

Taxes and Homeowners Associations: A Confusing Combination

Let's Talk Tax

By Brett Hersh, EA, MBA

If you own a home in a planned community or development there is a good chance you are a member of a homeowners' association (HOA). One perplexing aspect of HOA management is following the tax reporting requirements of the IRS. Some common questions our office receives are "Must our HOA file a tax return?" "What return must it file?" and "What happens if we haven't filed for a number of years?" In today's article, I will address some of these basic questions. My goal is to clarify some of the confusion associated with HOA tax reporting and help your HOA avoid the frustration and additional expense that often accompany noncompliance.

For federal tax purposes, homeowners associations are treated as corporations. Even if an HOA was created as an association or a nonprofit corporation with its respective state, it is still considered a regular corporation for federal tax purposes. The only exception is the rare instance in which the HOA has filed for recognition and been accepted as a nonprofit by the IRS. Such recognition is expensive, relatively difficult to obtain, and most often requested by filing form 1024 with the IRS and utilizing tax code section 501(c)(4).

Corporations are generally required to file Form 1120, U.S. Corporation Income Tax Return, annually. Filing form 1120 has several distinct disadvantages for an HOA. First, Form 1120 is fairly complex and requires a level of bookkeeping sophistication many HOAs lack. A second disadvantage of filing Form 1120 is that all of the HOA's "income" is taxable. Basically, this means that any funds collected and not spent (for example, funds set aside for road maintenance or replacement) during the year may be subject to corporate income tax. A third disadvantage of

Form 1120 for an HOA is that it may subject the HOA to making estimated tax payments, another burden for the often overburdened volunteer treasurer.

The tax code gives many HOAs the ability to avoid Form 1120 by making a special election. Section 528 allows Homeowner Associations that meet certain requirements to bypass Form 1120 by filing Form 1120-H, an income tax form specifically designed for Homeowner Associations. Form 1120-H is a one page form that is much easier to complete than the many page, multiple schedule Form 1120. Although most HOA's qualify, each must meet certain requirements to utilize this election. To file Form 1120-H, at least 60% of the HOA annual revenue must be "exempt-function income." Exempt-function income includes membership dues, assessments, fees and interest on those fees. Also, 90% of the HOA's expenditures must be for management, maintenance, acquisition and construction of association property.

If the HOA qualifies to file Form 1120-H, only its "non-exempt" income is taxable. Non-exempt income includes interest and dividends, rental income from property owned by the association, and laundry/vending machine income. The HOA is allowed to deduct expenses directly related to the generation of non-exempt income but must have written records to prove the deductions. Form 1120-H allows for a \$100 deduction from non-exempt income to arrive at taxable income. The HOA's taxable income is then subject to a flat tax rate of 30% (32% for time share associations).

Filing Form 1120-H is an election that must be made each year. The election is made by filing Form 1120-H by its due date (the 15th day of the third month after the end of the HOA's tax year - a six month extension to file can be obtained by filing Form 7004). Once made, the election cannot be revoked without IRS consent.

If Form 1120-H is not filed within twelve months of its due date (including extensions), the HOA may lose the opportunity to file the form 1120-H for that tax year. The HOA must then file the longer and more complex Form 1120. The HOA may also be required to pay penalties for late filing and late payment of any tax due.

In today's article we have, hopefully, clarified some of the confusion surrounding a Homeowners Association's income tax filing requirements. We have not, however, had time to discuss more complex HOA tax issues that may impact your association's particular circumstances. Please contact our office or contact another tax professional before making any tax-moves on your own.

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