

COMPREHENSIVE TAX SCENARIOS FOR HOMEOWNERS ASSOCIATIONS

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ABSTRACT

Two sets of tax regimes are available to HOAs. HOAs can be taxed as a C corporation with a graduated tax schedule. HOAs can also be taxed under §528 allowing for exempt function income, provided the HOA meets the eligibility requirements. This paper presents comprehensive tax scenarios highlighting potential pitfalls that the tax professional, as well as the HOA board member should be aware.¹

I. INTRODUCTION

With the privatization of services and amenities, the formation of a homeowners association (“HOAs”) is usually an integral part of the overall development of a real estate subdivision or a condominium project. Homeowners associations are usually corporate associations run by a volunteer board of directors that allow individual homeowners to act together in managing, maintaining, and improving their residences. Specific duties of the organization may include administration and enforcement of covenants for preserving architectural and general appearance of the development; management of common areas such as streets, sidewalks, swimming pools, tennis courts and greenbelt areas; and exterior maintenance and repair of member-owned property.

In order to provide services and maintain the amenities of a neighborhood, the HOA typically has the authority to collect dues, and levy its members special assessments when necessary. HOA Board members may be unaware that these assessments may have tax consequences. As such HOA Board members should have some knowledge of §528 and related Treasury Regulations, which exempts qualified HOAs from taxation on net income derived from

¹ This paper has been adapted from a previous published article entitled “Tax Issues for Homeowner Association,” by Cris de la Torre, Richard Newmark and Garth H. Allen, 32 COLO. LAW. January 2003. However, this paper does not discuss the Treasury Regulations in much detail but rather focuses on examples that illustrate common problems facing the practitioner.

typical HOA activities. This article examines §528 requirements and describes the limited situations in which it is beneficial for HOAs to elect §528 treatment. Comprehensive examples will illustrate the tax computations necessary to determine if a HOA qualifies for the tax exclusion, provide suggestions regarding how to remedy the failure to qualify, and demonstrate when a HOA may prefer to be taxed as an ordinary corporation.

II. OVERVIEW OF §528 AND HOA TAX OPTIONS

As part of the Tax Reform Act of 1976, Congress decided not to tax revenues of an association of homeowners who act together as long as an individual homeowner acting alone would not be taxed on the same activity.² Congress did not, however, want to exempt profit center activity from taxation. The HOA's income generally is assumed to be taxable *unless* the HOA qualifies and elects under §528 to exclude income. Under §528, all HOA activity related income, including income received to fund future operating, maintenance, and contingency reserves, is not taxable under §528. This is the main benefit of §528 as this same funding for future reserves could be taxable under Subchapter C.

A. *Tax Options for HOAs*

Prior to the enactment of §528 in 1976 (P.L. 94-455), HOAs could only qualify for tax-exempt treatment under §501(c)(4), which includes civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. However, homeowner associations may now qualify as an organization exempt from federal income tax under §501(c)(4) *only* if it meets three requirements.³ First, the homeowners association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified

² Committee Report for the Tax Reform Act of 1976, PL 94-445.

³ Rev. Rul. 74-99, 1974-1 CB 131 as modified in Rev. Rul. 80-63, 1980-1 CB 116.

as a governmental subdivision or unit. Second, it must not conduct activities directed to the exterior maintenance of any private residence. Third, common areas for facilities that the homeowners association owns and maintains must be for the use and enjoyment of the general public. The combined effect of the aforementioned Revenue Rulings and the enactment of §528 is to make it both difficult and unnecessary for a HOA to qualify under §501(c)(4).

As a result of §528, effectively there only two tax options for a typical HOA. First, if the HOA corporation, LLC, or LLP that qualifies under §528 for a taxable year, can elect a flat 30% tax on its taxable income as defined in §528(d). Alternatively, if the HOA does not qualify or does not elect to be taxed under §528, the HOA will be taxed as a C corporation. In general, this means that the excess of current receipts over current expenditures at the end of the year is taxable. Use of §528 may result in less taxable income due to the §528 exclusion, but a higher tax liability because the flat 30% rate is greater than the tax rates on the first \$75,000 of corporate taxable income. The effects of the election are complex to evaluate and therefore require careful calculation as illustrated in the comprehensive example contained herein.

B. *Election of Taxation as HOA*

Only three forms of associations may qualify for HOA status: condominiums, residential real estate management associations, and time-share associations. A “residential real estate management association” is defined under Treas. Reg. §1.528-1(c) defines as “owners of single-family residential units located in a subdivision, development or similar area.” An association elects taxation as a HOA by filing its tax return on Form 1120-H instead of Form 1120, by the due date, including extensions.⁴ A separate election must be made for each taxable year.⁵ Once

⁴ Treas. Reg. §1.528-8(a) and (b).

⁵ Treas. Reg. §1.528-8.

made, the annual election is binding on the HOA for the taxable year and may not be revoked without IRS approval.⁶ The process of allowing the HOA to elect §528 status permits the association the flexibility to file Form 1120-H only when it produces a lower tax liability. In fact, the 1120-H instructions state that the HOA should compare its total tax computed under Forms 1120 and 1120-H and file the form that results in the lowest tax.

III. LIMITING THE USE OF §528 TO HOAS

The Code and Treasury Regulations attempt to minimize the possible abuse of this section by profit seekers attempting to claim HOA status to minimize taxes. Consequently, under §528, a HOA is defined as an association “*organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property.*”⁷ “Organized and operated” is defined under Treas. Reg. §1.528-2(a) in terms of, “carrying on one or more of the exempt functions of a homeowner association” based on “all the facts and circumstances of each case.”

The term “association property” is defined in Treas. Reg. §1.528-3, and generally includes real and personal property owned by the organization that is “available for the common benefit.”⁸ The regulation lists several examples that would normally qualify, such as swimming pools and tennis courts; it also identifies property that would not qualify as HOA property because it is used primarily by nonmembers, such as a retreat or meeting place. Parking spaces, tennis courts, libraries, and churches are within the residential purpose requirement if the use is auxiliary to residential use.⁹ An association may also maintain privately owned areas so long as

⁶ Treas. Reg. §1.528-8(f).

⁷ §528(c)(1)(A) [emphasis added].

⁸ Treas. Reg. §1.528-3(a).

⁹ See Treas. Reg. §1.528-4(c) for further examples.

such areas affect the overall appearance and structure of the development. However, for this property to qualify as “association property,” there must be a covenant of appearance applying on the same basis to all property in the project, a *pro rata* annual mandatory assessment for maintaining this property on all members of the association, and membership in the association must be compulsory for all property owners in the project.

