

IRS RULES THAT RENTAL POOL IS A PARTNERSHIP

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The Internal Revenue Service (IRS) again in 1999 ruled that a rental pool of condominium owners constituted a partnership for tax purposes. This means filing partnership tax returns for several years for the rental pool, amending returns for all individual members of the rental pool (and probably the entire association membership), and payment of failure to file and negligence penalties.

In this most recent instance of battles between the IRS and a group of condominium owners over tax treatment of the rental pool, the developer who created the rental pool overlooked one crucial point. The consequences to the owners are far reaching. While the developer of the project who created the rental pool was successful in obtaining a tax opinion that arrangement would not constitute a partnership, the developer and writer of the tax opinion both apparently failed to heed the conclusion reached in Private Letter Ruling 8413003 several years earlier.

The 1983 case

Private Letter Ruling 8413003 dated November 30, 1983 (but issued in 1984) dealt with a situation very similar to the 1999 case. In the 1983 case, a group of interim owners acquired a condominium project by collectively securing financing from the same bank. To secure loan payments, the bank inserted a clause in all loan agreements as a requirement of making the loans. This clause required the owners to pledge all rental income to the bank to be used for servicing the debt to the bank. The owners of the project held their first meeting as a meeting of the rental pool of owners (not as a meeting of the condominium owners, who happened to be the same people) and passed a resolution that all rental income and expenses would be pooled for the benefit of the Association. The rental pool owners and the

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condominium owners were one and the same, but acted in two different capacities.

Separate financial records were maintained on the rental operations of the project. These records did not reflect any of the activities of the condominium corporation, but rather reflected only the expenses of operation of the rental pool and receipt of rental income. Each of the owners received a statement from the manager of the rental pool reflecting the total income and disbursements from the rental operation and that owner's percentage of the total.

The IRS indicated that Internal Revenue Code Section (IRC) 761 provides that the term "partnership" includes "a group, pool, or joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation, trust, or estate." The regulations related to this section provide that "a joint undertaking merely to share expenses is not a partnership, nor is mere co-ownership of property considered to be a partnership." The regulations further state, however,



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that "tenants in common may be partners if they actively carry on a trade business, financial operation, or venture, and divide the profits thereof. The determination of whether a partnership exists is to be made by considering whether in view of the party's actions, the parties in good faith, in acting with a business purpose intended to join together in the present conduct of the enterprise (Commissioner vs. Culbertson 337 U.S. 733,742 (1948))."

The IRS' consideration of these factors to the rental pool in question led them to the conclusion that the rental pool was a partnership for federal income tax purposes. This is because the agreement between the owners provided that all rents and expenses would be pooled for the joint benefit of the owners.

The 1999 case

The more recent Ruling, 99 ARD 077-11, FSA 9999-9999-187 reached a similar conclusion. This document, a **Field Service Advice**, was a request for clarification by an IRS auditor on a specific set of circumstances encountered in an actual audit. The facts are as follows:

A group of individual investors owned condominium units near a luxury resort hotel complex. Each condominium unit represented a fully furnished dwelling unit, a proportionate interest in the furniture fixtures and equipment located in the common areas, and a proportionate interest in the land on which the development was built.

Each condominium owner was required to enter into a separate rental management agreement with the management company, which was operated by the developer. Under this agreement, each unit owner elected to utilize a rental pool arrangement for allocating the rental income of the entire development. Rather than allocating income to each unit based on some rental experience, the rental pool arrangement allocates income based on the aggregate days of unit availability whether rented or not. This

rental management agreement is separate from the condominium association. The condominium association administers the condominium project, which activities are performed under an agency agreement with the same managing agents. The financial records for the condominium corporations are maintained separately from those of the rental pool operation.

The IRS considered these facts and noted that, while such an arrangement is not a partnership under state law, and the parties may not have intended to establish a partnership but instead intended to establish some other sort of business relationship, that is not binding for federal tax purposes (Luna vs. Commissioner, 42 T.C. 1067, 1077 [1964]).

