

CIRA Tax Principles

“Code and Case References for Condo and HOA
Taxation”

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Agenda

- Understanding the Basics
 - Common CIRA tax principles
 - Form 1120-H issues (Section 528)
 - Form 1120 issues (Section 277)
 - Other types of returns (990 & 1120-C)
- Questions So Far
- Case Study
- Special Issues

Common CIRA Tax Principles – Gross Income

- Defined in IRC Section 61
 - “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived...”
- Ordinary types of CIRA income
 - Member operating assessments
 - Member reserve fund assessments (capital/non-capital)
 - Member fees for services
 - Nonmember fees for services
 - Litigation settlements
 - Passive income

Common CIRA Tax Principles – Capital Contributions

- Defined in IRC Section 118
 - “In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.”
- Ordinary types of CIRA capital contributions
 - Monthly reserve fund assessments (for capital expenditures only)
 - See IRC Section 263 for a definition of “capital expenditures”
 - Special reserve fund assessments
 - Litigation settlements
 - Insurance proceeds

Common CIRA Tax Principles – Capital Contributions (Continued)

- Factors to consider when evaluating the capital nature of a contribution:
 - Is the expected purpose of the contribution capital in nature?
 - IRC Sec 263 (relates to capital expenditures)
 - Chicago Board of Trade and Maryland Country Club cases
 - Revenue Rulings 74-563, 75-370 and 75-371
 - Did members know in advance that it was a capital contribution?
 - Gibbons and Maryland Country Club cases
 - Revenue Rulings 75-370 and 75-371
 - General Counsel Memorandum(GCM) 35929

Common CIRA Tax Principles – Capital Contributions (Continued)

- Factors to consider when evaluating the capital nature of a contribution (continued):
 - Is it accounted for as a capital contribution and does it increase the member's capital account?
 - IRC Sec 118
 - Chicago Board of Trade case
 - General Counsel Memorandum(GCM) 35929
 - Is it held for the purpose indicated, and no other?
 - Chicago Board of Trade and Maryland Country Club cases

Common CIRA Tax Principles – Capital Contributions (Continued)

- Factors to consider when evaluating the capital nature of a contribution (continued):
 - Is the money actually expended for the intended purpose?
 - United Grocers case
 - Was the money held in a separate bank account from the operating (non-capital) funds of the CIRA?
 - Revenue Rulings 74-563, 75-370 & 75-371

Common CIRA Tax Principles – Prepaid Assessments

- Member assessments received in advance
 - Deferred revenue for financial reporting purposes
 - Tax treatment depends on nature of amount received
 - Regular operating assessments subject to tax unless Rev Proc 71-21 applies
 - Must be careful about reserve assessments as they don't meet the 12 month test in 71-21
 - Can make election in first year under IRC Section 456(c)

Common CIRA Tax Principles – Agency Relationships

- The receipt of funds for a specific limited purpose from which the association will derive no benefit may result in an agency relationship for tax purposes
- Most common types of agency relationships
 - Special assessments for the reserve fund
 - Litigation settlements from developers
 - Disaster insurance proceeds

Common CIRA Tax Principles – Assets Received From Developer

- Assets will have the same basis in the hands of the association as they did in the hands of the developer if they are transferred in exchange for shares (IRC Section 351 – mandatory). This would be an unusual way for developers to handle this type of transaction
- Normally, the developer allocates the cost of developing the common assets to the units being sold and takes a deduction on its tax return for their cost. Therefore, there is no remaining basis in the common area assets when they are transferred to the association, so the association does not record the transfer for tax purposes as it has no tax basis in the common area assets.

Form 1120-H IRC Section 528

Definition of Homeowners Associations per IRC Sec 528

- Condominium management associations organized and operated to acquire, build, manage, and care for the property in a condominium project substantially all of whose units are homes for individuals
- Residential real estate management associations organized and operated to acquire, build, manage, and care for a subdivision, development, or similar area substantially all of whose lots or buildings are homes for individuals.
- Timeshare associations in which the members hold rights to use or ownership interests in real property of the association.

Form 1120-H IRC Section 528

Additional Tests To Qualify Under Section 528

- *Substantially Residential Test.* Substantially all of the units must be held for residential purposes (except in the case of timeshare associations)
- *60% Income Test.* At least 60% of the association's gross income for the tax year must consist of exempt function income
- *90% Expenditure Test.* At least 90% of the association's expenses for the tax year must be for the purpose of carrying on one or more of the exempt functions of a condominium or homeowners' association. Timeshare associations must spend at least 90% during the taxable year for activities provided to *or on behalf of* their members
- *Lack of Benefit Test.* No member may profit from the association's net earnings

Form 1120-H IRC Section 528

If the Association Meets the Definition and the Additional Tests to Qualify Under Section 528 then:

- Exempt function income is exempt from corporate income tax (and state income tax in Florida)
- Not subject to the AMT
- Less risk and easier to prepare
- Must make an election by filing a timely return
- Homeowners association taxable income is taxed at 30% for condominium management associations and residential real estate management associations and 32% for timeshares
- No carryover or carryback of net operating loss

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Exempt Function Income

- *Source Test.* Generally, exempt function income must be received as membership dues, fees, or assessments from owners. Amounts paid by a developer on unsold units or lots also are considered exempt function income even though the developer does not actually use the units or lots. Likewise, a litigation settlement with the developer for prior under-assessments is considered exempt function income. Income on membership assessments, such as interest, however, is not exempt function income
- *Nature Test.* Amounts received from members must be paid solely as a result of membership in the association. As a general rule, they must be assessed ratably to all members. Amounts assessed based on the value or size of the property meet the nature test, but fees paid for services and per use admission fees do not, even though the amounts are paid by members and the facilities are restricted to members' use. (Exception for special use fees paid by members annually and that cover a 12 month period)

