Taxing Issues

Clubs Need to Know Their Responsibilities

by Amy Crane

When Kevin Bray became the Lucre Society Investment Club's first tax partner, he had no idea that his club would soon be facing a conflict with the Internal Revenue Service (IRS). Taxes seemed a routine matter for this club of 14 partners that was slowly building a portfolio and learning about investing.

Then he received a letter from the IRS demanding that the club's partners pay a $6,500 penalty for not filing a club tax return for the years 1997 and 1998. "We were ignorant during our first two years and believed that we didn't have to file," Bray says. "When we filed for 1997 and 1998 along with our 1999 return we were concerned about the possibility of a penalty, but hoped that we wouldn't have to pay one. We were devastated to see the full penalty."

The Minneapolis, Minn. club was founded in 1997 and had no income at all its first year. In 1998 the club netted a total of $60 in interest and dividends. At that point the partners believed that since the total income was less than $10 a person, they didn't have to file a tax return. When the partners filled out the tax return for 1999, they realized they had made a mistake in not filing earlier and filed late returns for 1997 and 1998. That was when they heard from the IRS.

Fortunately for the club, this story has a happy ending. "I wrote the IRS a letter explaining that we were a small club of 14 that was not generating substantial dividend and interest income and that the penalty was very harsh. I think it also helped that we were truthful," Bray says. Before writing to the IRS, he turned to the NAIC Web Site and the NAIC investing e-mail discussion list, the I-Club-List, for help. The IRS agreed with Bray's reasoning and waived the penalty.

The Lucre Society's experience demonstrates how important it is for investment clubs to file a tax return each year. While in many cases the IRS is willing to waive club penalties for late filing or not filing, this experience is one that many clubs would be happy to avoid.

Club Filing Requirements

According to IRS regulations, investment clubs formed as partnerships are required to file a federal partnership tax return, Form 1065. Clubs are also obligated to provide individual partners with K-1 forms. The K-1s are submitted with the club's tax return. Club partners include the data from the K-1 on their individual tax returns.

The NAIC Web Site (www.better-investing.org/clubs.irs.html) provides links to the IRS Web site, where club partners and treasurers can download IRS Publication #541, which covers regulations governing partnerships, and Publication #550, which deals with investment income and expenses. Treasurers can download tax forms from links on the NAIC Web Site. Several of the club accounting software packages also provide tax forms, making it easy to satisfy the filing requirements.

State regulations vary. In some states there are no requirements that a club file taxes, while other states do require filing. The NAIC Web Site has a list of filing requirements for each state at www.better-investing.org/clubs/tax99_states.html.

File on Time

Treasurers must ensure that the tax form is filed on or before April 15. While there is no requirement that the tax return be submitted earlier than April 15, it is a good idea to make sure it arrives at IRS offices by April 15, says Evonne Hurst, a director with the NAIC chapter in Milwaukee.

Club partners also need to receive their K-1 forms well in advance of the April 15 deadline so that they have ample time to prepare their personal tax returns. Herb Barnett, a member of the NAIC Computer Group Board of Directors, believes the treasurer should distribute the K-1 forms by the end of February or the beginning of March.

"A partnership legally has until April 15 to provide the club partners with their K-1 forms, but it's not appropriate for a club treasurer to take that long," he says. "With the club accounting and tax printer software available for clubs, doing the year-end distribution and preparing the tax return is a simple matter that takes very little time."

New Clubs

New clubs may be wondering when they should file a return, since many clubs don't have any income or dividends to report in their first year. "All new clubs should file in their very first year of existence," says Hurst, who is also a director of the National Investors Association. "Once you have a federal ID number, the IRS will come after you if you don't file. They have no idea what you are investing in, or if you have any income to report."

Rip West, an NAIC member and accountant, agrees. "With the tax software available on the market, preparing tax returns is a very simple affair," he says. "It just makes no sense to take a chance on being assessed a penalty for nonfiling. If the club has no income or expenses and has not yet obtained any tax preparation software, it still makes no sense not to file — the form for a club with no income or expenses is very simple to prepare by hand."

The IRS learns of a club's existence when a new club files for an Employer Identification Number. This number is needed so that a club can open bank, brokerage or dividend reinvestment accounts. The IRS issues this Employer Identification Number to any entity that will be receiving taxable income, according to the NAIC Web Site.

Filing Exceptions

In the past, NAIC recommended that clubs file an election that would make filing an annual partnership return unnecessary. Several years ago NAIC changed its recommendation and now advises that all clubs file a partnership return each year.

West believes all clubs should file an annual return, even those that initially made this election years ago. "The IRS has said in some private letters that this election was never meant for investment clubs," he says. "It is a complicated subject, but there are dangers for clubs that are still operating under that election. I recommend that they start filing immediately."

If the IRS Comes Calling

If your club has filed late or neglected to file a return, you may very well come to the attention of the IRS, as the Lucre Society did. So what should you do if you receive a letter from the IRS assessing penalties?

