The Trouble With Taxes . . .

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The Trouble with Taxes . . .

is

- Nobody wants to pay ‘em, but if you owe you owe.
- Nobody understands the complicated rules, but you still have to figure out how to file the right tax returns the right way.
- Tax law considers everything taxable, unless you can prove that it is not.
- If challenged by the IRS, **you** are considered wrong until you prove **them** wrong.

These are truisms for community associations, as well as individuals, partnerships, etc. We are going to take a **True/False quiz** for the rest of the presentation. See how well you do, and how many “false’s” you thought were “truth’s” and vice versa.

(For the rest of this handout, I will use the generic term “CA” to mean a residential community association, which encompasses planned unit developments (homeowners associations) as well as condominiums).

FALSE

CAs are nonprofit organizations so they do not owe taxes.

This is the number one tax question asked by homeowners, board members, managers and even accountants (outside of this industry). CAs are nonprofit *mutual benefit type* of corporations. To qualify for Federal tax exemption and pay no income taxes an organization must:

1. ***Serve some type of common good.***
2. Not be a "for-profit" entity.
3. Not have net earnings that benefit the members of the organization.
4. Not exert political influence

CAs are <u>not</u> organized for the common good of society, such as for religious, health and welfare, education or other tax-free type of purposes. A community association is simply a group of taxpayers who have formed an organization to share expenses. Thus, the CA is allowed to exclude from income most monies (and we will discuss the exceptions later) from the member/taxpayers. However, such items as interest income, which would be taxed at the taxpayer level, are also taxed at the CA level.

To be entirely honest, this section should be labeled 99.9% false. There is a very small percentage of CAs which are nonprofits who do not owe taxes on any income. These CAs are considered as "communities" for the public good. They cannot be condominiums, and even very large planned unit developments have difficulty getting exemption. IF exemption is granted by the IRS after applying for it, then all income is tax-free and an entirely different tax form is used each year. The tax form is form 990.

There is even a smaller percentage of CAs which file for exemption, receive exemption on membership income, but pay on interest income. These are "social clubs". They also file form 990.

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FALSE

We are a new Association and haven't even sold our first unit, so no tax returns are due.

CAs are corporations. As such, their "life" begins at the date of incorporation. Unlike individuals, there is no threshold, whereby tax returns are not due if income is below a certain dollar amount. Additionally, to file form 1120-H (which will be discussed later) requires an "election". The "election" takes place when the tax return is filed.

Thus, the bottom line – tax returns are due from the date of incorporation. The first year tax return may be a *short year return*. That is, the tax period would be from the date of incorporation (e.g. March 1st) to the end of the fiscal year (e.g. December 31st). This would be less than twelve months.

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TRUE

Tax returns are due the same time as individual returns.

Corporate tax returns are due 3 ½ months after the end of the CA's fiscal year. Thus, for 12/31 year ends, the tax returns are due April 15th.

Note for June 30 YE, the due date is Sept 15. (2 ½ months!)

For those 990 returns discussed previously, the due date is 4 ½ months, or May 15th.

Extensions can be granted. This is an extension to FILE returns, NOT to PAY taxes! Extensions are to the 15th day of the 10th month after year end.

This can get confusing! **See our website** (www.hoacpa.com), **FAQs, Tax**, for an FAQ/chart on the due dates and extension dates for each fiscal year end.

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True

CAs are the only taxable entity that can choose each year which tax form to file, and each of these tax forms has an entirely different tax rate.

Absolutely true! It is a bizarre tax law, and one that many do not fully understand. Here is the quick & simple explanation:

Form 1120-H

- Tax rate – 30%
- One page, easy tax return
- Uses the terms Exempt Function and Taxable Income
- Not necessary to have operating and reserve fund separate
- Not necessary to have Revenue Ruling 70-604
- Estimated tax payments not required
- Little audit risk
- Only available for residential associations (or substantially residential)
    - 85% of the units or lots must be residential
- CAs with large amounts of per use services (e.g. valet and maid) may not qualify
    - 60% of income must be exempt function
    - 90% of expenses must be exempt function (includes reserve expenses)

Form 1120 (See note below on 2018 Tax Act)

- Tax rate – first $50,000 of income – 15%
- More complicated return to prepare (multiple pages)
- Estimated tax payments required
- Have to detail all income and expenses of the Association
- Segregates income into Membership and Nonmembership
    - Renters are considered members for tax law.
    - Nonmembership, includes investment earnings, e.g.interest
- Capital Contributions are not taxable, if the following occurs:
    - Earmarked for a capital purpose (e.g. backed by a reserve study)
    - Segregated and held for a capital purpose (e.g. separate bank account, segregated on the financial statements, accounting for funds separately from operating funds)
        - "Capital" purpose does not include painting, contingency and maintenance type of items (see article at the end)
            - You can include in the reserve study and replacement fund, but the tax preparer must be able to break out the allocations and expenditures.
    - Advance notification to members (e.g. budget or reserve study)
    - Money expended for capital purposes
- Allows excess membership income to be carried over to the next year (Revenue Ruling 70-604 – discussed later)
- Allows excess deductions to be carried over to the next year.

