

Tax Law and Tax Exemption

Updates and Effects on Community Associations

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He has prepared nearly 100 tax exemption applications for associations and has consulted on more than 50 IRS tax audits of associations.

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Tax Law and Tax Exemption - Updates and Effects on Community Associations

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Tax Law and Tax Exemption

Updates and Effects on Community Associations

Introduction and Association Tax Basics

CAI has adopted a policy on taxation that focuses on three major platforms

1. Expanding the qualifications of IRC § 528 to allow more associations to take advantage of Form 1120-H
2. Educating about the advantages of Subchapter T for cooperative associations
3. Educating about the advantages of IRC § 501(c)(4)
4. Addressing bias exhibited by a number of IRS agents

All associations MUST file tax returns

Just because the association is a nonprofit organization, and maybe even exempt, doesn't mean you don't have to file a tax return. ALL associations must file a federal tax return, and probably a state tax return.

In 2010, IRS revoked exempt status for approximately 750,000 exempt organizations for failure to file tax returns.

Form 1120-H – Residential homeowners associations - [IRC § 528](#)

Form 1120-H is a one page tax form designed specifically for residential homeowners associations. It has a number of significant advantages and a couple of disadvantages.

- No tax risk - It's all about risk, not tax rates

Congress created IRC 528, which caused IRS to create Form 1120-H specifically for homeowners associations, and specifically to eliminate the risks of Form 1120. The biggest risk avoided is that your excess income avoids taxation. Form 1120-H also eliminates the risks inherent in accumulating “painting” reserves, and the risk of failing to comply with the “capital” requirements of IRC Section 118 (that's how you set aside reserves to avoid taxation as income).

- 30% tax rate - [IRC § 528\(b\)](#)

The 30% tax rate is the biggest downside of Form 1120-H, unless you have more than \$186,311 of taxable income – that's the tipping point where the 30% tax rate of Form 1120-H is actually less than the graduated tax structure of Form 1120, which starts at 15% and peaks at 34%.

Other downside factors are; (1) no NOL (Net Operating Loss) carryover, (2) no capital loss carryover, (3) no special deductions for dividends.

- Qualifying requirements are:
- 60% revenues test - [IRC § 528\(c\)\(1\)\(b\)](#)

60% of GROSS INCOME must be received from membership dues, fees, or assessments.

Be careful here, as reserve assessments are NOT part of GROSS INCOME.

Also be careful because tenants are not considered members for purposes of the source of income test.

- 90% expenditures test - [IRC § 528\(c\)\(1\)\(c\)](#)

90% of expenditures must be for the acquisition, construction, management, maintenance, and care of ASSOCIATION PROPERTY. This includes reserve expenditures.

The 90% test excludes recreational activities expenditures, and cable TV and utility expenditures related to members' use. This is where most associations will fail the test.

- Residential test - [IRC § 528\(c\)\(2\)](#)

Planned developments - Residential is defined as 85% of lots must be zoned for residential use. Residential use includes common area lots such as parking lots, swimming pools, tennis courts, AND NON ASSOCIATION PROPERTY such as schools, fire stations, libraries, churches which are auxiliary to residential use. Commercial uses such as shopping centers do not qualify as residential.

Condominium developments – Residential is defined as 85% of square footage within the development is used for residential purposes.

The definition of ASSOCIATION PROPERTY (- [IRC § 528\(c\)\(4\)](#)) is critical in reaching the determination of qualifying under the 85% residential test. Residential property includes (1) property held by the association, (2) property held in common by the members of the association, (3) property held privately by the members of the association, and (4) property owned by a government unit and used for benefit of the members of the association.

- No private inurement test - [IRC § 528\(c\)\(1\)\(d\)](#)

No part of “net earnings” inures to any member of the association. A rebate of excess dues, fees, or assessments is not considered as part of net earnings.

