

Does an HOA need to have a separate Bank Account for Reserve Funds?

After the June 2022 MLCA workshop on Reserves, Bob Curtis (CPA and discussion leader at the workshop) received a follow-up question from a Board Member of one of our member Homeowner Associations.

From Bob Curtis: *I received a request from a member HOA to help them find support to show that a separate Bank account is needed for an HOA to maintain their reserve funds. The issue is: Does an HOA need to have a separate Bank Account to maintain their Reserve Funds? The answer, which was discussed at the workshop, is YES. The documentation supporting this answer is detailed below.*

The requirement for a separate bank account is based on a combination of IRS Requirements, such as: Rev. Rul. 74-563; 75-370; 75-371 and the case law that was the basis for such rulings. The requirements apply whether the Association generally files a Form 1120, Form 1120-H, or Form 990, for its annual income tax return.

The following are excerpts from various communications discussing the requirement for a separate bank account. Keep in mind, separate accounting is also required as supported by the American Institute of Certified Public Accountants (AICPA) and their separate pronouncements.

This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction.

See below.

Tax Issues for Reserves – 1120 vs 1120H

- If you File a Federal Form 1120 – Managing the Reserve Fund is CRITICAL to keeping the reserve contributions non-taxable:
 - The purpose of the reserve assessment must be capital in nature. (IRC Section 263; Chicago Board of Trade, Maryland Country Club; Revenue Rulings 74-563, 75-370, and 75-371)
 - Members or unit owner-stockholders must have advance notice as to the intent of the purpose of the contribution. (Gibbons, Maryland Country Club; GCM 35929; Revenue Rulings 75-370 and 75-371)
 - The money contributed must be accounted for as a capital contribution. (IRC Section 118, Chicago Board of Trade, GCM 35929)
 - The money must be held for that purpose and for no other purpose. (Chicago Board of Trade, Maryland Country Club)
 - □ The money must be held in separate bank accounts from the operating (noncapital) monies of the CIRA. (Revenue Rulings 74-563, 75-370, and 75-371)
 - The money must be actually expended for the intended purpose. (United Grocers)
 - The money must increase the capital account of the member or unit owner-stockholder. (Chicago Board of Trade, GCM 35929)

ARE HOA RESERVE FUNDS TAXABLE?

The IRS generally does not consider reserve funds to be taxable income. But, if you don't keep your reserves in a separate bank account from your operating fund, then it may be subject to taxation. Bank interest, though, is considered interest income, which is taxable.

What's the Difference Between HOA Reserve Fund Accounting and an Operating Fund?

HOAs also maintain an operating fund, which is used to pay for day-to-day expenses. When a resident pays their monthly HOA fee, a portion of it goes to the operating fund, while another portion (probably smaller) should go to the reserve fund.

Operating and reserve funds are kept in two separate accounts.

5) Money must be **HELD IN SEPARATE BANK ACCOUNTS** from the operating (noncapital) bank accounts of the association. The IRS interpretation of this is that (as an example) roofing and paving funds, considered capital in nature, cannot be held in the same bank account as painting monies. Why? Painting is considered non-capital in nature. Combining painting or contingency reserves with your capital reserves jeopardizes the entire capital contribution. This is probably the most critical item in your reserve planning. If you do not have these separate bank accounts, you should probably not be filing Form 1120, as your tax risk is too high. This issue has been raised on virtually every IRS audit on Form 1120 on which I have consulted.

What this means is that most associations must maintain three different bank accounts – one for operating funds, one for capital reserve items, and one for noncapital reserve items. Virtually no one is doing this. This deficiency *could* potentially be overcome in an IRS audit if you have adequate accounting, but there is no guarantee. This is one of those situations where, although it is a pain to comply, it is still easy to comply, and why have to fight the IRS over an issue that is so easy to comply with.

This is an excerpt from an article by Gary Porter. Gary is a CPA, RS, PRA. He is the author of PPC's "Guide to Homeowners Associations" and "Homeowners Association Tax Library." These are the principal guides used by CPAs within the industry. He is also the author of "The Reserve Study Manual" and a past president of CAI (Community Associations Institute). MLCA is a member of CAI.