- Increased audit risk.

So…**on $50,000 of taxable income** the difference is $15,000 of tax on 1120-H versus $7,500 of tax on 1120, or a **savings of $7,500**.

However…**on $500 of taxable income** the difference is $150 versus $75 or a **savings of $75**.

2018 Tax Act Note: The 1120 rate in 2018 will change to a corporate flat tax rate of 21% instead of the graduated tax rates that start at 15% in 2017 (and prior years). There will likely be less incentive to file the 1120 as the gap in rates between the two returns will change from 15%/30% now to 21%/30% in 2018.

When is the additional tax savings worth the additional tax preparation effort, accounting requirements and audit risk????

This is a judgment call. We have a checklist to see how many of the "hoops" the Association has jumped through. If they have not complied with the majority of the requirements for 1120, then we file form 1120-H. We also compute the tax difference and in our firm we feel that savings of $200 or more justifies the additional effort and risk, if the Association complies and qualifies. We will even do the 1120, when the tax savings are less than $200, if the records are impeccable and the risk appears minimal.

Who makes the decision each year as to whether to file form 1120 or 1120-H?????

There is no one answer. This is the wording that our firm includes in our proposal letters:

Unless otherwise directed by the board of directors, we will review the tax situation of the association and will make the determination as to what type of tax returns will be filed and will direct the board as to what elections need to be made. The responsibility for the tax returns remains with you.

NOTE: Certain associations (such as all commercial) are REQUIRED to file an 1120 because they don't meet the "residential" test of the 1120-H.

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FALSE

Income from members is always tax-free.

When filing form 1120, income is designated as member/nonmember (and capital), and while member income can be carried over and used up on a subsequent year, membership income can be taxable.

When filing form 1120-H only exempt function income is tax-free. Exempt function is defined as being assessments billed as a result of membership in the organization, and is unilaterally charged to all members. This includes assessment income. What this does NOT include is “per use” fees. Thus, if the Association charges members fees to use common areas, those fees are taxable on 1120-H. (Note: they would be member income on 1120 and may not be taxed if net membership income is zero or less)

TIP – IRS has said if an Association assesses a fee on an annual basis rather than on a monthly or per use basis, the fee is tax-free. So, a planning tip is to annual assess for the fee (e.g. RV parking space, storage unit) rather than on a monthly basis.

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True

Excess membership income can be carried over to the next year.

Yes! It is a wonderful tax ruling known as Revenue Ruling 70-604. (See ruling, example of the election and a Q&A article at the end of this packet). There are no absolute answers regarding RR 70-604, but most of the CPAs in this industry agree with the following (based on IRS correspondence and audits):

- ✓ Members should make the election (by any means allowed in the bylaws).
- ✓ Make the election before year end, or at least before the tax return is filed.
- ✓ Do not use two years in a row.
- ✓ Does not need to contain a dollar amount.
- ✓ Consider noting something about the excess in the upcoming budget.
- ✓ Appears to be allowed for use by residential and commercial associations.

We strongly recommend that every Association make the 70-604 election on an annual basis. There is absolutely no downside. Even if the election is not used that year, it is available if needed at the time of an IRS audit. It leaves all options open to the Association. Plus, once the membership gets used to making the election, they will continue to do so each year without hesitation. Be sure and document in the annual meeting minutes (if that is when the election is made) and keep a copy of the resolution in the corporation minutes and resolutions book.

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One of the options of the 70-604 election is to transfer the excess monies to the replacement fund (reserves).

Very common misconception! Actually, 70-604 allows for only two options with regards to the excess membership income:

1. Carry over to next year.

2. Refund to members. (Not a good idea for many reasons – separate topic!)

However, if it is the Board's desire to transfer the excess monies to the replacement fund and they do not complete it before year end (or do not know the dollar amount to transfer by year end) they need to do so in two steps:

1. Carry it over to next year with RR 70-604.

2. Complete the transfer to the replacement fund in the next year (remember the rules for capital contribution listed above – capital purpose so may need new reserve study, segregated into separate bank account, and advance notification to members).

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True

Expenses can be deducted from taxable income.

Direct expenses can be deducted from taxable income. Actually, the IRS is more lenient with its interpretation of the rules with form 1120 than 1120-H, but most tax preparers take standard deductions against interest income for such items as management fee and tax preparation.

