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April 5, 2018

Board of Directors
Virginia Run Community Association, Inc.
15355 Wetherburn Court
Centreville, VA 22020

Dear Board of Directors:

At your request, we would like to provide some information on the income tax treatment for the Association's 2018 easement proceeds. The tax treatment is different based on the type of easement. Therefore, we have addressed each one separately.

Temporary Easement Proceeds

When an association receives temporary easement proceeds, it is considered to be taxable ordinary income, which is similar to rental income. This would be applicable when land is used temporarily rather than taken or sold. Deductions may be taken for related expenses such as legal fees, extra time spent by management, and any repairs necessary to restore the affected land area. For example, if a new fence is necessary to shield the area, or if any landscaping needs to be replaced, these expenses may be taken as a deduction to offset the taxable income.

Land Condemnation/Permanent Easement Proceeds

When an association receives proceeds for condemnation of common area land, or any type of permanent easement, it is considered a taxable gain. Homeowners associations do not have any cost basis in their common property since it is acquired from the declarant at inception. Therefore, the taxable gain would be equal to the entire easement proceeds. Unfortunately, simply applying the funds directly to replacement reserves will not eliminate the tax burden. Deductions may be taken to offset this taxable income, which are similar to those mentioned above, for such things as repairs necessary to restore the affected area (landscaping, fencing, etc.), legal fees to review the agreement, and any extra time spent by management on the project.

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For a permanent easement, there are some alternative ways to structure the transaction in order to avoid or minimize the tax liability.

Option 1: Refund to the Homeowners

If the proceeds were returned to the homeowners, then no taxes would be owed. The homeowners would have a reduction in the cost basis of their individual homes, which would not be considered taxable income to them. It would only affect their taxable gain or loss, if any, when they sell their homes.

If this option is selected, a letter should be sent to each homeowner explaining that a condemnation of common area land/permanent easement agreement has been entered into, the proceeds are being refunded to homeowners, and that the homeowners will have a reduction in their individual cost basis. The theory behind this is that the affected land is no longer available in the common area, and this reduction in common area land has reduced each homeowner's investment in their home.

Option 2: Refund to the Homeowners and Levy a Special Assessment

This is a viable option if an association has a specific capital project that needs funding. It could return a portion of the easement proceeds to the homeowners, as mentioned above, and at the same time, levy a special assessment in the same amount. This would be a decrease in cost basis and a corresponding increase in cost basis for each homeowner. It is important that the special assessment be used for a capital project rather than for repair and maintenance items. For financial statement purposes, it should be treated as a capital contribution and placed directly into a special project fund or replacement reserve equity account on the balance sheet. This would clearly separate it from operating assessments. As noted above, it must be used for a capital project.

In this case, we recommend that the letter to the homeowners, as mentioned above, also explain the special assessment terms, indicate that it is for a specific capital project, and explain that the homeowners may increase their individual cost basis by the amount of their portion of the special assessment. If this option is chosen, it could be handled without any disbursement of cash, as long as the letter to the homeowners clearly explains both the refund and offsetting charge.

Items to Consider for Both Types of Easements

For both types of easements, the Association should carefully track any related expenses so that they may be deducted against any potentially taxable income.

2-Year Replacement Period for Related Easement Repairs

If more time is needed to make the necessary easement related repairs, the IRS allows up to two years. This 2-year replacement period ends at the end of the fiscal year, two years after the proceeds are received. For temporary easements, this allows two years for related repairs. For permanent easements, this allows two years for related repairs, refunds to homeowners or refunds to homeowners with offsetting special assessments.

Extension for 2-Year Replacement Period

If the 2-year replacement period is not sufficient to make the necessary related repairs, then an association may request an extension before the end of the 2-year replacement period. Extensions are typically considered for periods of up to one additional year. An extension request would be made by writing a detailed letter to the IRS including specific information on the reason for the delay, expected timeline, status and costs of the damages and the planned related repairs.

Amended Returns

If all of the proceeds are not used by the end of the 2-year replacement period, any remainder will need to be recognized as taxable income. The IRS calls for this taxable income to be reported on an amended tax return for the year in which the proceeds were originally received. Additionally, when an association files amended tax returns, this will most likely result in penalties and interest for not having paid the tax in the year it was originally due.

Is the 2-Year Replacement Period Necessary?

If an association can make a reasonable estimate of the necessary related repairs during the first year, it should consider if it will be necessary to use the allowed 2-year replacement period.

If the estimated costs are lower than the easement proceeds, then an association may want to consider recognizing a portion as taxable income in the year received instead of using the 2-year replacement period. That is, it might make sense to go ahead and include some of the excess amount as taxable income for the year received rather than waiting. When an association utilizes the 2-year replacement period, and it does not use all of the proceeds, then as mentioned above, amended tax returns would be necessary. Also as mentioned above, when an association files amended tax returns it will most likely result in penalties and interest for not having paid the tax in the year it was originally due. Therefore, the 2-year replacement period should only be used if needed. Later on, if it is determined that there were related repairs necessary during the 2-year replacement period, then an association could opt to file an amended tax return to report additional deductions and request a refund.

If the costs of the related repairs cannot be reasonably estimated, then an association may want to wait and take advantage of the full 2-year replacement period before reporting the remainder as taxable income. This would help to avoid taxing funds that may be needed for related repairs.

Association's Decision on Using the 2-Year Replacement Period

We would like for the Association to direct us as to whether or not it will use the 2-year replacement period. Please check the appropriate box below and return a signed copy of this letter to our office. **A response is required before we can prepare the Association's income tax returns for the year the easement proceeds were received.**

☐ Yes, we want to use the 2-year replacement period to make related repairs. We understand that if these funds are not used **by the end of the 2-year replacement period**, then amended returns will be necessary to include the remainder in

taxable income. If amended returns are necessary, we understand that there will most likely be tax penalties and interest assessed by the IRS and/or the State for late payment of tax.

OR

☒ No, we do not want to use the 2-year replacement period to make related repairs. We understand that if these funds are not used **by the end of the year received**, then the remainder will be included in taxable income in the year received. If the quarterly estimated tax payments were not large enough during the year received to cover this additional tax, we understand that there will most likely be tax penalties and interest assessed by the IRS and/or the State for late payment of tax. Amended returns could be filed later on requesting a refund of the tax paid if proceeds are used during the 2-year replacement period.

Virginia Run Community Association, Inc.:

[signature] 4/12/18

Signature Date

Theodore F Troscianecki, President VA Run BOT

Printed Name and Title

Please let us know if you have any additional questions or concerns.

Sincerely,

[signature]

S. Gail Moore
Certified Public Accountant