- Only 3 IRS audits in recent years – “No change” – meaning no additional taxes paid as result of tax audit

The extremely low risk factor of Form 1120-H means that it is unlikely that an IRS audit will result in a significant tax assessment. Of the three known audits of Form 1120-H tax returns in recent years, there were no additional tax assessments. The reason? As long as

the association qualifies to file Form 1120-H and nonexempt income was reported, there is virtually no room for the IRS to find additional taxable income.

Form 1120 – Nonexempt membership organizations – IRC Section 277 (Default Form unless you qualify under any other section of the code)

When Form 1120 is filed, the association is not recognized as a homeowners association, as that definition applies ONLY when Form 1120-H is filed. Instead, the association is characterized as a nonexempt membership organization under [IRC § 277](#). This is not an election – IRC 277 is a mandatory code section and applies to all membership organizations that are not exempt under any other section of the Code.

Definitions are different on Form 1120 as compared to Form 1120-H. Form 1120-H uses the definitions of “exempt versus nonexempt” activities, and Form 1120 uses the definitions of “member versus nonmember” activities. These can result in substantially different tax results depending on the specific activities of the association. As an example, laundry facilities used by members results in nonexempt income on Form 1120-H (a taxable activity), and results in membership income on Form 1120 (a nontaxable activity unless there is excess member income).

- VERY HIGH tax risk

The high tax risk on Form 1120 generally results from excess member income and application of Revenue Ruling 70-604, or failure to comply with the capital contributions rules of IRC § 118.

Revenue Ruling 70-604 – This revenue ruling does not apply when an association files Form 1120-H, it only applies on Form 1120. Most associations use this to “roll over” excess member income to the following tax year to avoid taxation. Mistakes are often made in the mechanics of making this election. IRS requires member approval, and the election must be made prior to filing the tax return. Excess income may NOT be transferred to reserves.

IRC § 118 – This code section deals with contributions to the capital of a corporation. This is the tool used to accumulate reserves without being taxed on the assessments. However, this code section has been interpreted by several court cases that have established procedural criteria for compliance. Most associations are not aware of all of these requirements and can often fail to meet the exact requirements.

IRS has repeatedly asserted IRC § 481 on Form 1120 tax audits because of the failure to comply with IRC § 118. Application of IRC § 481 allows the IRS take the position that an improper tax accounting method was used and subject the entire reserve fund balance to taxation. These minor mistakes can cost the association tax assessments that are literally hundreds of times greater than the original calculated tax on Form 1120. This risk does not exist on Form 1120-H.

- 15% AND HIGHER tax rate

The Form 1120 tax rate starts at 15%, but only for the first \$50,000 of taxable income. After that, it “graduates” to higher rates, ultimately maximizing at 35%, which is HIGHER than the Form 1120-H tax rate of 30%.

- More than 50 IRS audits in last 20 years

These represent just the IRS audits on which Gary Porter has assisted. ALL BUT ONE of these IRS audits resulted in negative consequences – meaning additional taxes paid as result of tax audit. This gets back to the compliance issues and risk associated with Form 1120.

Form 1120-C – Cooperative organizations

Form 1120-C is applicable only to cooperative organizations recognized under Subchapter T of the Internal Revenue Code, Sections 1381 – 1388. Subchapter T is a mandatory section of the Code. In other words, if you fit the profile, then you are a subchapter T cooperative, even if you have never recognized that fact or filed as a cooperative. IRS heavily litigated the issue of cooperatives versus IRC Section 277 nonexempt membership organizations for homeowners associations in the 1980’s and 1990’s. That effectively ended with the Trump Village (the Donald’s father) Section 3 Inc. versus Commissioner case in 1995, in which the Court sided with the association that it was subject to Subchapter T, not IRC 277. IRS later acquiesced to this case. The Court further stated that Subchapter T both preceded and pre-empted IRC 277.

The issue was well worth fighting for, as cooperative enjoy a significant tax advantage over both Form 1120 and Form 1120-H associations. This is because an earlier case, Cotter and Company and Subsidiaries v. USA established the principle of “integrally intertwined activities” as being part of the core purpose of a cooperative, and therefore patronage activities (generally nontaxable) rather than non-patronage activities (taxable). The Trump case further established that reserves of a cooperative organization are an “integrally intertwined activity,” and the resulting interest income earned on accumulated, invested reserve funds is considered patronage income, even though earned from an outside source.

