

# DO ASSOCIATIONS HAVE TO PAY TAXES?

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## QUESTION:

I am a manager in a management company for several associations. I recently encountered a situation with a new CPA firm that we are dealing with. This CPA firm is aggressively marketing to our company, and to our associations, that we should use his firm to perform our association audits and prepare tax returns. His primary message is that generally, when he prepares tax returns, the associations do not pay any tax at all. This doesn't appear to be consistent with other information that I have received from CAI regarding association income taxes and it sounds too good to be true. Is it correct that we can legitimately avoid paying taxes?

## ANSWER:

I have heard this marketing pitch before, and have always responded that it is an extremely rare circumstance wherein the association can legitimately reduce its taxable income to zero and pay no tax.

Let's examine the reasoning behind the above comment. An individual must include interest income in his or her taxable income. That individual is allowed certain statutory deductions such as medical deductions, taxes, interest expense, etc. that may offset interest income. However, if no other deductions exist, then the only items that can be deducted directly from interest income are those expenses related to the production of the interest income. It works exactly the same way for homeowners associations, except the rules are more stringent. On Form 1120-H, the expenses must be directly connected to the production of income in order to be deductible. On Form 1120, the rules only require that the deductions must be reasonably connected to the production of interest income.

However, when you consider the requirements, it is illogical that the related expenses would ever exceed the amount of the income produced. If such were the case, you are then inviting scrutiny under a completely different set of IRS rules.

Let's look at some examples to see how these rules may be applied:

	Example 1	Example 2	Example 3
Interest Income	\$ 1,000	\$ 10,000	\$ 50,000
Related Deductions			
Investment Management (10%)*	(100)	(1,000)	(5,000)
Tax Return Preparation (actual)	(350)	(350)	(350)
Allocated Audit Fees (5%)*	(150)	(300)	(300)
State Income Taxes (actual)	(100)	(1,000)	(5,000)
Other Deductions Allocated*	(200)	(2,000)	(5,000)
Form 1120-H Deduction	(100)	(100)	(100)
Total Deductions:	<u>(1,000)</u>	<u>(4,750)</u>	<u>(15,750)</u>
Taxable Income	<u>\$ -</u>	<u>\$ 5,250</u>	<u>\$ 34,250</u>
Tax at 30%	<u>\$ -</u>	<u>\$ 1,575</u>	<u>\$ 10,275</u>

\* - per Concord Consumers Housing Cooperative Case



## *Do Associations Have To Pay Taxes? (cont'd)*

The above table illustrates what I commonly see in practice. For associations with interest income of \$1,000 or less, it is possible to bring the taxable income down to zero without being too aggressive on the deductions. But, when an association has \$10,000 or \$50,000 of interest income, you cannot legitimately get to zero taxable income. Due to the very low level of IRS audit activity, many CPA's (and I suspect, the one you are dealing with) have become complacent on these limitations on deductions and have become very aggressive on the allocation of deductions against interest income. While the CPA "advises" on this, the association is ultimately responsible for the decision as to the level of risk it is willing to assume relating to income tax deductions. The authority to make the decision can be delegated (most times to the CPA), but the responsibility cannot be delegated. When a board member signs the association tax return, he is doing so under penalty of perjury that the tax return is accurately stated.

I commonly hear of CPAs claiming deductions of management fees anywhere from 10-25% of total management fees regardless of the level of interest income. Obviously, this can be challenged on the basis of reasonableness. While it appears the Internal Revenue Service has largely ignored this area of abuse, that's not really accurate. It only appears so because the level of IRS audit activity is so low. The California Franchise Tax Board has been extremely aggressive in fighting this type of abuse. Is it logical to have a deduction of \$3,000 of allocated management fees against interest income of only \$3,000? Clearly, the answer is "NO". That is an unreasonable investment management fee to produce only \$3,000 worth of income. If the association is really incurring such high internal costs, then it would be wise to outsource its investment management function. Even the bank trust companies generally have fees of no larger than 5-6% of the total portfolio managed.

The Concord Consumers Cooperative Case (89 T.C. No. 12), a 1989 case (see the *Ledger Quarterly* Summer 1989 issue), gave us the clearest definition of what deductions were allowable against the production of interest income for a housing corporation that we have ever seen. In Concord, the courts ruled that they would accept a 5% allocation of management fees without any evidence of a correct amount that might be deductible. This was in the face of evidence of 11% of actual costs. The Court also indicated that a higher amount may be allowed if the corporation were able to

document that it was entitled to a higher deduction. The court further identified the following activities as being of activities of management companies that could be allocated against interest income.

1. Preparing financial statements
2. Making reports to the board
3. Reviewing investments
4. Making requests to withdraw money
5. Reconciling interest income
6. Checking interest rates at various banks
7. Changing banks or moving bank accounts
8. Making requests for reimbursements from reserve funds

It appears that many CPAs have interpreted the Concord case literally, by saying that 5% (or more) of management fees is always deductible. That logic fails, however, where there is little, if any, interest income. You can't logically take a deduction for investment management expenses that are greater than the income generated, since it is a passive activity. My opinion is that CPAs making such a large allocation of management fees against interest income are being far too aggressive. If the association understands that the CPA has recommended an aggressive position and agrees with it, then they have chosen to take the risks and presumably understand the risks. If the CPA has not adequately communicated to the association that a position may be aggressive, then the risk may have just shifted to the CPA.

It is also known that the IRS prefers to see Associations filing Form 1120-H, and the audit activity for Forms 1120 is almost non-existent. Most of the IRS audits that occur are for associations that file Form 1120. Even though they are rare, the two highly visible trouble spots that we are aware of in recent years are the 15 associations in San Diego seven years ago, and the 12 timeshare associations in Florida four years ago. All these associations filed Form 1120, and all were deemed by the IRS to have violated basic tax law in the preparation of the returns. The results were erroneous for all association involved. Based upon professional fees paid in an attempt to defend their positions, each association resulted in paying far more in fees than they would ever have paid in taxes had they simply filed Form 1120-H and taken reasonable deductions instead.

All of the above is a very long response to what seemed like a very straight forward question, but when



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you cut through the junk, what you've described is a potentially volatile situation in which you are correct to question the marketing positions taken by the CPA firm. The last thing that you as a manager need, is to be ensnared in messy tax audit resulting from recommending a CPA when you are already skeptical of his aggressive position. I cannot agree with an

aggressive position that would bring all associations to a zero taxable income and the resulting complete avoidance of income tax. In my opinion, that may step over the line of tax avoidance and into the realm of tax evasion.

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