A. *Income and Expenditure Tests*

Income Test. The source of income test requires that 60% of the HOA’s gross income come from “exempt function income,” including membership dues, fees or other assessments from the HOA members.¹⁰ The requirement prevents the HOA from being a nontaxable profit center. Based only on the definition of a HOA, hypothetically an “auxiliary” golf course in a residential development would generate tax-exempt income as long as the golf course was “organized and operated” as part of the development. Anticipating such a scenario, the Regulations’ definition of “organized and operated” is linked to the “source of income” and “expenditure” tests. Accordingly, in the golf course example, if more than 40% of the HOA’s income comes from non-member green fees or from members in the form of a voluntary fee for service, the HOA is disqualified from using §528 and forces the HOA to file Form 1120. Exclusive private golf clubs would qualify under §528. Assuming no outside revenue was produced, no tax advantage would occur, however, as the members would be paying for the upkeep the golf course in after-tax dollars. For purposes of calculating the ratio, the denominator, *i.e.*, gross income, should not include any sinking fund assessments collected for specific capital expenditures. See Treas. Reg. §1.528-9. Likewise the numerator, *i.e.*, the

¹⁰ Treas. Reg. § 1.528-5, citing Treas. Reg. § 1.528-9 for the definition of “exempt function income.”

exempt function income, should also exclude sinking fund collections earmarked for the replacement of association property in the form of capital assets. See Treas. Reg. §1.528-6(a).

Expenditure Test. This test requires that 90% of HOA funds must be used for “acquisition, construction, management, maintenance, and care of association property....”¹¹ Both current operating and capital expenditures on association property are included even if the property may also produce non-exempt function income, such as a clubhouse or pool that is rented for private parties. Treas. Reg. §1.528-6(c) lists several examples of qualifying expenditures, including the following: salaries of an association manager; paving of streets; security personnel; legal and accounting fees; upkeep of tennis courts, swimming pools, and clubhouse; replacement of common buildings, insurance premiums on association property; improvement of private property to the extent it is association property; and real estate and personal property taxes imposed on association property.

B. *Exempt Function Income*

Section 528 and the related Regulations are clear that money collected by the HOA from its members and used for the ordinary maintenance of association property is not taxable.¹² However, interest and dividend income from investments is subject to income tax even if the investment is funded by assessments that are not includible in income (*e.g.*, a sinking fund for a future capital expenditure).¹³ Additionally, association dues cannot be used for the betterment of private property.¹⁴ For example, channeling funds from an individual to the HOA for the purpose of improving the interior of an individual’s residence is not permitted. Treas. Reg.

¹¹ §528(c)(1)(C).

¹² Treas. Reg. §1.528-9(b)(3).

¹³ Treas. Reg. §1.528-9(c)(4).

¹⁴ §528(c)(1)(D).

§1.528-7 states that, “An organization is not a homeowners association if any part of its net earnings inures (other than as a direct result of its engaging in one or more exempt functions) to the benefit of any private person.” However, maintenance and repairs to residences’ exteriors, including roof replacement, are not considered private benefits as long as there is a covenant of appearance, and these areas affect the overall appearance of the development.

Under §528, exempt function income includes membership dues, fees, and assessments of owners of residential units or residential lots regardless of how these collections are labeled in the HOA’s accounting records. Exempt function income must be derived from owners of residential units or residential lots in their capacity as owner-members rather than in some other capacity such as customers for services.¹⁵ This distinction is critical because exempt function income is categorized as income derived from the ownership obligation related to association property, and not the ancillary services that may generate income. Of course, for the income from a unit to be considered exempt function income, the unit must be used for residential purposes, and not for commercial properties. Conversely, non-exempt function income is subject to tax. Fee-for-service collections for special use of association property (*e.g.*, renting the clubhouse for a party) would be taxable as non-exempt function income.¹⁶ By comparison, annual fees paid to use common facilities such as the clubhouse or tennis courts will be exempt function income.¹⁷

IV. COMPUTING FEDERAL AND STATE TAX LIABILITY

A. *Taxation Under §528*

¹⁵ Treas. Reg. §1.528-9(a).

¹⁶ Treas. Reg. §1.528-9(d).

¹⁷ Treas. Reg. §1.528-9(a).

Computing federal taxable income for a HOA that files Form 1120-H is similar to computing taxable income under Subchapter C, subject to a few critical exceptions. First, all income and deductions must be classified as either exempt or non-exempt based on the rules described previously. Proper classification is necessary to demonstrate that the income and expenditure tests are met.

There is no tax liability on net exempt function income. The net non-exempt income, less a special \$100 deduction, is subject to a flat 30% tax (32% for timeshare associations).¹⁸ HOAs filing an 1120-H are not entitled to a net operating loss deduction, nor any special deductions for corporations under Part VIII of Subchapter B, including the dividends-received deduction (§243) and the amortization of organizational costs over 60 months (§248).¹⁹

Homeowners Associations that file Form 1120-H are allowed a deduction for depreciation expense as long as the expense would normally qualify under Chapter 1 of the Code and the expense is also directly connected with the production of gross income (excluding exempt function income). To be directly connected with the production of gross income, depreciation or other similar items must have both proximate and primary relationships to the production of such income and have been incurred in the production of such income. Whether an expense is incurred in the production of gross income is determined on the basis of all the facts and circumstances involved in each case.²⁰

B. *Taxation Under §277 and Subchapter C*

¹⁸ §528(b).

¹⁹ §528(d)(2).

²⁰ Treas. Reg. §1.528-10(c)(1).

HOAs choosing to file Form 1120 must classify their income and deductions as member or non-member activities. This is similar to the exempt and non-exempt function classification of §528, except that fee-for-service income and related deductions from HOA members are included as member income; such income is classified as non-exempt income under §528. Section 277 does not allow HOAs or other membership organizations to use a loss generated from transactions between the association and its members to offset net income from other sources.²¹ HOAs will be subject to the restrictions in §277 as owners are generally required to become a member of the HOA as a condition of ownership.²² Thus, a loss that results from a HOA's member activities cannot be used to offset income from non-member activities, but the member loss can be carried forward indefinitely to offset member income in the succeeding year. Losses from non-member activities may only be applied against non-member income in other years subject to the normal rules governing NOLs.²³ Additionally, NOLs generated from non-member activities cannot be used to offset non-exempt income in a year when a HOA files an 1120-H.