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Exempt Function Income

- *Purpose Test.* Amounts received must be used for qualified purposes. Generally, a qualified purpose for this test is the same as for the 90% expenditure test.
- *Gross Income Test.* The gross income test excludes from exempt function income any amounts that the tax rules exclude from gross income. For example, the following amounts are not includable in an association's gross income and, therefore, are not exempt function income. (Thus, they should not be included on Line A of Form 1120-H.)
 - Tax exempt interest
 - Excess assessments that are refunded to members or are applied against future years
 - Assessments for capital improvements that are treated as capital contributions for tax purposes

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Nonexempt Function Income

- Revenue from non-association property (commercial operations and interest income)
- Revenue from nonmembers for the use of association property (guest fees, clubhouse rental, etc)
- Amounts charged to members for specific services (not assessed ratably to all members)

Form 1120 IRC Section 277

History of CIRA tax

- Sometimes referred to as the “country club” section
- Added to the Code in 1969
- Revenue Ruling 70-604 issued in 1970
- Temporary Regs issued in 1972 and withdrawn in 1986
- Capital contribution Regs issued in 1974 and 1975
- IRC Section 528 added in 1976
- Revenue Ruling 2003-73 issued in 2003

Form 1120 IRC Section 277

- Section 277 is mandatory for social clubs and membership organizations, unless you elect out under Section 528
- CIRAs are considered “membership organizations”
- Requires a division of income and expenses into “membership” and “non-membership” categories
- Cannot use membership net loss to offset non-membership net income
- Can use non-membership net loss to offset membership net income (reaffirmed under Rev Rul 2003-73)
- No longer applies to Co-ops

Form 1120 IRC Section 277

Other Issues

- “Net member loss” is not a loss but a carryforward of expenses per Section 277
- “Net member income” is not income but a carryforward of excess member assessments per Rev Rul 70-604
 - Member income is any income that comes from the members
 - Dues, fees, including fees for services
 - Non-member is not from members (Duh!)
 - Interest income, vending, laundry, clubhouse rental to non-members
- Non-member income and member income are similar, but not the same as, exempt function income and non-exempt function income (homeowners association taxable income)

Form 1120 IRC Section 277

Revenue Ruling 70-604 questions

- Issued before IRC Section 528, so question as to where IRS is going with this Revenue Ruling
- IRS has indicated that the election will be applied literally, and must be made by the members, even if that does not follow with state law
- Election must be made “timely”
 - What is timely? By year end? Before return is filed? Extensions?
- Revenue Ruling says “year’s” not “years”
 - Thus, not an indefinite carryforward
 - But, are the “excess member assessments carried forward and added to next year’s assessments, and then a new calculation performed?

Form 990 and 1120-C

- If you have a 501(c)(7) membership organization
 - Must file Form 990
 - Substantial risk due to “transparency” project for 990s
 - Notice that most of the court cases reference a Club
 - Unrelated Business Income (UBI) over 5% from non-members may be a problem; over 15% definitely a problem
 - May end up subject to 277 without the elections or benefits
- Co-ops now required to file Form 1120-C and taxed under IRC Sections 1381-1388 (Subchapter T)
 - Effective for tax years ending 12/31/07
 - Patronage vs. nonpatronage
 - 80% of gross income must come from tenant/shareholders

Questions So Far?

Case Study Facts

- You are doing the tax return for Hurricane Condo for 12/31/05, which was damaged in the hurricane of 2004. The condo received \$1,500,000 of damage and has a \$500,000 deductible. They had just finished a major roof and balcony replacement project in 2003, and all that was left in reserves at the time of the hurricane was \$250,000 to finish the painting after the restoration project. Reserve bank accounts are segregated from operating bank account balances, but reserve fund bank accounts are not split between capital and non-capital, although the reserve balances are maintained as separate line items on the books and capital reserve accounts are reported as such on the tax return. The reserves were drained in 2004 to cover clean-up costs after the storm.

Case Study Facts (Continued)

- The association levies a special assessment payable 1/15/05 of \$500,000, ½ to cover the hurricane clean up and ½ to replenish the painting reserve. The proceeds are split between the operating account and a reserve CD. The insurance proceeds are paid to the association on 1/31/05 and put in a separate, interest bearing “trust” account maintained by the condo’s attorney. All of the insurance proceeds are for roof, balconies, and building repairs. The association cannot find an acceptable contractor to start the repairs, so no significant work has been completed in 2005.

Case Study Facts (Continued)

- An excess member deduction of \$200,000 under 277 exists for 2004, but the condo filed an 1120-H
- There is excess member deductions of \$50,000 for 2005, before considering any special assessments.
- Exempt function items are the same as member items, before factoring in cable assessments. Cable assessments are a straight pass-through of \$60,000.
- Non-exempt net income and non-member net income is \$60,000 after allocation of expenses, all from interest earned on the CD and the insurance “trust” account.
- In 2005, the Board approved a 70-604 election, and in February of 2006, at the annual meeting of the members, the members ratified that action and approved one for 2006, if needed.

Special Issues

- Sale of Property
 - Common area assets
 - Could be non-exempt function income under IRC Section 528
 - May be an agency transaction that reduces basis of member
 - If association retains proceeds, basis reduction and capital contribution
 - Cell tower
 - If lease, income
 - If easement, may be basis reduction
- Condemnation
 - Property replaced – like kind involuntary conversion
 - Not replaced – reduction in basis and capital contribution
- Foreclosures and Abandonments
 - Investment in real estate – capital gain/loss (subject to limitation)

Conclusion

- Thank you
- Questions
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