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Donna D. Berger, Esq. *Editor*
David Muller, Esq. *Asst. Editor*

TAX ALERT: BASIC TAX CHARACTERISTICS OF HOMEOWNERS ASSOCIATIONS

By: L. Ryan Pinder, Esq.

Introduction

Under section 528 of the Internal Revenue Code, homeowners associations are eligible for a limited exemption from income taxation. The policy behind the exemption is to place the collective efforts of homeowners acting in concert to maintain and improve their residences on a par with homeowners acting individually for similar purposes. (S. Rep. No. 938, 94th Cong., 2s Sess. 393 (1976).



Homeowners Association

Defined

An organization can be classified, for tax purposes, as a homeowners association if it satisfies the following six conditions:

1. The organization must be a condominium management association, a residential real estate management association, or a timeshare association (as defined in the Internal Revenue Code).
2. The organization must be organized and operated to provide for the acquisition, construction, management, maintenance, and care of association property.
3. 60% or more of the organization's gross income for the taxable year must consist solely of amounts received as membership dues, fees, or assessments from owners of residential units, from owners of residences or residential lots, or from owners of timeshare rights to use, or timeshare ownership interests in, association property.

INDEX

Tax Alert	1-3
Reverse Mortgage	3-5
Financial Reporting Titbits	5-6

cont. on page 2

TAX ALERT, cont.

4. 90% or more of the organization's expenditures for the taxable year must be for the acquisition, construction, management, maintenance, and care of association property.
5. No part of the organization's net earnings may benefit any private shareholder or individual, other than by acquiring, constructing or providing management, maintenance and care of association property, or by a rebate or excess membership dues, fees, or assessments.
6. The organization must elect for the taxable year to be subject to the tax regime of IRC section 528. (See IRC § 528(c)(1))

Homeowners Association Taxable Income

Under IRC section 528 homeowners associations are taxed at a rate of 30% on the homeowners association taxable income. Homeowners association taxable income consists of all of the organization's income except exempt function income.

Exempt Function Income

Exempt function income includes any amount received as membership dues, fees, or assessments from:

- Owners of condominium housing units of a condominium management association;
- Owners of real property of a residential real estate management association; or
- Owners of timeshare rights to use, or timeshare ownership interests in, real property of a timeshare association. (See IRC § 528(d)(3))

To constitute exempt function income, a receipt must be derived from the owners in their

capacity as owner-members and not in some other capacity.

Tax

A flat tax of 30% (32% in the case of a timeshare association) is imposed on the "homeowners association taxable income" of a homeowners association (See IRC § 528(b)). Homeowners taxable income is equal to:

Gross income for the taxable year – deductions directly connected with the production of gross income



The calculation of homeowners taxable income is subject to the following modifications:

- A \$100 specific deduction is allowed;
- The net operating loss deduction is disallowed; and
- No deduction is allowed for dividends received, dividends paid, organization expenditure amortization, and repurchased bond premium amortization. (See IRC § 528(d)(2)).

Results of Ineligibility or Non-election for Treatment as a Homeowners Association

Organizations that do not meet the six basic requirements of a homeowners association, or qualifying organizations that do not elect to be treated as a homeowners association are taxed as corporations. The election to be treated as a homeowners association is made on a yearly basis; in some taxable years it may be more advantageous to be taxed as a corporation rather than as a homeowners association. Examples of situations in which it might be more advantageous to not make the section 528 election are:

cont. on page 3

TAX ALERT, cont.

- If 30% tax rate for homeowners associations would be higher than if the income for the year was taxed according to the graduated rates applicable to corporations.
- If the association has a net operating loss, treatment as a taxable corporation may be preferable as the net operating loss deduction is not allowed in computing the taxable income of a homeowners association.

Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, unless we expressly state otherwise, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the

purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

The discussion contained herein shall not constitute a legal opinion of any kind. The facts and circumstances will vary from one taxpayer to another, each taxpayer should seek advice on the taxpayer's particular circumstances from its own independent tax counsel or advisor as to all tax matters discussed herein.

For any questions or issues related to the taxation of homeowner or condominium associations please contact Ryan Pinder at: rpinder@becker-poliakoff.com.

REVERSE MORTGAGES

By: Mary R. Harvey, Esq.