When filing Form 1120, the tax liability for a HOA is computed by applying the graduated C corporation tax rates to the sum of member income (but not less than \$0) and non-member income. Whether the association files as a C corporation or elects to file under §528, a HOA is liable for state income taxes in states that impose a corporate income tax.

V. COMPREHENSIVE EXAMPLES

²¹ §277(a).

²² Treas. Reg. §1-528-1(a).

²³ §172(b)(1)(A).

A hypothetical HOA with 100 members will be used for all four examples. The examples are presented in the Appendix. Member fees are \$2,000 per year. Interest income is computed at 5% of the average reserve fund balances. In Examples 1a and 2a, total interest income is \$6,450, and \$8,750 in Examples 1b and 2b. The difference in interest income between the examples is due to differences in reserve expenditures. Examples 1a and 2a \$45,000 of reserves were spent from the roof reserve fund and \$47,000 was spent from the painting fund, but there were no reserve expenditures in Examples 1b and 2b. Other expenses for all four examples are the same except as noted in the following subsections. Federal tax liability is computed two ways: 1) assuming the HOA qualifies under §528, and 2) assuming the HOA is taxed as a regular C corporation.²⁴ State tax liability is computed as 5% of Federal taxable income.

A. *Assessments for Reserves*

In all four examples, the HOA collects \$50,000 in assessments for a painting reserve to repaint the exteriors of each owner's residence once every five years. Both the income and expenditures related to the painting reserve are includible with the tax-exempt activities if filing Form 1120-H, or member activities under §277 if filing Form 1120. Several court cases and rulings have specifically stated that painting is *not* of a capital nature (*e.g.*, Rev. Rul. 75-370, 1975-2 CB 25; *Vera M. Walker*, TC Memo 1992-416). In Examples 1a and 2a, the HOAs incur painting expenses of \$47,000. This reduces member income under §277 to a point whereby filing Form 1120 is more beneficial than filing Form 1120-H. In Examples 1b and 2b, no money is expended from painting reserves (*see* Exhibit 1, Examples 1b and 2b).

²⁴ For illustrative purposes, the tax liability under §528 is computed for Example 2b even though the HOA fails the expenditure test.

Additionally, the HOA collects \$50,000 for a roof-replacement reserve to replace the roof of each home once every 25 years. The collections are capital contributions under §118 and will not be includible as tax-exempt income if filing Form 1120-H, or member activities under §277 if filing Form 1120, under the following conditions: 1) assessments are properly earmarked for a specific capital improvement project, 2) the funds are kept in a separate bank account, and 3) the HOA keeps a separate accounting of the fund. The HOA should also have a reserve study conducted by a qualified professional to estimate the cost of capital repairs or replacement. If proper documentation and accounting are lacking, then the assessments may be included as tax-exempt income if filing Form 1120-H, or member income under §277 if filing Form 1120. Note that including the assessments for non-capital reserves as tax-exempt income when filing an 1120-H does not increase the HOA's tax liability, but it would increase the tax liability if filing Form 1120. Moreover, regardless of whether or not the assessments are includible as income, capital expenditures from the reserve funds are not included as a deduction (§263).

Collections for capital reserves (*e.g.*, the roof-replacement reserve) are not included for the 60% source of income test if they are classified as capital contributions.²⁵ This will generally not affect the outcome of the source of income test unless the HOA has a very large amount of non-exempt income (*e.g.*, a country club community that collects substantial green fees, and country-club dues from nonresidents). Exhibit 2 shows that all four of our examples easily meet this test.

B. *Expenditures from Reserves*

Contrary to capital reserve assessments, expenditures related to the capital reserves *are* included in the 90% expenditure test even if the collections are classified as a contribution to capital. This can help a HOA with significant non-exempt income still qualify under §528. In

²⁵ Treas. Reg. §§1.528-5 and 1.528-9(a).

Examples 1a and 2a, expenditures from the roof replacement reserve is \$45,000 and \$47,000 is expended from the exterior painting reserve. These reserve expenditures are particularly helpful in meeting the expenditure test when there are significant non-exempt expenses, provided that the expenditures are unrelated to assets that generate non tax-exempt income (*e.g.*, residential exteriors). Compare the HOA in Example 2a, which has \$92,000 of reserve expenditures to Example 2b, which has no reserve expenditures. Without the reserve expenditures, the HOA could not qualify for §528 treatment.

C. *Section 277 vs. Section 528 Classifications*

As mentioned in Section IV, the member/non-member classification under §277 is generally the same as the exempt/non-exempt classification under §528 except for classifying fee-for-service activities. Fee-for-service activities related to use by non-HOA members are similarly treated: it is a non-member activity under §277 and a non-exempt activity under §528. The rules change, however, when such activities are generated from HOA member use. Under §528, it is treated as non-exempt, but it is included with member income under §277. Member income under §277 includes all income that would be classified as tax-exempt activities under §528. One important exception to this classification scheme under Treas. Reg. §1.528-9(d) allows voluntary fee-for-service activities from HOA members to be treated as an exempt activity provided that the fees are paid no more than once every 12 months, and the privilege must last for the entire 12-month period.

Examples 2a and 2b have \$42,700 of fee-for-service income—\$14,600 from members and \$28,100 from non-members. Note the differences between non-exempt income and non-member income in Exhibit 1. Also, if HOA owners paid an annual fee to play tennis and racquetball, the \$14,600 of non-exempt income and its related expenses would be classified as

tax-exempt income, reducing Form 1120-H tax liability in Examples 2a and 2b. The amount of expenses related to the fee-for-service income allocated to non-member and non-exempt activities is explained later in this section.

D. *Allocating Expenses to Non-Exempt Income*

Section 528 and the related Regulations provide very little guidance concerning the allocation of expenses that relate to both exempt and non-exempt income. Treas. Reg. §1.528-10(c)(2) merely states that expenses for facilities and personnel used for both exempt and non-exempt functions “...shall be allocated between the two uses on a reasonable basis.

Expenses Related to Investment Income . In examples 1a and 1b, the non-exempt income, \$6,450 and \$8,750, respectively consists entirely of interest on the painting and roof-replacement reserves. Five percent (\$800) of the \$16,000 in management, bookkeeping/accounting, and legal fees are allocated to the interest income, which is consistent with the allowable allocation in *Concord Consumers Housing Cooperative v. Commissioner*²⁶ without supporting documentation. However, proper documentation should be provided whenever possible, such as having the management company separately invoice, or at least itemize, amounts billed for services related to management activities.

