

ASSOCIATION RESERVE FUNDS

TAXES & FINANCIAL MANAGEMENT

Presented by:

COZBY & COMPANY
- CERTIFIED PUBLIC ACCOUNTANTS -

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Presenter

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Presentation Format

- Present a section
- Take questions after each section
- Last $\frac{1}{2}$ hour for open ended discussions/questions

Workshop Goals

- Common Misconceptions Regarding Reserves
- Define Reserve Fund
- Understand How to Establish a Reserve Fund
- What You Should do With the Reserve Study
- Budget to Meet the Results of a Reserve Study
- Overview of Loans and Reserve Funds
- Understand FHA Interaction with Reserve Funds
- Understand Effect of Reserve Contributions on Unit Owner Tax Basis
- Resources for Additional Information

Common Misconceptions

- “It’s a big project so the reserve should pay for it”
 - Maintenance projects like painting and seal-coating are specifically cited by the IRS as being required to be paid out of operations. Budgets should reflect these projects correctly. In a year there are high operating expenses, reduce the reserve contribution or increase assessments.
- “I don’t have to worry about the IRS looking at our return”
 - When the IRS selects a condominium to review they usually make an example out of them. Board members have a fiduciary responsibility to comply with rules.
- “We don’t need a reserve study”
 - A reserve study benefits all current and future owners and sets out a long term plan for the association. It is also required from the IRS’s point of view and protects reserve contributions from being taxed.
- “Let’s not pay for an engineer, we will just do our own reserve study”
 - It is not in the best interest of your association to have board members acting like engineers and construction professionals. Possible FHA certification issues if reserve study not prepared by professional engineer as well.

Section 1

Define Reserve Fund

Why is there no single definition?

- There are multiple definitions of reserves from different regulatory sources and best practices.
 - ▣ State & Federal Statutes
 - ▣ Tax Law and Regulations
 - ▣ Association Governing Documents
 - ▣ FASB/GAAP (Financial Accounting Standards Board)
 - ▣ CAI Best Practices
- The definition of a reserve depends on the point of view you are working from.

What is a Reserve Fund?

- “Actual...funds at a given point in time identified by the association to defray the future repair or replacement costs of those major components the association is obligated to maintain. Also known as reserves, reserve accounts or cash reserves.”

□ *Source: CAI National Reserve Study Standards*

What is a Reserve Fund? - Taxes

- It is crucial for managers and board members to understand there is a direct effect of the tax form filed and their responsibilities related to their reserve fund.
- Federal tax filing options for most associations are
 - ▣ 1120 (More stringent requirements, lower tax rate)
 - ▣ 1120-H (Easier requirements, higher tax rate)
- After this class, find out what your association files and go back thru this section.

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)
- If you file a Federal Form 1120-H – Compliance with the IRS is much easier, but at a much higher tax cost to the association (30% flat rate vs. graduated corporate tax brackets) and only residential associations can file an 1120-H.
- By following the IRS guidelines for filing an 1120 regardless of your current filing choice, your association has the most flexibility to manage their tax burden in the future.
- Every association is unique and specific advice about your association from a tax professional specializing in this area of taxation is recommended.

Summary of Definitions

- For “book” or GAAP purposes – the reserve should only be used for capital items, but the Board has the right to use them for any legitimate association expense
- For tax purposes - IRS definition of reserves is far more strict and failure to follow these rules can put the association at risk of the Reserve Fund becoming taxable (no painting or sealcoating expenditures)

Follow IRS Definitions to be Conservative

Why Have a Reserve Fund?



- ❑ Protect property values by having funds available to properly maintain common areas
- ❑ Enhance resale values
- ❑ Comply with legal (state statute) and governing document requirements
- ❑ Meet FHA certification guidelines
- ❑ Avoid unexpected fee increases or special assessments

End of Section 1

Questions?

Section 2

Understand How to Establish a Reserve Fund

Establishing a Reserve Fund

- Conduct a professional reserve study
- Use the *Financial Analysis* of the reserve study to create a *Reserve Schedule*
- Select a *Funding Plan* to determine annual budget for reserve contributions
- Adopt an *Investment Policy*
- Determine how often the reserve study will be updated and adjust budget accordingly

What is the Reserve Schedule?

