

Reach Out and Find a Pot of Gold



Audits



Taxes



Planning for the Unexpected

**Annual Board Training
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Audits

What is an Audit?

An audit is engagement performed by an **INDEPENDENT** Certified Public Accountant to determine if the financial statements of the Association are **MATERIALLY CORRECT**, if they are presented in accordance with generally accepted accounting principles (**GAAP**), and if they have adequate **DISCLOSURES**.

- ❖ **Independence** – Is a matter of *fact and appearance*. The CPA should not, except in very limited circumstances, have ownership within the Association they audit. The CPA should not be paid based on the outcome of the audit or tax returns. The CPA must maintain objectivity in all circumstances and keep an *attitude of skepticism*. The CPA must not be swayed by personalities or the need to “keep the client happy”. This can get interesting with regards to defining the client – the management company, the board of directors or the membership of the Association? (See article attached – “Who is Our Client”)
- ❖ **Materially Correct** – The auditor, using *judgment*, determines materiality. The CPA professional guidelines set fairly high materiality standards. We believe for Associations that the materiality should generally be \$1,000 - \$2,000. This means that the CPA does not look at each and every transaction – a common misconception. The CPA may randomly look at smaller transactions, but it is not a requirement.
- ❖ **GAAP** – Generally accepted accounting principles for Associations requires that the financial statements be presented on the accrual basis of accounting, with full disclosures and supplementary information on the replacement fund. GAAP does not require fund accounting, but recommends it. GAAP suggests that property is not capitalized on the financial statements of Associations, but allows the option (and requires it in some circumstances) to place the common areas on the books of the Association.

❖ **Disclosures** – GAAP requires specific standard disclosures on the type of association, accounting methods, tax choices, and other such items. Other disclosures often missed or not understood include the following:

- FDIC limitation exceeded
- Related party transactions
- Litigation
- Special assessments, and whether the monies have been used as required
- Contingent liabilities, e.g. mold remediation

An audit also examines the **INTERNAL CONTROL POLICIES**, as well as **ACCOUNTING PROCEDURES**. Included in this handout is a checklist of basic internal control policies that we recommend all associations adopt (as adjusted for their particular issues). If there are significant deficiencies in internal control policies, a Report of Internal Control may need to be sent with the audit (see next page).

The Ten Commandments of Internal Control for Your Association

1. Thou shalt not sign blank checks, nor leave blank check stock unsecured.
2. Thou shalt deposit all checks in a timely manner (preferably daily). If a deposit is not made daily, then the undeposited funds should be adequately secured.
3. Thou shalt not accept cash. If absolutely necessary to accept cash, then do so only with 2 witnesses, then generate a receipt for the files.
4. Thou shalt not make checks payable to “Cash”.
5. Thou shalt require invoices, or other type of verification of the expense, on all paid bills. That invoice should be “canceled” in some manner after payment to avoid duplicate payment.
6. Thou shalt have two board signers on reserve withdrawals. Thou shalt not allow telephone withdrawals of reserve funds.
7. Thou shalt update signature cards in a timely manner whenever there is a change in board members or change in management personnel. The board may want to consider having a board member deliver/mail the signature cards to the bank.
8. Thou shalt require approval of write-offs of A/R balances by a person other than the person making the deposits and reconciling the bank accounts. The board shall approve all write-offs over a certain amount.
9. Thou shalt review all bank statements and reconciliations at least quarterly for ALL bank accounts - including certificates of deposit.
10. Thou shalt receive financial statements at least quarterly (monthly, is even better).

An auditor is always on the lookout for **FRAUD**; however, fraud detection is not the purpose of an audit. Attached is a copy of the fraud letter that we require each management company to sign before we begin an audit. We are looking for *incentives, opportunities* and *attitudes* with regards to either *fraudulent financial reporting* or *misappropriation of assets*. Some brief examples:

- Incentives/Fraudulent Financial Reporting – Board promises the manager a bonus at the holidays if security costs are 10 percent less than last year.
- Attitudes/Misappropriation of Assets – The manager feels underpaid and unappreciated, so justifies taking the clubhouse rental monies that come in cash.
- Opportunities/Misappropriation of Assets – There are no controls in place when collecting laundry coins.

In an audit, we will find **ERRORS**. As I tell all boards of directors, managers and anyone else who will listen, as auditors we are not disturbed by occasional errors. These occur as we are human. We will have to point out those errors (generally in a management letter) and we will give suggestions as to how to correct this type of error from occurring in the future, if appropriate. These are to be taken in a constructive manner. If there is anything of significance, then we would need to change the audit report (see future section). However, a *benefit* of an audit is to get professional advice how to improve your policies and procedures and the correction of unintentional error.

