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INCOME TAXES FOR COMMERCIAL CONDOMINIUM ASSOCIATIONS

Are They The Same As Commercial Rental Properties?

If you are a recent owner or property manager managing a Commercial Condominium Association ("CCA"), you must understand that both accounting and income taxes for a CCA are significantly different than a Commercial Rental Property.

CCA's are required to follow the Illinois Condominium Property Act and the by-laws and declaration of the Association. They must also follow certain Internal Revenue Code ("IRC") sections that apply to Condominium Associations. Income taxes for a CCA are not merely calculated by subtracting expenses from income and applying an income tax rate to the net amount. CCA income taxes are

much more complicated.

Fund Accounting Should Be Used

The first important concept that you should understand is that CCA's should be using fund accounting in order to possibly reduce their income tax liability. The following types of funds can be used:

1. Operating - This fund is for budgeted estimated common area costs of maintenance and operations.

2. Repair and Replacement (Reserve) - This fund is used to accumulate funds for future major repairs and replacement of existing common area components. The Illinois Condominium Property Act states that an Association must maintain reasonable reserves. One method to determine reasonable reserves is to have a reserve study prepared. It is recommended that an outside engineering firm prepare the reserve study.

3. Capital Improvement - This fund is designated for the acquisition or construction of new common area components not in existence currently.

4. Contingency/Deferred Maintenance - This is a separate operating fund that can be used for large periodic maintenance items such as painting and caulking.

IRC Section 118 allows capital (re-



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serve) assessments to be excluded from gross income and therefore treated as non-taxable on Federal Form 1120, if the Association meets the following guidelines:

The purpose of the assessment must be capital in nature. The reserve study supports the purpose of the capital assessment. However, painting, even if included in the reserve study, is considered an operating assessment, not a capital assessment.

Association 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 of the Association and the budget should segregate operating and reserve (capital) activities. Consequently, the Association benefits from using fund accounting.
4. Reserve (capital) assessments should be deposited into a separate account and reserve expenses 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 fund account in a relatively short period of time.

Segregate Membership And Non-Membership Activities

Another important concept that one should understand is that CCA's are subject to IRC Section 277. Under this section, an association must limit its deductions taken against membership income. For that reason, Associations must segregate membership and non-membership activities for income tax purposes. Associations can be taxed on both net membership income and net non-membership income. Membership income is generally defined as gross income received from its members. Non-membership income is generally considered to be income from investments and income received from non-members. Through various court cases, the Internal Revenue Service ("IRS") has provided guidance as to which expenses are eligible to be allocated against non-membership income and how to calculate the deductible portion of these expenses.

An Association's tax liability depends upon whether they have net membership and net non-membership income or loss.



If the Association has a net non-membership income, the Association is taxed at regular corporate income tax rates. If the Association has a net non-membership loss, the loss can be carried forward for twenty years or backwards for two years. Currently there is debate in the industry on whether an Association can offset net membership income with a net non-membership loss.

If an Association has a net membership loss, that loss can be carried forward to future years. If the Association has net membership income, the Association will incur an income tax liability on this net income at the regular corporate income tax rates or it has another choice.

Election To Defer Paying Income Taxes For One Year On Net Membership Income

The choice relates to the final concept that one needs to understand which is Revenue Ruling 70-604. Under this ruling, the Association may be able to defer paying income taxes or not pay income taxes at all on this 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 income tax on this deferred income in the next year. It is then extremely important for the Association to do proper planning when they are preparing their budget for the upcoming year. An Association can also make an election under Revenue Ruling 70-604 to refund net membership income to its members, but this option is

rarely exercised. In fact, I have never experienced any Association refunding money to its members. A question that comes up often is: Can an Association transfer excess net membership income to reserves and then not have to pay income tax on this excess? The answer is clearly NO! An Association cannot transfer excess net membership income to reserves to avoid paying taxes since the Association cannot re-characterize what the assessment was originally intended for. In order for Revenue Ruling 70-604 to be valid, the election has to be approved annually by the 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.