The “lost” deductions are generally those related to income other than investments. If the Association has rental property, income from a billboard or cell tower, advertising in the newsletter or other nonassessment types of income, often the accounting system has not been set up to “capture” these expenses.

TIP – Make sure that the Association books are set up so that any expenses related to the taxable income are clearly designated on the financial statements. Ensure that managers and board members know to classify expenses correctly as they are approved for payment.

For some type of per use income, a “one time” analysis might be beneficial. For example, in California, the State taxing agency has determined that laundry income is always a losing venture, so after years ago auditing laundry income and expense, they now concede that if an Association will just consider laundry income and expense as “break-even” they will not audit the issue. The IRS has not audited laundry income, to my knowledge, but they could. If there is a significant amount of money on a recurring per-use item, such as laundry, the Association may want to do its own analysis to ensure that there is not net taxable income and extrapolate those findings to future years.

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FALSE

If we have a loss in our operating fund or from commercial ventures, we can use that loss to offset interest (or other taxable) income and not pay taxes this year.

Interest (and other nonmembership or taxable income) is almost always taxable. This is the IRS number one reason for auditing CAs. There are many associations and many tax preparers who prepare tax returns offsetting membership losses against nonmember income. This is very succinctly and specifically disallowed in IRS law (it is one of the very few absolutely clear areas of CA tax law). Those losses, either from members or nonmember/commercial ventures, can offset future member and nonmember gains. The IRS is also very sensitive about net operating losses from commercial ventures and requires strict accounting with regards to these entities. They want to be sure that membership assessments are not "subsidizing" potentially taxable income.

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Income from litigation or insurance settlements is generally considered to be a nontaxable event.

Yes, it is considered to be a nontaxable return of capital to the extent of the unit owner's basis. These funds should be segregated, however, from operating and replacement funds. We prefer a separate bank account be set up, and separate accounts set up on the financial statements.

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FALSE

Interest on Association bank loans is deductible by the members on their personal taxes.

First, do not give tax advice. Send them to their tax preparer. However, for your information it is NOT tax deductible by the members. The “short” answer is that the loan is not secured by the owner’s property; it is secured by assessments of the CA.

It may not even be an expense against the interest income on the tax return of the Association. It definitely is not on form 1120-H. And, CPAs disagree about whether it is on form 1120 – if it is security by special assessments.

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True

CAs can reduce their exposure if audited by the IRS.

CAs seldom get audited; however, when they do, and form 1120 has been filed, there can be considerable risk. Without going into great detail, there is the potential that the entire reserve fund balance can become taxable. With the additional penalties and interest going back 3-4 years, the assessed dollar amount can be very large.

Avoid IRS problems by doing the following:

- ✓ Keep operating and replacement fund activity segregated – both in the cash accounts and in separate funds on the balance sheet.
  - o Segregate capital and noncapital type of reserve categories, where appropriate.

- ✓ Fund reserves in accordance with the budget and reserve study.

- ✓ Notify members as to the amount of their assessment that will be allocated to the replacement fund.

- ✓ If the Board decides to transfer additional monies to the reserve funds, be sure that the decision is backed up by a reserve study and that there is notification to members.

- ✓ Have the membership make the 70-604 election on an annual basis, and keep a of copy of the election.

- ✓ Make sure that your tax preparer understands the differences of the two different tax forms, and advises you as to which tax form is best for you.

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True

There are ways to reduce taxable income with advanced planning, good accounting, and basic knowledge of the tax laws. The most important items to go away from this seminar are:

- **Always have the members make the 70-604 election.**
- **Segregate operating and reserve cash and activity on the financial statements.**
- **Have a reserve study prepared to support allocating monies to the replacement fund.**
- **Consider annual assessments in lieu of per use fees for smaller associations and those associations which file form 1120-H.**
- **Have a company policy with regards to risk assessment and determine when form 1120 should be used, rather than form 1120-H for your Association clients.**

Revenue Ruling 70-604 Text

Internal Revenue Service
Revenue Ruling

Rev. Rul. 70-604

1970-2 C.B. 9

Sec. 61

IRS Headnote

Excess assessments by a condominium management corporation, over and above the amounts used for the operation of condominium property, that are returned to the stockholder-owners or applied to the following year's assessments are not taxable income to the corporation.

Full Text

Rev. Rul. 70-604

A condominium management corporation assesses its stockholder-owners for the purposes of managing, operating, maintaining, and replacing the common elements of the condominium property. This is the sole activity of the corporation and its by-laws do not authorize it to engage in any other activity.

A meeting is held each year by the stockholder-owners of the corporation, at which they decide what is to be done with any excess assessments not actually used for the purposes described above, i.e., they decide either to return the excess to themselves or to have the excess applied against the following year's assessments.