Report of Internal Controls

A Letter of Internal Controls is a required document when internal control deficiencies are found. This is a means for the CPA to communicate with the Board about items found within the audit. Some common items include:

- Cash in excess of FDIC in one bank
- Reminder to review old, outstanding checks or deposits in transit
- Errors found, and suggestions for correction in the future, if appropriate
- Accounting policy and procedure recommendations
- Internal control recommendations
- Recommendations for items to include in the board meeting minutes, for example approval of reserve expenses

Washington State Law – Audit Requirements

Old Act Condominiums – Those created before July 1, 1990

64.32.170 (Horizontal Property Regimes Act) – Requires an audit once a year by an auditor – all condominiums. (Potentially superseded by the New Act Condominium law; however, you need to have an attorney interpret the Association’s governing documents on the matter)

No mention of GAAP, but our “company policy” is to use GAAP unless otherwise directed, and we strongly recommend GAAP

New Act Condominiums – Those created after July 1, 1990

64.34.372 (Washington Condominium Act)

Condominiums with 50 or more units must be audited annually.

Condominiums with fewer than 50 units – audit is required; however, can be waived by 60% of the owners (other than the declarant/developer)

GAAP required

Homeowners Associations – excludes condominiums, non-residential developments and residential cooperatives

64.38.045 (Homeowners’ Associations)

Associations with annual assessments (note: it specifically says assessments, not other income – interesting) of \$50,000 or more requires an audit; however, can be waived by 67% of the owners

GAAP not required; however, “keep financial and other records sufficiently detailed to enable the association to fully declare to each owner the true statement of its financial status”. Same comment above about our preference to do GAAP

Following is an article on why to have an audit ~

Why Have an Audit of the Association's Financial Statements?

By Gayle L. Cagianut, CPA
Cagianut & Company, CPA
Newport & Bellevue, Washington

“Audits cost a lot of money.” “Who can understand financial statements, anyway?” “Our manager is totally trustworthy.” “Our homeowners don’t look at the audit once it is done.” “It is just a waste of time and effort.”

Have you heard any of the above statements when it is time for your Association’s audit? Or, possibly, is one of these your argument for voting NOT to have an audit? If so, keep reading and, hopefully, by the end of the article you will be re-thinking your decision.

Washington State requires audits for condominium associations when there are more than 50 units and for homeowner associations when there is more than \$50,000 in annual assessments. However, the law also allows, in some cases, for the membership to vote not to have the audit. So, the question is – Why have an audit of the association’s financial statements?

Fiduciary Duty

The board has a fiduciary duty to the Association members. The board is accountable to the membership for the use of the members’ assessment monies. Also, the management and care of the assets of the Association, including the buildings, common areas and investments are entrusted to board members. As part of this fiduciary duty, they are charged with making objective decisions. Having impartial advisors, such as a CPA, is a good fiduciary practice.

Run as a Business

The Association may be a nonprofit and/or mutual benefit organization; however, courts have upheld that it must be run like a business. Business leaders use professionals to guide them in the various areas of need. There are complex accounting, tax, and finance issues in an Association.

Oversight

A year end audit supplies independent oversight of the financial transactions that occurred during the prior year. The CPA is independent of all parties and will give an unbiased opinion of the actions of the board and management company.

Internal Controls

An auditor should assist the Association in setting up internal controls to ensure less chance of error or fraud. Most misstated financial statements are due to human error; however, there is always the chance that fraud can occur. While audits do not guarantee that all mistakes or fraud will be found, procedures are in place to assist in this process.

Complete and Accurate Financial Statements

CPAs are trained to present financial statements in accordance with generally accepted accounting principles (GAAP). This allows consistency when read by others, such as bankers, potential buyers, etc.

Disclosure to Owners and Potential Owners

Completion of the year end audit with accompanying financial statements and footnotes allows all current, as well as future, or potential, owners a complete, independent summary of the financial status of the Association. If those individuals choose not to read or understand those statements, that is their choice. The information has been made available to them.

Compliance with State, Tax and Accounting Laws and Regulations

There is a maze of laws and regulations which require compliance by an Association. With regards to financial and tax matters, the auditor can assist and guide the board of directors into compliance.

Here are some other thoughts to replace those at the onset of the article:

"Audits help board members perform their fiduciary duty". "Dollar for dollar, an audit provides a lot of value to the Association". "Audits are a normal cost of doing business...and the Association is a business". **"The auditor is an independent voice to the Association"**.

So, why would you have an audit?

- ✓ **To assist in your fiduciary duty**
- ✓ **To ensure the Association is being run as a business**
- ✓ **To distribute complete and accurate financial statements**
- ✓ **To be accountable to homeowners with regards to their assessment monies**
- ✓ **To gain knowledge about improved internal controls**
- ✓ **To achieve compliance with State, tax, and accounting laws and regulations**

What Can the Board and Manager Do to Assist in the Audit Process?