Expenses Related to Multiple Activities. The HOAs in Examples, 2a and 2b have a total of \$42,700 of fee-for-service income in addition to their interest income. In this case, twenty percent (\$3,200) of the management, legal, and bookkeeping/accounting fees are allocated to non-exempt income, which is commensurate with the level of non-exempt activities. Since a substantial amount of expenses are being allocated to non-exempt income, it is important to have employees and the management company track the amount of time spent on various activities.

²⁶ 89 T.C. 105, 1987.

Expenses Related to Fee-for-Service Activities. The allocation of dual use expenses in Examples 2a and 2b are based on facility use. The \$30,200 from tennis and racquetball court fees and \$20,000 of directly related expenses were generated from a total of 2,865 hours of court time: 1,825 of HOA member rental hours (1,825 hours x \$8/hr = \$14,600) and 1,040 of non-member rental hours (1,040 hours x \$15/hr = \$15,600). Under §528, the entire \$20,000 of expenses is considered non-exempt because voluntary fee-for service activities specifically defined as non-exempt activities.²⁷ In contrast to §528, only 36.3% (1,040/2,865) of the expenses (\$7,260) is non-member income under §277, while 63.7% (1,865/2,865) of the expenses (\$12,740) is classified as a member expense included in the expense portion for Examples 2a and 2b in Exhibit 1 and the expenditure tests in Exhibit 3.

In addition to the tennis/racquetball fees, the HOAs in Examples 2a and 2b generated \$12,500 from non-member pool/clubhouse memberships—50 memberships at \$250 per membership. Given that there are 100 HOA members, one-third (50/150) of the \$35,000 in direct pool/clubhouse expenses is allocated to non-exempt activities under §528 and non-member activities under §277.

Depreciation Expense. There are two main issues related to depreciation of HOA assets. The first is determining the basis of assets in the hands of the HOA, and the second is determining the circumstances in which the HOA is allowed to claim depreciation deductions.

If a developer contributes assets in exchange for an interest in the HOA, then the basis of the assets acquired by the HOA is the same as the basis in the hands of the developer, assuming that the 80% control requirement of §351 is met.²⁸ Usually, the developer allocates the cost of

²⁷ Treas. Reg. §1.528-9(d).

²⁸ §362(a).

the assets to each unit, so the developer's basis in the assets is \$0, which means that the HOA's basis is also \$0. In the more likely scenario whereby the developer contributes the assets to the HOA without receiving an interest in the HOA, the basis of the assets to the HOA is \$0.²⁹ Additionally, property acquired by the HOA will generally have a basis equal to its cost.³⁰

While rules that determine basis of HOA assets apply to all assets regardless of their classification (i.e., exempt/non-exempt, member/non-member), determining when depreciation is deductible depends on how the asset is used. Depreciation on assets or portions of dual-use assets used in a for-profit activity (e.g., fee-for-service activities) is deductible.³¹ However, it appears that depreciation of assets related to activities classified under §528 as exempt activities are not depreciable. The reasoning is that HOA association property, excluding property used to generate non-exempt income, is an extension of a HOA member's residence. Treas. Reg. §1.528-3(a) defines association property as property "...available for the common benefit of all members of the organization and must be of a nature that tends to enhance the beneficial enjoyment of the private residences by their owners." Therefore, association property cannot be depreciated because a personal residence is not depreciable under §167 or §262. Section 167(a) only allows a depreciation deduction for property used in a trade or business, or property held for the production of income, whereas §262 disallows a deduction for living expenses, and Treas. Reg. §1.262-1(b)(2) explicitly disallows deductions for maintaining a household though it does not specifically list depreciation as a household expense.

²⁹ §362(c)(1).

³⁰ §1012.

³¹ §167(a).

Examples 2a and 2b illustrate the allocation of \$7,000 depreciation between business and non-business income. Note that no depreciation is allocated to either exempt activities under §528 classification or member activities under §277 classification. Depreciation of \$2,333 ($\$7,000 \times (50/150)$) is allocated to both non-exempt activities under §528 classification and non-member activities under §277 classification. If the examples were changed such that members paid for pool/clubhouse use on a fee-for-service basis, then a portion of the depreciation expense would be allocated to member activities.

E. *Tax Liability and Net Operating Losses.*

Qualifying HOAs under §528 have more flexibility in computing their tax liability than do non-qualifying HOAs because qualifying HOAs can file as a regular C corporation subject to the rules of §277 (Form 1120) or elect to file as a qualifying HOA using the §528 rules (Form 1120-H). Due to this flexibility, qualifying HOAs should compute their tax liability using both Forms 1120 and 1120-H and choosing the method that produces the lower tax liability. In addition to comparing current tax liabilities, qualifying HOAs that generate member and/or non-member net losses when computing their taxable incomes using Form 1120 also need to examine the impact of carrying these losses to other tax years.

Net Losses from Member Activities. Examples 1a and 2a illustrate that when a HOA has little or no non-member net income, a HOA's current tax liability will be lower if it files a regular 1120 rather than an 1120-H (see Exhibit 1). This occurs because non-member net income is taxed at 15% when filing Form 1120, whereas non-exempt income when filing Form 1120-H is taxed at a flat 30% after deducting a \$100 exemption. Exhibit 4, which assumes that exempt net income or member net income is either zero or negative, shows that computing taxable income using the graduated corporate tax rates provides an advantage over the flat 30%

tax under §528 all the way until non-exempt net income reaches \$185,722 (\$185,770 if only computing Federal tax liability). Maximum tax savings of \$8,715 (\$8,720 if only computing Federal tax liability) occurs when non-exempt net income is \$75,000.

Examples 1a and 2a also show HOAs with member net losses. Member losses cannot be used to offset non-member income, but a member loss from one year can be deducted by a HOA in a succeeding year.³² This would allow a HOA to receive a tax benefit in the subsequent year, provided that it filed Form 1120 in the succeeding year. The tax savings from using a member carryover is \$1,755 (\$11,700 x 15%) for Example 1a and \$3,466 (\$23,107 x 15%) in Example 2a, assuming that the HOA is in the 15% tax bracket.

Section 277 is clear that if a HOA files Form 1120 in the year after a member loss, the HOA can deduct the loss on the succeeding 1120. However, the Code does not provide any guidance if the HOA files Form 1120-H in the succeeding year even though losses arising in a year when a HOA files Form 1120-H cannot be carried to another year.³³ The resolution of this issue may be provided by analogy to the treatment of NOLs generated by a non-HOA C corporation that files as an S corporation in succeeding years. The years in which the entity files an S corporation return are treated as if it were a C corporation with taxable income of \$0.³⁴ Based on this logic, the member loss should be carried forward to the next year in which the HOA files an 1120. Because §528(d)(2)(B) prohibits a HOA from deducting a §172 NOL, and §528 (Form 1120-H) does not require a HOA to compute net tax-exempt income, it appears that a HOA filing Form 1120-H could be deemed to have \$0 member income. Therefore, a HOA

³² §277(a).

