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## Special Tax Issues for Community Associations

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In any given year, a typical community association will have the option of filing either a traditional corporate federal income tax return, or filing a special federal homeowners association tax return. There are advantages and disadvantages to each method and the decision of which return to file should be carefully reviewed and determined annually.

Community associations are often organized as nonstock corporations or are otherwise “associations taxable as corporations” that would, by default, file a Form 1120, *U.S. Corporation Income Tax Return*, for federal income tax purposes. As a community association, however, the organization may be eligible to instead file a Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*. Each year, the association should determine (1) whether it is eligible to file a Form 1120-H; and (2) even if eligible to file a Form 1120-H, would be in a better position filing a standard corporate return.

### Form 1120 – Standard Corporate Filing:

By filing a standard corporate return, the association is generally subject to income tax on its “taxable income,” taxable income being gross income minus permitted deductions. However, while an association is taxed as a corporate entity, it is also a membership organization, and therefore subject to special deduction rules that limit annual deductions attributable to furnishing members with services, insurance, goods, or

other items of value. An association, as a membership organization, is only permitted to deduct these kinds of expenses from the income generated from its members. For example, a condominium cannot offset income generated by its reserve account with maintenance expenses on its building and grounds. This is because the interest earned is non-member income, and the expense is incurred to provide services to the members. To the extent the costs of providing services and other items of value to members exceed income generated from the members, the excess may be carried over to the next year as a deduction attributable to furnishing membership services. As to non-member costs and expenses (i.e., deductions), if certain requirements are satisfied, the association may be entitled to an NOL (net operating loss) deduction for any non-member deductions that exceed non-member income.

The “taxable income” of the association is then subject to taxation at the graduated tax rates applicable to corporations—the first \$50,000 is taxed at a fifteen percent rate, the next \$25,000 at a twenty-five percent rate, and taxable income exceeding \$75,000 at a thirty-four percent rate (assuming taxable income does not exceed \$10 million). In general, any NOL generated may be carried back two years to offset income in previous years, and carried forward for twenty years to offset income in the future.

**Form 1120-H – Special Homeowners Association Filing:**

A community association will generally qualify to file a Form 1120-H if it meets the following income and expense tests: (1) sixty percent or more of the gross income of the association for the taxable year consists solely of amounts received as membership dues, fees, or assessments from unit/home owners; and (2) ninety percent or more of the expenditures of the association for the taxable year are expenditures for the acquisition, construction, management, maintenance, and care of association property.

If the association files a Form 1120-H, it is not taxed on its “exempt function income,” meaning “any amount received as membership dues, fees, or assessments” from owners. However, non-exemption function income, or its “taxable income” is taxed at a thirty percent flat rate, rather than at the typical graduated rate for corporations (as set forth above). “Taxable income” is the association’s gross income for the taxable year (excluding exempt function income), minus allowed deductions directly connected with the production of gross income (excluding exempt function income). Therefore, if an association only has exempt function income, it will not have any taxable income. However, if an association electing to file the Form 1120-H has taxable income, the only deductions permitted are those directly related to the production of that taxable income. Further, an association filing a Form 1120-H is not permitted to use or generate an NOL.

Essential in determining whether revenue is “exempt function income” is not the particular label given the revenue source, but rather,

whether or not it is derived from members solely in their capacity as members. Examples of non-exempt function income include amounts received from members for special use of association facilities, income earned on reserve accounts, and amounts received from non-members.

**Summary of Advantages and Disadvantages of Each Method:**

If any association has primarily “exempt function income,” all such income in excess of expenses will be shielded from federal income tax if the association timely files a Form 1120-H. However, if the association has income from non-exempt sources, such as interest on investments or the sales of membership lots, any non-exempt income in excess of expenses will be taxed at a higher flat rate for an association filing a Form 1120-H rather than a Form 1120. Additionally, if the association generates losses, the use of a Form 1120-H will limit the association’s ability to carry those losses to prior or future years to offset income in those years.

An association’s tax preparer should prepare the association’s tax return using each method each year in order to determine the association’s appropriate course of action.

**Importance of Timely Filing:**

In order to preserve the option to file either a Form 1120 or Form 1120-H, as may be in the best interest for the association in a given year, the association should ensure that it has the ability to meet the election requirements to file a Form 1120-H. In order to qualify to file an 1120-H, in addition to meeting the income and

expenditure tests discussed above, the association must “elect” to be treated as a “homeowners association” in the manner required by the Treasury Department’s regulations. These regulations simply require that the election be made by filing the Form 1120-H. Although a simple requirement, if an association first files a Form 1120 and later determines that it would be in a better position by filing a Form-1120-H, the association may not amend the prior return without the IRS’s consent. Similarly, if the association files a Form 1120-H, it may not amend and file a Form 1120 without the consent of the IRS. Obtaining the IRS’s consent in either event is a time consuming and expensive process. Consent is obtained through a private letter ruling request procedure, for which the filing fee alone may reach \$11,500. The cost of obtaining such a ruling must be compared to the potential tax savings implicit in the change.

### **Treatment of Reserve Accounts:**

In order to fund a reserve account in any given year, the association must bring in funds in excess of its expenditures in that year. The treatment of these excess funds will depend on how the funds are generated and the filing method of the association in the year in question. Where the association files as a homeowners association on Form 1120-H, the reserved funds are generally tax exempt.<sup>1</sup> Where the

association files a Form 1120, however, the analysis is more complicated.

Under the traditional corporate filing on Form 1120, excess funds are by definition “net income” and thus, subject to federal income tax at the corporate graduated tax rates unless some exclusionary rule applies. Thus, there are several important exceptions to this general rule that may be available to an association with careful planning.

The IRS has approved an exclusion from the income of an association certain amounts collected from its members for capital improvements under an “agency” theory. Under this theory, the amounts collected by the association are collected in its capacity as an agent for its owners, rather than in its capacity as a service provider. This exclusion does not apply to funds collected by the association for the provision of services for which it was formed, such as maintenance of common elements. Thus, in order for this exception to apply, the purpose of assessments should be clearly established and the funds should not be commingled with other association funds.

The IRS has also approved an exclusion from the income of the association for certain “contributions to capital” by members of an association. Again, a dominant factor in determining whether funds are capital contributions falling within this income exclusion is whether the contributions are for capital improvements or for the provision of goods and services—the latter does not qualify for the exclusion. As with the agency exclusion, payments should be earmarked for capital

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<sup>1</sup> For purposes of determining whether the association is eligible to file Form 1120-H, however, amounts set aside for capital improvements or applied to a following year’s assessments will not be considered expenditures, nor will the receipt of such amounts be considered income.

projects and segregated from general assessment funds.

Although not related to reserve accounts, the IRS has also issued guidance on another method of shielding excess assessments from federal income tax where the association is not filing a Form 1120-H. The IRS has, by exercise of administrative authority, ruled that where an association holds an annual meeting and the member-owners decide that excess assessments should be returned to the owners or applied to the following year's assessments, such excess funds are not taxable, since, in effect, those funds have been returned to the member-owners. This exception is not provided for by statute, and availability of the exemption will be strictly construed by the IRS and determined on a case by case basis. Taking a conservative approach, a resolution to apply excess assessments to a following year's assessments should be made by the membership on an annual basis. Additionally, in years where the association files a Form 1120-H, the election is unnecessary and potentially unwise, so a decision to carry funds forward should not be made automatically as a matter of course, but rather after consideration of the association's particular circumstances.