IRS Audit Techniques Guide

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On April 28, 1999, the Jacksonville, Florida Service Center of the Internal Revenue Service (IRS) produced a draft copy of an Audit Techniques Guide (ATG) affecting the homeowners association industry. This Guide, entitled "Timeshare Vacation Plan Owners Associations," is a part of the IRS's "Market Segment Specialization Program" (MSSP), that is intended to provide guidance to IRS field auditors on how to conduct an audit on a taxpayer in a specific industry.

It has been reported by several practitioners that the IRS denies the existence of this draft Guide. Despite such denial, a copy was provided by the IRS to a Florida CPA who was active in the ARDA (American Resort Development Association) battle with the IRS over the Florida timeshare association audits several years ago. ARDA had been promised by the IRS the opportunity to comment on the guide in its development stage. It is my understanding that the draft ATG was developed with no input from either ARDA or CAI. This guide grew out of the timeshare audits conducted by the IRS in Florida several years ago. Hence, the focus on timeshare associations and development by the Jacksonville Service Center.

While specifically targeted to timeshare associations, the guide is intended to apply equally to all other forms of common interest developments. Page 1 of the Guide states "While the ATG is limited to the taxation of timeshare associations, it may also be useful to examiners in their examination of other types of owners associations; for example, condominium homeowners associations."

The guide attempts to provide some industry background, but unfortunately fails to even correctly name the organizations involved. As an example, CAI is referred to as CIRA, Common Interest Reality Associations . . . a national association, with many state chapters, of homeowners associations and other common interest reality associations. Apparently, the IRS Jacksonville Service Center is unaware of CAI (which may be a good thing, given their present posture on the industry), and doesn't realize the Common Interest Realty Associations (CIRA) is a name devised by the AICPA to identify all types of associations within the industry. The IRS might have a little more credibility in this ATG if they quoted their own statistics as to the number of associations filing tax returns annually. But, if they did that, they might realize that timeshare associations compose less than 5% of the market. They focused on one of the smallest segments of the association marketplace.

If you think you have no tax exposure, just ask yourself these questions:

1) ***Do you file Form 1120?***
2) ***Do you have reserves?***
3) ***Do you ever have excess assessments?***
4) ***Do you ever have excess member deductions?***
5) ***Do you ever have bad debts?***
6) ***Do you have prepaid assessments?***

If you answered yes to question one, I already know the answer to the other five questions. And, the answer is, you have tax audit exposure.

The ATG is divided into three sections:

1. **The General section**, chapters 1 – 3, covers information applicable to all timeshare associations, regardless of tax form filed.
2. **The Form 1120-H section**, chapter 4, addresses associations that file Form 1120-H in the year under examination.
3. **The Form 1120 section**, chapters 5 – 10, addresses associations that file Form 1120 in the year under examination.

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GENERAL SECTION

Chapter 1 -- Introduction -- This chapter provides an overview of the timeshare industry and explains and defines common terminology used in the industry.

Chapter 2 -- Industry Background -- This chapter discusses the different types of timeshare associations.

Chapter 3 -- Timeshare Vacation Plan Owners Associations -- This chapter explains the income tax filing requirements and elections, and discusses the financial peculiarities of the industry. Financial items discussed focus almost exclusively on those issues with which the IRS takes exception. These become individual chapters in the Form 1120 section of the ATG.

FORM 1120-H TAX RETURNS SECTION

Chapter 4 -- IRC Section 528 Elections (Form 1120-H) -- This chapter is only seven pages long, which is a testament to the small number of tax issues that exist when filing this form. IRC Section 528 was modified in 1997 to allow timeshare associations to qualify under that section. Congress intended to provide a safe harbor for associations by creating this section of the Internal Revenue Code, so that associations would not inadvertently be taxed on income generated for their "nonprofit" purposes. This is labeled "exempt function income. ***The safe harbor generated by Section 528 is so pervasive that, if an association qualifies to file the form, there are no significant tax issues.***

FORM 1120 TAX RETURNS SECTION

Chapter 5 -- General Audit Guidelines -- The nine pages in this chapter describe only very broad audit techniques, but they would guide even the most inexperienced tax auditor directly to any association's most vulnerable tax issues. One section of this chapter, entitled "Package Audit," advises the auditor to perform a package audit. This means they will also examine payroll tax returns (to find all of those people incorrectly classified as independent contractors and assess the association massive amounts of unpaid payroll taxes) and review Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons. Most timeshare associations have foreign (non U. S. citizens) owners. If these unit owners rent their weeks/intervals/units, such income is subject to a 30% withholding rate. If the timeshare association fails to withhold, guess who is responsible?