Held, the excess assessments for the taxable year over and above the actual expenses paid or incurred for the purposes described above are not taxable income to the corporation, since such excess, in effect, has been returned to the stockholder-owners.

RR 70-604 Election (This is on our website – www.hoacpa.com)

_____Association

Association Resolution for Revenue Ruling 70-604 Election

Excess Income Applied to the Following Year's Assessments

WHEREAS, the_____ Association is a corporation duly organized and existing under the laws of the State of Washington;

and

WHEREAS, the members desire that the corporation shall act in full accordance with the rulings and regulations of the Internal Revenue Service;

NOW, THEREFORE, the members hereby adopt the following resolution by and on behalf of the _____ Association:

RESOLVED, that any excess of membership income over membership expenses for the year ended _____, shall be applied against the subsequent tax year member assessments as provided by IRS Revenue Ruling 70-604.

This resolution is adopted and made a part of the minutes of the meeting of _____.
(Date)

By_____
President or Secretary

Article printed in Channel Islands Chapter of CAI Newsmagazine

Financial Q & A

by Gayle L. Cagianut, CPA

Question: When our Association makes the "70-604" election to carryover excess membership income to the next year on its tax returns, is it for the past year or the upcoming tax year?

Answer: As is the case with much of homeowners association tax law, we do not have an absolute answer from the Internal Revenue Service on this matter. However, based on other tax law we can draw some conclusions.

Tax elections must be made before the tax returns are filed. This generally includes through the date of the tax extension, if any. Thus, it appears that the 70-604 election could be made for the prior year if the tax returns had not been filed yet.

Since 70-604 is a tax planning tool, however, it is reasonable that the election could be made in advance of the year end. Thus, the tax election would be made for the upcoming year end. This allows the CPA to know, in advance, whether or not the membership has approved the election and whether it is an option when preparing the tax returns.

Some additional thought with regards to Revenue Ruling 70-604 elections:

- No dollar amount needs to be included when the election is made as that amount is not known until the year end financial statements are completed and the tax adjustments are made by the CPA for capital and non-capital reserve items.
- If the Association wishes to file form 1120-H (at the 30% tax rate), no 70-604 is necessary (although it is okay to go ahead and make the election anyway).
- Even though many, if not most, CPAs agree that the 70-604 election cannot be used two years in a row, the Association membership should continue making the election annually as it may be of use in an IRS audit situation, or there may be circumstances wherein the 70-604 election would be useful.
- There is a misunderstanding that the 70-604 election allows the option of transferring the excess membership income to reserves. This is not included in Revenue Ruling 70-604. The Revenue Ruling allows either carryover to the next year or refund to the membership. If the membership wishes to use the excess to fund reserves, it is a two-step process. First, the election would be to carryover excess membership income to the next year. Second, the excess monies would be allocated to the replacement fund (reserves). When transferring to reserves, remember that the IRS is also looking for such things as notification to members, agreement with the reserve study and budget, and whether capital or non-capital items are being funded.

As with any tax question, consult with your Association's accountant. There is still a diversity of interpretation of tax law, and there may be extenuating circumstances in your Association, which would allow a different answer from the above discussion**.**

In Reserve...

Article printed by Association Reserves on its website:

Can Painting and Tree Trimming Be Included in Reserves?

by Gayle L. Cagianut, CPA

There is a lot of confusion with regards to this issue and there are probably several different opinions. I will give you my opinion on the subject, and my reasoning.

There is some reluctance to include painting and tree trimming in the reserve study by some professionals. This stems from IRS rulings and audit findings which state that these are maintenance items and not "contributions to capital". That is, the assessments being collected for these types of reserve items cannot be excluded from income of the association under the "contributions to capital" definition. Other items that may fall into this category include termite repairs, contingency allocations, reserve study fees and other repair types of expenses. This only applies if the association is filing form 1120 (Corporation Tax Return) rather than form 1120-H (Homeowners Association Tax Return). Then, for IRS purposes these are operating expenses.

"For IRS purposes" is the key phrase. There are ways that your accountant can adjust for these tax differences on the tax return. It is not uncommon to have differences between generally accepted accounting principles and tax laws. With regards to non-capital reserves, your accountant may also suggest that the cash set aside be segregated from other reserves. Once again, this depends on the type of tax return filed.

It is my opinion that an association should be run like a business and, as such, decisions should be based on what is best for the association operationally, not just for tax purposes. Therefore those items which are not annual in nature (or two years at the most) are best budgeted in the reserve fund rather than the operating fund. Then, the accountant can adjust the tax returns accordingly. Many reserve preparers will segregate capital and non-capital in their reports so the accountant can easily make this adjustment.