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CPA

Guidance -- Reserve Fund

This document discusses recommendations for establishing and maintaining a reserve fund for a homeowners association (HOA). With proper establishment of this fund, income taxes can be reduced and the association can assure that every present and future homeowner pays a fair share of required future capital expenditures.

The governing documents of the HOA may require the establishment of a reserve fund. Many HOAs do this by collecting more money than is spent each year. However to take advantage of available tax savings opportunities, recommended procedures regarding reserves need to be implemented and followed.

These recommendations require that all common area elements of the HOA needing future capital expenditures be identified. A reserve fund for these expenditures needs to be established and a reserve fund budget developed. A portion of each yearly assessment needs to be designated for this reserve fund. Finally, specific accounting procedures need to be followed. These accounting procedures are based on requirements of the IRS, state law, and guidelines of the American Institute of Certified Public Accountants.

An in-depth discussion follows that explains these recommended procedures and how they should be implemented. These procedures, which should be adopted before the year begins in order to take advantage of tax savings opportunities for the year, may at first seem complicated. However, once fully implemented, they are quite simple to comply with. To understand the justification of these procedures, it is first necessary to understand tax filing alternatives.

A. Tax Filing Alternatives

Generally, HOAs have the option of selecting one of two alternatives for filing their annual federal income tax returns. They can file as a corporation (Form 1120) or as an exempt homeowners association (Form 1120-H). Filing as a corporation (Form 1120) can result in less federal tax liability than filing as an exempt association; however additional record keeping is necessary and certain methods of handling funds are required. To better understand how certain record keeping and financial procedures related to corporate filing can result in less tax liability, a brief description of both types of filing--together with their advantages and disadvantages--is provided below.

1. **Form 1120H**: Filing Form 1120H constitutes an election by the organization to be taxed as an exempt homeowners association. An election made for a past year cannot be revoked without the consent of the Commissioner of IRS, and special circumstances must exist before the Commissioner will revoke this election. To file an 1120H, certain income and expense requirements must first be satisfied. Most homeowners associations meet these requirements. The advantage of this election is that no special record keeping requirements are necessary to prevent "over" or "excess" assessments--the amount by which total assessments exceed total expenses--from being taxed. The disadvantage of the election is that association taxable income is taxed at a 30 percent rate. For many associations, taxable income is basically interest income.

2. **Form 1120:** To effectively file a tax return using Form 1120, an HOA must also comply with IRS regulations regarding membership organizations. As a corporation, the first $50,000 of the organization's corporate taxable income is

taxed at a 15 percent rate. For a homeowners association, corporate taxable income includes "excess" assessments as well as interest income. However, by following certain procedures explained later, it is possible to reduce corporate taxable income even while increasing total assessments collected. The net effect of these procedures is to have only interest income taxed at a 15 percent rate. Thus, the advantage of filing Form 1120 in lieu of Form 1120H is a 50 percent reduction in income taxes. The disadvantage--and it is a minor one--is that to reduce corporate taxable income in this manner requires additional bookkeeping

B. Definitions

By following procedures outlined below, many HOAs can file using Form 1120 and have its corporate taxable income be comprised of only interest earned. To understand the logic of these procedures, the following brief definitions are provided:

1. Capital Expenditure - As it concerns most HOAs, a capital expenditure is the cost of making improvements or replacements which add to the value or useful life of the property the organization owns or is responsible for maintaining. Unlike non-capital expenditures, capital expenditures are not made every year. An example of a capital expenditure is the cost of replacing and repairing private roads.

2. Non-capital (Operating) Expenditure - These are ordinary and necessary expenses incurred each year by the organization in providing the services for which it was formed. Examples of non-capital (i.e. operating) expenditures include ordinary maintenance of the community entrance, snow removal, insurance, electricity, administrative expenses, etc.

3. Contributed Capital - As it concerns most HOAs, contributed capital is a specific contribution of funds for a specific purpose by the unit owners to the capital of the organization. It is not income and is therefore nontaxable on the corporate tax return. For an assessment to be considered nontaxable contributed capital in lieu of taxable income, certain conditions must be met. These conditions are discussed in the recommended procedures outlined below.

C. General Accounting Procedures and their Justification

1. The Board of Directors should estimate, based on an engineering study or the Board's expertise, the current state of the HOA's common area elements that require future capital expenditures. For many HOAs, the largest common area element is the private roads owned by the association. The replacement costs, estimated useful lives and remaining useful lives of all of these elements need to be estimated. A reserve fund needs to be established which allocates money already saved to these elements. Thus, the amount of additional funds required for specific capital expenditures in the future can then be estimated and the amount of money that should be collected as an assessment from each homeowner each year can be determined. All this information can be shown on a simple one or two page budget and reserve schedule. This process is necessary because nontaxable contributed capital is not a regular assessment. Rather, it is a special replacement fund assessment for capital purposes.