1. **APPROVE THE AUDIT ENGAGEMENT LETTER** several months before year-end so that the audit can be put on the CPAs workplan early. In our firm it is basically “first in/first out”. Proposals start going out in August. Then, ensure that the audit is **SCHEDULED IN A TIMELY MANNER** after the end of the year. If there are any particular deadlines (e.g. the board wants the audit at the April 15th board meeting), let the auditor know immediately.
2. Review the year end outstanding assessments receivable for potential **BAD DEBTS**. Determine if there are accounts which an allowance for bad debts needs to be setup.
3. Repay any monies **DUE TO OR DUE FROM THE REPLACEMENT FUND (RESERVES)** prior to year-end. If not possible, document how the repayment will occur.
4. Analyze the year-end financial statements and have the accounting department **MAKE ANY CORRECTIONS** before finalizing for the year. For example, if you find that an expense has been coded incorrectly (e.g. a landscape invoice was coded to pools), ensure that that has been corrected before the year-end is completed.
5. Analyze the year-end financial statements and **MAKE NOTE OF UNUSUAL ITEMS** and provide this to the yearend accountant and include analysis in your year-end treasurer’s report. For example, if snow removal expense was unusually high due to weather conditions, explain that, or if insurance costs rose an unexpected 30%, make note of that.
6. **REVIEW THE DRAFT REPORT** as soon as it arrives. Specifically review any unusual footnotes to ensure that they are complete and accurate. Read the Report of Internal Control. Discuss any concerns with the CPA.
7. Ensure that the **REPRESENTATION LETTERS ARE SIGNED** and returned in a timely manner. The final report cannot be issued without the signed representation letters.

What Does the Report Say?

The audit report is the only part of the year-end financial statement packet that is **“OWNED” BY THE CPA**. The financial statements and footnote disclosures are the Association’s. Thus, the Association has to take responsibility for both of those and has control over them.

The audit report has very standardized wording. In the vast majority of the cases the audit report gives what is known as a **“CLEAN OPINION”**. That is, the CPA feels comfortable stating that the financial statements are in compliance with GAAP, are materially correct, are consistent in their application of accounting principles, are properly presented with all required financial statements, have the required unaudited supplementary information included and have complete and accurate footnote disclosures.

We include a paragraph, however, that clarifies that this audit opinion is NOT expressing an opinion on the adequacy of the replacement fund. This is not required, but many CPAs include this explanatory paragraph. An explanatory paragraph can be used anytime the CPA really wants to be sure that something is understood and included in the year end package, as, again, this is actually the only page under the full control of the CPA.

There can be other types of opinions. A **“DISCLAIMER”** will say “except for...” then go on to explain what is being disclaimed. This might be used when it is a first year audit or one account balance cannot be verified.

An **“ADVERSE”** opinion is rarely used in Associations and is a negative opinion, stating that the financial statements are not adequate.

Explaining an Audit & Financial Statements to the Board

The financial statements tell a story about the Association, and those who read and understand them can learn a lot from taking the time to review each page of the audit packet. However, I understand that for most people these financial statements are a mystery. So, when I have a chance to discuss the audit and financial statements with a board of directors, there are **THREE PLACES THAT I DIRECT THEIR ATTENTION** (in this order):

Operating Fund Excess <Deficiency> of Revenues over Expenses on the Statement of Revenues and Expenses

This is a long title for “**DID WE BREAK EVEN LAST YEAR IN THE OPERATING FUND**”? This can be found on the Statement of Revenues and Expenses (more commonly known as the Profit & Loss Statement (P&L) or Income Statement). As a nonprofit corporation, your goal is to have enough income each year to pay your operating expenses and fund reserves. Did this occur?

Note: The Operating Fund is supposed to break even each year. However, the Replacement Fund does not have that same constraint. Some years it will have a large net income as the fund is being built up. Other years it will have a large net loss as the monies are expended. While the Operating Fund operates on a 1 year budget, the Replacement Fund operates on a 20-30 year budget, so it is necessary only to break even over those 20-30 years.

Operating Fund Balance on the Balance Sheet

While the Statement of Revenues and Expenses shows the activity for one year, the Operating Fund Balance is the accumulation of income and loss over the life of the Association. The goal should be to have **1-3 MONTHS OF OPERATING EXPENSES AS A BALANCE IN THE OPERATING FUND** for contingencies and as a “cushion” for cash flow requirements.

Due Between Funds on the Balance Sheet

Are there **ANY MONIES OWED TO OR FROM THE OPERATING AND REPLACEMENT FUNDS**? If so, is there a repayment plan? If not, should this amount be approved to be written off or “forgiven”?

If a board understands these three items, they can make informed choices for the future.

Who is our Client?

by Gayle L. Cagianut, CPA; Cagianut & Company, CPA

Who exactly is the client in an audit engagement? The engagement letter is usually written to the **board of directors** of an association. Often, it is signed by the **management company**, as an agent of the board. However, it is the actual **membership** of the association to whom the board is accountable.

Primary client - the membership

It is our firm's strong belief that even though we are generally "recruited" for bids by the management company, and may report to the board of directors, we serve the members of an association. It is these members who pay their dues each month and rely on the honesty and reliability of the board to oversee the proper utilization of those funds. It is to these members that a copy of the year-end report is distributed. It is these members who live in and use the common areas of the association and who will elect the next board of directors based upon their performance.