The real damage of chapter 5 is in two of the four exhibits, which are sample forms to be used by the tax auditor in accumulating information in performing the audit. An inexperienced auditor would not know to ask for these items, but a knowledgeable auditor would. These forms level the playing field considerably against the association. The two forms are:

- **Sample Initial Information Document request Form** – This lists 15 specific documents that the IRS auditor should use to accumulate information, all of which is designed to get the auditor to your exposure areas as quickly as possible.
- **Sample Initial Interview Questions** – This form lists 65 questions that will elicit responses that clearly identify each area of non compliance. The checklist is divided into sections forcing the auditor to focus on key audit areas. These are the areas perceived by the IRS to be the largest areas of abuse by associations, and include; prepaid assessments, reserves, excess assessments, application of IRC Section 277, and bad debts.

With chapters six through nine, the IRS really gets to the guts of the issues, by going into considerable detail to explain the issues, relevant tax law, and provide examples based on prior audit experience. Each section instructs the tax auditor exactly how to find the audit adjustments, and tax dollars, he is looking for.

Chapter 6 -- Prepaid Assessments -- The IRS takes 11 pages to explain how to audit one single line of the financial statements. In the timeshare industry, it is normal to have the annual dues billing occur 60 days before the year begins, with a delinquency date set as of the first day of the fiscal year. As a result, an association may receive as much as 50% of its member assessments for the year before the year actually begins. These are prepaid assessments. These assessments also exist in

other forms of common interest associations, but normally to a lesser degree.

The applicable tax law is found in IRC Sections 446, 451 and 456, Revenue Ruling 74-607, Revenue Procedure 71-21, the "Claim of Right Doctrine" and several court cases. Each of these items is discussed below.

IRC Section 446 provides that taxable income is to be computed under the method of accounting used by the taxpayer in computing book income unless such method does not clearly reflect income.

IRC Section 451 provides that income is to be included in the taxable year received unless, under the taxpayer's method of accounting, it is properly includible in a different period. **Treasury Regulation 1.451-1(a)** provides that under the accrual method of accounting, income is to be recorded in the year in which "all the events have occurred which fix the right to receive such income…."

IRC Section 456 provides that a qualifying membership organization may include prepaid dues in income ratably over the tax years during which the organization is required to render services. IRC Section 456 must be elected in the initial year of operations. The IRS position is that the election provisions of IRC Section 456 do not apply for an association's prepaid assessments.

Revenue Ruling 74-607 states that "all the events that fix the right to receive income occur when: (1) the required performance occurs, (2) payment therefor is due, or (3) payment therefor is made, whichever happens earliest."

Revenue Procedure 71-21 explains the procedures under which accrual basis taxpayers may defer income received in one taxable year for services to be performed in ***the next succeeding taxable year***. Section 3.02 of this Revenue Procedure provides that prepaid income may be deferred if <u>all</u> the services to be performed are performed in the succeeding tax year. Section 3.03 states that if any of the services will not be completed by the succeeding taxable year, or are to be performed at an unspecified future date, then prepaid income is to be included in taxable income in the year of receipt.

The Claim of Right Doctrine was defined by the Supreme Court in <u>North American Oil Consolidated v. Burnett</u> and stated that money is included in a taxpayer's income when the taxpayer receives it "without restrictions as to its disposition . . . even though it may still be claimed that he is not entitled to receive the money, and even though he may still be judged liable to restore its equivalent."

While it appears based upon a reading of these citations that an association would be entitled to defer any prepaid income, the IRS interprets these rulings to mean that no association would ever really qualify to defer prepaid dues. The IRS states that Revenue Procedure 71-21 does not apply to associations because:

1. <u>All</u> services are not required to be completed by the subsequent tax year just due to the possibility of excess assessments, and the inclusion of reserves (which are for a distant year) as part of the dues billing.
2. Most associations fail to comply with section 3.02 of Revenue Procedure 71-21 because they do not include in income in the succeeding taxable year the amount of income related to services not yet performed.
3. Revenue Procedure 71-21 does not clearly reflect an association's income under IRC Section 446 because the yearly prepaid assessments tend to be consistent. This creates a permanent deferral of income.
4. The limited scope of revenue Procedure 71-21 was not intended to apply to the prepaid dues of an association.
5. An association's prepaid assessments may (do) not constitute prepayments for services within the meaning given "services" in revenue Procedure 71-21.
6. Revenue Procedure71-21 cannot apply unless the association has used and complied with the Procedure consistently since its initial year.
7. For associations entering into management contracts with for-profit management companies, all services to be provided under the agreement are not provided by the association in accordance with section 3.02.

