

Income and Sales tax – The Road Around (or Through) the Code

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An Overview of Tonight's Webinar

- Federal Taxes
- State Taxes
- Sales & Use Tax
- Capital Improvements
- Energy credits
- 1099 reporting



Federal Taxes - An Overview

- In general, all CIRAs taxed as corporations
- This webinar will just cover federal taxes for condominiums and homeowner associations
- Tax laws governing cooperatives are much more complex than what we can cover tonight



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CIRA—stands for Common Interest Realty Association which encompasses condominiums, homeowner associations, Cooperatives, time share

Coops file a form 1120-C under subchapter T in the Internal Revenue code

Federal Taxes - An Overview

- CIRAs for the most part are not tax exempt, (qualifying for 501c status)



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CIRAs for the most part are not tax exempt, (qualifying for 501c status) and therefore cannot file Form 990

To qualify for tax exempt status, must serve community—IRS deems that associations generally do not qualify for tax exempt status as they serve their members NOT the community at large

Federal Taxes- Some Background

- Originally, all CIRAs had to file as a regular corporation.
- Section 277 of the Internal Revenue Code was added to require segregation of membership vs. non-membership income.
 - To prevent offsetting membership loss against taxable non-membership income



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Originally, all CIRAs had to file as a regular corporation

-taxed on excess, if any, of income over expenses

Section 277 of the Internal Revenue Code was added in 1969 to require segregation of membership vs. non membership income.

This was done to prevent offsetting membership loss against taxable non-membership income

Federal Taxes - Some Background

- In 1976, IRC section 528 was added to provide CIRAs with two benefits
 - Simple method of filing
 - Income considered as “exempt function” not be taxed
- Intent of Congress that the CIRA receive no benefit or suffer no penalty as compared to individual homeowners
 - Build reserves with no tax consequence
 - Rate similar to individual homeowners



Federal Taxes - Summary of Options

- File as regular corporation under Section 277
 - Form 1120
 - Standard federal form for corporations
- File as a condominium/homeowner association under Section 528
 - Form 1120H
 - Specifically for condominiums and homeowner associations
- Election made at the time of filing—
based on the return filed



Form 1120

- Divide all sources of revenue as either membership or non-membership



Form 1120 - Membership income

- Membership income is monies received from Association members
 - Assessments
 - Late Fees
 - Membership Fees
 - Clubhouse rental income
- Excess Membership income over expenses must be deferred to subsequent years so not subject to taxation



Form 1120 - Non-Membership Income

- Non-membership income is monies received from nonmember sources
 - Interest income from banks
 - Rental income on an association owned unit
 - Antenna rental income
- Taxed on excess of non-membership income over related expenses
- Non-membership income cannot be deferred to the next year



General Guidelines - 1120

- IRC Section 277
- Excess membership income must be deferred to be used in future operating periods
 - Approve a surplus resolution to defer membership income to be used in next year



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1120

General guidelines under IRC Section 277

In order to not be taxed on excess membership income, must defer to future years.

- Prepare a surplus resolution to defer membership to be used in next year
 - Document
 - Approve

If not deferred, excess membership income may be subject to tax

General Guidelines - 1120 (cont.)

- Guidelines to follow to exclude replacement fund contributions from membership income
 - Contributions to replacement fund must be communicated to unit owners
 - Contributions should be based on a plan
 - Cash in replacement funds should be segregated from that of operating funds, and accounts labeled as such
 - Expenditures of replacement funds should only be used for repair and replacement of common property



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1120

General guidelines under IRC Section 277

Exclude replacement contributions from membership income

- Contributions to replacement fund must be communicated to unitowners
 - *Done via the budget process*
- Contributions should be based on a plan
 - *Based on valid engineering study*
- Cash in replacement funds should be segregated from that of operating funds, and accounts labeled as such
 - *Have banks/investment company specifically label account*
- Expenditures of replacement funds should only be used for repair and replacement of common property.
 - *Don't use funds to pay for operating expenses*

General Guidelines - 1120 (cont.)

- May carryforward excess membership deductions for use in future years



1120 H

- Divide all sources of revenue as either exempt function income or non-exempt function income



Only taxed on non exempt function income

1120 H - Exempt Function Income

- Exempt function income:
 - from unit owners
 - amounts must be solely as a result of membership in the association and assessed ratably to all unit owners
 - Must be for qualified purposes
 - Must meet gross income test



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Exempt function—must meet four tests

- **Source**—must be received from owners of units
- **Nature**—amounts must be paid solely as a result of membership in the association, and assessed ratably. Fees paid for services and per use admission fees are not considered exempt function income
- **Purpose**—amounts must be for qualified purposes
- **Gross income**—excludes from exempt function any amounts that the tax rules exclude from gross income (tax exempt interest, excess assessments applied to future years, capital contributions)

1120 H – Non-exempt Function Income

- Non exempt function income-results primarily from 3 sources
 - Revenue from non association property
 - Revenue from non members for use of association property
 - Amounts charged to association members for specific services. (fees not assessed ratably to all members)



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Non exempt function income-results primarily from 3 sources