However, the CPA must also interact with the board of directors and the management company. This is another very important aspect of the engagement. In some facets of the review or audit, we feel that the board and the management company are "sub-clients." Let me explain it further.

Our main objective is to ensure that the financial statements are complete, accurate and properly reported. In this instance, our client is the association membership. This is the primary focus of the audit or review engagement. We want to ensure that the members are properly informed of the financial status of their association.

Obligation to the board

However, another objective in our firm is to educate the board of directors and assist them through the complexities of association management. This is a secondary focus of our engagement, and these issues we direct to the board. There are items which are not of such significance whereby they must be disclosed in the actual audit or review report. Instead, they are matters relating directly to the board's role in an association. We use a "management letter" to communicate these points to the board. These may be suggestions concerning internal control, civil code compliance, documentation, or other items which come to our attention. Since the association is run by a volunteer board of directors, some of whom have little experience or expertise in the area of community associations, we feel that these recommendations are useful to them as they learn better how to manage their association.

The importance of the management company

Lastly, we are concerned about the management company itself. As we are engaged to audit an association's financial statements, we work closely with the manager, who generally has all the records and has had a history with the association. As we are working with the management company, we also provide suggestions to allow them to be better managers. Such suggestions may be the area of internal controls, accounting procedures, civil code compliance or other items as they come to our attention. The manager has the responsibility to be a bit of everything - accountant, attorney, landscaper, construction manager, etc. Thus, it is impossible for them to know everything about everything. Laws and procedures change quickly and we feel that it is our responsibility to inform the managers of these changes. So, in this instance the manager is also our client. Additionally, we as CPAs have the opportunity to work with many management companies and by doing so we can see what works and what doesn't, and may be able to share some of these ideas.

Put priorities in order

The scenario I've just presented can cause some problems. It is difficult to have three distinct groups of individuals with whom you work, and to whom you are accountable. Then, what is known as a "conflict of interest" can arise. It is important that the CPA firm have a policy as to whom their client really is, and set priorities as to what influence each of these factors will have on an engagement. When a board of directors or management company have too much control over an accountant, it is possible that the CPA loses objectivity and independence. It is then that the CPA starts to worry more about getting the job, rather than getting the job done correctly. It is unfair to put undue pressure on the CPA to not disclose any information. Luckily, most CPAs will not allow their integrity to be jeopardized in such a manner.

As the financial watchdogs of society, it is our responsibility to properly report and disclose an association's financial position. This is a very important function which should not be taken lightly. The individual members of the association should be assured that the CPA is working on behalf of them. The direction and assistance of the board and management company is invaluable, but must be put in perspective with the goals of the engagement.



INTERNAL CONTROLS CHECKLIST

(These are the *minimum* standards we recommend for associations)

- Board meeting minutes approval will consist of:
 - ⇒ Opening/closing of bank accounts
 - ⇒ All reserve expenditures
 - ⇒ Major contracts

- Board receives financial statements, at least quarterly, consisting of:
 - ⇒ Balance sheet
 - ⇒ Income statement comparison to budget

- Board reviews **all** bank statements **and** reconciliations at least quarterly (including certificates of deposit):
 - ⇒ Operating accounts
 - ⇒ All reserve accounts

- The Board has a signatory policy on cash accounts in compliance with their governing documents and State law. If the Board does not sign checks, other controls are in place to ensure approval and proper payment of expenses.

- The Board must approve all bad debt write offs or adjustments to A/R balances over \$_____ (depends on Association.)

- All related party transactions/conflicts of interest are disclosed to the Board and, where appropriate, to the membership.

- The Board has a policy to determine what contracts need to go out to bid.

- The Association accepts no cash, or has very specific controls with regards to cash acceptance.

Cagianut & Company, CPA

Approved by Board of Directors

_____ Association

Date _____

By _____

Title _____

October 24, 2006

Dear Management Company CEO or CFO, On-Site Manager, or Self-Managed Association,

This is our annual fraud responsibility notification letter. As you are aware, it is your responsibility to ensure that controls are in place to detect and deter fraud. As your accounting firm, it is our responsibility to assist you in this process. Additionally, we must plan our audit accordingly. As such, we request that you inform us immediately if any of the following occur:

- Suspected fraud or embezzlement.
- Illegal acts by your employees or Association board members.
- Changes in your internal control system.
- Undue pressure from board members to misstate the financial statements, the budget or reserve study.

We have identified some areas which may increase the potential for fraud risk. If any of these occur in any of the audits we perform, please let us know at the onset of the engagement. They are as follows:

- Accepting cash payments.
- Lack of an adequate bid process.
- Not giving timely financial statements to board members.
- Signing of blank checks.

