

Property Owner Associations & Uncle Sam



By Holly Golden, CPA



The taxation of condominium, homeowners' and timeshare associations allows an opportunity that is unavailable in any other area of taxation: the ability to choose which tax form to file and, therefore, which tax rates apply. Most associations will choose the type of form that results in the lowest tax for the entity. However, the tax calculation is complicated and many associations depend upon their accountants to assist with this decision and process.

Associations are required to file income tax returns and may choose to be taxed under Internal Revenue Code Section 277 or Section 528. Associations that file under Code Section 528 file the tax form 1120-H and those filing under Code Section 277 file tax form 1120, or the same tax form filed by corporations. Commercial condominium associations are required to file Form 1120 under Code Section 277. Under limited circumstances, homeowners associations may file a Form 990 or a tax return for exempt or not-for-profit organizations.

If an association elects to be taxed under Code Section 528 and file the form 1120-H, it will essentially pay tax on income that is unrelated to the specific purpose of the homeowners association. For example, when filing an 1120-H income tax return, an association will pay income tax on revenues such as investment income, income

derived from the sale of promotional items (license plates for example) and income from the rental of facilities to external third parties. Direct expenses applicable to those revenues and a percentage of administrative costs can be allocated against the revenues to lower the amount to be taxed upon. The Form 1120-H is a relatively simple and less time consuming tax form to complete as compared to the Form 1120, however the income tax rate is higher at a flat tax rate of 30%. The Form 1120, to be filed when electing Internal Revenue Code Section 277, is more complex and time consuming to complete but has a lower tax rate (15% on the first \$50,000) than that of the 1120-H. The 1120, like the 1120-H, taxes an association on its net nonexempt function income by allowing an association to defer certain income under the election of Revenue Ruling 70-604. This ruling allows the subtraction of member income such as annual assessments, utility incomes and/or clubhouse rental fees from taxable income and the association is therefore not taxed on these amounts.


The decision to file a Form 1120 or 1120-H for income tax purposes can involve complicated and time consuming calculations and allocations and is best left to a tax preparer that is knowledgeable in the area. For example, the allocation of security wages, cost of roads and signage and cost of gate passes against gate income. Either way, associations do not pay income taxes on income that is paid by members and that is directly allocable to association and member purposes and activities. Generally taxable income to an association is that income that is derived from activities not directly related to operating an association such as investment or other miscellaneous revenues, less related expenses.

Several areas of cash inflows that are not considered taxable income (at certain points) to an association include:

Prepaid Assessments: In general, prepaid assessments from members should be treated as deferred revenue and classified to an association's balance sheet at

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year end. According to an IRS Revenue Procedure, any of these prepaid assessments that are considered deferred revenues at a particular year-end should be reclassified as revenues within the following twelve months.

Reserves: Amounts collected for capital reserves should be clearly designated as funds that are restricted for specific use. All though not required, reserve funds should be placed in an account separate from operating funds so that it is obvious they are for future capital and not current projects. Some associations have failed to do such and IRS examinations have required them to be classified as current operating income.

Capital Contributions: Amounts assessed to the owners for the general replacement of property within an association are considered contributions of capital to the association by the owners and are therefore not considered income. There are several areas of importance to consider during the capital assessment process in order to ensure capital assessments are indeed just that:

- The basis of the assessment must be capital in nature: Example - assessments for roof replacements or the construction of a security guard gate.
- Association members should be informed in advance of the purpose of the capital assessment. This can be done via distribution of the budget and a replacement reserve study, distribution of board of directors meeting minutes where the assessment was approved or separately stated on invoices.
- The amount received for the capital assessment must be accounted for as a capital contribution - Translation: The members' contributed capital (equity) account should increase

when the cash received from the capital assessment is recorded in the accounting records.

- The funds should be held for capital improvement projects and nothing else.
- The funds should actually be spent on the original intended purpose for which they were collected.
- Ordinary repairs and maintenance (such as painting, engine repairs or insect prevention) are not considered capital improvements.
- Requires a membership vote

If those of you reading this article have ever as much as looked at your own personal income tax return, you must know the IRS does not have an objective of making the preparation of income taxes simple. The number of property owners' associations across the United States continues to increase annually and as they do, IRS tax codes and regulations will more than likely change as well. This article is only a brief summary of the details that are involved in the preparation of income tax returns for Property Owner Associations. Please consult your tax advisor with any questions or concerns you have that are specifically related to your community.

Holly Golden is a Certified Public Accountant with Robinson Grant and Co., P.A. in Hilton Head Island, South Carolina. She can be reached at 843-682-6410 or holly@robinsongrant.com. www.robinsongrant.com

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