



Let's Play 20 Questions: Taxes & Audits!

Catherine Kuhn

{Editor's Note: The following is the first in a two-part article. Part two will appear in the April issue.}

One thing is certain for community associations: An annual federal tax return. Another thing *MAY* be certain: an annual Certified Public Accountant (CPA) audit. If this is surprising to you, read on. If this is not surprising to you, read on anyway; as community associations are so unique in their tax treatment!

Let's test your knowledge by playing "20 Questions."

Are associations required to file an annual federal tax return?

YES. Associations are required to file annually, even if they do not have taxable income. The return is required from the date of inception, even if assessments are not yet billed.

What type of tax return do associations file?

Most associations file a form 1120-H return, which is a special return for this industry. Some associations file a form 1120 return, which is the regular corporate return. This industry is *unique* in the tax law since *most* associations may "flip flop" back and forth each year between an 1120-H and an 1120. Some associations (such as commercial associations, and associations that don't meet certain tests) are *required* to file an 1120 return. A *few* associations are considered a Non-Profit for tax purposes and file a form 990 tax return. This is rare and has stringent/narrow requirements.

Do associations pay tax?

YES. For the 1120-H return, they pay 30% tax on net "non-exempt function income." Examples would be interest/investment income on all accounts, income from non-members (such as cell tower income or rental of an association owned unit), and "user fees" from members. For the 1120 return, Associations pay graduated corporate tax rates on net membership income and net non-membership income. These can be very complex issues, so it is always best to have an industry CPA advise on the best tax return choice and prepare the return for the association.

Is there a way to avoid tax?

If the Association has interest/investment income, or income from non-members, other than the standard exemption available, it is difficult to avoid paying any tax. There are strategies to minimize tax. The association should work with their CPA on appropriate deductions that may be taken against the taxable income. If there is other taxable income, keep good accounting records of the potential direct expenses related to the production of income. Additionally, if the association qualifies for 1120 tax return filing, some tax rates are below the 30% "flat tax" for the 1120-H return. As noted above, the 1120 return is recommended in limited circumstances due to the requirements, and higher IRS audit risk.

What are some of the requirements to file an 1120 tax return?

If the Association thinks they are planning on filing an 1120 tax return, they should consult with their CPA as this gets very complex, quickly. Generally, the association needs to follow strict accounting requirements including segregation of operating and reserve cash, and "fund accounting" is preferable. The Association should adopt and adhere to a budget that agrees with the reserve study, have minimal "transfers between funds", document repayment plans for "due between funds" and be aware of the capital and non-capital items in the reserve study. They also need to have the association membership approve the "70-604" tax election.

What is the "70-604" tax election?

This is a federal tax election only, and does not impact the books. As noted above, if the association files an 1120 tax return, the "net membership income" is taxable. The 70-604 allows the net membership income to be deferred from year one to year two. Since the 70-604 cannot be used two years in a row, this is only a deferral of tax. If the association still has net membership income remaining at the end of year two, if an 1120 return is again filed, and no offsetting membership losses exist, the net membership income is taxable. Our firm recommends that each association approve the 70-604 each year at the annual meeting, regardless of the type of return filed. This is because it is not known (until the return filing) which form will be appropriate, and if an 1120 is necessary, the 70-604 may be needed. It also provides extra "IRS audit insurance", regardless of the form filed each year. Again, this election is approved by the membership, not the board.

Is transferring monies to reserves the same as the "70-604"?

No. Should be two separate motions. Our firm's website has a 70-604 approval form that qualifies with the IRS.

When is the tax return due to the IRS?

The return is due 3.5 months after the year end. For calendar year associations, this is April 15. There is an extension available, however any tax due must be paid by the tax return original due date.

What is an audit?

An independent CPA is engaged by the association to determine if the year end financial statements are materially correct, in accordance with Generally Accepted Accounting Principles (GAAP) and that adequate financial statement disclosures have been presented. The CPA should not be connected to the association in any way. "Materiality" is a matter of CPA judgment, however it means the CPA does not look at every transaction. Examples of "disclosures" would be litigation, special assessments, contingencies, FDIC limitation exceeded, and significant events occurring after year end but before the date of the Auditors' Report.

Is our association required to have an annual audit?

This depends on the body of Washington law (RCW) that governs the association, and the size of the association. Please read the noted RCW for more clarification and consult your attorney if unclear.

- **"New Act" Condominiums (Created after 7/1/90 -RCW 64.34.372)** Condominiums with 50 or more units must be audited annually. Condominiums with less than 50 units have an annual audit requirement, however, there are annual waiver provisions.
- **"Old Act" Condominiums: (Created before 7/1/90)** Generally, the requirements default to the New Act Condominiums provisions, however, if the governing documents require an annual audit, then an audit is required, regardless of the number of units.

- **Homeowners Associations (RCW 64.38.045)** Associations with annual assessments of \$50,000 or more must be audited annually, however, there are annual waiver provisions.

Additionally, there is an audit requirement for New Act Condominiums upon the legal transition from developer control. (RCW 64.34.312)

When is an audit recommended, regardless of the requirements?

Because the board is charged with governance of the association, they need to think through carefully whether the waiver of an audit is advised. Some of the reasons to have an audit include:

- The CPA may also issue a "Report of Internal Control." This contains recommendations that protect the board and association.
- Provides significant disclosures to current and future owners.
- Construction defect settlements.
- Insurance proceeds/settlements.
- Large special assessments.
- Large construction projects.
- Change in management companies.

If there is suspected fraud, a separate "forensic audit" may be appropriate.

What is needed in an audit?

The auditor will ask for the financial records and reports for both the audit year and subsequent year. If it is a new client, the auditor will ask for the financial records of the prior year end. Additionally, the auditor will also ask for governing documents, reserve studies, tax returns, budgets, and board minutes.

How long will the audit take?

In our firm, if all information is provided when requested, the process is about six to eight weeks.

Who receives the audited financial statements?

The Auditors' Report is addressed to the association board and membership. Other users include future owners (in the re-sale certificate) and current or possible association lenders. (The "Report of Internal Control" is addressed to the association board and management.)

What do we do if an audit discloses an issue?

Discuss the audit results with your management company and CPA, if you don't understand the issue. Then, the board should discuss their plans to rectify the issue, and document this in the board minutes.

Are there more questions?

Possibly, this article has raised more questions for you, than answered. Consult your association CPA, as there are numerous exceptions/details that are beyond the scope of this article.

Was this really 20 questions?

No. Apparently the CPA cannot count. 🙄