

Association of Condominium,  
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Homeowners Associations



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## July/August 2010

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### Upcoming ACTHA Events

#### FALL EXPO's!!!

Details on page 9 and [www.actha.org](http://www.actha.org)

## "WHICH FEDERAL INCOME TAX RETURN IS RIGHT FOR YOUR ASSOCIATION?"

By Steve M. Silberman, CPA

As a CPA, one of the most frequently asked questions I get from Board members (especially new Board members from associations just turned over from the developer) is: Are we a not-for-profit corporation and if we are, do we have to file an income tax return?

First of all, most associations are usually incorporated as not-for-profit corporations by the developer. If this did not happen to your association, I recommend hiring an attorney to incorporate your association as a not-for-profit corporation, even though you could go to the Secretary of State's website yourself to incorporate. Once incorporated, you must remember that each year your association has to file an annual report with the Illinois Secretary of State and pay an annual fee in order to stay incorporated.

Residential condominiums, townhomes, and homeowners' associations are not-for-profit corporations that generally do not qualify for Federal income tax-exempt status. Residential associations may be taxed under Internal Revenue Code (IRC) Section 277 or may elect to be taxed under IRC Section 528. Under IRC Section 277, associations file Federal Form 1120 and under IRC Section 528, associations file Federal Form 1120-H. An association can decide annually which form it would like to file. So let's discuss which form is right for your association and the differences between each form.

Continued on page 4



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# TIP OF THE MONTH

## Reserves

The Illinois Condominium Property Act requires every budget to include reasonable reserves. What factors are used to determine reasonability?

- ⇒ Repair and replacement costs and estimated useful life of the common elements
- ⇒ The current and anticipated return on investment of association funds (if any),
- ⇒ The result of an independent professional reserve study,
- ⇒ The financial impact on the owners and the market value of the units of any assessment increase needed to fund the reserves, and
- ⇒ The ability of the association to obtain financing or refinancing.

Depending on the size of an association, the most important thing a board can do in terms of maintaining or establishing financial stability is to conduct a reserve study. A reserve study will allow a board to project how much it will need to collect in assessments to maintain association property. Barring any unforeseen expenses, this will prevent the Board from having to pass special assessments to make up for budget shortfalls. Because a preventative maintenance schedule will be a part of a reserve study, it will also allow an association to extend the life of the building and its fixtures.

*Sima Kirsch ^ The Law Offices of Sima Kirsch ^ 4831 N. Bell Ave., Ste. 2 ^ Chicago 60625*

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### ACTHA BOARD RESIGNATION

It is with regret that ACTHA announces the Board resignation of **Brian Gilligan** (Hunt Club on the Lake in Mt. Prospect). Brian has served with distinction since 2001 as a Director, Officer and chair of the Membership Committee. We are pleased, however, to state that Brian will continue as an active member on committees and at conference/trade show events. *If interested in serving on the Board, contact [Gael@actha.org](mailto:Gael@actha.org)*

### Board of Directors Officers

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**Legal Advisors:** Rob Kogen, Kovitz, Shifrin Nesbit / Charles VanderVennet, Attorney in private practice

**Accountant/Advisor:** Garry Chankin, Frost Ruttenberg & Rothblatt, C.P.A.

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## FEDERAL FORM 1120-H

Federal Form 1120-H was developed so that associations would not be taxed for carrying out its main function of managing and maintaining the common elements. Commercial condominium associations cannot file Federal Form 1120-H. IRC Section 528 states that income and expenses must be allocated between exempt function activities and non-exempt function activities. Associations are only taxed on its net non-exempt function income at a Federal tax rate of 30%. (Timeshare Associations are taxed at a Federal tax rate of 32%). So what is exempt and non-exempt function income?

**Exempt Function Income is:** Operating income received as assessments from owners of condominium, townhome or homeowners' associations. They also can be assessments received from developers on unsold units or lots. These assessments must be assessed ratably to be exempt function income.

**Non-exempt Function Income (or taxable income) is:** 1) Income from non-association property - commercial operations and interest and dividends. 2) Income from non-members for use of association property. 3) User charges to association members for special services unless the user charge is

assessed once in a twelve month period and the benefit lasts for the entire twelve month period. An example of a user charge is laundry income.

The advantages of Federal Form 1120-H are as follows:

1. Associations are not taxed on exempt function income.
2. The tax form is a one page form, with supplementary schedules, so it costs less to prepare.
3. The form has less risk than Federal Form 1120. There are four tests that have to be met to file Federal Form 1120-H, but most residential associations will qualify.
4. Fund accounting is not required since capital or reserve assessments are not taxed.
5. No election forms are required like on Federal Form 1120.
6. As long as you keep filing Federal Form 1120-H, no estimated taxes are required.

## FEDERAL FORM 1120

The key advantage of Federal Form 1120 is that an association could pay tax at a lower rate than Federal Form 1120-H. Income tax rates start out at 15% on the first \$50,000, however, the risk of compliance is far



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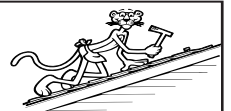
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greater since an association must follow certain required procedures. Also, since the form is much longer and more complex it costs more to prepare than Federal Form 1120-H.

