

THE ASSOCIATION IRS AUDIT

By Gary A. Porter, CPA

The IRS has created a draft audit manual for its agents applicable to the homeowners association industry that, when placed into service, could have far reaching consequences. Because the number of IRS audits is so few, most people within the industry are very complacent about the way we have been doing things. Some of us have even come through tax audits relatively unscathed. But, the existence of the IRS audit guide changes everything. No longer will we be dealing with uninformed tax auditors who can't even understand the industry. No longer will we be able give them a snow job to keep them away from the real issues.

So what if you are audited? How bad can it be? Well, as they say, it only takes one nuclear bomb to ruin your day.

And if a tax audit goes bad, it could hit you like a nuclear bomb. So how do we explain this? Instead of getting technical, let's get personal. Let's get real. Below is a fictional scenario that incorporates **real** issues from **real** audits that have occurred. This article puts them all together into one association so we can see how devastating a tax audit could really be.

THE IRS AUDIT

The IRS agent enters the CPA's office and thanks him for agreeing to have this closing conference regarding the audit of the 1997 and 1998 income tax returns of the ABC homeowners' association. The CPA has been cooperative in working with the IRS agent, believing that his client has fully complied with IRS regulations and tax law regarding the various areas that were questioned during the audit. Unfortunately, the IRS auditor did not keep the CPA fully apprised of the positions he developed as the audit progressed, and accumulated all of the issues for this closing conference.

CPA: Thank you Mr. Agent for coming to my office to conduct this closing conference.

IRS: You are certainly welcome, and I thank you for your cooperation during the course of the audit. As you are aware, I have performed an audit of the 1997 and 1998 income tax returns of ABC Homeowners Association.

CPA: Yes, and I know that we have provided you with all of the information you need, and that my client has done an excellent job of complying with IRS requirements, so I

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am expecting a “no change” on this audit (“no change” indicates that the CPA is expecting that there will be no adjustments to the tax returns as filed). And, I'm certainly glad you selected this client because they are the best example of any association client I have as to how to do things properly.

IRS: Well, I hear your point of view, but the fact is I do have several proposed adjustments as a result of my audit.

CPA: I don't understand. You never told me about any proposed adjustments. On what return?

IRS: Let's take the 1997 income tax return first. You filed that on Form 1120 as a nonexempt membership organization and claimed a rollover of \$40,000 of excess membership income (operating funds) from 1997 to 1998 under the provisions of revenue Ruling 70-604. I'm going to disallow that rollover because the association failed to make an election that was approved by the members.

CPA: But, the board of directors approved it and they are the people who are authorized by state law to act on behalf of the Association. They are the agents for the members.

IRS: Sorry, but I'm not concerned state law. I'm concerned about Revenue Ruling 70-604, and that Revenue Ruling clearly states that the election requires member approval. Board of director approval doesn't meet the requirements of the Ruling.