³³ §528(d)(2)(B).

³⁴ Treas. Reg. 1.172-1(f).

would be able to carry a member loss (when filing Form 1120) to the next tax year in which it files another 1120 when it files Form 1120-H in intervening years, provided that the NOL has not expired. Unfortunately, there is no authoritative pronouncement specifically addressing the carryover of member losses, so it is unclear whether or not the IRS agrees with this analysis.

HOAs with Member Income . Example 1b illustrates that when a HOA has a significant amount of member net income, a HOA's current tax liability will be lower if it files an 1120-H rather than an 1120 (see Exhibit 1). This would also be true for Example 2b, except that this HOA fails the 90% expenditure test, and therefore, does not have the option to file an 1120-H.³⁵ This occurs because member net income on Form 1120 is taxed at 15% in Example 1b (part of the income in Example 2b is taxed at 25%), whereas exempt net income on Form 1120-H is not taxed. Exhibit 5 shows the amount of exempt net income (assuming that exempt and non-exempt income is the same as member and non-member net income) for given amounts of non-exempt net income that will produce the same tax liability under both Forms 1120 and 1120-H. Tax exempt income in excess of the amount on the graph for a given amount of non-exempt net income will produce a lower tax liability if the HOA files Form 1120-H. Thus, a HOA that has significant member net income can reduce their tax liability by filing Form 1120-H.

HOAs that choose to, or are required to file Form 1120 that generate assessments in excess of the amounts used for the operation of the HOA can get relief by following Rev. Rul. 70-604, 1970 CB 9. To obtain relief, the membership must make a resolution to either refund the excess assessments or apply the excess to the following year's assessments. For a large HOA, the refund option may not be viable as individual checks would have to be written to each member. If the excess assessments option is used, the excess assessments may only be carried

³⁵ Tax liability if filing an 1120-H for Example 2b is computed for illustrative purposes.

over for one year (see GCM 34613 and TAM 9539001 use the singular “year’s” when referring to the carryover authorized by Rev. Rul. 70-604). Failure to have the membership make a proper resolution or provide proper documentation could result in loss of the income reduction.

VI. CHECK LIST FOR SELECTING THE APPROPRIATE TAX REGIME

Most HOAs are corporations, thus paying corporate income tax if the §528 election is not made. However, the majority of HOAs will not have a problem complying with the intent and spirit of §528. If the HOA does not elect the qualified status of §528, it will be taxed as a for-profit entity. Historically, many HOAs did not elect §528 status but rather carefully coordinated income and expenses so that revenue did not exceed expenses at year’s end. If, however, a HOA erred in coordinating income and expenses, taxable income could result.

This paper has highlighted the process in which a tax professional should approach the decision in selecting the appropriate tax regime for filing, which would include the following:

- The amount of non exempt function income,
- Categorization of member and non-member income,
- The annual amount of reserves being collected,
- The amount of depreciation expense allocated to non-member income, or non exempt function income,
- Calculation of the income and expenditure tests,
- Consideration of using Rev. Rul. 70-604 to eliminate excess assessments, and
- Tax calculations of under Forms 1120 and 1120-H.

The HOA must classify its income as either exempt or nonexempt to properly use §528. Classifying income as member or non-member income is necessary to satisfy §277. This part of

the analysis is necessary in order to properly apportion expenses, including depreciation, to each category and is necessary under both tax forms.

The amount of reserves being collected may play a significant factor in deciding which tax form to file. In the early part of a HOA's development, significant reserves may be collected. Under §528 this is exempt function income. However, if the association chooses to file under Form 1120, attention must be given to adhering to §118, along with making sure that the assessments are properly documented and segregated in a separate bank account. As the examples indicate, the issue of reserves by themselves, will not determine whether a HOA uses §528, however, given the graduated rates and the non-exempt income analysis mentioned previously.

The amount of depreciation expense is another issue that may have bearing on the decision. If the HOA has a significant amount of non-member income and a fair amount of depreciation expense, then the HOA may want to elect to be taxed as a C corporation and file Form 1120 to offset the non-member income. Likewise, the depreciation expense, calculated from the allowable percentage from the member/non-member designation, may also be allocated to non-exempt function income under §528. In either case, the depreciation calculation may affect one more than the other, depending on the amount of non-member income (Form 1120) or the amount of non-exempt function income (Form 1120-H).

Calculations of the income and the expenditure tests are also necessary as part of the decision calculus. If the HOA fails to meet either of the two tests, then the HOA is required to file as an ordinary C corporation, regardless of any other factors. Finally, assuming that the HOA meets both the income and expenditure tests, the HOA should prepare its tax calculation

under each form to determine the smallest tax liability, taking into account all of the previous tests and categorizations of income and expenses.

When an HOA has excess assessments over the amounts used for the operation of the HOA, consideration should be given to making an election under Rev. Rul. 70-604 to either refund the excess assessments or apply them to the subsequent year's assessments. This is only an issue if the HOA will be filing Form 1120 as excess assessments are not taxable when filing Form 1120-H. If considering this election, care must be taken to ensure that the resolution and supporting documentation meet the requirements of Rev. Rul. 70-604.

In general, when §528 HOAs have taxable income, the income is taxed at 30% as opposed to the progressive corporate tax beginning at 15%. HOAs with significant nonexempt function income will often prefer to elect against §528 status and in favor of taxation as an ordinary C corporation. In practice, most HOAs will file their taxes using either Form 1120 or possibly the simplified Form 1120-A. The typical HOA, with little or no net income from exempt activities, will be in a better position with the lower graduated rates afforded to for-profit corporations unless it generates a significant amount of non-exempt net income. However, if the HOA produces a considerable amount of exempt function income in excess of its expenditures, then choosing to file a Form 1120-H will be preferable subject to the qualifications discussed in this section.