The net result of the above is that the IRS' position is that assessments are taxable in the year received, regardless of the year to which they are intended to apply.

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Chapter 7 -- Reserves -- The IRS uses 23 pages in this chapter to instruct the auditor how to see through the smoke and mirrors and find an audit adjustment. The IRS noted that, based on their experience in audit examinations performed, most associations are not consistent in their treatment of reserves. This inconsistency is what opens up the association to tax audit exposure.

The applicable tax law is found in IRC Sections 118, 263, and 461, and Revenue Rulings 74-563, 75-370, and 75-371, and several court cases.

IRC Section 118 provides for an exclusion from income of items that represent a contribution to the capital of the corporation.

IRC Section 263 governs the rules related to capital expenditures.

IRC Section 461 contains general rules for the taxable year of deductions.

Revenue Rulings 74-563, 75-370, and 75-371 are all specific rulings related to association reserves. These Rulings hold that, for the specific items listed (clearly capital expenditures), that are funded in the manner described (special assessments on members who are advised in advance of the specific capital nature of the assessment, recorded separately, deposited into separate bank accounts, and expended for the stated purpose), the assessments may be excluded from income as being additions to the capital of the corporation.

The various court cases uphold and reaffirm the principles set forth in the above citations.

The IRS' interpretation of the above citations is generally unfavorable to associations. To put this entire matter in perspective, it is important to note that the ATG states "Some timeshare associations treat each yearly addition for all reserves as special assessments. In these situations, the timeshare association's characterization of amounts as special assessments may not be consistent with the meaning given special assessments in the tax law." The author has specifically discussed this issue of the meaning of special assessments in the above cited revenue rulings with the national office of the IRS, and the authors of the rulings. The conclusion reached by the Jacksonville Service Center in writing the ATG is in direct conflict with the stated position of the national office.

The ATG discusses the inconsistent treatment afforded reserves by associations, that unfortunately, this author has also observed on too many occasions, although not as many as suggested by the IRS. The inconsistent treatment relates to the requirements for:

- Special assessments
- That are approved by a vote of the owners
- Designated for a specific capital purpose
- Retained intact in separate bank accounts, and
- Are actually spent for the approved designated capital expenditures.

The ATG states that "…few, if any, timeshare associations permanently exclude their annual owner assessments allocated to reserves from taxable income." They reach this conclusion because "…few, if any, of the [above] five requirements are met by many timeshare associations." The IRS interprets this to mean that if the associations fail to comply with the requirements consistently, then they are failing to "permanently" exclude reserve assessments from income. If they are not consistent in their treatment, then they may be alternately attempting to "permanently" exclude, or "defer" reserves from taxable income. This constitutes a change in the association's tax accounting method for reserves that will result in an IRC Section 481(a) adjustment.

The IRC Section 481 (a) adjustment is perhaps the most feared adjustment of all, because of its significant impact on taxable income. **Concisely stated, Section 481 (a) allows the IRS to add the entire reserve balance at the beginning of the earliest year under examination to taxable income, because of an unauthorized change in tax accounting method.** Think about this for a minute. If your opening reserve balance (three years ago) was $1,000,000, then that amount just got added to the taxable income of that year. Calculate tax at 34%, penalties, and interest, and you may have a tax bill roughly equal to the entire cash balance in reserves.

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Everything you read in this chapter is screaming to you to file Form 1120-H, where you simply don't have to face these issues. And, the IRS is already convinced that nobody does it right.

Chapter 8 -- Excess Assessments -- Sixteen pages are devoted to explaining that timeshare associations are not entitled to use Revenue Ruling 70-604 to defer excess income, and how to find a huge audit adjustment almost every time. An association's excess assessments represent the portion of annual owner assessments collected that remain unspent at the end of a tax year. Associations have used a variety of techniques to attempt to avoid taxation of this excess income.

Applicable tax law is found in IRC Sections 446, 451, and 461, and Revenue Ruling 70-604.

IRC Section 446 requires recognition of income in year of receipt.

IRC Section 451 does not allow the deferral of excess assessments to the following tax year. Excess income are included in taxable income in the in which the excess income occurs.

The **IRC Section 461** "all events test" dictates that an association is not entitled to claim a tax deduction for its excess assessments.

