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Housing Cooperatives: Accounting and Tax Issues

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Part I

Basic background

Housing co-ops come in many varieties

- Sizes
- Structures
- Memberships
- Number of locations

Common Interest Real-estate Association **(CIRA)**

- Involve owners of real estate or shares of stock or membership certificates
- Membership cannot be separated from ownership of the real estate
- Funding comes from member assessments
- Members share the use of common property
- Self-governance

Different types of CIRAs

- Cooperatives
- Condominiums
- Cohousing organizations
- Homeowners associations
- Timeshares

Housing co-op defined

- From the National Association of Housing Cooperatives:

  People joining, on a democratic basis, to own or control the housing and related community facilities in which they live

- From the University of Wisconsin Center for Cooperatives:

  A housing cooperative forms when people come together to own and control the buildings in which they live.

Cooperative versus condominium

- A **cooperative member** owns a cooperative interest (an ownership interest in the cooperative corporation and its property as a whole plus the exclusive right to occupy a particular dwelling unit). Co-ops usually assist members to find perspective purchasers, and no real estate transaction fees are involved.
- A **condominium owner** owns fee title to a dwelling unit plus an undivided interest in the common property of the condominium development (the land and the buildings themselves). Owners must find their own buyer and the sale is a real estate transaction.

General types of housing co-ops

- Full equity (market rate)
- Limited equity
- No equity (“leasing”)
  - Possibly eligible for tax-exempt status

Part II

Accounting matters

Basic financial statements

- Balance Sheet
  - The organization’s financial situation at a particular **point in time**
  - Shows total **Assets** equal to total **Liabilities plus Equity** – hence the name “Balance Sheet”
- Income Statement (or Profit & Loss Statement)
  - The organization’s financial performance over a given **period in time**
- Statement of Cash Flows
  - **Reconciles** the net income for the year to the change in cash

The fundamental equation of accounting

- Assets = Liabilities + Equity

- What you HAVE = What you OWE plus what you OWN

  (Not a formal definition)

HAVE	=	OWE	+	OWN
(Asset)	=	(Liability)	+	(Equity)

Balance sheet example

Assets	
Cash	$ 15,000
Accounts receivable	2,000
Restricted cash	30,000
Land	20,000
Building	80,000
Total assets	**$ 147,000**
Liabilities	
Accounts payable	$ 3,000
Loans payable	80,000
Member deposits	10,000
Total liabilities	93,000
Equity	
Retained Earnings	54,000
Total liabilities and equity	**$ 147,000**

Income statement example

Revenue	
Carrying charges	$ 130,000
Interest income	1,000
Total revenue	131,000
Expenses	
Loan interest	7,000
Utilities	29,000
Depreciation	5,000
Maintenance	82,000
Education	4,000
Total expenses	127,000
Net income	**$ 4,000**
Beginning retained earnings	50,000
Ending retained earnings	54,000

Equity

- An element of the balance sheet
- Two primary components:
  - Retained earnings
    - All the prior years' net incomes not distributed back to the members
    - At the end the of year, net income gets added into retained earnings
  - Member shares (or stock, certificates, capital contributions, deposits)
    - What members must contribute to the co-op as a condition of joining the organization
    - Recorded as **equity** if the return of shares is not automatic when the member leaves the co-op. If the return of shares IS automatic, minus any nonpayment of charges and/or damage assessments, this should be recorded as a **liability.**
- When some of the earnings are returned to the owners of a co-op, this is know as a **patronage dividend** (relatively uncommon for housing co-ops)

Internal controls

- The organization's processes that ensure the integrity of financial information and prevent fraud
  - Reviews of financial transactions by someone who does not process them – "dual control"
    - Review of cash disbursements (canceled check images)
    - Review of payroll reports
    - Review of accounting transactions recorded
  - Proper documentation behind financial transactions
  - Vendor approval processes
  - Budgetary analysis, benchmarking

Depreciation

- Some assets – buildings, renovations, furniture, equipment – are not recorded as expenses when purchased
- Instead, they're recorded as **assets** *(balance sheet)* and then **depreciated** over several years *(income statement)*
- **Depreciation** spreads out & expenses the costs of those assets over several future years

Capitalization of improvements and acquisitions

- Best practice: adopt a capitalization policy (a dollar threshold) that dictates when items are **capitalized** or **expensed**
- For tax purposes, the co-op can take a “de Minimis safe harbor election”
  - For entities that have regular audits, items under $5,000 can be expensed
  - For other organizations, items under $2,500 can be expensed
- But a co-op should adopt a policy that’s reasonable for its particular circumstances