- A reserve schedule is the financial summary of the reserve study
- It should establish the long-term funding goals of the Association (what projects will be funded by what date)

Source: CAI National Reserve Study Standards

Components	Estimated Remaining Useful Life (Years)	Estimated Current Replacement Cost	Replacement Fund Balance at Beginning of Year	Estimated Required Annual Contribution	Replacement Fund Balance at End of Year
Asphalt	15	177,377	16,698	10,712	27,410
Concrete	Varies*	412,780	63,138	18,402	81,540
Roofing	20	303,620	61,005	20,218	81,223
Exterior building	10	216,670	68,674	16,443	85,117
Plumbing	30	Varies*	5,163	5,000	10,163
Electrical system	30	Varies*	4,495	3,300	7,795
Doors and Windows	30	Varies*	4,010	1,000	5,010
Fans and vents	12	23,200	5,932	1,439	7,371
Tennis courts	20	Varies*	6,683	2,000	8,683
Signs	17	5,000	983	300	1,283
Retaining wall	25	240,000	22,746	8,691	31,437
TOTALS			\$259,527	\$ 87,505	\$347,032

*Represents more than one time frame or amount in this category.

Types of Funding Plans – 1) Full

- Full Funding – maintain reserves close to 100% funded for all components
 - For each component, take the replacement cost and divide it by the remaining useful life. This will determine the annual budget by component.
 - Example – Roof will cost \$100,000 to replace and has 10 years of useful life remaining. The annual budgeted reserve contribution is \$10,000 for the roof.
 - Add all the component annual budgets together, and this is your total annual budgeted reserve contribution.

Types of Funding Plans – 2) Baseline

- Baseline Funding – keep reserve fund cash balance above zero
 - ▣ Goal is to make sure the reserve balance does not drop below zero during the budget period
 - ▣ Only ensures there is enough cash to pay for planned projects during year, no safety net
 - ▣ Each component may not be fully funded
 - ▣ Risk of not having enough funds for projects that come due before their useful life is complete
 - ▣ Important to have annual updates to reserve study

Types of Funding Plans – 3) Threshold

- Threshold Funding – keep balance at a predetermined amount
 - Same concept as Baseline, but instead of -0- there is an amount the reserve will not go under, for example \$500,000
 - Offers more flexibility to handle unexpected items
 - One idea is to set the threshold amount to be the most expensive project in the reserve study
 - This method can inadvertently result in noncompliance with FHA requirements (10% rule)

Types of Funding Plans – 4) Statutory

- Statutory Funding – amounts based on local statutes
 - MA – MGL 183A Section 10(i)
 - All condominiums shall be required to maintain an adequate replacement reserve fund, collected as part of the common expenses and deposited in an account or accounts separate and segregated from operating funds. The requirements of this subsection may be modified pursuant to subsection (m) of this section.
 - Consult with your attorney if you have additional questions regarding statutory or governing document requirements specific to your association

End of Section 2

Questions?

Section 3

What Should You do
With the Reserve Study?

Organize the Reserve Schedule

- ❑ For budget preparation and tax purposes (as highlighted earlier), the reserve schedule should further identify each line item as either operating or reserve:
 - ❑ ***Operating/Maintenance Items (Non Capital)***
 - ❑ Ongoing maintenance that protects the underlying capital assets
 - ❑ Painting (protects the wood trim and siding in-between replacement)
 - ❑ Sealcoating (protects the paving in-between replacement)
 - ❑ Just because something is expensive, does not qualify it to be paid from the reserve
 - ❑ ***Reserve/Capital Replacement Items (Capital)***
 - ❑ Replacing roofs/siding/trim/paving/structures
 - ❑ Painting the replaced property when installed is allowed
 - ❑ Sealcoating replaced pavement when installed is allowed
- ❑ Once organized, you are ready to prepare operating and reserve budgets that incorporate this important information.

We Have the Study, Now What?

- The study should be made available to any current or prospective unit owners. (This does not mean copying the entire study and distributing.)
- If you have an Independent CPA performing a compilation/review/audit – a summary of this information is required to be included in your annual financial statements. Provide a copy of study to CPA.
- Summarize the Reserve Schedule as indicated above in a spreadsheet and update as projects progress and funds are raised. Use this as a tool in between reserve studies.
- Have your study updated every 1-5 years.

