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In This Issue:
Business Spotlight
HOA Pulse Articles
Web Articles

Investments, Taxes & Insurance—What is Your Fiduciary Responsibility? Managing Your Non-Profit Corporation

Board Members assume a legal liability when elected. Banking and investments, taxes and accounting and insurance are central areas of focus when properly managing your non-profit corporation.

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Business Spotlight

Timing

Time is measured by each person's personal time clock and means different things to different people. Time is manageable and predictable and we have time for most everything. See how the idea of time relates to homeowner associations.

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Reserves As Capital Contributions

The tax rules for reserve contributions by a homeowners association are far more complex than most people realize. Many associations filing Form 1120 are at risk in an IRS audit situation because that will have failed to comply with one or more of the seven parameters established in tax law. This article identifies each of the seven parameters with which you must comply, tells you where the authority for that parameter is established, and shows you the common sense manner in which the association can fully comply with the tax law.

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Alliance Association Financial Services understands the challenges and opportunities that community management companies face each day.

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Managing Your Non-Profit Corporation

By: Craig Huntington

Last July I was speaking to a group of 200 board members on the importance of protecting and enhancing the value of the condos and homes in their associations. It's the central responsibility of the board, but it didn't take long for us to turn to the central question asked by most board members. Thirty five minutes into the conversation, a young lady asked, "*I was just elected as the Treasurer of my Homeowners Association...I didn't really want the position, but no one else was running. What is my liability?*"

It's a common question we have all heard or asked ourselves, and it is an important one. We are all concerned about the legal liability that we take on as board members, and perhaps more importantly, we want to do a good job; we want to be good stewards of the community that we are a part of.

I have come to recognize there are three central areas of focus when properly managing your non-profit corporation: (1) banking and investments, (2) taxes and accounting and (3) insurance.

Banking and Investments

When investing your association's funds, the number one rule to remember is, *it's not your money!* You are a fiduciary who is responsible for the funds of the association, and the individuals who make up the association. Your first priority is the safety of the funds. When considering an investment option, ask yourself, "*will anyone thank you for getting an extra percent of interest?*" Now ask yourself, "*what would happen if you lost just one percent of the principal?*"

It is also important to develop an investment policy. This policy should address the amount of money that will be kept in your checking account and what action should be taken if the account goes over or under the target balance. It should also address how your reserve funds should be invested. For example, *all funds should be kept in FDIC insured CD's with maturities less than one year.* By having an established policy the board does not have to meet every time a CD comes due. The treasurer and manager already have direction from the policy that dictates the action to be taken with the funds. Many banks have products like CDARS (Certificate of Deposit Account Registry Service) or other CD placement programs that can insure all your funds are FDIC insured, thus eliminating the need to run all over town looking for another bank to place \$100,000 CD.

I encourage associations to ladder their CDs to maximize interest income while at the same time maintaining a certain level of liquidity within the reserve funds. If you have \$100,000 to invest, consider opening a 3, 6, 9 and 12 month CD each for \$25,000. As they mature roll them into a 12 month CD. In nine months you will have four one year CD's that mature every 90 days.

Associations that keep high balances in their checking accounts and spend more than \$100,000 per month should consider a sweep account. In a sweep account the association can set a target threshold that is constantly met by sweeping funds in and out of the checking account and investment account. These are often money market funds that are made up of short-term treasures and thus backed by the full faith of the federal government.



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Investments, Taxes & Insurance—What is your Fiduciary Responsibility?

Managing Your Non-Profit Corporation-Cont.

Taxes and Accounting

Associations typically only pay taxes on interest income and other non assessment related income such as income from vending machines, rent etc. Because interest is taxable, the association can deduct any financial advice that they may purchase. You may talk to your CPA about deducting some of your management fee if your manager assists with investment policies and decisions. There are many other deductions that can be found all the way up to becoming a tax free entity, similar to a city, which many large associations qualify for. It is also important to work with a CPA firm that understands the community association industry, one that is involved in CAI on both the local and national level.