Replacement fund study

- A required disclosure in the footnotes of CIRA reports (*except for "no-equity" co-ops*)
- Estimates of costs of future major repairs and replacements of the co-op's tangible assets
- A professional study is not required
- "Unaudited" component of an auditor's report

Special assessments

- Assessed for specific purpose, above and beyond normal operations
- Should be recognized as revenue in the period in which the funds are expended
- Therefore, funds to be expensed during the next year cause the assessments to be recorded as deferred revenue in the current year

Methods of accounting

- **Two primary methods of accounting:**
  - Accrual – for GAAP (Generally Accepted Accounting Principles) reports
  - Cash *(or possibly "Modified Cash")* – commonly produced for internal reports

GAAP basis

- **GAAP =** Generally Accepted Accounting Principles
  - Also know as the "accrual method" or "accrual basis"
  - Used for most formal financial reports, such as audit reports
  - This best reflects the organization's true economic situation
  - Revenue recognized when it's actually **earned**
  - Expenses recognized when they're actually **incurred**

Cash basis

- Revenue recognized when cash is **received**
- Expenses recognized when cash is **paid**
- Simple and straightforward
- Aligns with budgetary amounts
- Most co-op budgets, and internal income statements, are done on the cash basis

Budget variance reports (internal)

- Usually presented on the Cash basis
- Major distinctions between GAAP financial statements and cash income statements
- Make sure the report's basis of accounting is clear!
  - Income: might be cash received, not accrued amounts
  - Expenses: might be cash payments, not incurred amounts
  - Loan payments: might all show as expenses
  - Major maintenance projects: might all show as expenses

Part III

Let’s work through an example!

Weownit Cooperative – a new development

Initial situation

- By the end of the December, the cooperative had borrowed $1,000,000 to develop its first property.

- The development cost exactly $1,000,000.

Balance Sheet Prior to Opening

Assets	
Land and building	$ 1,000,000
Total assets	$ 1,000,000
Liabilities	
Loans payable	$ 1,000,000
Total liabilities	1,000,000
Equity	0
Liabilities and equity	$ 1,000,000

Assumption #1

- The co-op has thirty units and was full to start the year. The members are assessed $1,000 each for the month of January, for a total of $30,000. But two members didn't pay during the month, and one member paid their January <u>and</u> February charges.

Income Statement following Assumption #1

GAAP What the statement *should* be		**Internal financial report (cash basis)** What the statement *might* be	
Revenue		**Revenue**	
Assessments	$ 30,000	Assessments	$ 29,000
Total expenses	0	**Total expenses**	0
Net income	$ 30,000	**Net income**	$ 29,000

Balance Sheet (GAAP) following Assumption #1

Assets	
Cash	$ 29,000
Accounts receivable	2,000
Land and building	1,000,000
Total assets	1,031,000
Liabilities	
Deferred revenue	$ 1,000
Liabilities	1,000,000
Total liabilities	$ 1,001,000
Equity	
Net income – year to date	30,000
Total liabilities and equity	$ 1,031,000

Assumption #2

- Also in January, the co-op purchased $5,000 of supplies, for which it paid $4,000 by the end of the month. And its staff incurred $8,000 in wages, for which it paid $7,000 by the end of the month.

Income Statement following Assumption #2

GAAP What the statement *should* be		**Internal financial report (cash basis)** What the statement *might* be	
Revenue		**Revenue**	
Assessments	$ 30,000	Assessments	$ 29,000
Expenses		**Expenses**	
Supplies	5,000	Supplies	4,000
Wages	8,000	Wages	7,000
Total expenses	13,000	**Total expenses**	11,000
Net income	$ 17,000	**Net income**	$ 18,000

Balance Sheet (GAAP) following Assumption #2

Assets	
Cash	$ 18,000
Accounts receivable	2,000
Land and building	1,000,000
Total assets	$ 1,020,000
Liabilities	
Accounts payable	$ 2,000
Deferred revenue	1,000
Loans payable	1,000,000
Total liabilities	1,003,000
Equity	
Net income – year to date	17,000
Total liabilities and equity	$ 1,020,000

Assumption #3

- Also in January, the co-op made a loan payment of $3,000. $2,000 of this is comprised of interest, and $1,000 paid down the principal balance.