Remember also, it is your responsibility to do the following:

- Communicate the importance of ethical behavior and appropriate business practices to your staff and boards of directors.
- Implement programs and controls to detect and deter fraud.
- Comply with State statutes, local ordinances and contracts.

We need this letter signed and returned (via fax or mail) before we can begin the 2006 audits on your associations. We appreciate your cooperation in this matter.

Sincerely,
Cagianut & Company

Management Company/Association _____

Attn: _____

Received and read by _____ Date _____



Taxes

The Trouble with Taxes... is

- Nobody wants to pay 'em, but if you owe you owe.
- Nobody understands the complicated rules, but you still have to figure out how to file the right tax returns the right way.
- Tax law considers everything taxable, unless you can prove that it is not.
- If challenged by the IRS, **you** are considered wrong until you prove **them** wrong.

These are truisms for community associations, as well as individuals, partnerships, etc. We are going to look at what is **True and False** as it relates to Association taxes.

(For the rest of this handout, I will use the generic term "CA" to mean a residential community association, which encompasses planned unit developments (homeowners associations) as well as condominiums).

FALSE

CAs are nonprofit organizations so they do not owe taxes.

This is the number one tax question asked by homeowners, board members, managers and even accountants (outside of this industry). CAs are nonprofit *mutual benefit* type of corporations. To qualify for Federal tax exemption and pay no income taxes an organization must:

1. **Serve some type of common good.**
2. Not be a “for-profit” entity.
3. Not have net earnings that benefit the members of the organization.
4. Not exert political influence

CAs are not organized for the common good of society, such as for religious, health and welfare, education or other tax-free type of purposes. A community association is simply a group of taxpayers who have formed an organization to share expenses. Thus, the CA is allowed to exclude from income most monies (and we will discuss the exceptions later) from the member/taxpayers. However, such items as interest income, which would be taxed at the taxpayer level, are also taxed at the CA level.

To be entirely honest, this section should be labeled 99.9% false. There is a very small percentage of CAs which are nonprofits who do not owe taxes on any income. These CAs are considered as “communities” for the public good. They cannot be condominiums, and even very large planned unit developments have difficulty getting exemption. IF exemption is granted by the IRS after applying for it, then all income is tax-free and an entirely different tax form is used each year. The tax form is form 990.

There is even a smaller percentage of CAs which file for exemption, receive exemption on membership income, but pay on interest income. These are “social clubs”. They also file form 990.

FALSE

We are a new Association and haven't even sold our first unit, so no tax returns are due OR We don't have any taxable income so no tax returns are due.

CAs are corporations. As such, their "life" begins at the date of incorporation. Unlike individuals, there is no threshold, whereby tax returns are not due if income is below a certain dollar amount. Additionally, to file form 1120-H (which will be discussed later) requires an "election". The "election" takes place when the tax return is filed.

Thus, the bottom line – tax returns are due from the date of incorporation and for EVERY YEAR thereafter.

FALSE

Tax returns are due the same time as individual returns.

Corporate tax returns are due 2 ½ months after the end of the CA's fiscal year. Thus, for 12/31 year ends, the tax returns are due March 15th, not April 15th.

For those 990 returns discussed previously, the due date is 4 ½ months, or May 15th.

An automatic extension can be granted for six months. This is an extension to FILE returns, NOT to PAY taxes!

True

CAs are the only taxable entity that can choose each year which tax form to file, and each of these tax forms has an entirely different tax rate.

Absolutely true! It is a bizarre tax law, and one that many do not fully understand. Here is the quick & simple explanation:

Form 1120-H

- ❖ Tax rate – 30%
- ❖ One page, easy tax return
- ❖ Uses the terms Exempt Function and Taxable Income
- ❖ Not necessary to have operating and reserve fund separate
- ❖ Not necessary to have Revenue Ruling 70-604
- ❖ Estimated tax payments not required
- ❖ Little audit risk
- ❖ Only available for residential associations (or substantially residential)
 - 85% of the units or lots must be residential
- ❖ CAs with large amounts of per use services (e.g. valet and maid) may not qualify
 - 60% of income must be exempt function
 - 90% of expenses must be exempt function (includes reserve expenses)

Form 1120 (or 1120-A)

- ❖ Tax rate – first \$50,000 of income – 15%
- ❖ Much more complicated return to prepare (multiple pages)
- ❖ Estimated tax payments required
- ❖ Have to detail all income and expenses of the Association
- ❖ Segregates income into Membership and Nonmembership
- ❖ Capital Contributions are not taxable, if certain steps followed
- ❖ Allows excess membership income to be carried over to the next year (Revenue Ruling 70-604 – discussed later)
- ❖ Allows excess deductions to be carried over to the next year.
- ❖ Increased audit risk.

Who makes the decision each year as to whether to file form 1120 or 1120-H?????

There is no one answer. This is the wording that our firm includes in our proposal letters...so, effectively we make the decision unless directed otherwise. 90%+ of the Associations file form 1120-H.