As a board member you should review your association's financial statement at minimum, once a quarter. With that being said, your financials are produced once a month, so take a moment each month to ensure their accuracy, and ALWAYS review your reconciliation. You should always be able connect the balance sheet to bank statements; this is a must. Do not be afraid to ask questions. Most management companies know board members want to understand their financial statements, and they want to help you do that. Finally, I am a strong believer in using modified accrual for financial reporting. Full accrual does not allow timely production of financial statements, but modified allows items such as utilities to be paid and reported when due while large one time expenditures such as insurance can be spread out over the year.

Insurance

Insurance is perhaps the most important components of the non-profit association, yet it is often entirely overlooked. When elected to a board your first question should be, "may I review the Directors & Officer Insurance (D & O)?" If your association does not have D & O Insurance resign today! No one should volunteer their time if it puts them in a position were they could be sued. Yes, there is protection from most lawsuits for volunteer boards, but that does not always stop someone from filing a suit, which will be expensive to defend against right or wrong.

When it comes to the fire and liability insurance of your association, be sure to review the limits. With the ever-increasing cost of construction, I have seen many under insured associations that have policies based on decade old reconstruction forecasts and costs. It goes without saying that the new premium will be more, but if you need to use the insurance, you will be glad you elected to pay the higher premium.

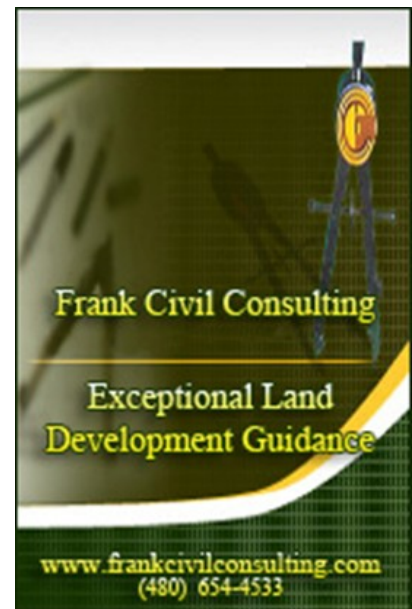
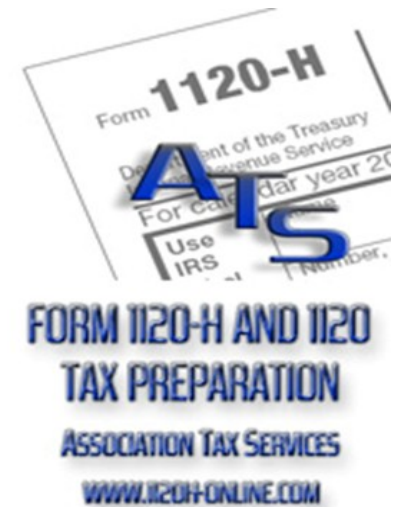
Remember you are a fiduciary. Do not risk safety to get a little more interest, review your financials on a regular basis and do not be penny wise and pound foolish when purchasing insurance.

Craig Huntington

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Timing

By: Karen Bennett, PCAM, CCAM

Time is measured by each person's personal time clock. Time means different things to different people. There is the impatient person cuing through a line that never seems to move. There is the person in love where time flies and the concept of time seems to stand still, all in the same day. The employee who gets up late and gets to work late and never seems to catch up. The Grandma who plans way in advance to be on time and then always has to wait.

Because time always affects us even though we may not be paying attention, we need to keep in mind that time is manageable and predictable and we have time for most everything. But, let's take the idea of time as it relates to homeowner associations from the perspective of the different characters that interact each month.

The Board of Directors -

For the board, time starts at the board meeting. A meeting is called to order by the President. The agendas of most association meetings are very similar and should flow from the announcement of quorum and the call to order to Old Business and any ending remarks with the announcement of the next scheduled meeting.

Right after the meeting the pending action and work for the next month's meeting starts right away. The meeting place must be confirmed, the minutes and action list created. The most time consuming requests need to go out so that the vendors and others will have time to start gathering the information for their responses.

The unknown factor is the requests for information and action that occurs between the board meetings between the board and the manager. Usually, the President of the board contacts the manager and asks for updates or additional information. This time needed to do the work of the association for the next month can be greatly impacted by the additional time to respond and perhaps redo action given at the board meeting. The board is one of the manager's bosses and cannot be ignored.