IRC Section 277 states that income for Federal Form 1120 should be allocated between membership and non-membership income. An association can be taxed on both if there is net income, however, an association can make an annual election to defer net membership income.

Revenue Ruling 70-604 allows associations to defer net membership income for one year but if the association has net membership income in the next year then the association would have to pay tax in the next year on the deferred income. An association can also make an election under Revenue Ruling 70-604 to refund net membership income, but in my thirty plus years of working with associations, I have never seen an association refund money. A question that I get asked about all the time is: Can our association transfer excess net membership income to reserves and then not have to pay taxes on this excess? The answer is NO if you are filing Federal Form 1120. IRC Section 118 states that an association cannot transfer excess net membership income to reserves to avoid paying taxes since you cannot re-characterize what the assessments were for originally. In order for Revenue Ruling 70-604 to be valid, the election has to be made annually by all members (usually at the annual meeting) and it should preferably be made before the end of the year. The dollar amount does not have to be specified.

Capital contributions (reserve assessments) will be treated as non-taxable on Federal Form 1120 if certain guidelines are followed:

1. The purpose of the assessment must be capital in nature. The reserve study supports the purpose of the capital assessment. However, painting, even if it was included in your reserve study, is an operating assessment, not a capital assessment.
2. Members must have advance notice. Distributing copies of the budget to the members is considered advance notice.
3. The assessment must be accounted for as a capital contribution and held for that purpose. The books and records, along with the budget should segregate operating and reserve (capital) activities. Therefore, the association should use fund accounting.
4. Reserve (capital) assessments should be deposited into a separate account and reserve expenditures should be paid out of this separate account. An association can pay

for capital expenditures out of the operating fund account as long as the reserve account reimburses the operating account in a relatively short period of time.

Now that you have a brief understanding of the two forms, you might be wondering which form should your association be using? This is a hard question to answer unless your CPA knows the facts and issues associated with your association.

Usually if your association has little interest income and no (or minimal) user fees you will file Federal Form 1120-H. As interest income grows, your association should look at filing Federal Form 1120 as an alternative. If your association has minimal interest income, but you have a net loss from your net membership (for example due to a painting project) you may want to file Federal Form 1120 since that loss gets carried forward. If your association files Federal Form 1120 because of the large amount of non-membership income, you want to make sure that you do tax planning ahead of time to minimize your net membership income.

You now should have a better understanding about the different types of Federal income tax returns and which Federal income tax return is right for your association.

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Continued from page 10

Another benefit credit cards can provide is the flexibility. With checks, an authorized signatory must be physically present to sign the check. Credit cards can allow different individuals to make purchases based on relevance or convenience. However, with this flexibility also comes the potential for misuse or fraud. As a result, associations must have very strong internal controls surrounding credit card use. Examples of these internal controls could include, but are not limited to, the following:

- ⇒ Keeping the card in a locked safe or drawer to which only authorized individuals have access
- ⇒ Credit card purchases over a certain limit are to be pre-approved by more than one board member
- ⇒ Invoices/bills should be examined and signed off on by more than one board member
- ⇒ Periodic rotation of responsibilities to ensure no one board member has opportunity for fraud or cover-up.
- ⇒ Credit card statements or online activity must be reviewed and monitored by someone other than the board member who has access to the card. In addition, the monthly statements should be presented to the board monthly.

Finally, if your association does decide a credit card will be beneficial, be aware one might be harder to obtain than you might think. Visa and Mastercard both require someone to personally guarantee a card before credit is extended. This can present a dilemma in situations where ownership is often changing.

In the end, what is beneficial for one association might not be beneficial for another. When deciding on a credit card, evaluating the pros and cons most relevant to your association will be the most integral part of reaching your decision.

*Larry Little ^ The A.C.T. Group*

**CORRECTION TO JUNE 2010 ISSUE:** Recently appointed ACTHA Board member, Michael McCormick is an owner but not the President of his condominium association Shore Manor in Chicago.

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# FALL EXPO PROGRAM INFO

Sat., Sept. 25: Tinley Park Convention Center

Sat., Oct. 9: Lincolnshire Marriott

Both Expo's feature a trade show and interactive demonstrations from 8—noon.

Over 60 exhibitors are expected at each Expo!

**FREE Trade Show! FREE parking!!! FREE Breakfast!!!**

Registration form for Educational Seminars on page 10 or register online at [www.actha.org](http://www.actha.org)

## *Tinley Park Educational Programs*

9:30—10:30 a.m. Choose from one of two choices:

**FHA & Financing Issues**—This session will cover the steps for certifying for FHA approval and its pros and cons. Various other issues preventing lenders from approving loans in associations, such as, delinquency rates, owner/tenant occupancy ratio, and reserve funding will also be addressed. *Speakers: Keith Jones of Keay and Costello & Belinda Robinson, Housing Specialist, U. S. Dept. of Housing & Urban Development*

