all transactions that were in the process of updating when a failure occurred. The records containing information regarding the contents of the data base records allow restoration of any records involved in the failure. Serious failures, in which the full file is destroyed, are still best handled by the latest file dump. Then the reconstruction log can be

used to merge in the after copy of those master records that have been updated by transactions since the last dump.

Whichever recovery procedures an installation decides upon, it is essential that those procedures be carefully planned ahead of time and just as carefully documented. This means that the installation must investigate very thoroughly all potential sources of systems failure and consciously attempt to provide for recovery from each individual type of potential failure. In addition, it is important that operating personnel be made completely familiar with the proposed recovery routines and be carefully trained in the implications of those activities. Recovery plans should be periodically reviewed in order to determine that they are as applicable as when first designed. As part of the evaluation of the processing system, the auditor verifies that the client has made adequate provision to protect the data base and to provide for recovery routines that will facilitate continued operations. This is particularly true in those instances where the operations literally depend upon the successful functioning of a real-time system.

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3. Consideration should also be given to amending the governing instruments to provide that the members may vote each year to determine if the assessments in excess of disbursements for the year (excluding the separate fund discussed above) should be refunded to the members or applied against the assessments for the future year. The Internal Revenue Service has ruled in Revenue Ruling 70-604 that if the above provisions are present the excess of receipts over disbursements for current maintenance may be excluded from taxable income.

Remedial legislation for homeowners' associations is being considered by the House Ways and Means Committee, but even if such legislation is enacted it may not be effective for prior years.

In conclusion, it appears that until homeowners' associations are given specific exempt status under the Internal Revenue Code, steps should be taken to avoid future taxation on the accumulation of funds and to minimize or eliminate potential deficiencies for prior years.

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