- Revenue from non association property-- Investment income earned on cash accounts

- Revenue from non members for use of association property

- Amounts charged to association members for specific services. (fees not assessed ratably to all members, laundry income, clubhouse rental income, pool income)

General Guidelines-1120H

- IRC section 528
- Must pass the following tests:
 - Substantially residential test.
 - 60% gross income test
 - 90% of its expenditures are qualifying expenditures
 - Lack of private benefit.
- Cannot carryforward net exempt function loss



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Tests defined:

1. Substantially residential test. 85% of square footage of all units must be used for residential purposes (condominium assoc.) or 85% of the lots must be zoned for residential purposes
2. 60% gross income test—60% of association's gross income must consist of exempt function income, received from owners in their capacity as association members
3. 90% of its expenditures are qualifying expenditures. Can be either current operating expenditures or capital expenditures made for the maintenance and care of the association property
4. Lack of private benefit test—homeowners can not receive distributions of earnings of the association

Note: if utilities for units are submetered, then cannot file 1120H, as revenue and expenses would not be considered as exempt function in terms of meeting the 60 and 90 percent tests

Federal Taxes - Expenses

- Can allocate expenses that are generated in the production of income



Federal Taxes – Tax Rates

- Using 1120 then follow regular corporate tax rates starting at 15% and increasing when taxable income reaches levels of \$50,000, \$75,000, \$100,000, \$335,000 and \$10,000,000
- Using 1120H, then use a standard deduction of \$100 and then taxed at rate of 30% regardless of the amount of taxable income



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Using 1120 then follow regular corporate tax rates starting at 15% and increasing up to 39% when taxable income reaches levels of \$50,000 , \$75,000, \$100,000 , \$335,000 and \$10,000,000.

Using 1120H, then use a standard deduction of \$100 and then taxed at rate of 30% regardless of the amount of taxable income

At about \$186,000, the straight 30% rate results in a lower tax liability

What to File?

Reasons for deciding which to file

- Lowest tax
- High surplus carryover from year to year
- Not following guidelines to exclude replacement funding from membership income.



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Based on the existing tax rates, usually the 1120 will give the lowest tax. But you cannot look at this in a vacuum

1. High accumulated surplus, not meeting the requirements of deferring revenues for one year. And therefore membership income could be taxed. Better to file 1120H. No surplus carryover concerns in 1120H and so can file.
2. Not meeting guidelines to exclude replacement funding from membership income, better to file 1120H
3. High amounts of income that are not assessed ratably, better to file 1120.

Special Areas

- Tax exempt interest
- Capital losses
- Offsetting of non-membership gains/losses in different activities



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Tax exempt interest --is not considered taxable under either filing

Capital Loss-- A CIRA may also have a capital loss. That is more common now that many associations are investing in U.S. Treasury Notes and other investment vehicles to obtain a higher yield than on certificates of deposit. Gains on investment sales are capital gains and are fully taxable. Losses on investment sales, however, are considered capital losses and may only be offset against capital gains. They are not deductible. Capital losses may be carried back three years and carried forward five years.

Offsetting of gains/losses--After segregating both income and expenses into membership and non-membership categories, CIRAs will arrive at net membership income or loss and net non-membership income or loss. In determining net non-membership income, income and losses from all non-membership activities may be aggregated. Thus, interest income may be offset by losses from other non-membership activities, provided that the non-membership activities are profit motivated

Federal Tax Payments

- Federal tax payments must be made either using Electronic Funds Transfer System (EFTPS) or using Form 8109, Federal Tax Deposit Coupon
- IRS in process of changing these rules and many banks are no longer accepting Form 8109
- CIRAs should register online at www.eftps.com



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- Federal tax payments must be made either using Electronic Funds Transfer System (EFTPS) or using Form 8109, Federal Tax Deposit Coupon
- IRS strongly prefers EFTPS
- Many CIRAs used Form 8109 due to small amount of tax due
- Processed at CIRAs bank and direct debit from account to IRS
- IRS in process of changing these rules and many banks are no longer accepting Form 8109
- Possible penalties for paying tax using paper check.
- IRS has not released new rules surrounding tax payments
- CIRAs should register online at www.eftps.com and sign up
- Advance registration is required

New Jersey State Taxes

- Condominium and homeowners associations are incorporated under Title 15A of the New Jersey Statutes and therefore are not liable for New Jersey corporation business income tax
 - No returns to file and no tax to pay
- Cooperatives must file a NJ state return
 - At a minimum will be NJ minimum tax based on gross receipts



Sales Tax

In NJ, tax of 7% on:

- All sales of tangible property, unless exception applies
- Certain specifically stated services
- Responsibility of seller to collect sales tax and remit to state



Use Tax

- Mirror image of sales tax
- Same transactions subject to tax
- If seller fails to collect (or is not required to collect) sales tax, responsibility shifts to buyer to pay use tax



Sales Tax Areas for CIRAs

- Health and Sports Club Membership Fees
- Storage Units
- Parking



Health and Sports Club Membership Fees

- Subject to tax if not part of monthly maintenance fee
- In other words, if membership is optional, amount is subject to tax
- Exception: if member must pay to use facility on a per use basis