The Manager –

The Manager works for many bosses. The boss of the Management Company or the Supervisor assigned to manage the Manager, the boards of each of the Manager's associations, and finally, the homeowners and residents who live in the associations.

The Manager will always want to please and take care of the requests of all of the parties described above. Therein lays the problem. Prioritizing time and available hours in the day.

If the boards are generally happy the Management Company bosses will usually leave the Manager alone. If the Board trusts the Manager, the boards will usually allow the Manager time to fulfill her duties as they are typically done on time. The board that constantly requests updates and additional information obviously does not trust the Manager to get the job done in a timely and complete fashion. It behooves the Manager to keep the board informed on a mutually agreeable timetable as to the progress and information they will need to make their upcoming decisions. The Manager has approximately "one month," to gather and organize the data to send to the board prior to their next monthly board meeting.



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Timing—Cont.

The Homeowner –

The resident or homeowner usually sees time through a very different prism. The homeowner will report something that needs attention and assume it will be done by day's end. Sometimes that doesn't happen. Sending an e-mail at any time of day or night, will accumulate times the number of associations and responsibilities of each manager. Oftentimes, the customer service desk can handle straightforward repairs or requests for service. Other times those requests are passed on for the Manager to handle.

The organization, communication ability and support staff will greatly improve the time needed to complete a request for service. While the time needed may seem to take too long to solve, the best results are handled by good communication and follow through. An e-mail or telephone message can explain a time delay and lead to more time to resolve the issue. Most residents can appreciate and understand the time it takes to fix something as long as we take the time to tell them.

You see, timing is everything ~

Karen Bennett, PCAM, CCAM

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Reserves as Capital Contributions

By: Gary Porter CPA

The tax rules for reserve contributions by a homeowners association are far more complex than most people realize. Many associations filing Form 1120 are at risk in an IRS audit situation because that will have failed to comply with one or more of the seven parameters established in tax law. This article identifies each of the seven parameters with which you must comply, tells you where the authority for that parameter is established, and shows you the common sense manner in which the association can fully comply with the tax law.

Most discussions about homeowner association income taxes begin and end with the single issue of filing Form 1120 or Form 1120-H. This is usually discussed simply from the perspective as the difference in tax rates. But, Form 1120 carries significantly higher tax risk. The largest risk, and the focus of this article, is the issue of reserves being considered as capital contributions for tax purposes. This an important issue because capital contributions are automatically excluded from income. It has no significant impact if filing Form 1120-H, as Exempt Function Income (EFI) is not taxed on that Form. It is a critical issue on Form 1120, as any amounts received from members that cannot be classified as capital contributions may create excess member income under IRC Section 277 that is subject to taxation.

The Internal Revenue Code (IRC) is law passed by Congress. Regulations are the Internal Revenue Service (IRS) interpretation of that law. Revenue Rulings are specific situations described by the IRS that clarify how certain tax rules are to be applied. Judicial decisions by various courts provide the final say in how certain tax law is interpreted. There are actually numerous other levels of authoritative rulings, but these are the primary guiding authorities. It is important to understand this framework to see why something as simple as a reserve contribution can actually be very complex.

The basic structure of the Internal Revenue Code is that all receipts are considered income under IRC Section 61, unless exempted from income by another section of the Code. IRC Section 118, "Contributions to the Capital of a Corporation," exempts capital contributions from income. IRC Section 118 has been interpreted by numerous subsequent rulings. The balance of this article examines each of the criteria raised by those various rulings.

While IRC Section 118 establishes the broad principle that capital contributions are not included in taxable income, the detailed parameters established by subsequent rulings are:

The **PURPOSE** of the assessment must be capital in nature (IRC Section 263, Revenue Rulings 74-563, 75-370, and 75-375, Court cases *Chicago Board of Trade* and *Maryland Country Club*)

ADVANCE NOTICE must be given to members as to the intent of the purpose of the capital contribution (Court cases *Gibbons* and *Maryland Country Club*, Revenue Rulings 75-370 and 75-371, GCM [General Counsel Memorandum] 35929)

Money contributed must be **ACCOUNTED FOR** as a capital contribution (IRC Section 118, Court case *Chicago Board of Trade*, GCM 35929)

