Special Tax Treatment for Residential Associations

by Bob Titus, CPA

There is one section in the Internal Revenue Code that provides for unique tax treatment for condominium, homeowners, and time-share associations. That section is known as Section 528, and it was enacted with the Tax Reform Act of 1976. Prior to its passage, associations were treated the same as all other corporations. What motivated its passage was that Congress thought it was inappropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity. If an association qualifies and elects to be taxed under this section, it does so by filing Form 1120-H, U.S. Income Tax Return for Homeowners Associations.

There are several factors that could influence an association to elect to be taxed as a homeowners association. Among these factors, the two most common are:

The relative ease of filling out Form 1120-H, as opposed to the complexity and compliance issues associated with filing as a regular corporation. The level of tax knowledge required of a preparer to fill out Form 1120-H is not too great. Whereas, filing as a regular corporation, with its complex compliance requirements, would require the assistance of an experienced tax preparer.

All associations that elect to be taxed as a homeowners association are entitled to a specific $100 deduction from its taxable income. This means that associations with relatively small amounts of taxable income could have their tax liability eliminated by the application of the specific $100 deduction.

Offsetting the advantages of electing to be taxed as a homeowners association is one rather important disadvantage: homeowner associations are taxed at a rate of 30 percent (32 percent for timeshare associations). This compares unfavorably to the tax rate on regular corporations. For regular corporations, the tax rate is 15 percent on the first $50,000 of taxable income.

The election to be taxed as a homeowners association is made simply by filing Form 1120-H. But before an association can file as a homeowners association, it must be qualified to do so by satisfying certain income and expenditure thresholds.

Income Threshold

To meet the income test, 60 percent of the association's gross income must come from exempt sources. Gross income for tax purposes is basically all of the income an association takes in except income from member assessments for the buildup of reserves for future major repairs and replacements. The Internal Revenue Code treats this type of income as a contribution to equity, not as an income item. This does not mean that all reserve assessments are excluded from gross income, only those reserve assessments that are capital in nature, such as roof replacements and pavement resurfacings. Reserve assessments accumulated for maintenance items, such as painting, are included in gross income since they are not capital in nature.

Income from exempt sources is income received from members in their capacity as members, which primarily would be dues and assessments. All other types of income would be income from non-exempt sources. Primary examples of non-exempt income would be interest income, income from non-members, and income from members in their capacity as customers. To meet the income test, at least 60 percent of the association's gross income—as defined by the Internal Revenue Code—must come from exempt sources.

Expenditure Threshold

To meet the expenditure test, 90 percent of the association's gross expenditures must be qualifying expenditures. Qualifying expenditures are all the expenditures of an association, both operating and capital in nature, that are made for the acquisition, construction, management, maintenance, and care of association property. Basically, qualifying expenditures are the gross expenditures made during the taxable year, which includes all of the expenditures made from the reserve funds, both capital and noncapital in nature, less those expenses incurred as a result of nonexempt income and those expenses incurred to produce nonexempt income. Deducting qualifying expenditures from gross expenditures leaves those expenditures that are categorized as non-qualifying. If these expenditures so categorized exceed 10 percent of the gross expenditures, the association does not qualify to be taxed as a homeowners association.

An expense that is incurred because of the existence of a nonexempt income item would be categorized as a non-qualifying expense. An example of this type of expense is state income taxes. The other type of expense categorized as non-qualifying is an expense incurred to produce nonexempt income. If an association has interest income, it is common to allocate a percentage of management and accounting fees to the non-qualifying expense category since it can be inferred that they were incurred in connection with the production of the interest income. As another example, if an association has income from running a laundry, then an allocation of a portion of its utilities bills would be put in the non-qualifying category.

Taxable Income and Preparing the Return

If an association satisfies the income and expenditure thresholds, it can file a tax return as a homeowners association. As a homeowners association, an association pays taxes on its taxable income. Its taxable income is based on its nonexempt income reduced by those expenses categorized as non-qualifying and further reduced by a $100 specific deduction.

In preparing Form 1120-H, there are essentially six input amounts required:

- Total exempt income
- Total qualifying expenditures
- Total gross expenditures
- Non-exempt interest income
- Other non-exempt income
- Total expenses categorized as non-qualifying

A flat rate of 30 percent (32 percent for timeshare associations) is applied to the taxable income to arrive at the amount of the tax. As was previously mentioned, if an association files its tax return as a regular corporation, its tax could be as low as 15 percent of its taxable income. In many cases, an association's taxable income as a homeowners association is very close to its taxable income as a regular corporation. With the tax rate of a homeowners association being twice that of a regular corporation, it may seem—on its face—that one should always file as a regular corporation. Before a decision is made to do so, an association should be aware that filing a return properly as a regular corporation requires knowledge of association taxation that is normally possessed by an experienced tax preparer.

*Bob Titus, CPA is the president of Ace Association Accounting, Inc. For more information, visit **www.AceAssociationAccounting.com**.* ■