Income Statement following Assumption #3

GAAP What the statement *should* be		**Internal financial report (cash basis)** What the statement *might* be	
Revenue		**Revenue**	
Assessments	$ 30,000	Assessments	$ 29,000
Expenses		**Expenses**	
Supplies	5,000	Supplies	4,000
Wages	8,000	Wages	7,000
Interest	2,000	Mortgage payments	3,000
Total expenses	15,000	**Total expenses**	14,000
Net income	$ 15,000	**Net income**	$ 15,000

Balance Sheet (GAAP) following Assumption #3

Assets	
Cash	$ 15,000
Accounts receivable	2,000
Land and building	1,000,000
Total assets	$ 1,017,000
Liabilities	
Accounts payable	$ 2,000
Deferred Revenue	1,000
Loans payable	999,000
Total liabilities	1,002,000
Equity	
Net income – year to date	15,000
Total liabilities and equity	$ 1,017,000

Assumption #4

- Also in January, the co-op acquired a $7,000 pool table for its common room. It paid for the pool table by the end of the month.

Income Statement following Assumption #4

GAAP
What the statement *should* be

Revenue	
Assessments	$ 30,000
Expenses	
Supplies	5,000
Wages	8,000
Interest	2,000
Total expenses	15,000
Net income	$ 15,000

Internal financial report (cash basis)
What the statement *might* be

Revenue	
Assessments	$ 29,000
Expenses	
Supplies	4,000
Wages	7,000
Mortgage payments	3,000
Improvements	7,000
Total expenses	21,000
Net income	$ 8,000

Balance Sheet (GAAP) following Assumption #4

Assets	
Cash	$ 8,000
Accounts receivable	2,000
Land and building	1,000,000
Equipment	7,000
Total assets	$ 1,017,000
Liabilities	
Accounts payable	$ 2,000
Deferred revenue	1,000
Loans payable	999,000
Total liabilities	1,002,000
Equity	
Net income – year to date	15,000
Total liabilities and equity	$ 1,017,000

Assumption #5

- The co-op depreciates is property and equipment at a rate of $12,000 per year.

Income Statement following Assumption #5

GAAP
What the statement *should* be

Revenue	
Assessments	$ 30,000
Expenses	
Supplies	5,000
Wages	8,000
Interest	2,000
Depreciation	1,000
Total expenses	16,000
Net income	$ 14,000

Internal financial report (cash basis)
What the statement *might* be

Revenue	
Assessments	$ 29,000
Expenses	
Supplies	4,000
Wages	7,000
Mortgage payments	3,000
Improvements	7,000
Total expenses	21,000
Net income	$ 8,000

Balance Sheet (GAAP) following Assumption #5

Assets	
Cash	$ 8,000
Accounts receivable	2,000
Land and building	1,000,000
Equipment	7,000
Accumulated depreciation	*(1,000)*
Total assets	$ 1,016,000
Liabilities	
Accounts payable	$ 2,000
Deferred revenue	1,000
Loans payable	999,000
Total liabilities	1,002,000
Equity	
Net income – year to date	14,000
Total liabilities and equity	$ 1,016,000

Part IV

New developments, major improvements, and financing issues

Accounting for development/improvement projects

- Costs **directly related to the physical structure** should be capitalized as part of the new asset
  - Costs of acquiring the property
  - Costs of renovations
  - Architect fees
  - Other professional services
  - Title transfer costs
  - Interest incurred with a construction loan
- These costs are then depreciated with the property itself

New property acquisition

- Need to separate the cost of the land versus the cost of the building
  - Can use any reasonable method
    - One common method: the most recent property tax assessment
- Land: does not depreciate
- Building: does depreciate (27.5 years for federal tax purposes)

Costs of obtaining loans

- Referred to as loan costs, loan fees, and/or debt issuance costs
  - Loan financing costs charged by the financial institution
  - Professional fees involved with obtaining financing
- Should **not** be expensed – should be recorded in the liabilities section of the balance sheet
  - Will have a negative balance – a “contra liability”
  - Amortized, as interest expense, over the length of the loan

Sources of co-op financing

- Credit Unions
- Lenders developed specifically for co-ops:
  - Shared Capital Cooperative
  - Capital Impact Partners
  - Kagawa Fund for Student Co-op Development
  - National Co-op Bank
  - Cooperative Fund of New England

Mortgage payment components

- Three variables combine to determine the monthly mortgage payment:
  - Principal balance
  - Interest rate
  - Amortization – length of repayment
- This payment is constant from month to month.
  - What changes is the amount of the payment which is applied to interest *(income statement)* versus the amount of the payment which is applied to principal *(balance sheet)*.