Money must be **HELD FOR THAT PURPOSE** and no other purpose (Court cases *Chicago Board of Trade* and *Maryland Country Club*)

Money must be **HELD IN SEPARATE BANK ACCOUNTS** from the operating (noncapital) bank accounts of the association (Revenue Rulings 75-370 and 75-371)

Money must be actually **EXPENDED FOR THE INTENDED PURPOSE** (Court Case *United Grocers*)

Money must **INCREASE THE CAPITAL ACCOUNT OF THE MEMBER** or unit owner-stockholder (Court case *Chicago Board of Trade*, GCM 35929)

My many years of experience as a tax preparer in the homeowner association industry have provided numerous to me that virtually no associations are aware of these critically important rules, and few tax preparers believe they are important. I have been retained as a consultant on dozens of homeowner association IRS audits, probably more than any other tax practitioner in the country. In all but one case, Form 1120 was involved. I did not prepare ANY of the tax returns being audited by the



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IRS; I was retained at the recommendation of the CPA firm or tax attorney as their expert consultant. The issue of capital contributions existed in 100% of these IRS audits.

Associations that do not adhere to each of the parameters set forth above MAY not lose their reserves as capital contributions in an IRS audit, but each instance where the association fails to adhere significantly increases the risk that your reserve additions will not qualify as capital contributions.

How associations can qualify under each of the parameters set forth above.

- 1) The **PURPOSE** of the assessment is described in IRC Section 263 as “Any amount paid out for new buildings or for permanent improvements or benefits made to increase the value . . . “ and “Any amount expended in restoring property . . . “ That pretty much describes the majority of reserve funds expended by associations. But, it also includes additions to or replacements of personal property. It **DOES NOT** include monies expended or set aside for painting or contingencies.

The purpose for which funds are being accumulated in reserves is generally set forth in the reserve study. Is a reserve study absolutely required to establish the capital purpose? No, it could be more informal, such as being described in the budget. However, the reserve study is better, and this is an instance where it is better to comply than to have to fight this issue in an IRS audit.

Other critical mistakes associations make are (a) not formally adopting their reserve study, (b) having a reserve study that contains multiple proposed funding plans with no indication of which plan was adopted, (c) having a reserve study that does not agree with the amounts adopted in the association’s annual budget as reserve contributions.

- 2) **ADVANCE NOTICE** is usually given to members as part of the annual budget, with accompanying information that discloses the reason for the “Capital” reserve assessments. It is critical to note that if painting or contingency are part of the reserve budget and the amounts are not disclosed it jeopardizes the entire capital contribution, because painting and contingency are not capital in nature..
- 3) Money contributed must be **ACCOUNTED FOR** as a capital contribution in the association’s financial statements. While this is routinely done in professionally managed associations, too many small, self-managed associations fail to take this critical step. As long as reserve monies are held in a separate bank account and there is a clear record of reserve contributions and expenditures, the association should be able to overcome this accounting deficiency in an IRS audit situation.
- 4) Money must be **HELD FOR THAT PURPOSE** and no other purpose. This means that once you set aside monies in reserve accounts, you should **NEVER** invade those reserve accounts for operating purposes. California statutes permit associations to borrow from reserve under certain circumstances. While permitted under California law, federal tax law does allow such use of funds.



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

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

- 6) Money must be actually **EXPENDED FOR THE INTENDED PURPOSE**. This does not mean that if you assessed money for roofing that that exact amount must be expended for roofing. It means that if you assess reserve monies for a capital purpose, it must be spent for a capital purpose. Reserve bank accounts commingle various capital components (roofing, paving, fencing, etc.). That dollar in the account does not know that it is a roofing dollar or a paving dollar. That dollar does not know what kind of dollar it is, other than it is a capital dollar. That is the only important criteria.
- 7) Money must **INCREASE THE CAPITAL ACCOUNT OF THE MEMBER** or unit owner-stockholder. This is effectively an automatic process with which the association normally need take no action. The reason is that, as defined in other sections of the Code, a member's "capital account" is presumed to reflect an increase in value for monies added to reserves.

What all of this means is that the association must be very careful in its handling of reserves IF IT IS FILING FORM 1120. If you're filing Form 1120-H, you can effectively ignore all of the above and still have a safe tax return.