2. At the Board's direction and based on estimates calculated above, the HOA should divide the total assessment it collects into two segments--regular assessments and reserve assessments. The reserve assessment is accounted for separately in the books of the corporation. This procedure is necessary because for reserve assessments to be considered nontaxable contributed capital, there must be a separate accounting of these funds.

3. The HOA should maintain a separate bank account which is used for the deposit of these reserve assessments. The bank account should be considered the HOA's "reserve" fund for capital expenditures. This procedure is necessary because the

IRS requires that reserve assessments cannot be commingled with regular assessments if the reserve assessments are to be considered nontaxable contributed capital. While it appears that the IRS should not be concerned with an organization's banking arrangements, present IRS revenue rulings nevertheless make this requirement.

4. The balance in the reserve account should be reduced for any expenditure made for capital items for which the account was established. The money in the reserve account must be restricted to only its designated purpose for it to be considered nontaxable contributed capital. As the designated expenses are paid from this account, less money of the corporation will be under this restriction. No operating expenses should be paid with reserve funds.

5. Even when not including the money collected and deposited in the reserve account during the year, the HOA may nevertheless have excess membership income as a result of regular assessments exceeding the corporation's expenses for the year. To prevent these excess assessments from being considered part of taxable income, the HOA has several alternatives. The Board of Directors should hold a meeting at the end of the year to decide what to do with these excess assessments. If it is decided to either return the excess to the owners on a pro-rata basis or to use the excess to pay for some of the following year's operating expenses--and thereby effectively reducing the following year's regular assessments--the IRS will not consider the excess as taxable income for the year ending. **The form of such a resolution is available on this website.** It is based on IRS Revenue Ruling 70-604, which permits this action. In addition, the following year's budget should show this excess income as a source of money in the operating fund budget. On the other hand, any "loss" which may result from underestimating regular assessments (that is, the amount operating expenses exceed operating assessments) can be carried forward to future years. This may possibly eliminate the need to hold a Board meeting while the membership loss is still on the books.

6. All actions of the corporation in setting up the reserve fund and using these funds, as well as any meetings held to decide what to do with excess assessments, should be documented in the minutes of the meetings of the Board of Directors. Thus, documentary proof of the HOA's plan of action is available for IRS inspection, if necessary.

D. Practical Suggestions

Two separate funds will be maintained by the HOA. In theory, a part of each homeowner assessment payment should be deposited into the reserve account as it is received and checks should be written from the reserve account as capital expenditures are made. However, doing this would unnecessarily complicate an HOA's accounting and banking. Instead, after collecting all assessments, money designated for reserves could be transferred from the operating to the reserve account. Similarly, when a payment for a capital expenditure is made, a check could be written from operating account. After all reserve expenditures have been made, this money could be transferred from the reserve to the operating account. Following this process, one fund will owe money to the other fund at any point in time. This money owed should be transferred before the year ends. An HOA could adopt a policy explaining this process so that an actual transfer may need to be made only once a year. Sample wording of a reserve fund policy follows:

> *The Board of Directors conducted a study to estimate the remaining useful lives of common property components and the costs of future major repairs and replacements on ______. Estimates obtained from the licensed contractors who inspected the property are used as the basis of replacement cost estimates of common area components requiring future capital expenditures. The board is attempting to fund for major repairs and replacements over the remaining useful lives of these components based on future replacement costs and considering amounts previously accumulated in the replacement fund. The Association is establishing and maintaining a*

reserve fund for the repairs and replacements of common areas, including the private streets and roadways by allocation and payment yearly to such reserve fund of an amount to be designated by the Board of Directors and approved by the membership. The reserve fund may be expended only for the purpose of effecting the replacement and improvement of common areas, major repairs, and operating contingencies of a non-recurring nature. The portion of the homeowner's assessments paid into such reserve fund is considered to be contributions to the capital of the Association by the homeowners. Because the replacement reserve is restricted to the purposes for which it was established, it will classified as designated members' equity in the financial statements. When an expenditure is made for which the replacement reserve was established, a transfer in the amount of this expenditure is made from designated members' equity to undesignated members' equity. The restriction is thereby removed because the amount has been spent for it's designated purpose, leaving only the remaining balance in the reserve fund designated.

E. Advantages of Following Procedures

Following these procedures will provide an HOA with the following advantages

1. The HOA can file Form 1120 with only interest income being taxed at a 15 percent rate. "Excess" assessments will not be subject to federal tax. Thus federal income taxes are effectively cut in half when compared to the Form 1120H alternative.
2. The Board can determine whether current assessments are adequate for future capital requirements. If adequate amounts are not collected yearly, not all unit owners will be sharing fairly in the "hidden" yearly costs of using the depletable assets (i.e. roads) of the Association. Owners who have used these assets--but have since moved--may not have paid a fair share for their use of the assets. Consequently, newer unit owners may be burdened with more than their fair share of these costs.