Unless otherwise directed by the board of directors, we will review the tax situation of the association and will make the determination as to what type of tax returns will be filed and will direct the board as to what elections need to be made. The responsibility for the tax returns remains with you.

FALSE

Income from members is always tax-free.

When filing form 1120, income is designated as member/nonmember (and capital), and while member income can be carried over and used up on a subsequent year, membership income can be taxable.

When filing form 1120-H only exempt function income is tax-free. Exempt function is defined as being assessments billed as a result of membership in the organization, and is unilaterally charged to all members. This includes assessment income. What this does NOT include is “per use” fees. Thus, if the Association charges members fees to use common areas, those fees are taxable on 1120-H. (Note: they would be member income on 1120 and may not be taxed if net membership income is zero or less)

TIP – IRS has said if an Association assesses a fee on an annual basis rather than on a monthly or per use basis, the fee is tax-free. So, a planning tip is to annual assess for the fee (e.g. RV parking space, storage unit) rather than on a monthly basis.

True

Income from nonmembers is generally taxable.

Income that does not come from members is usually taxable. Some examples of taxable nonmember income are:

- ✓ Cell Tower lease income
- ✓ Cable/internet easement income
- ✓ Rent from a manager's unit or a foreclosed unit
- ✓ Advertising
- ✓ Bank buyouts to Association to obtain clear title (new this year!)
- ✓ Condemnation Proceeds (e.g. from State or County)

True

Income from litigation or insurance settlements is generally considered to be a nontaxable event.

Yes, it is considered to be a nontaxable return of capital to the extent of the unit owner's basis. These funds should be segregated, however, from operating and replacement funds. We prefer a separate bank account be set up, and separate accounts set up on the financial statements.

True

Expenses can be deducted from taxable income.

Direct expenses can be deducted from taxable income. Actually, the IRS is more lenient with its interpretation of the rules with form 1120 than 1120-H, but most tax preparers take standard deductions against interest income for such items as management fee and tax preparation.

The "lost" deductions are generally those related to income other than investments. If the Association has rental property, income from a billboard or cell tower, advertising in the newsletter or other nonassessment types of income, often the accounting system has not been set up to "capture" these expenses.

TIP – Make sure that the Association books are set up so that any expenses related to the taxable income are clearly designated on the financial statements. Ensure that managers and board members know to classify expenses correctly as they are approved for payment.

For some type of per use income, a "one time" analysis might be beneficial. For example, in California, the State taxing agency has determined that laundry income is always a losing venture, so after years of auditing laundry income and expense, they now concede that if an Association will just consider laundry income and expense as "break-even" they will not audit the issue. The IRS has not audited laundry income, to my knowledge, but they could. If there is a significant amount of money on a recurring per-use item, such as laundry, the Association may want to do its own analysis to ensure that there is not net taxable income and extrapolate those findings to future years.

FALSE

Interest on Association bank loans is deductible by the members on their personal taxes.

First, do not give tax advice. Send them to their tax preparer. However, for your information it is NOT tax deductible by the members. The “short” answer is that the loan is not secured by the owner’s property; it is secured by assessments of the CA.

It may not even be an expense against the interest income on the tax return of the Association. It definitely is not on form 1120-H. And, CPAs disagree about whether it is on form 1120 – if it is secured by special assessments.

True

It is a good idea for the membership to make the Revenue Ruling 70-604 election every year.

IRS Revenue Ruling 70-604 states that any excess membership income will be carried over to the next year for tax purposes. This tax election known as “70-604” is only really necessary if form 1120 is filed. However, it is good “insurance” in case of an IRS audit in the future and it does not hurt to have it approved – even when form 1120-H is filed. It is a tax-only election meaning that no cash gets transferred and financial statements are not adjusted.

Thus, we recommend that all associations make the election on an annual basis.

*Association Resolution for Revenue Ruling 70-604 Election-
Excess Income Applied to the Following Year's Assessments*

WHEREAS, the _____
Association is a corporation duly organized and existing under the laws of the State of
California;

and

WHEREAS, the members desire that the corporation shall act in full accordance
with the rulings and regulations of the Internal Revenue Service;

NOW, THEREFORE, the members hereby adopt the following resolution by and
on behalf of the _____ Association:

RESOLVED, that any excess of membership income over membership expenses for the
year ended _____, shall be applied against the subsequent tax year
member assessments as provided by IRS Revenue Ruling 70-604.

This resolution is adopted and made a part of the minutes of the meeting of

(Date)

By _____
President or Secretary

Financial Q&A

By Gayle L. Cagianut, CPA

I was just talking with our community association manager on the phone, and she said to remind the board to include the “seventy dash six-oh-four” in the annual meeting agenda. I asked what that was and she said it was a tax election that the CPAs recommend. Could you explain this further?

The “seventy dash six-oh-four” is a shortcut way of referring to IRS Revenue Ruling 70-604. This is a ruling issued by the Internal Revenue Service in 1970 which is an effective and powerful tax planning tool. Unfortunately, many associations do not fully understand the reasons and ramifications of this ruling. It is good that you asked and are interested in further information about it.