Exhibit 1: Net Income and Tax Liability of HOA Examples

	Example 1a	Example 1b	Example 2a	Example 2b
Total Exempt Income	250,000	250,000	250,000	250,000
Total Exempt Expenses	261,700	214,700	274,967	182,967
Exempt Net Income	(11,700)	35,300	(24,967)	67,033
Total Non-Exempt Income	6,450	8,750	49,150	51,450
Total Non-Exempt Expenses	900	900	34,967	34,967
Non-Exempt Net Income	5,550	7,850	14,183	16,483
Total Member Income	250,000	250,000	264,600	264,600
Total Member Expenses	261,700	214,700	287,707	195,707
Member Net Income	(11,700)	35,300	(23,107)	68,893
Total Non-Member Income	6,450	8,750	34,550	36,850
Total Non-Member Expenses	800	800	22,127	22,127
Non-Member Net Income	5,650	7,950	12,423	14,723
Taxable Income Before \$100 Exemption if filing Form 1120-H[*]	5,550	7,850	14,183	16,483
Tax Liability if filing From 1120-H	1,665	2,355	4,255	4,945
State Tax Liability (assume 5% tax rate)	273	388	704	819
Total Federal & State Tax Liability for 1120-H	1,938	2,743	4,959	5,764
Taxable Income if filing Form 1120	5,650	43,250	12,423	83,617
Tax Liability if filing From 1120	848	6,488	1,863	16,680
State Tax Liability (assume 5% tax rate)	278	2,158	709	4,176
Total Federal & State Tax Liability for 1120	1,125	8,645	2,573	20,856

* Tax liability for Example 2b is computed for Form 1120-H for illustrative purposes even though it fails the 90% expenditure test.

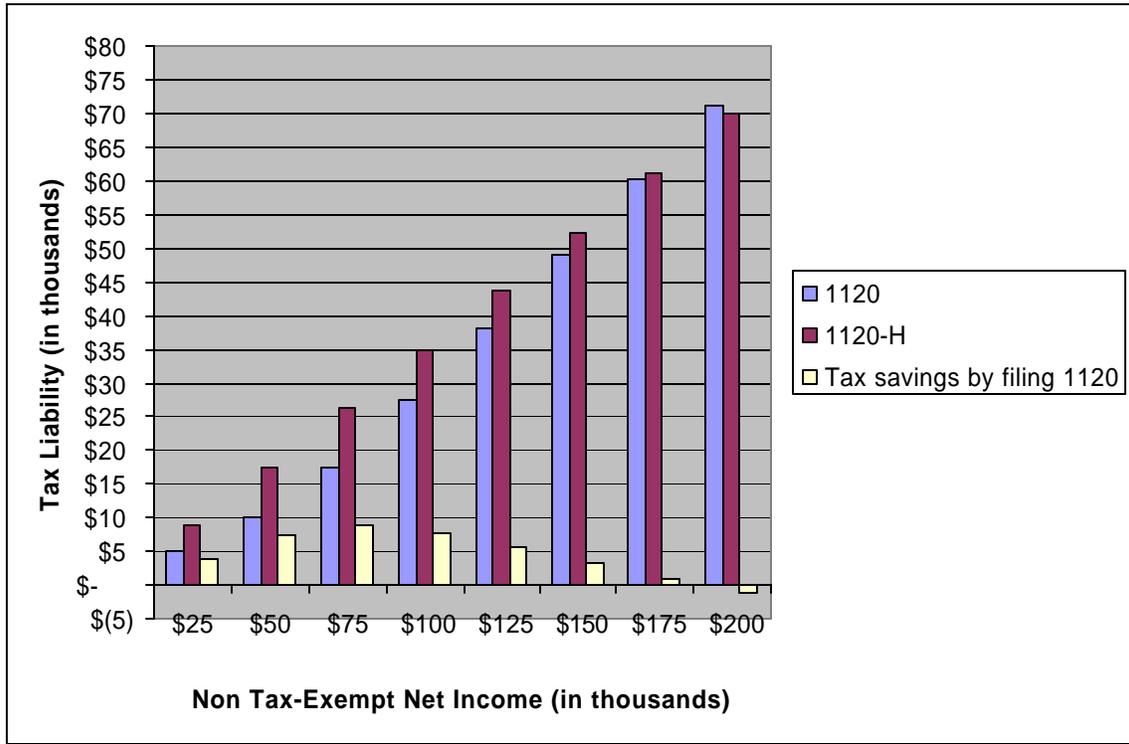
Exhibit 2: Source of Income Test

Source of Income Test	Example 1a	Example 1b	Example 2a	Example 2b
Total Exempt Income	250,000	250,000	250,000	250,000
Total Exempt and Non-exempt Income	256,450	258,750	299,150	301,450
Percentage of Income that Is Exempt	97.5%	96.6%	83.6%	82.9%

Exhibit 3: Expenditure Test

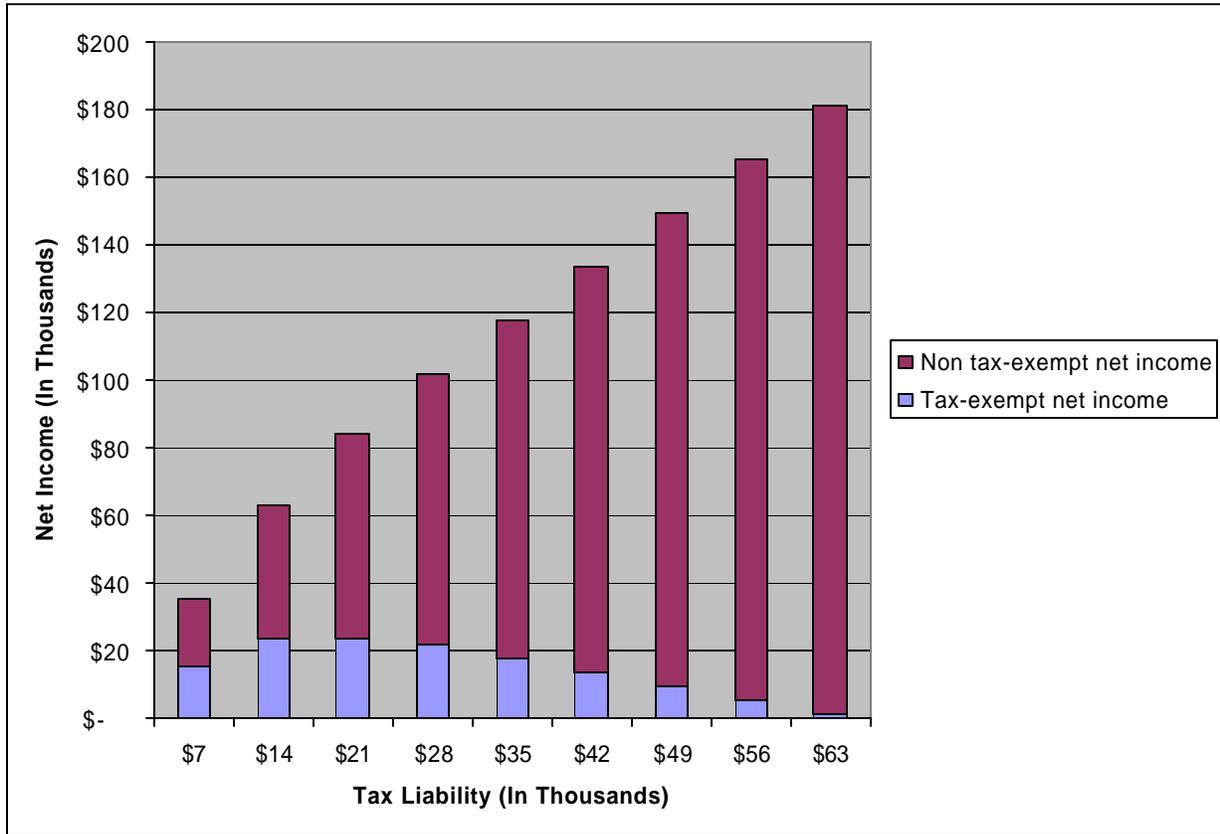
Expenditure Test	Example 1a	Example 1b	Example 2a	Example 2b
Total Exempt Expenditures (not depreciation)	306,700	214,700	317,633	180,633
Total Expenditures	307,600	215,600	352,600	215,600
Percentage of Expenditures that Are Exempt	99.7%	99.6%	90.1%	83.8%

