CAN PAINTING AND TREE TRIMMING BE PAID FROM RESERVES?

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We continue to find some reluctance to include major, infrequent common area expenses such as painting and tree trimming in the Reserve Study. This stems from IRS rulings and audit filings which state that these are “maintenance” items and not “contributions to capital”. This brings about the distinction between “Capital” Reserves and “Operating” (or “maintenance”) Reserves.

By IRS definitions the assessments being collected for these “maintenance” types of future Reserve expenses cannot be deducted from taxable income of the association under the “contributions to capital” definition. Other items that may fall into this category include termite treatment and repair, asphalt seal coat, contingency allocations, reserve study fees, etc. The list of these often significant, non-capital expenses, is long.

Note that these are only IRS definitions, these are only issues if the association is filing Federal Tax Form 1120 (Corporation Tax Return) rather than the more commonly-used form 1120-H (Homeowners Association Tax Form). Even if the association chooses to file Form 1120, there are ways that your accountant can adjust for these tax differences. It is not uncommon to have differences between generally accepted accounting principles and tax laws. With regards to non-capital reserves, your accountant may also suggest that the cash set aside be segregated from other reserves. Once again, this only applies to those associations filing Form 1120.

It is my opinion that an association should be run like a business, and as such, decisions should be based on what is best for the association operationally, not just for tax purposes. Therefore those items which pass the three-part test for Reserve designation (common area expense, reasonably predictable, , and above a cost that makes it “significant” to the association) are best budgeted through Reserves, not the Operational budget. Then, the major objectives of the association are met and the accountant can adjust the tax returns accordingly (if the association files Form 1120). It is typical for a Reserve Study to clearly identify the Reserve components, so the accountant can easily make the necessary adjustments.