End of Section 3

Questions?

Section 4

Budget to Meet the Results of a Reserve Study

Guiding Principles for Funding Plan

- Have sufficient funds available when needed
- Create a stable annual reserve fund contribution rate over the long-term (20 - 30 years)
- Plan expenditures for reserve projects to be as evenly distributed over the years as possible. Don't get caught doing roofs and siding in the same year. Try to stagger large ticket projects and implement in phases over multiple years
- Be fiscally responsible, leave the association in better shape than when you started

Budgeting - General

- Maintenance and ongoing expenses should be budgeted in an “Operating Budget” (including the Non Capital projects from Reserve Study)
- Reserve Contributions should be determined based on a long term, professionally prepared Reserve Study (Capital projects)
- Budgets are educated guesses of the future, they are not perfect
- Approved budgets are a Board’s guidelines for management. They provide the framework and constraints for management to operate. The Board should not micromanage the budget.
- Document budget overruns and unusual expenses in your minutes. It is not necessary to continually amend a budget.
- Have a contingency built into your budget (5% of assessments)

Budgeting for Reserves – Reality

- Budgets rarely work out perfectly
- When operating costs exceed budget – consider reducing annual reserve contribution or issuing a special assessment
 - ▣ AVOID BORROWING FROM RESERVES (IRS rules prohibit commingling of funds)
- When operating costs are under budget – consider increasing the reserve contribution
- Deficits and surpluses need to be managed each year in a proactive and tax efficient manner

Adopt an Investment Policy

- Once enough funds have been collected for portions of them to be invested, the Board should adopt a CONSERVATIVE investment policy (See CAI example and consult with attorney for any applicable state laws)
- Timing of projects will effect type of investment
- Rate of return is NOT as important as preservation of principle and access to cash
- Laddered CDs are a simple solution
- Look for local banks that offer DIF or SIF insurance. This is additional insurance above FDIC that covers 100% of your deposits regardless of amount. (*Using multiple banks to mitigate risk is therefore not required.*)
- Consider your home state municipal bond investments – income is generally tax exempt for federal and state purposes. This increases the effective rate of return on the investment. Consult with an investment advisor further about this type of investment before implementing.

End of Section 4

Questions?

Section 5

Overview of Loans and Reserve Funds

Overview of Loans & Reserve Funds

- Generally there are two types of loan activities that associations engage in regarding their reserve funds
 - ▣ 1) Obtain a bank loan to pay for a reserve project
 - ▣ 2) Lend money from the reserve fund to the operating fund
- Let's go over some of the pro's and con's of each type of loan activity

Loans – Obtaining a Bank Loan

- When to do it?
 - ▣ As a last option.
- Pro's
 - ▣ Provides funding for project that is essential to be completed to maintain the property.
 - ▣ Avoids special assessments and putting financial strain on unit owners directly.
- Con's
 - ▣ Lowers value of units. Buyers want to see reserve funds not loans. Buyers don't want threat of special assessment.
 - ▣ Increases cost of project and does not fix overall problem of inadequate reserve funds.

Loans – Borrowing Amongst Funds

- Can you do it?
 - Yes, but with CAUTION.
 - IRS will allow a legitimate, documented loan with an appropriate interest rate and repayment terms. If the loan does not meet their strict standards, then the association runs the risk of the loan being disallowed and the reserve fund becoming taxable.
 - You will also need to consult with your attorney to make sure there are no state statutes prohibiting this type of activity in an association.

Loans – Borrowing Amongst Funds

□ Should you do it?

▣ Depends.

- Good Reason – Reserve fund is fully funded according to a professional reserve study. Operating fund had a prior bank loan for an improvement and is paying 7% interest to the bank. Board decides that since they have adequate reserve funds, they can have the reserve fund payoff the bank loan by loaning money to the operating fund. They enter into a legitimate note. The result is no more interest paid to bank and instead they pay themselves the interest.
- Bad Reason – Operating is constantly short on funds because there are many unit owners in foreclosure. There is a reserve fund, but no reserve study has been obtained. The Board wants to borrow funds from the Reserve fund on an as needed basis to cover operating expenses. This does not have a clear repayment plan and lacks the structure the IRS requires. Also, the Board has no understanding of the impact to their reserves by borrowing money since there is no reserve study. Instead of borrowing from reserves, the Board should increase operating assessments.