Exhibit 4: Combined Federal and State Tax Liability for Given Levels of Non-Exempt (Non-Member) Income*



* This exhibit assumes that tax-exempt and member net income is either zero or negative.

Exhibit 5: Combined Amounts of Tax-Exempt and Non-Exempt Net Income that Produce the Same Tax Liability* for both Forms 1120 and 1120-H



* Tax liabilities are rounded. Actual liabilities are \$35 less than reported in the graph.

Appendix 1a

			<u>§528</u>	<u>§528</u>	<u>§277</u>	<u>§277</u>
Example 1a:		<u>Totals</u>	<u>Exempt</u>	<u>Non-exempt</u>	<u>Member</u>	<u>Non-Member</u>
No tennis/racquetball or pool income						
Interest on sinking fund is minimal.						
Large expenditures related to reserves.						
Revenue:						
HOA Member Fees (excluding sinking fund contrib):						
# of members	100					
\$ per member	<u>2,000</u>	200,000	200,000	-	200,000	-
HOA Member Roof reserve fund contributions:						
# of members	100					
\$ per member (roof every 20 yrs @ \$10,000/roof)	<u>500</u>	50,000	-	-		
HOA Member Painting reserve fund contributions:						
# of members	100					
\$ per member (paint every 5 yrs @ \$2,500/house)	<u>500</u>	50,000	50,000	-	50,000	-
Tennis/racquetball court time fees for members:						
# of rental hours	-					
Cost per hour	-	-	-	-	-	-
Tennis/racquetball court time fees for non-members:						
# of rental hours	-					
Cost per hour	-	-	-	-	-	-
Pool/clubhouse memberships for nonmembers						
# of memberships	-					
\$ per rental	-	-	-	-	-	-
Interest on roof reserve fund (interest rate)	5%	3,875	-	3,875	-	3,875
Interest on painting reserve fund (interest rate)	5%	<u>2,575</u>	-	<u>2,575</u>	-	<u>2,575</u>
Total Revenue		<u>306,450</u>	<u>250,000</u>	<u>6,450</u>	<u>250,000</u>	<u>6,450</u>
Expenses:						
Exterior home painting		47,000	47,000	-	47,000	-
Roof replacement		45,000	-	-	-	-
Management, accounting/bookkeeping, and legal fees		16,000	15,200	800	15,200	800
Tennis/racquetball court maintenance, utilities, Ins., & R/E tax		20,000	20,000	-	20,000	-
Clubhouse/Pool expenses:						
Lifeguards, Maintenance, Utilities, Ins., & R/E Tax		28,000	28,000	-	28,000	-
Depreciation		7,000	-	-	-	-
R&M, Lawn, Utilities, R/E tax, Ins., & other Exp. for Commons		151,500	151,500	-	151,500	-
Exemption (only available if filing as a qualifying HOA)		<u>100</u>	-	<u>100</u>	-	-
Total Expenses		<u>314,600</u>	<u>261,700</u>	<u>900</u>	<u>261,700</u>	<u>800</u>
Net Income		<u>(8,150)</u>	<u>(11,700)</u>	<u>5,550</u>	<u>(11,700)</u>	<u>5,650</u>

Appendix 1b

			<u>§528</u>	<u>§528</u>		<u>§277</u>	<u>§277</u>
Example 1b:		<u>Totals</u>	<u>Exempt</u>	<u>Non-exempt</u>		<u>Member</u>	<u>Non-Member</u>
No tennis/racquetball or pool income							
Interest on sinking fund is lower.							
No expenditures related to reserves.							
Revenue:							
HOA Member Fees (excluding sinking fund contrib):							
# of members	100						
\$ per member	<u>2,000</u>	200,000	200,000	-		200,000	-
HOA Member Roof reserve fund contributions:							
# of members	100						
\$ per member (roof every 20 yrs @ \$10,000/roof)	<u>500</u>	50,000	-	-			
HOA Member Painting reserve fund contributions:							
# of members	100						
\$ per member (paint every 5 yrs @ \$2,500/house)	<u>500</u>	50,000	50,000	-		50,000	-
Tennis/racquetball court time fees for members:							
# of rental hours	-						
Cost per hour	-	-	-	-		-	-
Tennis/racquetball court time fees for non-members:							
# of rental hours	-						
Cost per hour	-	-	-	-		-	-
Pool/clubhouse memberships for nonmembers							
# of memberships	-						
\$ per rental	-	-	-	-		-	-
Interest on roof reserve fund (interest rate)	5%	5,000	-	5,000		-	5,000
Interest on painting reserve fund (interest rate)	5%	<u>3,750</u>	-	<u>3,750</u>		-	<u>3,750</u>
Total Revenue		<u>308,750</u>	<u>250,000</u>	<u>8,750</u>		<u>250,000</u>	<u>8,750</u>
Expenses:							
Exterior home painting		-	-	-		-	-
Roof replacement		-	-	-		-	-
Management, accounting/bookkeeping, and legal fees		16,000	15,200	800		15,200	800
Tennis/racquetball court maintenance, utilities, Ins., & R/E tax		20,000	20,000	-		20,000	-
Clubhouse/Pool expenses:							
Lifeguards, Maintenance, Utilities, Ins., & R/E Tax		28,000	28,000	-		28,000	-
Depreciation		7,000	-	-		-	-
R&M, Lawn, Utilities, R/E tax, Ins., & other Exp. for Commons		151,500	151,500	-		151,500	-
Exemption (only available if filing as a qualifying HOA)		<u>100</u>	-	<u>100</u>		-	-
Total Expenses		<u>222,600</u>	<u>214,700</u>	<u>900</u>		<u>214,700</u>	<u>800</u>
Net Income		<u>86,150</u>	<u>35,300</u>	<u>7,850</u>		<u>35,300</u>	<u>7,950</u>