There has been debate on whether Revenue Ruling 70-604 applies to CCA's. Many in the industry believe the key to whether this revenue ruling applies is not whether the Association is commercial or residential, but the scope of the activities of the Association. If the scope of the activities of a CCA is similar to a Residential Condominium Association ("RCA"), then Revenue Ruling 70-604 should apply. If the scope of the activities far exceeds the scope of activities for a RCA, then it will not apply.

Accounting for a CCA and the elections and filing of income taxes is extremely complicated. Specialized knowledge is required in order for the CCA to benefit from the accounting and income tax rules. Therefore, it is recommended that a CCA consult with professionals that specialize in the accounting and income tax rules for CCA's. ■



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Since Steven joined FR&R in 1978, he has become a trusted business adviser, accountant and consultant to a variety of clients, including physician practices, condominium and homeowner associations, manufacturing companies, dental laboratories, contractors, and various service businesses. His many years of experience, coupled with his technical expertise and vast resources both inside and outside the firm, allow Steven to guide a wide range of small to midsize clients not only in their day-to-day operations, but also as they expand their businesses, streamline operations or plan their exit strategies.

Among his accomplishments, Steven:

- Advised a local wholesaler with sales in excess of \$15 million during its product expansion – including determining the acquisition price, analyzing the tax ramifications, compiling cost projections, overseeing the negotiations and reviewing the contracts – that increased the company by 30 percent.
- Mediated and negotiated a succession plan that successfully transferred ownership of a small business to its employee.
- Restructured 15-doctor medical practice to coax it from being on the brink of closure to its current financial status as a thriving moneymaker for its core physicians.
- Uncovered management company fraud for a homeowners association that was depleting much-needed reserves.

A graduate of the University of Illinois at Urbana-Champaign with a Bachelor of Science in accounting, Steven went on to earn his CPA as well as to become an ISA Certified Internal Quality Systems Auditor. As an FR&R' vice president and secretary, Steven serves in a number of key firm positions including as a member of the Physician Practice Group Committee, Education Committee, Condominium and Homeowners Association Committee and the QuickBooks Committee. Steven's more than 25 years of experience working with homeowners associations has made him a sought-after presenter for numerous organizations including the Association of Condominium, Townhouse and Homeowners Associations.

He also is a member of the American Institute of Certified Public Accountants and the Illinois CPA Society, as well as the Medical Group Management Association (MGMA), Community Associations Institute (CAI) and Association of Condominium, Townhouse and Homeowner Association (ACTHA). Steven has also served as a member of the board of directors for a number of his clients.



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Steve joined FR&R, bringing with him 20 years of public accounting experience, including 9 years with a national CPA firm, and over 10 years working as Tax Director with one of the wealthiest family groups in Illinois. He specializes in sophisticated tax and business planning for individuals and small to mid-sized companies. Steve has done tax planning for many companies involving transactions such as mergers, acquisitions, divestitures, and like-kind exchanges. He has taught courses on taxation for small businesses, accounting periods and methods, and financial statement interperiod tax allocation. He has appeared on radio and cable television programs covering new tax law developments and issues related to individual income and estate taxation.

Among his accomplishments, Steve:

- Saved over \$250,000 in estate tax for a small estate using tax planning techniques that were employed post-mortem.
- Worked as team leader on a \$10,000,000 IRS appeals case that ended with a no-change letter.
- Worked as Tax Director responsible for all tax aspects of a merger of a family-owned telecommunications company into a national phone company.
- Worked as Tax Department head overseeing tax policy and professional development.
- Ran a successful accounting practice in Indianapolis as a sole-proprietor.

A graduate of the University of Illinois with a bachelor's degree in accounting, Steve was awarded his CPA certificate in 1978. He obtained his masters in taxation at DePaul University in 1985. He also served on the Federal Tax Committee of the Illinois CPA Society and acted as liaison with the State Tax Committee. He is a member of the American Institute of Certified Public Accountants and The Illinois CPA Society. He is a former member of the Tax Executives Institute, the National Association of Certified Valuation Analysts and the National Association of Securities Dealers (NASD).