

Revised Water System Organizational Plan

Summary

Beginning on January 31, 2012, the operation, administration, maintenance, and repair of the Herron Island Water System will once again become a function of HMC Management (as it has been in the past). Responsibility for this aspect of island business will no longer be assigned to the Herron Island Water Utility, which was recently formed as a legal entity separate from HMC Management for this purpose.

In short, the overall costs of maintaining a separate water utility would exceed any tax benefit it would provide. To save money for HMC Members, HMC Management will be solely responsible for all aspects of the water system. For more detail, read on.

The Background

The services that HMC Management provides to its Members, including residential water service, are funded primarily through Member Assessments and ferry fees. Member Assessments have historically included all charges associated with administering, operating, repairing, and maintaining our aging water system; each Member paid the same amount for this water service, regardless of the amount of water they actually used.

As you are no doubt aware, HMC is embarking upon a wholesale upgrade of the Herron Island Water System, which represents perhaps the largest capital improvement project ever undertaken on Herron Island. This project will not only improve the longevity and reliability of our water system, but will also give us the opportunity to meter water use for each connection, which will permit us to comply with Washington State conservation requirements (water usage must be metered by 2017), and enable us to charge the Members individually according to how much water they use.

When HMC started this process, the Membership expressed the desire that the revenues related to the Herron Island Water System be segregated from and accounted for separately from the general budget for HMC Management. We did our best to respond to concerns of the Members that water rates not be used to subsidize other operations of HMC Management. As a part of this effort, HMC Membership was presented with and voted on two separate budgets in 2011: one for its general account and one for its water system operations under the name "Herron Island Water Utility." Since that time, HMC Management has been working on the process to segregate the revenues, costs, and reserves for the water system, and has performed these functions using the name "Herron Island Water Utility."

It was initially estimated that the receipt of revenues by the Utility would expose HMC Members to an increased annual tax liability of approximately \$15,000. So that the revenues received by the Utility would be exempt from federal taxation, the Utility formally applied to the IRS for tax-exempt status for those revenues. In response to our application, the IRS required that the Utility be formed as a formal entity separate from HMC Management, that it have its own Articles of Incorporation, and that it be operated in the same manner as any other not-for-profit corporate entity.¹ This necessarily included the appointment of an initial Board of Directors and the subsequent establishment of formal Utility Bylaws. We formed the Herron Island Water Utility (the "Utility") as a not-for-profit corporation on October 19, 2011 by the filing of Articles of

¹ Note that this was not a USDA requirement.

Incorporation with the State of Washington. These Articles of Incorporation named the current board members of HMC Management as its initial board members.

But the creation of the Utility and the transfer of responsibility for operation and administration of the water system brought to light several issues to be resolved, specifically with regard to the relationship of the Utility to HMC Management. On the one hand, HMC Management owns and will continue to own the water system itself. On the other hand, we wanted to administer the water system separately through the Utility primarily to maintain the integrity of the accounting for the benefit of HMC Members and, through the creation of a separate corporate entity, achieve the benefit of the tax exemption for water-related revenues. Because they were now separate legal entities, a Board of Directors would be required for each (although the board composition could be the same).

Since forming the Utility, however, and largely during the drafting process for the Utility Bylaws, we recognized that the maintenance of an entity separate from HMC Management would, at a minimum, 1) generate potential conflicts between the two boards of directors (creating the need for a solid mechanism for conflict resolution), 2) increase the costs of required periodic financial audits, and 3) create a substantially greater administrative burden on our precious staff.

Considering these and several other factors, we went back to the drawing board, beginning with a re-evaluation of the basis for the anticipated tax liability. The \$15,000 annual federal tax estimate had been based on all receipts projected for the Utility, including water system base fees and amounts designated for capital repayment. Upon further investigation and consultation with tax professionals, we now understand that water system base fees and capital repayments may be considered by the IRS to be "exempt function income," and not subject to federal taxation for HMC Management as a homeowners association. Only the "per-unit" user fees for water would be the primary taxable income related to the water system. The resulting annual federal tax exposure would thus be significantly less than we initially estimated. It became apparent that the anticipated tax benefit to HMC Members no longer outweighed the simplicity and lower costs of having HMC Management operate and administer the water system directly.²

The Current Plan

Thus, at the last meeting of the Board of Directors for the Herron Island Water Utility, the Utility Board reported that it had re-evaluated its course of action and announced its intention for HMC Management to resume sole responsibility for the operation and administration of the water system. And because HMC Management had historically been responsible for these functions and already had the necessary powers to fulfill these functions under its Bylaws, HMC Management was already prepared to proceed under this revised plan.

Under this plan, several issues will be addressed and resolved as follows:

1. There will only be one Board of Directors, the Board of Directors for HMC Management, that will manage the ownership, administration, operation, maintenance, and repair of the Herron Island Water System. Similarly, there will only be one Manager reporting to one Board of Directors.

² The IRS just recently reported that it had granted the Herron Island Water Utility tax exempt status for its revenues as a water utility.

2. HMC Management will continue to maintain two budgets: one for general and one for the water utility function and will continue to maintain separate accounting for the water utility function with respect to 1) revenues and collection of assessments related to water, 2) costs of maintenance and repair, and 3) reserves. To this end, HMC Management will maintain bank accounts for the water utility function that are separate from the general accounts for HMC Management.
3. HMC Management will be empowered and responsible to enforce the collection of all Assessments and User Fees, whether they are collected as a general Assessment or as an Assessment designated as being related to the water system. In the past, before the internal segregation of the accounts, HMC Management sent each HMC Member a single bill for their Assessment; this bill covered both general and water-related Assessments. Since segregation of the water accounting from the general accounting, HMC Management has been sending out separate bills for each of these Assessments, with the "water bill" being sent out to all Assessable Unit Owners under the name of "Herron Island Water Utility." Each of these bills represents an "Assessment" for the purpose of collection under the Bylaws of HMC Management. Under the HMC Bylaws, if a Member does not pay all of his or her Assessment when due, that Member's Assessment is considered delinquent, and that Member is no longer considered a Member in Good Standing. HMC Management will treat late or non-payment of a water bill in the same manner as if the Member did not pay the bill for their general Assessment: that Member's Assessment will be considered delinquent, and that Member will no longer be considered a Member in Good Standing until the account is paid in full. In short, those who are delinquent in the payment of their water bills will be treated in the same manner as those who are delinquent in the payment of their general Assessments.
4. Any "per-unit" user fees received by HMC Management for water would receive the same tax treatment as our ferry fees (*i.e.*, not exempt from federal taxation). Still, we expect that the operational costs of HMC Management will continue to exceed the taxable income for HMC Management, and thus there will be few, if any, federal tax consequences for HMC Management (our revenues will continue to be subject to state excise taxes).
5. HMC Management will continue to file its tax returns as a homeowner's association, entitling it to receive special tax treatment as it has in the past under the federal tax code.
6. There will be no upcoming vote of the Membership to approve Bylaws for the Utility, or to ratify the appointment of its Directors. The Utility would permit the Washington Secretary of State to administratively dissolve the Utility (rather than having the Utility dissolved by a vote of its members).

As you can see, we have valiantly tried to do the *right* thing, first by segregating the water utility function from the other functions of HMC Management, and then by seeking tax-exempt status for our water-related revenues. But after further examination, this course of action turned out to be too expensive and cumbersome, and was hence the *wrong* thing. Our current plan is expected to achieve the self-sufficiency desired by Members for the water "department," while doing so in the most cost-effective manner.

Your HMC Board of Directors