Basically, it is a tax election that states that any excess membership income remaining at the end of the year is carried over into the next year, or is refunded to owners. This election may allow the Association to file form 1120 (rather than form 1120-H) for its Federal taxes and pay tax at 15% on the first \$50,000 of taxable income rather than 30%. (Note: taxable income is generally interest and possibly other nonmember income).

The IRS has not issued much in the way of official guidance on the use of Revenue Ruling 70-604, but based upon audit activity across the nation, informal communications with IRS personnel, and a draft audit guide for IRS auditors, we know somewhat of their thinking on this matter. Below are a few of the issues involved and the information we have available at this time. It is our firm’s opinion that an Association should be conservative in its financial practices, so we do not encourage Association’s to take undue tax risks. However, with the lack of absolute guidance from the IRS there are some practitioners and some Associations which feel comfortable with taking more risk on their tax returns. This should be done with caution and knowledge of the ramifications.

Who Must Make This Election?

The original ruling stated “the membership” made the election. In audits and in the draft audit guide, the IRS has upheld that the members must make this election using whatever approved voting process is allowed by law – thus, it can be at an annual meeting using proxies, by mailing ballots, etc. Some associations argue that the board is an agent of the membership and they should have the right to make the election. This may be valid if taken to a court of law, but at this time the IRS has not agreed with this stance. In the San Diego audits of several years ago, the CPA was making this election for the membership and this was disallowed.

When Does the Election Need to Be Made?

The IRS has been entirely silent on this matter. It appears reasonable that the election should be made before the tax return is filed, and many of us believe that it is better if the election is made before year-end.

Can the Election be Made Every Year?

Most CPAs agree that an Association should make the election every year, then the accountant will determine whether or not it is in the best interest of the Association to use such an election.

The IRS issued correspondence that indicates that the 70-604 election cannot be used two year's in a row. Also, in the recent draft audit guide the ruling is consistently referred to as a "one year carryover". That is, the excess from year one must be "absorbed" in year two. Thus, it appears that 70-604 must skip a year between usage. Our firm feels that there is much less risk in taking this position.

How are the Association financial statements affected?

This is a tax only election, so does not affect how the financial statements are presented to the owners. However, some CPAs recommend that the next year's budget should include a "shortfall" which is absorbed by the prior year excess income. The difficulty in this is that the election is made and the budget prepared before the amount of the excess income is known. Thus, this is not a reasonable reality. If there is significant excess income, at the time the tax returns are prepared the association may want to address this matter and record in the minutes where the excess will be used. Another possibility may be to transfer some of this excess to the replacement fund (reserves), but be aware that the 70-604 election does not allow that the excess be transferred to reserves. It requires it to be carried over to the next year or refunded. Thus, to transfer the amount to reserves requires two steps 1) to make the election to carryover from the prior year, then 2) in the subsequent year to make an additional contribution to capital reserves – based upon a reserve study or other justification and notification to the membership. The Association should consider consulting with their accountant to ensure that this is properly done.

To recap:

- 1) Have the membership make the election
- 2) Make the election before the end of the fiscal year
- 3) Use only one year, then either "absorb" the excess membership income the next year or change to form 1120-H for one year
- 4) Consider documenting usage of net membership excess if the amount is material

If the above items are considered, Revenue Ruling 70-604 can be an effective tax planning tool for the majority of community associations.



Planning for the Unexpected

When the unexpected occurs how do the Board and management handle the financial shortfalls?

- Operating Contingency
 - We recommend that an Association keep 1-3 months of operating expenses as a balance in the Operating Fund for contingencies and other unexpected cash flow requirements.

- Increasing Assessments
 - If the expense can be delayed, the Association may be able to fund the event with future, increased assessments.

- Special Assessments
 - A special assessment may be necessary to fund the shortfall or funding requirement.

- Reserve Monies
 - In limited situations it may be appropriate to use reserve monies. Be sure to check with your attorney, reserve preparer, management, Washington RCW and possibly your CPA.

The Board should keep the “unexpected” in mind as they budget – especially in current economic conditions. See the following article ~

Association Budgeting in “Tough Economic Times”

Every person should have a budget...and few do. A budget helps smooth out the ups and downs of short term and long term financial goals. However, we, as individuals, have options when financial upheavals strike – options such as taking on another job, changing our lifestyle, increasing credit card debt or even walking away from financial obligations through bankruptcy and foreclosure. Most of these options are not available to an Association

Associations are communities of individuals who are pooling their financial resources to protect their real estate investment, maintain a lifestyle and share maintenance and other obligations. These are the same individuals that may not have a budget in their own life. Thus, when it comes to preparing a budget for their Association it is a difficult process. Unlike individuals or government entities, there is not a lot of credit out there for an Association. It is often difficult to borrow money. The Association cannot walk away from its debt by filing bankruptcy. Thus, the Association is left finding ways to pay bills and keep the place maintained. Here are five budget suggestions in what is often termed (and albeit the oft overused phrase) “tough economic times” –

1. Don’t expect to collect all budgeted assessments (and associated costs)

The reality is that most Associations will encounter bad debt write-offs. The budget must reflect the fact that some of the unit owners won’t pay their assessments. Because the banks will not quickly foreclose on the units there may be a long period of time where the association does not receive assessments. How to estimate the amount to budget for noncollection of assessments is very subjective and specific to each situation – but it is important not to underestimate this amount. It is better to assume the worst and then collect more than what you expected.

