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THE QUEENSTON COMMON CASE: THE COURT UPHOLDS ACTIONS OF A DILIGENT BOARD

By Dennis R. Casale, Esq.
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Periodically, we invite guest authors to provide our readers with insights and information on a wide variety of issues affecting Board fiduciary responsibilities. Dennis R. Casale, Esq. and Audrey D. Wisotsky, Esq. are partners in the law firm of Pepper Hamilton LLP specializing in community association law. Pepper Hamilton LLP is a multi-practice law firm with 400 lawyers in 11 offices. Mr. Casale can be reached via E-mail at casaled@pepperlaw.com and Ms. Wisotsky may be contacted at wisotska@pepperlaw.com.

In a recent case, *Novitt, et al. v. Board of Directors of Queenston Common Property Owners Association, et als.*, the Superior Court of New Jersey, Chancery Division, upheld a Condominium Association's right to authorize (1) the replacement of common elements within the condominium, and (2) the financing of the costs of such replacements.

The court decided that the replacement of the siding and windows was not a capital improvement, relying in part on the testimony of one of the Association's expert witnesses—Jules Frankel of Wilkin & Guttenplan, P.C.

The case arose when Queenston's Board of Trustees authorized the replacement of the siding and wood trim with vinyl siding, and replacement of the exterior windows. The Board determined that it would fund the project from two sources, (1) its reserve fund, and (2) a loan to be secured and



collateralized by the monthly maintenance fees paid by each unit owner.

A few homeowners challenged the Board's actions by filing a lawsuit. The initial issue in the case was whether the windows were to be considered part of the units or common elements. The Board, relying upon an opinion from its counsel, determined that a window was a common element based on language within the master deed, in which references to windows and doors were used solely to define the areas which were boundaries, but not included in the units. Therefore, it was determined that the Association had the responsibility to maintain, repair and replace the windows. The court agreed that the windows "are a common element such that they comprise part of the unit structure and are the responsibility of the Association to maintain."

The court then addressed the issue of whether the installation of the siding and windows was a "replacement" or a "capital improvement." In accordance with the Association's bylaws, capital improvements over \$5,000 would require approval by members of the Association. Conversely, the Board had the authority to authorize the repair/replacement of

(Continued on Page 2)

CLUB DOs AND DON'Ts

By Anissa Telle

Have your residents created informal social clubs? Do they use the clubhouse as their meeting place? Isn't that one of the benefits of the Community Association lifestyle? If you answered "Yes" to all three questions—then keep reading. We have some advice to assist Associations and their membership to facilitate compliance with relevant tax and other considerations.

Background

Often, our Association clients have available a clubhouse facility that contains community multipurpose rooms for use and/or rent. The residents often create informal social organizations (clubs) based upon particular areas of interest (e.g. sewing club, bridge club, computer club, photography, etc). These clubs usually raise money by contributions from members, which can be in the form of dues, ticket or admission sales to events such as dinners and dances (open to non-members), or infrequent sales of tangible goods, such as bake sales. Although these activities are all innocent enough, the club and Association need to be cautious. The Association may make space available for these clubs to meet and conduct their operations, but the clubs are not necessarily sponsored by the Association or operated by it. This distinction, between, and separation of, operations and finances is very important, and if not properly heeded, both entities may risk financial liability, while creating the need for various local and federal tax filings.



Segregation of Club and Association Operations

If the club is not an Association-sponsored activity or organization, an important issue is to have a clear delineation between the Association and the club. Without this "operating independence," the Association risks being considered responsible for the actions of the club members. The club should consider the following steps to minimize the Association's exposure:

1. Ensure the club is properly incorporated as an entity separate from the Association
2. Verify that the club has adopted its own bylaws
3. Maintain separate bank accounts
4. Maintain separate financial records.

In addition, we would advise Associations to consult an attorney to review the clubs' status as an independent entity from the Association, to help protect the Association from unwanted ramifications.

Income Tax Liability

This is a potential issue that requires some discussion.

All income is required to be reported and tax must be paid on earnings from investments and fundraising activities. This is an annual compliance requirement that exists for both incorporated and non-incorporated entities.