A Reverse Mortgage generally allows older homeowners (*age sixty-two (62) and older*) to use part of their equity in their homes and not have to sell their homes or take on additional monthly bills. The provisions of a Reverse Mortgage can be very attractive to owners when their income is limited but equity in their home is high. In a Reverse Mortgage the Lender is advancing the owner money and generally the owner does not have to pay it back as long as they live in the home.



The owner uses the equity in the home but does not increase the monthly debt as there is usually no repayment of the mortgage while the owner lives in the home. The owner may use the equity by converting it into cash (lump sum amount), use it as a line of credit, or even use it to generate a monthly income for themselves.

There are privately insured Reverse Mortgages and a federally insured program of Reverse Mortgages available to owners. To qualify for a federally insured Reverse Mortgage the current owner(s), in addition to meeting the age requirement, must live in the home as the principal residence. Further, the home must be a single family residence in a 1 to 4 unit dwelling, a condominium, or located in a PUD (planned unit development). Other types of residences, such as manufactured homes, are limited in eligibility. Generally mobile homes and cooperatives are not

cont. on page 4

REVERSE MORTGAGES, *cont.*

eligible for the Reverse Mortgage.

Older owners who qualify for a Reverse Mortgage generally live on a fixed, lower income. A real advantage to the Reverse Mortgage versus a traditional bank loan is that under this program "income" is not a primary factor nor is it a factor at all in most programs of this type. Rather, "equity" is the main determination for the loan. Therefore, older owners can qualify for the loan if there is equity in the home.

The owner retains the title to the property and therefore, the unit owner remains responsible for all facets such as dues, assessments, taxes, insurance and upkeep. The mortgage is attached to the property and is usually not a personal debt.

The Reverse Mortgage allows for the added protection that the mortgage amount cannot exceed the value of the home at the time the loan is repaid. Generally, a Reverse Mortgage must only be paid back upon the occurrence of certain events such as death of the last eligible owner, sale of the property, or when the last eligible owner does not live at the property as the principal residence. Since there is no repayment on a Reverse Mortgage the lender of the Reverse Mortgage cannot foreclose on the property or force the owner to leave the home which is a great comfort to older homeowners, whereas, a bank loan may put the home at risk of foreclosure if there are monthly repayment schedules which the owner cannot pay due to lack of funds, for example, or illness.

There are different types of Reverse Mortgages which allow the owner to use the money for various uses and which may have various tax and estate planning advantages or disadvantages. The owner of a unit should refer any and all questions on a Reverse Mortgage to his lender, tax advisor or estate planner. Some associations have presented specific concerns as to how a Reverse Mortgage works in the community association environment.

A common question is whether the unit owner is still

the owner of record or does the bank own the property when there is a Reverse Mortgage in place. It should be noted that the unit owner is still the owner of record on the property.

Another concern is whether unit owners with Reverse Mortgages have a right to vote? The answer is yes. The Reverse Mortgage does not change the ownership of the unit. The unit owner remains the owner of record and retains the title to the home. The bank does not own the property therefore the owner maintains all voting rights pursuant to the governing documents.

Do unit owners who have Reverse Mortgages forfeit any rights?

The answer is no. The unit owners still have all the use rights and other rights afforded under the governing documents.

Do unit owners remain responsible for assessments, special assessments, and following the governing documents, including rules and regulations of the association?

The answer is yes. The owner retains title to the home and as such is still responsible to follow the governing documents, the rules and regulations, to pay assessments, pay taxes, insurance, utilities and other expenses of the property. Further, the owner is still subject to all remedies the Association has should rules be broken or should the owner fail to pay assessments or special assessments as provided for in the governing documents and/or Florida Statutes. For example, an owner who failed to pay general or special assessments would still be subject to foreclosure from an Association pursuant to the governing documents and the law.

Another common question is whether the association has to be notified when owners have Reverse Mortgages. Usually, a provision requiring notice would be contained in the governing documents. For example, if the governing documents of your association provide that an owner may not mortgage the property or may only mortgage it through an

