Co-Op to Condominium Conversions:

Exploring the tax implications for the Association as a whole and the individual unit owners.

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Note: The information in this flyer is intended for guideline and example purposes only with respect to Cooperative to Condominium Association conversions, and not to be used in lieu of the Internal Revenue Code or Federal/State Statute itself. This flyer is not legal counsel and should not be used for such purposes.

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Introduction

This report examines the tax implications of converting a Cooperative (Co-op) Association into a Condominium Association in the State of Florida. Cooperative Associations often ponder converting to a Condominium Association. Condominium units often sell at a premium in comparison to Cooperative units. Condominium Associations receive "beneficial" tax treatments in comparison to Cooperative Associations through IRC §528, which allows Condominium Associations to file IRS Form 1120-H for their annual tax return. However, the conversion of a Cooperative Association to a Condominium Association is not a simple process.

Obstacles

Common obstacles generally concern the legal conversion process, the Co-op's proprietary leases, outstanding mortgages of the Co-op's shareholders, and the ambiguous tax implications for both the individual shareholders and the Co-op Association.

The Process

A Cooperative Association is converted to a Condominium Association when the individual unit owners' Shareholder Title of Ownership (proprietary lease) of the Co-op Association is converted into individual residential units, as defined by Florida Statute 718. The Association's legal counsel would need to prepare and properly file a sufficient Declaration of the Condominium, along with the appropriate Bylaws, and the Association's architect would need to draw-up plans for each newly formed residential unit to be conveyed to the unit owners.

Obstacles - continued

Proprietary Lease

The proprietary lease of a Co-op Association generally requires a super-majority vote of shareholders (usually two-thirds of the voting interest) to terminate all proprietary leases and thereby end the Co-op Association; however, Florida Statute 607.1202 (Florida Business Corporation Act, Shareholder Approval of Certain Dispositions.-) mandates a format for the disposition and termination of the Co-op Association. To further complicate matters for the Co-op Association, even if the Association receives the appropriate shareholder approval, any shareholder that casts a dissenting vote are (or may be) entitled to be paid the fair value of their shares. Co-op Associations should not attempt to go through this process without experienced legal counsel.

Outstanding Shareholders' Mortgage(s)

As part of the conversion process, the mortgage indebtedness for both the Co-op Association as a whole and the shareholders', respectively, would have to be resolved.

Co-op Associations usually hold a mortgage on the building or land which would need to be satisfied as part of the conversion process. There would likely be a prepayment penalty on the early repayment of the mortgage. Additionally, the funds necessary to repay the Co-op's mortgage would have to come from the shareholders. Certain shareholders may not be able to provide the necessary cash contributions on a pro-rata basis necessary to repay the Association's mortgage.

The Association would have to coordinate with a lending institution to provide a facility to enable shareholders to replace their Co-op share loans (mortgages) on the exchanged condominium units with the appropriate mortgage for a Condominium. Certain shareholders may not be able to meet the lending requirements necessary for conversion.

Tax Implications: Individual Shareholders

The exchange of Co-op shares for a Condominium is considered a taxable event, and the Shareholders would be taxed on their respective gains. IRC §121 excludes the first $250,000 ($500,000 for married taxpayers filing jointly) from any resulting gain by a qualifying taxpayer. For purposes of IRC §121, the resulting gain excluded from taxation is only applicable to those taxpayers that used their homes as a principal residence for at least two of the past five years.

For those shareholders that do not qualify under IRC §121 and have used their units an investment, the tax code is somewhat ambiguous. IRC §1031 provides that like-kind exchanges are eligible to defer the capital gains tax on the sale of a property if a like-kind property is purchased, such as the case would be during the conversion of the Association from a Co-op to a Condominium; however, there are many caveats and rules to a like-kind exchange that many disqualify certain shareholders. IRC §1031 like-kind exchanges would require careful planning and should only be undertaken with the help of an experienced professional.

For those shareholders that have treated their units as a second home, the tax code is sparse, and the income tax impact on those Shareholders would be substantial.

Obstacles - continued

Tax Implications: Co-op Association

The obstacles for the conversion of a Co-op to a Condominium is further complicated by the tax implications attributable directly to the Co-op Association itself. IRC §216(e) provides that no gain or loss shall be recognized on the distribution of a “dwelling unit” to a shareholder if the distribution is in exchange for the shareholder’s stock in the Co-op and the distributed “dwelling unit” is used as the respective shareholder’s primary residence.

Unfortunately, IRC §216(e) does not resolve the tax implications for the Co-op Associations entirely. The Treasury Department has thus far failed to clarify any would-be exceptions to IRC §216(e). Additionally, IRC §216(e) does not shield shareholders from the income tax liability for distributions made to shareholders who are not using their respective units before and after the conversion as their primary residence. Finally, IRC §331-346 provides that upon liquidation of the Co-op Association, the shareholders would generally recognize a gain in an amount equal to the difference between the fair market value of the assets received and the adjusted basis of the shareholder’s stock on the distribution of net assets from the Association to the shareholders.

Any such tax liability applicable to the Co-op Association itself during the conversion process would be paid by the Co-op shareholders themselves.

Conclusion

The great uncertainty, risk, and tax-implications of the conversion from a Co-op Association to a Condominium Association is a continued deterrent to Co-op Associations. The process itself is often drawn-out and burdensome. The process often results in further necessary steps when considering proprietary leases and shareholder’s outstanding mortgages. The tax implications to shareholders could be considered too burdensome. The tax implications to the Co-op Association itself are oftentimes considered to be too risky. If a Co-op Association’s Board is serious about conversion to a Condominium, the Board’s first steps should be to consult with its legal counsel and accountants to get a better understanding of the anticipated impacts to the Association itself.