CPA: That's not acceptable. Every year I advise the association



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- that they should make an election under Revenue Ruling 70-604, and every year the board of directors does it.
- IRS:** Well, where is it? I've reviewed the minutes and nowhere is it documented that the board of directors approved it. And even if they did, that still doesn't address the issue that the ruling states that the members must make the election. I read the minutes of the annual membership meeting, and this election was not addressed in the annual membership meeting in any way. I'm sorry, but I'm making an adjustment to taxable income of \$40,000 because any excess membership income is taxable in addition to the taxable interest income that you reflected on the income tax return.
- CPA:** We need to discuss this further, but for right now let's set this aside. I believe you said that you have several adjustments?
- IRS:** Yes, let me come to the second item here. You indicated on Schedule M-1 of the tax return, the reconciliation from book income to taxable income that you had excluded \$200,000 of member assessments from income as capital contributions under IRC Section 118. I must disallow this because there is no evidence that these are capital contributions. For instance, you didn't place this money into separate bank accounts, and you don't have any reserve study to back this up.
- CPA:** Those are capital contributions under Internal Revenue Code Section 118, and Code Section 118 says nothing about either a reserve study or separate cash accounts.
- IRS:** You're right that Code Section 118 does not require either of those items, but it does require a specific capital purpose. You need a reserve study to prove your specific capital purpose. And various Revenue Rulings and court cases require the separate bank accounts.
- CPA:** We do have a specific capital purpose. It can be supported by expenditures. Just look at how we spent the money.
- IRS:** How you spent the money is important. But, if the money is not first earmarked for a specific capital purpose, it cannot qualify as a capital contribution. And, we also have several Revenue Rulings, 74-563, 75-370, and 75-371 which are specific to homeowners associations, that give examples of items that are capital contributions and items that are not. It is also important to note that these three Revenue Rulings all require that the money be placed in a separate bank account. In addition, there are several court cases that also back this up.
- CPA:** Maybe we don't have the money in separate bank accounts, but we do segregate the money on the financial statements. There is no requirement that we can see, regardless of what those Revenue Rulings say, for separate bank accounts. Show it to me in the Code. We have accounted for the money separately and that should be a sufficient accounting to show that we intended the money to be a capital contribution.
- IRS:** Sorry, but I must make an adjustment for \$200,000 because you failed to put the money into separate bank accounts and have a reserve study, both of which are clearly required for money that is intended to be a capital contribution. Further, I noticed that according to your budget, \$50,000 of the amount that you were excluding on Schedule M-1 as capital contributions were your annual painting reserve assessment. Revenue Ruling 75-370 clearly states that painting is a noncapital item.
- CPA:** Painting is a capital item. It's a major expenditure and it only happens once every five or six years. We spend \$250,000 on that. Something that big has to be a capital expenditure. How could you call it anything else?
- IRS:** "Capital" is determined by the nature of activity. Painting is simply a non-annual maintenance expense. It is not a capital item. So even if I were to allow the rest of the reserves set-aside as capital, the \$50,000 portion that represents your annual painting reserve contribution would still be considered member income on Form 1120. And, even if you had separate bank accounts, commingling painting (noncapital) money with roofing (capital) money would taint the nature of the "capital" funds.
- IRS:** The Association's financial statements indicate that you have an expense for reserve expenses, but does not identify what they are. As I was out here during the audit and questioned you on these, it turns out the \$60,000 identified as reserve expenses were monies expended to replace roofing on a portion of the condominium units. These are capital expenditures and are not deductible on a tax return. And you didn't make a Schedule M-1 adjustment to pull these expenses out of deductions. Therefore, you treated them as a membership deduction on the tax return, and they are not an allowable deduction.
- CPA:** It was money expended by the Association for member services. As you can tell, I always deduct the total expenses of the association. I simply condense this to a single line item called member services expenses, except for those few expenditures that were related to and



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allocated against interest income.

IRS: But you can't deduct capital items. It doesn't matter whether they were member expenses or nonmember expenses. Under Code Section 262, capital expenditures are never deductible. Therefore, I have a \$60,000 adjustment here.

CPA: (Starting to get very agitated) Your attitude on this is totally unacceptable.

IRS: I'm sorry, but I'm just following the law, and the total adjustments I have for 1997 are approximately \$300,000, which will translate into approximately \$100,000 in income taxes. Of course, in addition to this additional tax, you will owe interest on the underpayment, plus a negligence penalty which will increase the total owed to approximately \$140,000.

CPA: We were not negligent. We were using accepted tax and accounting principles. There just happens to be very little guidance available for homeowners' associations.

IRS: There are plenty of rulings that deal with Code Section 277 organizations. You keep using the term "homeowners' association." But a homeowners association is an organization that files Form 1120-H. You filed Form 1120, and therefore the concept of homeowners association simply does not exist for you at this point. You are a nonexempt membership organization and rules applicable to those organizations apply to you when you file Form 1120. I admit that the rules are rather obscure and you have to go to a lot of places to get them, but the guidance is available. The fact that you didn't dig for it may mean that we can also assess a negligence penalty against you as the tax preparer in addition to the negligence penalty being applied against the association in this matter.

CPA: This is totally unacceptable and your attitude is very belligerent. I demand to talk to your supervisor about this.

IRS: That's within your right, but I have already discussed this matter with my supervisor, and he concurs with my findings. Let me finish going through this presentation and if you still want to discuss this with my supervisor when we're finished, I'll give you his name and telephone number and you can give him a call. The last adjustment that I want to discuss with you relating to 1997 relates to the Code Section 481 accounting method issue.

CPA: Say what?