"Don't ignore it!" Barnett says. "Since the club itself normally pays no taxes, it should be possible to just demonstrate that all members received the information necessary to complete their personal tax returns. If the IRS isn't willing to cancel the penalty, follow the IRS appeal procedure and get in touch with NAIC as promptly as possible."

Shirley Knudsen, a member of the regional board of advisers for the Southeast Florida NAIC Chapter, agrees with Barnett. "Never ignore an IRS notice," she says. "They do not like being ignored, and it could make the situation worse."

Jerry Dressel, a former NAIC CompuServe Forum sysop and an experienced club treasurer, notes that "the penalty for failing to file or filing late is quite severe." Penalties are $50 for each partner for each month up to five months that the club files late or doesn't file at all.

Appealing a Penalty

All the club tax experts recommend that any club receiving a penalty notice not pay the penalty immediately, but first try to work the situation out with the IRS. "The first inclination of clubs receiving such a notice is to panic," says West. "This panic often leads the club to send off a check immediately for the entire amount of the penalty assessment. In my opinion, that is exactly the wrong approach to take.

"The first step should be to attempt to talk to a real human being," West continues. "This should be done by phone. Any mail will probably be answered by an unfeeling computer."

Dressel agrees with West and Barnett that any club contacted by the IRS should get in touch with the IRS as soon as possible. "Assuming that the club properly allocated its taxable items to its partners and that each of those partners properly reported those items on their individual tax returns, I would recommend that they contact the IRS," he says. "This contact should be in writing and by talking directly to the IRS representatives, working their way up the chain of command, as necessary.

"If applicable, the club should indicate that the failure to file was unintentional, that each member did indeed report their share of taxable items allocated by the club and, therefore, the penalty doesn't fit the crime," he continues. "The club should request that the penalty be abated." Hurst notes that a visit to the local IRS office with the appropriate paperwork in hand can be an effective way to resolve the situation.

The Club Audit

Whether your club has had problems with the IRS or not, partners should verify that a tax return was submitted by the treasurer or tax partner. This should be done during the club's annual audit. The audit also serves to verify that the club's treasurer has made the transactions that the club has voted on, and that all monies and stock certificates are where they are supposed to be.

"At the time of the audit, the treasurer has to be able to produce valid records as to where the club's money is and where the stock is," Hurst says. "It is the responsibility of the club partners to verify the treasurer's books.

"I once heard from a club where the longtime treasurer had died, and the partners were looking for their money and stock certificates," she says. "It turned out that there was no money and no stock certificates. The treasurer had been stealing the money for years, all while producing beautiful records. The club had never verified these records with an audit, and the partners were left with nothing."

The Audit Committee

Hurst recommends that the audit committee be made up of two or three partners who should be chosen on a rotating basis from the club so that all partners are familiar with auditing procedures. Knudsen recommends that the treasurer, another officer and two partners chosen from the membership be involved.

Debra Dolly, treasurer for the Crossroads Investment Club in

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Cameron, Mo., says her club's audit committee is made up of two partners that meet to go over the books each February. "As members of NAIC, every year we receive the Investment Club Verification Form that outlines the audit procedures," she says. "The committee goes over the bank statements, the final broker statement and the dividend reinvestment statements.

"The first thing the committee does is go over the member status reports. They confirm that the amounts that the partners paid in was deposited in the bank," she continues. "Then they verify that all dividends were recorded and look at the cash on hand in the broker and bank statements. The committee also compares the broker statement

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to the valuation statement to make sure that the club has all the stock that the valuation statement reports." Lastly, members of the audit committee compare the checks that Dolly writes to the broker and bank statements to make sure they match up. Knudsen, who is also the chairman of the National Investor's Association Board of Directors, notes that in her club the committee also checks to be sure that the secretary and any other partner that spent money on the club's behalf were properly reimbursed. The audit process takes two to three hours, and the committee can complete it in one evening.

The Audit and the Tax Return

One step that the Crossroads Investment Club audit committee has not taken in the past but plans to take in the future is to verify the tax return. Barnett recommends that the treasurer bring a copy of the tax filing to the club meeting along with the canceled post office return receipt.

If a club wants to be extra careful to ensure that the tax return is filed, the treasurer could fill out the form and give it to another partner to actually mail. Or the treasurer could file the return with a return receipt requested, and that return receipt could be returned to a club officer other than the treasurer, Knudsen says.

However it is done, it is important for club partners to verify that a federal tax form and, if required, a state tax form are submitted to the proper authorities in a timely manner. "As a minimum, the club's audit committee should examine the books once a year and verify that the tax return was filed on time as part of that review," Knudsen says.

While club taxes and audits may seem like routine matters compared to club investing and portfolio management, it pays club partners to follow correct procedures carefully. Without verified books, a club's assets and results may not be what the partners thought they were.

"An audit is an important part of a club's business procedures," Knudsen says. "Unfortunately, a lot of clubs overlook the audit although it is a procedure that clubs should perform every year. A club is a business partnership, and it is important to make sure that everything is as it should be with the club's books and that the tax return is filed correctly and on time." ■

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