Income Tax Considerations

Associations have the option of annually selecting the type of income tax return to file: (1) Form 1120-H, U.S. Income Tax Return for Homeowners Association, or (2) Form 1120, U.S. Corporation Income Tax Return.

Form 1120-H, U.S. Income Tax Return for Homeowners Association

The tax rate for Form 1120-H is 30 percent for non-exempt income, which is generally the association's interest and dividend income. This non-exempt income is offset by a small portion (approximately five percent) of the association's bookkeeping and management fees, along with the tax preparation fee and an exemption of $100. Tax is then paid on the net difference.

Advantages of Filing Form 1120-H

1. Form 1120-H is a one-page form, and it is easier to complete than form 1120.
2. Exempt function income is not taxable.
3. Associations are not subject to the alternative minimum tax on form 1120-H.

Disadvantages of Filing Form 1120-H

1. Taxable income is taxed at a 30% rate versus the regular corporate rates available when filing form 1120.
2. Associations are not entitled to net operating loss deductions.
3. Associations are not entitled to write off organizational costs.

Form 1120, U.S. Corporation Income Tax Return

The tax rate for Form 1120 ranges from 15 to 39 percent. The tax is based on the **non-membership** income net of applicable expenses paid by the association. Although Form 1120 may result in lower taxes, the following steps must be taken in order to file that form:

1. Reserve funds must be segregated from operating funds. A separate checking account should be used for all reserve expenditures.
2. The budget must clearly state that funds are being set aside for future repairs and replacements.
3. Estimated income taxes must be paid quarterly to avoid penalties and interest.
4. Assessments collected must be specified as to which portion is for operating and which portion is for future repairs and replacements.
5. Although assessments collected for future repairs and replacements are excluded from income, expenditures for these items are also excluded as deductions.

6. Using Revenue Ruling 70-604, associations may exclude from taxable income excess **membership income** by recharacterizing as follows:

   a. Apply the excess of membership income over membership expenses to the following year's assessments, or
   b. Apply the excess of membership income over membership expenses to the capital reserves of the association, or
   c. Refund the excess of membership income over membership expenses to the association's members.

NOTE: The association should complete a resolution adopting the use of these Revenue Rulings. The resolution should be made part of the association's minutes of the homeowners.

Advantages of Filing Form 1120

1. Taxable income is taxed at the regular corporate rates (15% on the first $50,000 of taxable income) versus the 30% tax rate required when filing form 1120-H.

Disadvantages of Filing Form 1120

1. Form 1120 is a longer, more complex form to complete, and the cost of preparing form 1120 may offset the tax benefits received.
2. Associations must prepare a resolution to carry over excess membership income to the next fiscal year.
3. Associations that file form 1120 have greater exposure to IRS audits.

When selecting which form to file, the association should consider the tax liability that could arise from potential audits of Form 1120. Since 1993, several associations in California have been audited by the IRS and some associations may have to pay large tax bills as a result of these audits.

Filing Form 1120-H is the most conservative method, but the IRS can not challenge and tax the exempt function income of the association. As a result, no future tax liabilities would arise from prior year tax returns.