IRS: Code Section 481 governs unacceptable accounting methods. Based on your method of accounting for reserves and capital contributions, meaning improperly excluding those items as income and improperly claiming deductions, you have used an inappropriate accounting method. Under Code Section 481, what that means is that I go back to the earliest year open under the statute. In this case, it's 1996. The Association's opening reserve balance in 1996 of \$1,000,000 is also a potential adjustment. I looked at your ten years prior tax returns for which Form 1120 had been filed. In all of those years you used an improper method of accounting for reserves. You alternated between deducting the contribution to reserves and directly deducting reserve expenditures. You invaded the reserves to borrow money for the operating fund when it ran short. You failed to make reserve contributions when money was tight. Therefore, I am proposing a \$1,000,000 adjustment under Code Section 481 for use of an improper accounting method. This results in approximately \$340,000 in tax plus interest and negligence penalty of approximately \$120,000, raising your total tax bill to approximately \$600,000.

CPA: But this is insane. The association now has only \$300,000 in cash due to that major street resurfacing project we just finished, and you've just told me that you're proposing a tax bill of \$600,000.

IRS: I understand the situation you're in, but this is just proper application of tax law to the facts that apply in this case.

CPA: We're just going to take this to tax court then. We can't accept this.

IRS: That's fine. I understand, but I estimate that your litigation costs on this will exceed \$150,000. We believe, based on prior rulings and case law, that the courts are going to hold in favor of the IRS on the positions that I have set forth here.

CPA: You're leaving me no choice in this matter. A \$480,000 tax bill is completely unacceptable and unreasonable. This is never what congress intended.

IRS: Whether it was intended or not, it is what tax law provides for. I would also like to go over the 1998 tax return with you.

CPA: (Now not only agitated, but full of sarcasm) Oh, I just can't wait.



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IRS: I can start off by saying that the Association made all of the same accounting mistakes in 1998 that they made in 1997. But, since the association filed Form 1120-H in 1998, I have no adjustments. You met the 60% test, the 90% test, and the residential test, and you paid taxes on the interest income. You paid approximately \$6,000 in tax, which was just about double the \$3,000 tax paid on the 1997 income tax return on the same amount of interest income.

CPA: I guess that you're telling me is the additional \$3,000 in tax that the association paid was considerably cheaper in the long run.

IRS: Yes! Obviously, there are considerable risks in filing Form 1120. Form 1120-H was a tax form specifically designed for associations. You should have taken advantage of it.

CPA: I'll discuss this with my client and consider whether we wish to discuss this with your supervisor, and I'm sure we'll engage a tax attorney at this point. Goodbye.

IRS: Goodbye.

CONCLUSION

While the above fictional discussion never occurred, it could occur at any time. **It could happen to you.** The positions taken by the IRS agent are real. And unfortunately, the responses by the CPA are very likely to be just as real. The importance in complying in every single regard with the IRS regulations is critical to your tax defense. Your tax defense does not start when the IRS audit starts.

Your tax defense starts when you do your accounting, a full year before the tax return is ever filed. If the association's accounting policies, practices, and procedures are not in complete compliance with IRS requirements, they should not file Form 1120.

The unfortunate ones are those associations that cannot qualify to file Form 1120-H. These are primarily associations that conduct considerable recreational or business activities for which the expenditures do not meet the 90% test requirements of Code Section 528 on Form 1120-H. A recent survey of associations indicates that as many as 15% of homeowners associations nationwide will not qualify to file Form 1120-H.

The purpose of this article is not scare anyone, but to point out the importance of complying with both the letter and intent of tax law - not what you want it to mean, but what it says. No person (or association) should pay more tax than they are legally obligated to pay. However, the tax law for associations is very complex, and the majority of IRS audits in the last several years have indicated that the IRS has taken exactly the positions set forth above. With the addition of the draft IRS "Audit Techniques Guide" the risk is even higher in the future. The author is not an advocate of blindly filing Form 1120-H. However, I am an advocate for protecting the interests of the association whenever they have not fully complied with the stringent accounting requirements for Form 1120. In most cases, that means I recommend that Form 1120-H be filed, because it is extremely difficult to meet all of the requirements for safely filing Form 1120. I also find that when the association's board fully understands the risk of filing Form 1120, most will opt for Form 1120-H. When an association directs me to file Form 1120 after I have explained the risks to them and recommended filing Form 1120-H, I require that the board sign an authorization for me to prepare Form 1120 stating that they understand the risks and have consciously made the decision to file Form 1120. The association is the taxpayer, and only they should make the decision as to which form to file. However, it must be an informed decision, most often based on the recommendation of their CPA. My advice to the association is a conservative position. If the association wants to assume an aggressive tax position, they must bear the risk of that decision.

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