Mortgage loans over time

- During the first few years of the loan, the interest charges take up a relatively high amount of the mortgage payments.
  - Gradually, as the principal balance declines over time, the interest charges decrease, and higher amounts of the mortgage payments are applied to the principal.

Loan Amortization Example – Beginning of the Loan

Loan amount: 300,000
Interest rate: 7%
Repayment period (amortization): 20 years

Calculated monthly payment: 2,326

Payment	interest	principal	loan balance
			300,000
2,326	1,750	576	299,424
2,326	1,747	579	298,845

Loan Amortization Example – End of the Loan

Loan amount: 300,000
Interest rate: 7%
Repayment period (amortization): 20 years

Calculated monthly payment: 2,326

Payment	interest	principal	loan balance
			4,611
2,326	27	2,299	2,312
2,326	14	2,312	0

Part V

Income tax issues

IRS approach to housing co-ops

- The IRS has given formal recognition of property ownership to housing co-ops
- Internal Revenue Code (IRC) Section 216 – involves tax benefits to co-op members. To qualify for 216 status, a number of tests need to be satisfied

IRC Section 216 requirements

- Corporate form
- Only one class of stock outstanding
- Right to occupy a unit
- Meet financial tests (any one of these)
  - At least 80% income from members
  - At least 80% of square footage is used (or available for use) by members
  - At least 90% of expenditures relate to the property and are for the members' benefit
- No distributions to members which aren't derived from earnings and profits

Tax benefits available to members of IRC 216 co-ops

- Property taxes – itemized deduction
- Interest expense – itemized deduction
- The co-op itself may deduct the property taxes and interest expense at the corporate level. So double deduction is possible!
- Can allocate equally to all members, OR by other methods that reasonably allocate costs to units
- Co-op must give proper notice to members to facilitate the deduction

Some member assessments can be excluded from taxable revenue

- Assessments for capital improvements
- Assessments for mortgage amortizations
- Financial Statement presentation: diversity in practice – sometimes the assessments are listed as revenue, sometimes as direct contributions to equity

Non-taxable member assessments

- These assessments must be clearly earmarked up front
  - Clearly separate and distinct from assessments for normal operations
- They need to be carefully accounted for on an ongoing basis
- Expenditures must meet the definition of capital improvements (they must be for capitalized assets)
- Considered capital contributions to equity of the co-op, not taxable revenue

Patronage dividends

- A method of refunding net earnings to a co-op's members
- Somewhat rare for housing co-ops – but are seen occasionally
- Rational basis: equally to all members, by square footage, or by charges paid
- Patronage income: earned to facilitate the co-op's activities, versus simply enhancing profitability
- Usually NOT taxable to the recipients
- First year: must complete IRS Form 3491

Patronage dividends

- Not all of the dividends need to be paid to the members in cash
    - Up to 80% may be retained by the co-op indefinitely
    - Nonetheless, the entire amount is deductible by the co-op
    - The cash portion (at least 20%) must be paid within eight and a half months of the fiscal year-end date

Tax depreciation

- Residential buildings & improvements: assigned a statutory life of 27.5 years for tax depreciation purposes
- Appliances, electronic equipment, and vehicles: statutory life is generally five years
- Furniture and other equipment: statutory life is generally seven years
- “Accelerated” tax depreciation can be taken on some assets, allowing a deduction of up to 100% in the year they’re placed into service
    - Generally not available to buildings & improvements

Tax forms

- Co-op form is the 1120-C
- Housing co-ops are explicitly disallowed from filing a Homeowners Association return (1120-H)
- But some “no equity” co-ops have obtained federal tax-exempt status and file the Form 990 for nonprofit organizations
    - Co-ops providing affordable housing for students, low-income members, elderly members, etc.

Form 1120-C

- The first time an 1120-C is filed, the IRS needs to receive proof that the organization is a co-op
  - Commonly involves attaching the Articles of Incorporation and/or Bylaws
- If patronage dividends are paid, the due date is eight and a half months after the fiscal year end
  - If not, the due date is three and a half months after the fiscal year end (can be extended)
- 1120-C records distinctions between patronage and non-patronage activities
- If a co-op *receives* patronage dividends, it must list the sources and details of that income

Resources

- NASCO (North American Students of Cooperation)
  www.nasco.coop
- NAHC (National Association of Housing Cooperatives)
  http://coophousing.org
- University of Wisconsin Center for Cooperatives
  http://www.uwcc.wisc.edu
- California Center for Cooperative Development
  https://www.cccd.coop

Thank You!

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