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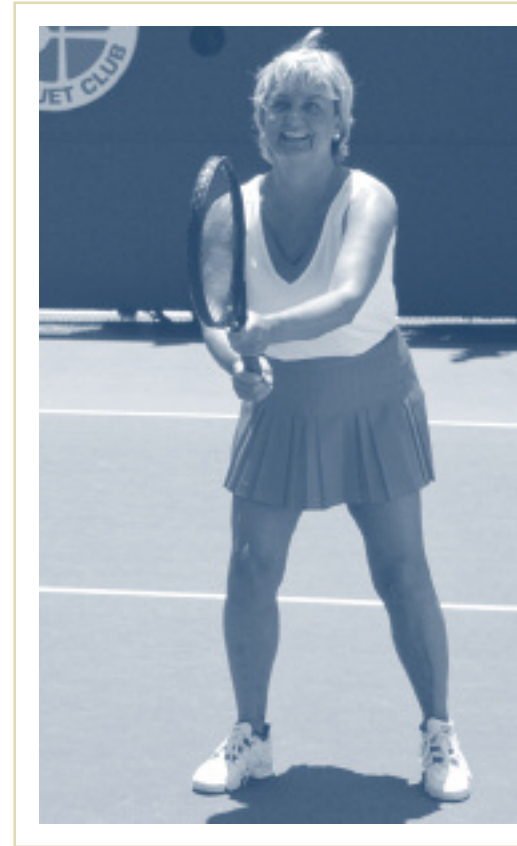
REVERSE MORTGAGES, *cont.*

institutional mortgage or is obligated to request written permission from the Association, then the owner is obligated to follow the appropriate procedures.

Of concern is whether the Association's insurance carrier has to be notified that unit owners have Reverse Mortgages? Typically, if the governing documents and insurance policies provide that insurance coverage includes certain coverage for the unit owners and their mortgagees then it is advisable to notify the insurance carrier of any institutional mortgagee including a holder of the Reverse Mortgage.

It should be noted that usually a Reverse Mortgage will be the only Mortgage on the home as the programs generally require that any prior mortgages be paid off. Certain insurance coverage such as paint, wallpaper, interior walls, finishes, carpeting, or other insured items, that may be insured for the benefit of the owners and their mortgagees, may fall into this category. Also, the Reverse Mortgage lender may require an "endorsement" on the Association's insurance policy.

There are many websites that help educate consumers on Reverse Mortgages, including AARP at www.aarp.org, the U.S. Department of Housing and Urban Development (HUD) at www.hud.gov, and the Federal Trade Commission at www.ftc.gov/credit. This information is for your general understanding only and is not to be construed as legal advice, tax or estate planning advice on Reverse Mortgages.



FINANCIAL REPORTING TIDBITS

Did you know that: Condominium, Cooperative and Homeowner Associations must prepare financial reports each year.

Condominium Associations must prepare financial reports for the prior fiscal year no later than 90 days after the end of the fiscal year, or such other date as may be stated in the bylaws. Homeowner Associations must prepare annual financial reports within 60 days after the end of the fiscal year.

Condominium and Homeowner Associations must provide copies of the financial report, if requested, to its members at no charge.

cont. on page 6

FINANCIAL REPORTING TIDBITS, *cont.*

Cooperative Associations must prepare **and** either mail or hand-deliver to its members a complete financial report of receipts and expenditures for the previous 12 months or alternatively, provide a complete set of financial statements for the previous 12 months, not later than 60 days after the end of the fiscal year, calendar year or such other time as may be stated in the bylaws. Cooperative associations with 50 or fewer units do not have to prepare financial reports.

Financial reports for condominium and homeowner associations, and for those cooperative associations who choose to prepare a complete set of financial statements, are prepared based upon the amount of the association's annual revenues. Specifically, associations with annual revenues of at least \$100,000.00 but less than \$200,000.00 must at a minimum, prepare compiled financial statements. Associations with annual revenues of at least \$200,000.00 but less than \$400,000.00 must at a minimum prepare reviewed financial statements. Associations with annual revenues in excess of \$400,000.00 must prepare audited financial statements. Associations with annual revenues of less than \$100,000.00 and all condominium associations with less than 50 units (regardless of its annual revenues) must prepare a report of cash receipts and expenditures.

Associations may reduce (but not eliminate) the level of financial reporting described above if a majority of the owners present at a properly noticed meeting vote to do so. For example, an association required to prepare audited financial statements in a given fiscal year may vote to reduce the level and prepare instead either reviewed or compiled financial statements or a report of cash receipts and expenditures. The reduction, if approved, is valid only for that particular fiscal year.

The bylaws may mandate a certain level of financial reporting each year (e.g. audited financial statements). If this is the case, the association must follow the bylaws regardless of the amount of its annual revenues and cannot vote to reduce this level without amending the bylaws.



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