Along with the bad debt budget line item there needs to be consideration for payment of collection measures on those past due assessments. While the costs can be passed along to the unit owner, if the unit owner ends up walking away from the unit, the Association may not collect the monies they expended trying to get the unit owner to pay. However, the Association must have a collection policy and uniformly enact it. It also may be necessary at times to force a foreclosure to get the unit back and get someone in that will pay rent or will purchase the unit and pay assessments. The Board must understand that a portion of their bad debt allowance must include not only the assessment that isn’t collected but the unreimbursed legal costs that are expended to try and collect that debt.

2. Focus on long-term as well as short term

The Board is charged with protecting, maintaining and enhancing the assets of the association. The decisions made today affect future as well as current owners. If the decision is made not to maintain the buildings or not to set aside monies for future major repairs and replacement of common area components, the value of the investment may decrease and the costs will be born disproportionately by future owners.

Lack of focus on longer term goals often means that a special assessment is needed. Special assessments are not popular in that future owners are generally paying for past mistakes and that is not well received by those owners. Plus, special assessments make it difficult for the owner to budget for that expense personally. When they purchased the unit in the Association they were aware of the monthly obligation and they should have been aware that it would go up as inflation occurred. But, a large one-time assessment (even with a payment plan option) was not in their budget and may considerably impact on their financial situation adversely.

All too often the Board wants to stop funding reserves or borrow from reserves (with no realistic payback). That is not a good answer. The deterioration of the common areas will continue. Instead, this is the time to have a reserve study and come up with a realistic reserve funding plan. With the advice of the reserve professional in collaboration with the Board and management, a plan may be developed that will adequately fund reserves with the minimal amount of monthly obligation. But, once that plan is determined the Association needs to fund that plan. Funding reserves (the replacement fund) is an important obligation of the Association.

3. Have a plan when there is a deficit

The Association is an ongoing entity that doesn't operate in the vacuum of just the current year. Thus, when the Board works on the budget they need to look to the past as well as the future.

If there was a shortfall last year and there was no contingency fund, the Board needs to budget for that shortfall in the current year's budget. It will not go away on its own. One recommendation is to include a budget line item – Prior Year Operating Deficit. This makes the issue very visible.

Alternately, if the Association is lucky enough to have an operating fund that has built up during the past years, then a current year budget could include usage of some of that prior year excess. But, be sure that it is not all used up in one year and that there still remains a balance for future years. Most recommendations are to have ½ to 3 months of operating expenses as a balance in the operating fund for contingencies.

4. Evaluate expectations

Possibly there are previous expectations that can be reduced when money is tight. There may be large projects that were deemed important in prior years that can be delayed until a future year. There may be nonessential services that can be reduced without a large impact on the unit owners or with the agreement of the unit owners.

However, if the unit owners bought into the Association because of certain features – 24 hour concierge service, gated and patrolled community, clubhouse amenities – the Board needs to evaluate those expectations and not eliminate them if quality of life would be adversely affected. Determining expectations may be a difficult process and not everyone's expectations are the same. This requires good communication skills and an understanding of the community.

CAUTION - eliminating a budget line item that reduces the budget a minuscule amount while not meeting unit owners expectations may be counterproductive to developing a community where people want to live. So, carefully evaluate the benefit of the reduction to the cost of the reduced expectation.

5. Operate with a business-like attitude

Operate the Association as a business. Take the time necessary to really review and understand the financial statements of the Association. Learn from historical financial statements as to where the monies come from and where they are spent. The Board should ask questions if they do not understand. Financial matters are a vital part of running this business.

The Board is not expected to know everything about running the Association. Thus, as with any business owner, they should bring in professionals to assist and advise them. This is never more true than in the budgeting process. There may be cost saving tools out there of which the Board is unaware. The most amount of time should be spent on the largest dollar items on the budget. Get input from those vendors or companies about how to save money without sacrificing service or product quality.

Ultimately, the Board must determine the correct assessment that it takes to operate the Association. This is not the assessment amount that will make them popular with the current group of unit owners. This is the amount that it takes to meet the Association's obligations as well as the needs and expectations of the majority of the unit owners. The Board needs to make the decision to increase assessments and/or decrease costs as needed. The Board needs to be willing to be tough in order to ensure the Association's financial well-being in these "tough economic times".