

WHAT? We Owe Income Taxes This Year?

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This spring, we have heard that question asked more often than in any year in recent memory. Why? As associations mature, reserve balances are increasing and a primary component of taxable income is interest earnings. Other factors are increasing interest rates and large reserve balances from recent litigation settlements.

If you do not understand your association's taxes, don't feel alone. Community Association taxes are very complex. It is quite possible that even your personal tax preparer has little or no knowledge on this subject as there is some very unique tax law in this area. There are important choices to make that can minimize the taxes paid.

Let's start with the basics. Your association is a non-profit corporation? True. Thus, as a non-profit entity, you owe no income taxes? False! This is a common misconception among board members, especially those first time volunteers. Most associations are required to file a corporate tax return. If you think about it, if there is income that the association generates (such as interest earnings) that would be taxable to you as an individual, then chances are the IRS is going to want to tax the association. Otherwise, there might be an incentive to "shelter" your interest earnings from tax by keeping excess reserve balances in the association.

Unlike individual federal tax returns, which are due April 15th, association tax returns are due two months fifteen days after the end of the fiscal year. Thus, for December 31st year end associations, the due date is March 15th. Like individuals, an association can get an extension of up to six months to file its federal taxes. It should be noted that this is an extension to file the tax return – not an extension to pay the taxes! Any taxes due must be paid by the original due date, or the association will have to pay penalties and interest.

So on what income does an association pay tax? This can get very complicated, as will be described in the following paragraphs, but at the very least, the association generally needs to pay tax on its interest earnings. Other items that may or may not be taxable include laundry income, rental income for the clubhouse or other common areas, and sales of goods or services to non-members. Generally membership income is non-taxable.

Residential Associations have a unique tax situation found in no other area of tax law, in that they have the choice of how to file their tax returns and what tax rate to pay – with many rules and regulations surrounding these choices. An association with mostly residential units may file as a homeowners' association using Form 1120-H, or may file as a regular corporation using Form 1120. This decision can change annually. The association may file form 1120-H one year, then 1120 the next, then back to 1120-H the

third year. Additionally, some larger associations may be exempt from taxation and may file Form 990. This is a permanent decision. The following paragraphs will attempt to quickly explain the differences, but the explanations will touch just the surface issues.

Form 1120-H is the form that was specifically designed for residential homeowners associations. It is the easiest to prepare. Non-exempt function income is taxed at a rate of 30%. Non-exempt function income includes interest and rental income, net of expenses. A tax savings hint to avoid being taxed on the rental income is to assess the fee on an annual basis or as part of the regular assessment, rather than as a per use fee. It is the per use fee which causes the income to be taxable. Thus, if you have parking spaces that you want to rent to members, you may decide to assess the fee once a year rather than monthly, or for clubhouse use you may choose to add a few dollars to everyone's monthly assessments rather than charge a per use fee.

Form 1120 is the regular corporation tax form. It is much more difficult to prepare, and can cause even membership net income to be taxable. But, it has a much more favorable tax rate – 15% on the first \$50,000 of taxable income. Another advantage is that rental income from members may not be taxable. With proper planning and budgeting, an association may be able to cut its taxes substantially. As noted earlier, we are seeing very large reserve balances due to maturing associations and litigation settlements. The difference between 15% and 30% on the interest can be significant! A common planning tool is Revenue Ruling 70-604, which says that the membership may choose to have any net membership income transferred to the next year or returned to the owners. This is an important election that may benefit an association. The drawbacks are, however, that it appears use of this election may not be possible in consecutive years and we recommend the election to be made by the membership, instead of by the board. The board also needs to be aware of the inherent risks that may be involved in filing form 1120. Some of the more restrictive accounting procedures – such as segregation of operating and reserve cash, adoption and adherence to a reserve study budget and adequate accounting for various reserve items by category – are issues to consider. Last, there may be additional IRS audit risk when filing form 1120. These matters should be carefully weighed to determine whether the association qualifies to file form 1120 and whether the tax advantages outweigh the risk. Is it too late to do anything for 2006 if you have a high tax liability? It may still be possible to make your 70-604 election for 2006, if your 2006 tax return has not been filed. However, consult your CPA due to the restrictive accounting procedures needed for 2006 and the risk involved, as outlined above.

Form 990 is for larger associations that are communities among themselves. These associations are exempt from taxation. This designation is difficult to get, but some associations have been successful in obtaining this tax status.

Commercial Associations generally are required to file Form 1120. Also, if there are a significant number of commercial units mixed with residential units, the Association may not be able to file an 1120-H. The complexities surrounding commercial and mixed use associations are beyond the scope of this article.

Take time to discuss your Association and its tax matters with your association CPA. Ask whether there are any tax saving tools which your association could use. Discuss

whether to file 1120 or 1120-H and whether your current accounting procedures allow you to make this choice. Consider whether or not to use Revenue Ruling 70-604. Evaluate the “per use” fees charged currently. Remember, the final tax responsibility rests with the board members. It is a member of the board who will sign the return, and the board must ensure that the best interests of the association membership are being met.

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