A club can receive a tax exemption from the Internal Revenue Service if it meets specific requirements to qualify as a social club. If this exemption is granted, an annual filing may still be necessary, but tax may not be due.

A club cannot be considered "automatically" tax exempt—it must apply to the IRS for an exemption. Without such an exemption, a club could be faced with an unpleasant "double whammy" resulting in:

- Tax liability on revenues
- Disallowance of deductions for club expenses.

If incorporated, it is important that the club be formed under New Jersey Not-for-Profit statutes to avoid New Jersey income tax as well.

Sales Tax Liability

If the organization is recognized by the IRS as formed under Section 501(c)(3), (i.e., is formed exclusively for religious, charitable or educational purposes), then Form ST-5 should be filed. This form provides the organization with an exemption from:

- Paying sales and use tax on its purchases made for exempt purposes
- Collecting sales tax, if the organization has only occasional fundraising or qualifying thrift store sales.

If the organization does not qualify to receive an ST-5 exemption, the club may be liable to collect sales tax. One exception, however, exists for the sale of tangible personal property on an occasional basis (e.g. yard sales).

There are specific compliance rules surrounding these issues, but it is important for the clubs to be aware of, and comply with, applicable regulations. The alternative could result in enforcement actions from the State.

Concluding Thoughts

Associations need to understand the importance of financial issues relevant to the use of the clubhouse by the residents, and we recommend that appropriate procedures be instituted (where applicable) and followed to ensure adequate compliance with State and Federal regulations.

Multiple financial problems can be avoided by structuring the clubs properly, and clubs will function for their intended purpose—to enhance the quality of life for their members.

As always, if your Association or club needs further advice in this area, please feel free to contact your Wilkin & Guttentplan advisor.



In the Fall 2002 issue of the CPA, our article on Cash versus Accrual Basis Accounting presented an example illustration which contained a typographical error. We apologize for any confusion caused by this oversight. The corrected illustration follows:

Using the information provided in SECTION A, the differences between cash and accrual basis accounting are illustrated in SECTION B:

SECTION A			
	YEAR		
	2001	2002	2003
Cash collections from unit owners for monthly maintenance fee income:			
From 2001 assessments	\$ 80,000 A	\$15,000 B	\$5,000 C
From 2002 assessments	\$10,000 D	\$90,000 E	\$30,000 F
Cash payments for Association maintenance expenses:			
On 2001 costs	\$80,000 G	\$27,000 H	\$ - I
On 2002 costs	\$6,000 J	\$50,000 K	\$14,000 L

SECTION B		
	YEAR	
	2001	2002
CASH BASIS:		
Revenue	\$ 90,000 A+D	\$105,000 B+E
Expenses	<u>86,000</u> G+J	<u>77,000</u> H+K
Excess of revenues collected over (under) expenses	\$4,000	\$ 28,000
ACCRUAL BASIS:		
Revenue	\$100,000 A+B+C	\$130,000 D+E+F
Expenses	<u>107,000</u> G+H+I	<u>70,000</u> J+K+L
Excess of revenues over (under) expenses	\$(7,000)	\$ 60,000

NOTE THIS DIFFERENCE

Using the cash basis, the entity generated a surplus of \$4,000, but the accrual basis actually shows a \$7,000 deficit!

This is because the accrual basis reflects the *actual revenues and expenses incurred for the calendar year*. Using the cash basis method of accounting, 2001 revenues were understated by \$10,000, which is the difference between the cash and accrual revenue amounts for 2001, and expenses were also understated, by \$21,000, which is the difference between the cash and accrual expense amounts for 2001. How does the accrual basis account for this variance? Because the accrual basis “matches” the Association’s expenses incurred (but not necessarily paid) with the revenue to be earned for the corresponding time period.

Thus, by totaling all of the 2001 anticipated revenue **A+B+C** the revenue *earned* in 2001 was \$100,000, rather than the \$90,000 reflected using the cash basis method. Similarly, the expenses incurred using the accrual basis in 2001 were \$107,000 **G+H+I**, rather than the sum of \$86,000 that was actually disbursed.



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