Revenue Ruling 70-604 has been held by the IRS to not be applicable to timeshare associations. In this chapter the IRS points put that timeshare associations may not make an election under Revenue Ruling 70-604 to defer the excess income to the subsequent tax year. A taxpayer may follow a revenue ruling only when its circumstances are substantially similar to the facts of the subject ruling. In this case, that means only associations who limit themselves to providing maintenance activities for common area properties. This automatically excludes timeshare associations, who by their very nature, provide much more extensive services and activities. It may also exclude certain residential full ownership associations that conduct extensive activities.

The IRS further holds that if an association has previously not included its excess assessments in income, and changes its accounting to comply with the above provisions, even if such change is mandated by an IRS audit, such action is considered to be a change in tax accounting method. This change in tax accounting method will trigger an IRC Section 481(a) adjustment.

Chapter 9 -- IRC Section 277 Deduction Limitations -- This is a relatively easy tax issue and requires only six pages from the IRS. This discussion is necessary only because many associations do not comply with the provisions of IRC Section 277. The IRS notes that many associations offset nonmember (interest) income with an excess of member expenses over member income. IRC Section 277 requires the separation of member and nonmember transactions. Member "losses" (excess of member expenses over member income) are not net operating losses under IRC Section 172. They may not be carried back, and must be carried forward to succeeding tax years, and may only be used to offset net member income of future years. There is no limitation on how long this may be carried over.

Chapter 10 -- Other Issues -- Only two pages are used to discuss several issues, but watch out here, because bad debts are discussed in this section. And, particularly in timeshare associations, this can give rise to a very significant tax adjustment. Most associations claim at least a nominal bad debt deduction. The IRS holds that a bad debt deduction is allowable only in the tax year in which the association has exercised all its legal remedies to collect unpaid assessments. Also, a bad debt deduction is only allowed for income included in gross income. Consequently, no deduction is allowed against assessment income for years that a Form 1120-H was filed, as the assessment income was not included in gross income.

Author's commentary -- The Audit Techniques Guide is successful in exploring and disclosing the most significant weaknesses of associations filing Form 1120. It probably comes into play too late for the IRS, at least for their intended purpose. Many, if not most, timeshare associations have already switched to filing Form 1120-H. For timeshare associations, the amount of tax paid is not the significant issue, protection of association assets from "the big hit" is the primary issue. The simplest way to do that is to file Form 1120-H and pay a little extra tax. I have always stated that an association shouldn't look at

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the difference between the 15% tax rate and 30% tax rate as additional taxes paid, but as an insurance premium paid to the IRS to protect you from harm. ***It's not about taxes, it's about risk management.*** When you pay the premium (the extra tax), you pretty much guarantee that either (1) you will not be audited by the IRS, or if you are, that (2) there will be no adverse tax consequences. Form 1120-H, and the underlying Code Section 528, were created specifically by congress to provide a safe harbor for associations.

The Guide can really be viewed as advice to file Form 1120-H. Even though the tax rate is higher at 32% (for timeshare associations, 30% for full-ownership associations) versus the 15% beginning rate on Form 1120, the tax rate should not even be a consideration if the association cannot meet the stringent requirements set forth above to file Form 1120. The risk is just not worth it. When most association directors are advised of the true risk of filing Form 1120, they will decide it is not a risk they are willing to take. I have had association directors ask me in the past to make the decision on which form to file for their association, but I cannot do so. I can only advise, as it is their decision as to how much risk they are willing to assume. I educate them on the risks and costs, and give my recommendation, but it is the directors' decision.

It will be interesting to see the future of association tax audits after the issuance of this Guide. I, like other association CPA tax practitioners, have had the experience of dealing with the IRS on the tax audit of an association client. Like most other practitioners, I came through the experience fairly well, with little or no tax adjustment. I can't take credit for the result, however. That credit goes to the IRS itself, for sending out field agents who have no industry knowledge or experience and don't know how to properly and efficiently conduct a tax audit of an association. When this Guide is officially issued and is available to field agents, I fear we could be looking at a completely different tax audit climate. The tax auditor, with this Guide as backup, will enter the audit with a roadmap on how to find **BIG** audit adjustments. If you think you have no tax exposure, just ask yourself these questions:

1) **Do you file Form 1120?**
2) Do you have reserves?
3) Do you ever have excess assessments?
4) Do you ever have excess member deductions?
5) Do you ever have bad debts?
6) Do you have prepaid assessments?

If you answered yes to question one, I already know the answer to the other five questions. And, the answer is, you have tax audit exposure. We are very fortunate that the IRS audits less than 1% of corporate tax returns, otherwise we might see more situations like we saw in San Diego seven years ago, or Florida five years ago, where one informed, tenacious IRS auditor caused considerable damage by going after multiple associations.

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