The IRS reached the following conclusions as a result of their examination:

- The managing agent is not a partner in the partnership. The managing agent agreement does not create any sort of a partnership between the management agent and the condominium unit owners. The managing agent performed its duties under a separate management agent agreement with each condominium owner and received a fee based on gross revenues, plus an incentive fee for net revenues. This right to receive profits under an agreement was deemed not to constitute a partnership, as there were no other factors support a stronger relationship. In addition, the managing agent, also the developer, had established an escrow account to cover any short falls for the first several years of operations. The IRS considered this factor also, and indicated that that was not intended to be a sharing of losses among partners, but rather was in the nature of the stop loss guarantee by the managing agent as promoter of the project.
- The rental pool arrangement does create a partnership among the condominium unit owners.



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The reason for this is that arrangement established a joint profit motive among the owners sufficient to create a business entity that may be classified as a partnership. The IRS noted that Treasury Regulations Section 1.761-1(a) provided that ". . . mere co-ownership of property that is kept in repair and rented or leased does not constitute a partnership. However, tenants in common may be partners if they actively carry on a trade or business, financial operation, or venture, and divide the profits thereof." In the subject arrangement, each condominium owner does receive a net income allocation based on the aggregate rental operations of the rental pool, which constitutes the active carrying on of a trade or business. The crucial factor here is that the rental pool, as specified in the rental pool arrangement, allocates income to the unit owners based on the total number of days that the unit has been made available to the rental pool, not its actual rental experience. This meant that the distributive share distributed to each unit owner represented the average profit that the partnership derived from the rental of all units of the project or of any particular class of the project. It did not reflect the fair rental value of any specific unit, or the projected annual rent that a given unit would generate. The IRS concluded that the partnership was merely managing a rental pool on behalf of the unit owners.

- The IRS further examined this entity to determine the nature of the entity. In this examination, they considered IRC Section 301.7701-2(a)(2), which provides that ". . . an organization or associates that have an objective to carry on business and divide the gains therefrom may be classified as a partnership or an association taxable as a corporation." This required that the IRS then consider the characteristics of the corporation:
 - *Continuity of life* - - The rental pool was deemed to have continuity of life.

- *Centralization of management* - - The rental pool was considered to have centralization of management.
- *Limited liability* - - Unit owners under this arrangement do not have limited liability, therefore the rental pool lacked this corporate characteristic.
- *Free transferability* - - Because the condominium declaration required that transfer of a unit could not occur without the consent of the management agent and an advisory board consisting of elected members of the condominium association the rental pool does not have free transferability. Therefore the rental pool also lacks this corporate characteristic.

Therefore the IRS concluded that the rental pool was a partnership because although there was continuity of life and centralization of management, the rental pool did not have limited liability or free transferability, and therefore could not be classified as a corporation. As a result the rental pool was classified as a partnership for federal tax purposes.

It is common for condominium associations in resort locations to create rental pools to accommodate the needs of the absentee owners. Condominium associations that have rental pool activities should be advised of the two rulings discussed above, and be aware of the possible consequences of pooling rental income. In both cases noted above, the rental pool failed to file partnership tax returns and was held liable for failure to file and negligence penalties for all years open under the statute of limitations. This obviously affected the individual income tax return of every unit owner participating in the rental pool, therefore having very far-reaching implications. How would you like to explain to 100 unhappy condominium owners that were each going to have to amend three years tax returns?



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If the rental pool had been structured slightly differently, it could have avoided this partnership classification. The IRS indicated very clearly that it was the pooling of rental income that created the partnership as that created a commonality of gross revenues and net profits for each unit owner. If instead, the rental pool tracked separately the rental income generated by each rental unit, and only pooled the expenses, it would not result in the creation of a partnership. Rather, it would fall under that provision of Treasury Regulation 1.761(a) which states that a joint undertaking merely to share expenses is not a partnership.

CPA's advising their clients on such matters should also be aware of these Rulings. An additional matter that is addressed in the 1999 Ruling is that the IRS also clearly indicated that to the extent that payments (association assessments) were made for regular maintenance and repair, they are deductible by the investor in accordance with IRC Section 280A. However, to the extent that they were made for capital improvements or the replacement of personal properties (reserve contributions) they are capital contributions and may not be deducted.

As always, careful advance planning can avoid unintended consequences later on.

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