REPLACEMENT RESERVE FUNDS

ACCOUNTING FOR YOUR FUTURE

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USE OF RESERVE FUNDS

- CAPITAL EXPENSES
  - Major repairs or replacements of common elements
  - Engineer's reserve study should be your primary guideline for determining if an item qualifies for expensing out of the Reserve Fund
  - Not painting (IRS Revenue Ruling 75-370)
- PROFESSIONAL FEES
  - Architectural and Engineering project evaluations
  - Project management
- INCOME TAXES

FUNDING RESERVE ACTIVITIES

- Assessments
  - Condominium fees
  - Supplemental fees
  - Special assessments
- Bank Loans
- Other Sources
  - Investment income
  - Conveyance fees

ASSESSMENTS

- Condominium fees
  - Built into the base condominium fee
    - "Foundational Funding " of Reserve Fund based upon engineer's reserve study suggested funding
    - Generally would never cease as it is a perpetual funding mechanism
  - Accounting methods
    - All revenue recorded in Operating Fund with monthly transfer to the Reserve Fund based on budget (GNPM uses this method)
    - Monthly condo fee revenue is recorded proportionately based on budgeted % into both the Operating and Reserve Funds' revenues.

ASSESSMENTS

- Supplemental fees
  - Billed and due each monthly
  - Liability for future billings passes to new owner with sale of unit
  - Usually a static, set monthly amount based on percentage of beneficial interest (in-line with condo fee billing methodology)
  - Usually does not have an explicitly stated interest expense component
  - Some states have more beneficial collection laws for supplemental fees vs. special assessments

ASSESSMENTS

- Special Assessments
  - Effectively billed 100% up front on first billing; however, payments may be due over 1 or more payment periods thereafter
  - Technically, the obligation of the unit owner of record at date of billing; therefore, full payoff of assessment is due at time of unit sale (usually collected at time of unit sale closing)
  - Often used with projects funded with debt because of interest rate matching possibilities

BANK LOANS

- Fairly new over the last 12 years (difficult for condos to get a loan previous to that)
- Generally secured by condo cash accounts or future condominium fee assessments
- Suggest "Construction Loan" type structure vs. one, up-front payment equal to entire loan at loan closing
- Match interest rate to unit owners with the interest rate charged by bank (be aware of variable interest & time-based rate adjustments)
- Negotiate ability to make unrestricted, extra lump sum payments against principle

Income Tax Impacts

- NH, MA, and ME condominium are taxable corporations or trusts (they <u>not</u> non-profits or 100% tax exempt under federal tax laws)
- More $$$ in bank = more taxable interest income
- Certain expense deductions can be taken against interest income as allowed by the IRS but that will cap out – excess results in net taxable income and usually tax due

Income Tax Impacts

- Why is less interest income being earned:
  - Interest rates at <2%. Rates will rise in the future; many condos not paying taxes now, may in the future.
  - "Pre-funding" the Reserve Fund less now with regular condo fees (owners want lower fees or don't want to fund projects that may occur when they may no longer live there) – relying on supplemental and special assessments at time of need instead
  - Use of bank loans. Instead of earning interest income on assessments collected, condos are now paying interest to bank (role reversal)

Income Tax Table

Tax Return	Federal	New Hampshire	Massachusetts	Maine
Form 1120-H:	30% tax rate	8.5% tax rate (tax on taxable income) *plus* 0.75% rax rate on interest expense paid (tax on loan expense)	5.25% tax rate (tax on taxable income)	5.4% tax rate (tax on taxable income)
Form 1120:	15% tax rate (starting) graduated tax rate increases w/ more income	8.5% tax rate (tax on taxable income) *plus* 0.75% rax rate on interest expense paid (tax on loan expense)	Greater of: $456 (flat tax) **/ or /** 8.0% tax rate (tax on taxable income) *plus* 0.26% tax rate (tax on net worth = tax on equity balance)	5.4% tax rate (tax on taxable income)

NOTES