



ARE WE OR AREN'T WE? TAX-EXEMPT, THAT IS ...

by Stephen M. Tilson, CPA

Most all associations “simply” must make an IRS filing every year, normally Form 1120 (see below). Assessments and fees paid by members are not taxable, but interest income and any income paid to the association by non-members is taxable. So what if your community has neither? The lack of taxable income does not eliminate your need to file. You must file every year.

BACKGROUND

All CIRAs are taxed as corporations. CIRAs come in many different configurations including residential condominium associations, homeowner’s associations, time-share associations, cooperatives and commercial condominium associations. This article does not address the taxation of either time-share associations or cooperatives since we don’t see those in our practice.

Commercial condominium associations are always required to file a Form 1120. However, residential condominiums and homeowner’s associations can file either a Form 1120H, a Form 1120 or a Form 990.

Congress enacted Internal Revenue Code (IRC) Section 277 in 1969 to deal with the taxation of CIRAs. IRC 277 required that Form 1120 be filed for all CIRAs. In 1976 Congress enacted IRC Section 528 which created Form 1120H for use by CIRAs. This is

probably the most commonly used tax form today for CIRAs.

Under a very narrow set of circumstances some residential homeowner’s associations can file a Form 990, Return for Organization Exempt from Income Tax.

TAX-EXEMPT ORGANIZATIONS

IRC Section 501 controls the taxation of exempt organizations. There are a variety of tax-exempt organizations that everyone is familiar with, including churches, schools, charities and foundations. Generally any entity organized and operated exclusively for religious, charitable, scientific, educational or literary purposes is tax-exempt. There are any number of IRC code sections that apply to different types of exempt organizations.

TAX-EXEMPT CIRAS

The vast majority of CIRAs will not qualify as tax-exempt organizations under IRC Section 501. For the few CIRAs that will qualify, they will qualify under either IRC Section 501(c) (4) as a “social welfare organization” or under IRC Section 501(c) (7) as a “recreational organization”. We won’t spend any time on 501(c) (7) organizations because in order to qualify a CIRA must be operated exclusively for “pleasure or recreation”. In addition,

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Most property owners associations are nonprofit corporations. However, not all nonprofit corporations are exempt from taxation – this often causes confusion. This article will discuss the filings that property owners associations, referred to in “tax lingo” as common interest realty associations (CIRAs), are required to make under Federal tax laws, and what it takes to qualify as a tax exempt nonprofit corporation. Generally speaking, very few associations will be able to qualify as tax exempt.

Bottom line for most associations...

It will be the exception rather than the rule that your association qualifies for tax exempt status.

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501(c) (7) organizations are still required to pay income tax on any interest income earned.

Common Interest Realty Associations (CIRAs) interested in qualifying for tax-exempt status under 501(c) (4) are required to go through a formal application process which includes submission of Form 1024, Application for Recognition of Exemption under Section 501(a) and an application fee that is currently \$850. Applications and fees are submitted to the IRS Exempt Section central processing facility in Covington, Kentucky. It generally takes the IRS 120 days to begin processing the application but it can take as long as two years to complete processing the application and to grant tax-exempt status to a CIRA. The end result of the application process, if approved, is the issuance of a "Determination Letter" granting tax-exempt status.

This is where it begins to get tough. In order to qualify for tax-exempt status the CIRA must meet all of the following requirements:

The CIRA must serve a "community" that bears a reasonable relationship to an area normally identified as a governmental unit. The IRS has never bothered to define "community", and there are no court cases or revenue rulings that define "community". This is difficult. The CIRA must not conduct activities directed to the exterior maintenance of any private residence. This automatically excludes residential condominium associations from qualifying for tax-exempt status. Common areas of the CIRA must be open for the use and enjoyment of the general public, another tough requirement.

There are IRS private letter rulings and revenue rulings that put a finer point on some of these definitions as they apply on a case-by-case basis, but as you can see these are tough hurdles to overcome.

As a practical example, a development that is gated, by definition, wouldn't qualify because the common areas have to be open to the general public.

There is one other consideration. The IRS decided to step up audit activities for exempt organizations in general starting in 2011. Please consider your situation carefully before filing your application for exemption.

ARE WE OR AREN'T WE?

When a board member is confused about the tax status of the CIRA it is quite understandable. The key to under-

standing the situation is to realize that the IRS and the State of Texas really serve two very different functions in the process of our discussion.

The IRS is responsible for administering one uniform set of tax laws across every state in the United States of America. The IRS has nothing to do with the legal creation of business entities, whether those entities are LLCs, LLPs, corporations or partnerships, etc. It is however, the responsibility of each individual state to pass statutes and laws that create business entities.

It just so happens in Texas, that the name of the state statute that creates a CIRA is the "Texas Nonprofit Corporation Act". Texas does not have the power or authority to confer federal tax status on any entity. Texas allows for the creation of the business entity and IRS determines how that entity is taxed.

WHAT NOW?

If after reading this article you can say for sure that your association is federally tax-exempt, then be mindful how that business is conducted in order to maintain that exemption and not jeopardize the association's tax status.

If after reading this article you can say for sure that your association is a nonprofit corporation in the "Eyes of Texas" and not federally tax-exempt as determined by the IRS, consider applying for an exemption if (and only if) your association meets the exemption criteria. Remember, it isn't just about being exempt from most income tax; it is about opening your community to all who desire to enjoy its' amenities.

Steve is a life long Austinite. He graduated from The University of Texas with a degree in accounting in 1975. He served for six years on the CAI Austin board of directors as both President and Treasurer and has been a platinum sponsor of the chapter for some time. Our CPAs are members of the American Institute of Certified Public Accountants and the Texas Society of Certified Public Accountants.