Appendix 2a

			<u>§528</u>	<u>§528</u>	<u>§277</u>	<u>§277</u>
Example 2a:		<u>Totals</u>	<u>Exempt</u>	<u>Non-exempt</u>	<u>Member</u>	<u>Non-Member</u>
Tennis/racquetball and pool income						
Interest on sinking fund is minimal.						
Large expenditures related to reserves.						
Revenue:						
HOA Member Fees (excluding sinking fund contrib):						
# of members	100					
\$ per member	<u>2,000</u>	200,000	200,000	-	200,000	-
HOA Member Roof reserve fund contributions:						
# of members	100					
\$ per member (roof every 20 yrs @ \$10,000/roof)	<u>500</u>	50,000	-	-		
HOA Member Painting reserve fund contributions:						
# of members	100					
\$ per member (paint every 5 yrs @ \$2,500/house)	<u>500</u>	50,000	50,000	-	50,000	-
Tennis/racquetball court time fees for members:						
# of rental hours	1,825					
Cost per hour	<u>8</u>	14,600	-	14,600	14,600	-
Tennis/racquetball court time fees for non-members:						
# of rental hours	1,040					
Cost per hour	<u>15</u>	15,600	-	15,600	-	15,600
Pool/clubhouse memberships for nonmembers						
# of memberships	50					
\$ per rental	<u>250</u>	12,500	-	12,500	-	12,500
Interest on roof reserve fund (interest rate)	5%	3,875	-	3,875	-	3,875
Interest on painting reserve fund (interest rate)	5%	<u>2,575</u>	-	<u>2,575</u>	-	<u>2,575</u>
Total Revenue		<u>349,150</u>	<u>250,000</u>	<u>49,150</u>	<u>264,600</u>	<u>34,550</u>
Expenses:						
Exterior home painting		47,000	47,000	-	47,000	-
Roof replacement		45,000	45,000		45,000	-
Management, accounting/bookkeeping, and legal fees		16,000	12,800	3,200	12,800	3,200
Tennis/racquetball court maintenance, utilities, Ins., & R/E tax		20,000	-	20,000	12,740	7,260
Clubhouse/Pool expenses:						
Lifeguards, Maintenance, Utilities, Ins., & R/E Tax		28,000	18,667	9,333	18,667	9,333
Depreciation		7,000	-	2,333	-	2,333
R&M, Lawn, Utilities, R/E tax, Ins., & other Exp. for Commons		151,500	151,500	-	151,500	151,500
Exemption (only available if filing as a qualifying HOA)		<u>100</u>	-	<u>100</u>	-	-
Total Expenses		<u>314,600</u>	<u>274,967</u>	<u>34,967</u>	<u>287,707</u>	<u>22,127</u>
Net Income		<u>34,550</u>	<u>(24,967)</u>	<u>14,183</u>	<u>(23,107)</u>	<u>12,423</u>

Appendix 2b

			<u>§528</u>	<u>§528</u>		<u>§277</u>	<u>§277</u>
Example 2b:		<u>Totals</u>	<u>Exempt</u>	<u>Non-exempt</u>		<u>Member</u>	<u>Non-Member</u>
Tennis/racquetball and pool income							
Interest on sinking fund is higher.							
Large expenditures related to reserves.							
Revenue:							
HOA Member Fees (excluding sinking fund contrib):							
# of members	100						
\$ per member	<u>2,000</u>	200,000	200,000	-		200,000	-
HOA Member Roof reserve fund contributions:							
# of members	100						
\$ per member (roof every 20 yrs @ \$10,000/roof)	<u>500</u>	50,000	-	-			
HOA Member Painting reserve fund contributions:							
# of members	100						
\$ per member (paint every 5 yrs @ \$2,500/house)	<u>500</u>	50,000	50,000	-		50,000	-
Tennis/Racquetball court time fees for members:							
# of rental hours	1,825						
Cost per hour	<u>8</u>	14,600	-	14,600		14,600	-
Tennis/Racquetball court time fees for non-members:							
# of rental hours	1,040						
Cost per hour	<u>15</u>	15,600	-	15,600		-	15,600
Pool/clubhouse memberships for nonmembers							
# of memberships	50						
\$ per rental	<u>250</u>	12,500	-	12,500		-	12,500
Interest on roof reserve fund (interest rate)	5%	5,000	-	5,000		-	5,000
Interest on painting reserve fund (interest rate)	5%	<u>3,750</u>	-	<u>3,750</u>		-	<u>3,750</u>
Total Revenue		<u>351,450</u>	<u>250,000</u>	<u>51,450</u>		<u>264,600</u>	<u>36,850</u>
Expenses:							
Exterior home painting		-	-	-		-	-
Roof replacement		-	-	-		-	-
Management, accounting/bookkeeping, and legal fees		16,000	12,800	3,200		12,800	3,200
Tennis/racquetball court maintenance, utilities, Ins., & R/E tax		20,000	-	20,000		12,740	7,260
Clubhouse/Pool expenses:							
Lifeguards, Maintenance, Utilities, Ins., & R/E Tax		28,000	18,667	9,333		18,667	9,333
Depreciation		7,000	-	2,333		-	2,333
R&M, Lawn, Utilities, R/E tax, Ins., & other Exp. for Commons		151,500	151,500	-		151,500	-
Exemption (only available if filing as a qualifying HOA)		<u>100</u>	-	<u>100</u>		-	-
Total Expenses		<u>222,600</u>	<u>182,967</u>	<u>34,967</u>		<u>195,707</u>	<u>22,127</u>
Net Income		<u>128,850</u>	<u>67,033</u>	<u>16,483</u>		<u>68,893</u>	<u>14,723</u>