End of Section 5

Questions?

Section 6

Understand FHA Interaction with Reserve Funds

FHA Interaction with Reserve Funds

- For those associations seeking FHA certification, there are a few additional budget items to consider
 - Budgeted reserve contribution must be 10% of the association's operating assessments
 - This does not mean the reserve fund has to increase by 10%, or that you cannot spend the money in the same year you contribute it. It also does not reference the actual reserve contribution.
 - Make the budgeted reserve contribution a clear budget line item.
 - Consider adding a budget vs. actual schedule to your annual CPA issued financials.
 - The budget must contain sufficient funds to cover insurance deductibles as well as be overall “adequate” for the association.
 - What is adequate for one association might not be adequate for another association, so this is hard to define. You should consult your insurance agent, attorney, and accountant further for guidance on meeting FHA certification requirements for your association.

End of Section 6

Questions?

Section 7

Understand Effect of
Reserve Contributions on
Unit Owner Tax Basis

What?

- Contributions owners pay towards their reserve fund increase the tax basis in their home.
- The catch? Only contributions towards CAPITAL projects (no regular maintenance like painting and sealcoating).
- This is another reason to keep your reserve fund in accordance with the stricter tax rules. See the slide “Organize the Reserve Schedule” in Section 3.

Basis Example

- Single homeowner pays \$250,000 for a condo, pays closing costs of \$3000, spends \$10,000 for interior renovations over 5 years.

- Basis in home is:

■ Cost/purchase	\$250,000
■ Closing costs	3,000
■ Improvements	<u>10,000</u>
Basis before capital assessments	\$263,000

- Homeowner also paid \$400/mo for 5 years in capital reserve contributions

- Basis in home becomes:

■ Basis calculated above	\$263,000
■ Capital assessments (\$400 x 12 mos x 5 yrs)	<u>24,000</u>
Basis after capital assessments	\$287,000

What Type of Unit Owner is Affected?

- Owners that use the unit as their residence will most likely shield all taxable gain by use of the IRC 121 Exclusion of Gain on Residences (\$250K single/\$500K MFJ). Therefore significant appreciate of value would have to occur for most residential owners to benefit from tracking this info.
- Owners that work from home and claim a home office deduction could depreciation more basis in their home and realize higher deductions each year.
- Owner that are investors and rent the units will benefit by knowing there is a difference in how their condo fee is to be treated. Investors that currently deduct the entire condo fee (operating and reserve) as an operating expense are in error. Only the operating fee is deductible as a maintenance expense and the capital assessment should be added to basis and depreciated.

What Can You Do to Help Unit Owners?

- Provide a clear separation of operating assessments vs. capital assessments to unit owners.
 - ▣ Separate line items on invoices.
 - ▣ Year end recap letter detailing allocation of assessments between operating and capital.
- Have your capital assessments based on only capital projects that meet the IRS rules of capital expenditures.

End of Section 7

Questions?

Section 8

Resources for Additional Information

CAI Great Resources

- www.cairf.org
 - Foundation for Community Association Research
 - ▣ Free Best Practices Reports to download
 - ▣ “Report #1: Reserve Studies/Management”
- www.caine.org
 - New England Chapter of CAI
 - ▣ Education Programs
 - ▣ Condo Media Articles
- Business Partners of CAI – They’re not just vendors

AICPA/FASB (What CPAs Use)

□ cirawiki.aicpa.org

Common Interest Realty Association Wiki

- Free resource from AIPCA used to educate CPAs on the community association environment
- Explains all major accounting and disclosure requirements
- Find out why your CPA makes you do things a certain way and what they are looking for when they perform their work.

HOAPulse.com

- www.hoapulse.com

- Excellent resource for articles regarding HOA's from a CPA perspective. Excellent author – Gary Porter
- “The Benefits of Having a Reserve Study”
- “Unit Owners Tax Basis in Condo Associations”
- “Should Painting be Included in the Reserve Study?”
- “The 10 Year Reserve Study”

Additional Handouts Available

- General Guide to Community Association Taxation
- What is the Difference Between a Compilation, a Review, and an Audit? Comparative Overview

QUESTIONS?

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