**Financial Mismanagement**— Both new and established associations can find themselves faced with assessment levels which are too low or insufficient funds set aside in for common element maintenance, repair and replacement. This session will discuss how to address these issues, including suggested approaches to help weary owners who don't want to see assessments increased. *Speakers: Lara Andersen of Tressler, LLC and Mike Majewski of Seldon Fox*

Noon—1 p.m. Choose from one of two choices

**Applying a Collection Policy**— Laid off owners, foreclosures, short sales and sluggish non-distressed sales continue to plague the association's bottom line. Establishing and applying a collection policy is critical to maintaining enough cash flow to keep afloat. *Speakers: Dawn Moody of Keough & Moody and Martin Stone of HSR Property Services*

**Conflict & Compromise**— Owners against owners, owners against the board, the board against owners, the board against the board and all with an axe to grind. What happened to good neighbors and a friendly community? Learn what options and methods can restore the harmony and give you peace. *Speaker: Tomi Wahlstrom of Otavala*

## *Lincolnshire Educational Programs*

9:30—10:30 a.m. Choose from one of two choices:

**The Property is Disintegrating**—After turnover, reality sets in and the findings can be devastating. The builder is gone and not honoring their promises to fix the problems. Is a lawsuit the answer? Who can help and advise when there are limited funds. *Speakers: George Pilja & Doug Palandech of Foran Glennon Palandech Ponzi and Rudloff PC and Mark Waldman of Waldman Engineering Consultants*

**Insurance: Who Pays**—Where is the answer? Are there clear instructions and priorities to point in the right direction? Maybe it's the association, the owner who suffered damage, or the owner who caused the damage. And does it matter if there was negligence? *Speakers: Stuart Fullett of Fosco Fullett Rosenlund and Joel David of CAU*

Noon—1 p.m. Choose from one of two choices

**FHA & Financing Issues**- This session will cover the steps involved in certifying your association for FHA approval; its pros and cons. Various other issues preventing lenders from approving loans in associations, such as, delinquency rates, owner/tenant occupancy ratio, and reserve funding will also be addressed. *Speakers: Don Kekstadt of Lieberman Management and Kerry Bartell of Kovitz Shifrin Nesbit*

**Reserves & Investment Strategies**- This session will illustrate which financial instruments will satisfy the needs for safeguarding reserves and being compliant with the requirements of State law and the association's governing documents. *Speakers: Craig Finck of Harris and Steve Silberman of Frost Ruttenberg Rothblatt*

# ACTHA NORTH & SOUTH EXPO REGISTRATION FORM

**YES!!** I want to register for the

\_\_\_\_\_ South Expo: Sept. 25, Tinley Park Convention Center \_\_\_\_\_ North Expo: Oct. 9, Lincolnshire Marriott

**THERE IS NO CHARGE TO ATTEND THE EXPO OR VIEW INTERACTIVE DEMONSTRATIONS.**

**THE FEE TO ATTEND ANY OF THE EDUCATIONAL PROGRAMS** is: ACTHA Member rate: \$ 25 or \$ 20 if sending 3 or more from the same association; Non-member rate: \$ 45 per person

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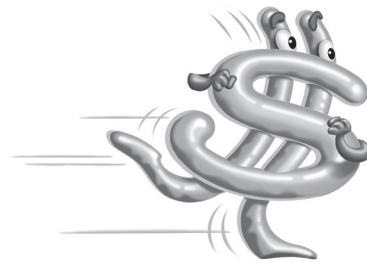
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*NOTE: Confirmations are not sent except upon request. For the South Expo: No refunds are given after Sept. 20 and there is an additional charge of \$ 15 per person for anyone registering after that date or at the door. For the North Expo: No refunds are given after Oct. 5 and there is an additional charge of \$ 15 per person for anyone registering or paying at the door. All other cancellations are subject to a 25% handling fee.*



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### **New rules trigger lengthy delays.**

As of February 1, 2010, new HUD regulations went into effect, requiring associations to certify with the FHA. There may be months-long delays in HUD processing of applications for certification for those associations which don't act quickly. Buyers of properties in those associations will be unable to acquire mortgages.

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### **What can you do?**

The attorneys at Kovitz Shifrin Nesbit can find out if your association is FHA-certified, and, if not, we can assist your board in expediting the complex certification process.

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## Question of the Month



**Q.** What are the pros and con's of an association having and using a credit card? What procedures should a board have in place if they decide to use one? What should the access be?

**A.** A credit card can be a very useful addition to the financial operations of an association. However, a credit card can also cause problems if an association does not both put in place, and adhere to strict policies and procedures regarding its use. As a result, an association should carefully weigh all pros and cons before deciding whether a credit card would be beneficial.

The primary benefit of a credit card is the speed and efficiency it can bring. Items can be purchased online, recurring bills can be setup for automatic payment and invoices for services rendered or goods delivered can be paid on the spot. But with this increase in speed and efficiency comes the tendency to stray from established financial control procedures. It is important that an association follows the same approval procedures for purchases or payments made by credit card as they would for a purchase or payment made by check. Further, the paper trail left by a credit card payment is shorter than that of a check payment. An association must be sure to retain all supporting documentation (i.e. –purchase order, invoice, receipt, etc.) for all credit card purchases.