Exception: Season Passes

- A business may sell season passes which entitle the purchaser to a reduced rate, but not to any right, privilege or entitlement not also available to the general public. The charge for the season pass is not a membership fee, since it merely allows a discounted rate which the general public is also entitled to. The only advantage of a season pass is economic. (From NJ Division of Taxation web site)



Exception: Season Passes *(cont.)*

- Most common with golf courses.
- Must keep above definition in mind when marketing these arrangements



Parking

- General rule is that fees for residential parking are exempt
- Unclear aspects:
 - Guest parking fees paid for by the guest
 - Valet parking service fees



Storage Units

- Controversial area
- Law states that income from rental of storage units are taxable if vendor is engaged in the business of furnishing space for storage
- Reasonable position that CIRAs are not "in the business of" renting storage units
- However, we are aware of at least one situation where State has held income from storage units is taxable



In-Unit Repairs

- Unless service is included in monthly maintenance fee (same for all unit owners), CIRA must charge sales tax just like any other contractor
- When parts are acquired from vendor, CIRA should pay sales tax
- When services are performed, CIRA should separately state parts and labor



In-Unit Repairs *(cont.)*

- Charge sales tax on labor only
- If parts are not separately stated, charge sales tax on entire invoice



NJ Urban Enterprise Zone

- Designed to encourage economic growth in select areas
- Reduced sales tax in UEZ to 3.5%
- Other tax benefits
- Strict rules to get benefits (i.e. purchases must be done face to face)



NJ Urban Enterprise Zone *(cont.)*

- Select UEZs
 - Jersey City
 - Newark
 - Guttenberg
 - West New York
 - North Bergen
 - New Brunswick
 - Long Branch
 - Asbury Park



Use Tax Concerns

- Out of State Purchases
- Repairs
- Installation
- Maintenance
- Landscaping
- Capital Improvements



Repairs, Installations, Maintenance and Landscaping

- Amounts paid for these services are subject to sales tax
- If parts are separately stated on invoice, tax only on labor
- If parts not separately stated, entire invoice is subject to tax
- Frequent area of non compliance by vendors
- Creates use tax liability for CIRAs



Capital Improvements

- Defined as: "an installation of tangible personal property which increases the capital value or useful life of the real property (land or buildings). The item(s) installed must be permanently attached to the real property"
- Subjective determination. Frequent area of disagreement between NJ Division of Taxation and taxpayers



Capital Improvements *(cont.)*

- If contract constitutes a capital improvement, CIRA pays no sales tax on contract
- Exceptions to general rule: flooring and installed security systems
- CIRA must issue ST-8 to contractor



Filing Requirements

- Sales tax returns filed online either monthly or quarterly based on tax due.
- If tax due for month is greater than \$500, filing must be done monthly
- If tax due for month is \$500 or less, filing must be done quarterly
- If no sales tax is due and average use tax for the last 3 years is less than \$2,000, file Form 18B, Annual Use Tax Filing. (paper form)



Best Practices for CIRAs

- Ensure that either all invoices have sales tax charged or document why no sales tax is charged. Pay use tax if required
- If required, file sales tax returns as required. Done online through NJ Division of Taxation
- If no sales or use tax, still file Form ST-18B, Annual Business Use Tax Return



Best Practices for CIRAs *(cont.)*

- Filing this Form starts the statute of limitations. Prevents State of NJ from going back 7 years or longer during audit. Generally limits audit period to 3 years
- For capital improvements, consider carefully nature of project to ensure capital improvement treatment is reasonable



Best Practices for CIRAs *(cont.)*

- Consider keeping use tax funds in reserve if treatment is not clear cut or write to State of NJ and seek written guidance
- Keep all ST-8s issued on file to support capital improvement treatment. Keep other evidence of project (blueprints, permits, etc)



Energy Tax Credits

- Complex and unsettled area as it relates to CIRAs
- Credit is based on % of amount spent for qualifying investments (i.e. solar)
- Tax code says that \$ spend by CIRA is treated as if the residents paid for their respective share. Reference to "dwelling units" in law
- Therefore, credit goes to residents, not CIRA



Energy Tax Credits - Unsettled Questions

- If CIRA puts solar panel to power clubhouse, does the credit "passed out" to the residents since individual dwelling units are not involved?
- Most private business taxpayers are eligible to get cash grant from Treasury Department rather than tax credit. Makes financing decision much easier



Energy Tax Credits - Unsettled Questions

- Unclear if CIRAs are entitled to get cash grant
- Appears to be no way to get binding ruling from Treasury in advance if grant will be issued



Form 1099 Reporting

- CIRA must issue Form 1099 for all non-corporate recipients who received \$600 or more for services
- No 1099 required if payee is “Inc.” or “Corp.”
- Issue Form 1099 for payments to an individual or to an LLC



Form 1099 Reporting *(cont.)*

- Exception: always issue Form 1099 to attorney or law firm, even if incorporated
- Forms must be sent to recipient by January 31st. Due to IRS by February
- Significant expansion in 2012



Questions?

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