CHAPTER 3

Budgeting for the Association

The most important responsibility the treasurer has to the community is the preparation of the annual operating budget. The budget is a formal financial plan that determines the annual assessment. It can also be used as a tool to measure actual performance and activity.

One effective way to measure association activity is to compare prior-year budgets with the current budget and note financial spending trends. Prior-year budgets serve as the historical basis for the current year's budget.

Begin the budget process as early as possible. Some associations have developed two-, three- and five-year budgets to help with the planning and development of data. The ultimate objective of this type of budgeting is to avoid surprise increases in fees and/or special assessments.

The board should involve the community—through the budget committee and public hearings—in the budgeting process as much as possible. Committee and hearing results should be disseminated to the entire membership through the community newsletter or through the distribution and public posting of fact sheets.

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Consider the following in the development of the operating budget:

- **Avoid fee targeting.** When developing its operating budget, the association must carefully avoid the pitfall of rationalizing expense levels in particular categories to arrive at a predetermined fee increase or a no-fee increase. Some examples of fee-target budgets include the projection that it will be a mild winter or a cool summer and, therefore, electricity usage can be reduced; a guess that it won't snow much, so snow removal costs can be reduced; and the rationalization that the association won't need to budget much for repairs and maintenance because the property is in good condition.

The board must avoid these and other similar rationalizations. The budget must be developed in an objective, step-by-step manner based on historical data and carefully-developed projections.

▪ **Failure to collect unit-owner assessments.** Many condominium budget preparers overlook cash-flow problems caused by delinquencies and slow payers. In most associations, the budget preparer backs into annual assessments through the determination of expenses. To meet cash-flow needs, this method assumes all unit owners will pay promptly each month. This is not always the case. Consequently, to avoid cash flow problems, an aging of receivables should be obtained and evaluated. A bad debt amount should be determined and established for the annual budget. Also, the board should budget for costs to collect delinquent amounts.

Members' equity represents the association's net worth at a point in time: assets minus liabilities equal members' equity.

▪ **Income taxes.** An association should estimate and budget for federal and state income taxes. Generally, the association should budget on the basis of interest income. Condominiums and HOAs may choose one of two methods for filing federal income taxes: 1) as a Section 277 corporation, or 2) as a Section 528 nonprofit organization. Cooperatives should file under Subchapter T (Sections 1381–1388).

The rates are as follows:

- **Section 528 Organization:** a flat 30 percent
- **Section 277 Corporation and Subchapter T** (based on a graduated scale):
  - *Taxable income up to $50,000:* 15 percent
  - *$50,000 to $75,000:* 25 percent
  - *Over $75,000:* 34 percent
  - *Surcharge over $100,000 (Up to $11,750 of tax):* 5 percent

▪ **Other taxes.** Other types of taxes may be appropriate to a specific association. They should be accounted for in the budget. These taxes are as follows:

1. Personal property taxes. If an incorporated association has related personal property, it might be subject to personal property tax.

2. Real estate taxes. If an association has acquired a condominium unit, the association must pay real estate taxes. Homeowner associations that are deeded recreational facilities and common elements may be required to pay some real estate taxes on these items. Real estate taxes on recreational facilities and common elements should be nominal, if they are charged at all.

3. Payroll taxes. If the association has employees, it must pay federal and state unemployment taxes and employer's FICA.

▪ **Other income**. Be sure to include all income sources when determining the budgeted assessment. Common other-income categories include: interest, laundry, late charges, special fees (such as move-in fees), repair charges, pool use, legal cost recovery, vending machines, and newsletter advertising.

▪ **Insurance.** Insurance needs should be budgeted for and evaluated carefully. Because of falling interest rates, insurance companies' yields on investments are dropping. As a result, a corresponding increase in the cost of the insurance premiums may occur. Look for these changes when budgeting. The association should also budget for the amount of its insurance coverage deductible. Check A.M. Best ratings to make sure the selected insurance company has ratings that are within the requirements of the association's documents.

■ **Association borrowing.** Many associations are borrowing from banks to undertake major construction, improvements, or rehabilitation projects. If an association has borrowed funds, it must budget a payback of the loan plus the interest cost of the borrowing.

■ **Budget documentation and support.** Approval of budget should be documented in board meeting minutes. The budget should contain a narrative supporting the individual line items and a detailed schedule of replacement reserves. The treasurer should also consider areas that might be specific to the association, and budget for contingencies (three percent of the annual budget is a rule of thumb) and replacement reserves (in line with the required annual contribution based on the replacement reserve schedule and for any major projects). (See Table 1, page 9.)

Borrowing Funds and/or Special Assessments to Fund Major Projects

The association should consider borrowing funds for property repairs or improvements only as a last resort. The carrying cost of the borrowing (interest on the loan) adds to the cost of the repairs and/or improvements. This means that, ultimately, the amount assessed to the unit owners will be greater than if the unit owners were assessed immediately for the repairs.

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Further, the interest expense incurred by an association on a loan has only a minimal tax impact on the community. On the other hand, if there was a special assessment and a unit owner took out a personal home equity loan to pay the special assessment, then the interest expense on that home equity loan might possibly be a personal tax deduction.

If the association decides to borrow, it should consider short-term borrowing (from one to four years). The value in such borrowing is that it allows the association to maintain its replacement reserves at increasing levels and provides it with the opportunity to increase condominium fees gradually and uniformly over the life of the loan. However, if condominium fees are not increased, benefits of the borrowing will be negated and the community's financial position will be affected adversely. Adequately planned, developed, and funded replacement reserves protect members from unexpected special assessments and prevent the board's need to borrow funds.