- Moderate tax risk

There is very little risk associated with Form 1120-C. Patronage and non-patronage activities are fairly well defined, and patronage loss carryovers and patronage dividends limit the exposure to taxable income of net patronage activities.

- Integrally intertwined activities

Established in the Cotter and Company and Subsidiaries v. USA case. This established the principle of “integrally intertwined activities” as being part of the core purpose of a cooperative, and therefore patronage activities (generally nontaxable) rather than non-

patronage activities (taxable). This is a significant tax advantage not enjoyed on Form 1120 or 1120-H.

- Patronage dividends – IRC 1382

Patronage dividends may be used to substantially limit any taxable net patronage income. While similar in concept to Revenue Ruling 70-604 applicable to Form 1120, the rules are well established. By giving written notice to members, the cooperative effectively returns the excess patronage income to the members to avoid taxation. The amount of patronage dividend is allowed as a deduction on Form 1120-C.

Form 990 – Exempt associations

- Three different types
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- 501(c)(7) – Recreational organizations
- 501(c)(3) – Charitable organizations
- No tax risk
- Same tax rates as Form 1120 for any taxable activities
- Only 1 audit of tax exempt associations in last twenty years

Differences between Form 1120-H (IRC Section 528) tax exemption and 501(c)(4) tax exemption

- Form 1120-H provides only a partial tax exemption – meaning that member exempt activities avoid taxation
- Taxability of interest income – taxable on Form 1120-H, Not taxable on Form 990 for a 501(c)(4) organization

The role of governing documents and tax issues

- Governing documents should NEVER refer to tax status of association
- Lawyers drafting documents should consider consulting qualified tax advisor

Qualification requirements

- IRC 528 – Form 1120-H – Residential homeowners association
 - Residential in nature
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 - Must serve a community – Public access
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501(c)(4) – Social Welfare organizations emerging issues

- Self-declare status
 - How to self-declare
 - Value of application for **recognition** of exempt status
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List of attachments

General attachments

- CAI Policy on Taxation
- Article – Reserves as Capital Contributions

Form 1120-H attachments

- Form 1120-H
- Form 1120-H Instructions
- Form 1120-H Checklist
- IRC (Internal Revenue Code) Section 528

Form 1120 attachments

- Form 1120
- Revenue Ruling 70-604
- Form 1120 Checklist
- Article – Risks of Form 1120
- Article – Making the Revenue Ruling 70-604 election
- Article – Timing of the Revenue Ruling 70-604 election
- Article – Revenue Ruling 70-604 carryovers
- Article – How do you explain Rev Rul 70-604 to your members?
- 1120 vs. 1120-H Risk-Based Comparison

Form 1120-C attachments

- Form 1120-C
- Puget Sound Plywood v. USA
- Cotter and Company and Subsidiaries v. USA
- Trump Village Section 3 v. Commissioner

Form 990 attachments

- IRC 501(c)(4)
- IRC 501(c)(7)
- Treasury Regulations 1.501(c)(4)
- Treasury Regulations 1.501(c)(7)
- Treasury Regulations 1.337(D)-4
- Internal Revenue Manual
- Listing of revocations
- Revenue Ruling 72-102
- GCM 34219
- Revenue Ruling 74-99
- GCM 35570
- Revenue Ruling 75-286
- Revenue Ruling 75-386
- Revenue Ruling 75-494
- Revenue Ruling 80-63
- Revenue Ruling 80-108

- IRC 6033(j)
- Revenue Procedure 2015-9
- Rancho Santa Fe Association v. USA
- Flat Top Lake Association v. Commissioner
- Commissioner v. Lake Forest
- Article – Large Scale Associations Unique Tax Considerations
- Article – Can Gated Association Qualify for Tax Exemption