If the association fails to comply with the above parameters established in tax law, **THERE IS NOTHING THAT THE TAX PREPARER CAN DO TO MITIGATE YOUR TAX RISK**. The tax preparer's responsibility is limited to properly presenting reserve activity in Schedules M-1 and M-2 of the association's Form 1120 tax return. Any errors at this level can generally be overcome during an IRS audit.

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Gary Porter, CPA is also the creator and co-author of *Homeowners Association Tax Library*, published by Practitioners Publishing Company (PPC) (see our bookstore for link) – 822 pages, containing full text of all relevant tax rulings. He is also the creator and co-author of PPC's *Guide to Homeowners Associations and Other Common Interest Realty Associations*.

Article Title	Article Summary	State
Strict West Valley HOA wants green grass	HOA insists on green grass so residents decide to paint their grass instead of replacing it.	Arizona
Naples homeowner groups find success in resident discount card program	Community hands out discount card to those who pay association dues. Card offers discounts to vendors in their community.	Florida
Hawthorne residents caught off guard by Metro project	Residents, who claim they were not sufficiently notified about a proposed new Metro rail yard, fear the site may bring health risks.	California
Settlement: New tax could keep neighborhood library open	The city of Aurora and a local HOA have reached a settlement in a lawsuit filed over the closing of a local library	Colorado
Germantown likely to acquire Poplar Grove and Devonshire Gardens Streets	Neighborhoods won preliminary approval for their private streets to eventually become public.	Tennessee
Potomac homeowner, HOA at odds over right to rent	Homeowner ordered to stop renting rooms in her home.	Maryland
Panel approves legislation to keep HOAs from putting limits on politicians	Senate panel voted to strip homeowner associations of most of their ability to limit politicians from seeking votes from residents.	Arizona
Federal prosecutors under investigation for alleged obstruction of justice in HOA probe	Prosecutors in the U.S. attorney's office in Las Vegas are under criminal investigation, suspected of leaking sensitive information about the probe of massive fraud involving valley homeowners associations.	Nevada
Control of Regatta Bay taken away from developers, given to homeowners	An error made years ago is finally rectified when Regatta Bay was transferred to the homeowners	Florida
Should delinquent condo owners lose Internet, TV service	A Bill is being proposed to include removing access to internet and tv services if a resident is behind in their association maintenance fees.	Florida
Law sought to warn of hotel, apartment bedbug problems	Lawmakers want to force hotel, apartment and condo owners to warn potential renters and buyers of any recent bedbug problems.	Connecticut
Nevada legislators considering reform for HOAs	SB174 changes Nevada statute on HOAs and features pro-homeowner measures.	Nevada
Solar panel bills get little light in Senate committee	Bills to restrict HOAs from limiting solar panels will face challenges	Texas

Article Title	Article Summary	State
Troubleshooters: Homeowner not getting what HOA promised	Homeowner feels she is not getting anything promised her when she purchased her condominium. Legal action may be in the future.	North Carolina
Fence fight in Frisco: Homeowner vs. HOA	Resident who asked to move her fence 10 feet closer to the street was denied since it went against the covenants. Resident did it anyway and is now being sued.	Texas
Mission Viejo HOA, city settle lawsuit over library	HOA sues city of Aurora for closing local library.	Colorado
Georgetown Lake zoning, regulations approved	The Georgetown Lake HOA has worked hard to get zoning regulations in place for Georgetown Lake	Montana
Ravalli County jury acquits man in altercation that led to his shooting	Man acquitted on charges he attacked the President of an HOA.	Montana
Complaint registry worries some local HOAs	Aurora HOA presidents are a bit skeptical about the information gathered as a result of a new law that requires all Colorado HOAs to register with the state by March 1.	Colorado
Condo rule requires owners to have insurance	Condo liability insurance, increased assessments, bank accounts and closed board meetings are the topics of discussion.	Illinois
Charging stations pose obstacles for condos	Condo boards face the increase in electric cars and providing charging stations on their property.	Illinois
Oceanside: Oceana residents angry over green waste fee	Waste Management to begin charging community members for disposing of green waste	California