

Year-End Treasurer's Guide

A Workshop by Ira Smilovitz



Published by:

ICLUBcentral Inc.

1430 Massachusetts Avenue

Cambridge, MA 02138

617-491-3300

www.iclub.com

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About the Author

A chemist (B.S.) and chemical engineer (M.Eng.) by academic training but the son of accountants, Ira has never been one to travel in a straight line when there's an interesting detour available. In addition to the obligatory product/process engineering of electronic components, personal care products, and laundry products, Ira has been a professional voyeur, software consultant, tax preparer, bookkeeper, and financial coach.

Over the years, Ira has become a key resource for investment clubs with accounting questions. The NAIC Computer Group Advisory Board awarded him its Kenfield-Burriss Online Service Award in 2005 in recognition of the support he has provided (and continues to provide) to hundreds of clubs throughout the country.

Ira lives in Leonia, NJ with his wife and children. He has been the treasurer of Lakshmi Investments, LLC, since 1999.



Introduction

Modern investment club accounting can be very much like driving by GPS. Little mistakes seem innocuous, but slowly they compound, and suddenly you find yourself lost in the woods of seemingly threatening numbers.

Over the next few pages, we'll tackle the seemingly daunting task of closing the club's books at year-end and preparing the club's tax return(s). We'll start with the underlying principles behind the year-end process, and then present the specific actions that you'll need to take. If my investment club accounting GPS is set correctly, this will be a painless journey.

Why Do We Do What We Do?

One word explains it all: taxes. If it weren't for the requirement to settle up with our Uncle in Washington DC, life would be simple. We could just keep track of the value of the investment club, determine some way to equitably divide up that value among the members, and be done with it.

However, life isn't that simple. We are required to make an annual accounting of our income and pay taxes on that income. Once the income is taxed, we don't have to pay taxes again on the same money. So, we need to keep track of how much of our share of the club's value has already been taxed and how much is yet to be taxed.

Finally, the tax laws of the United States require that we determine the source/type of income and expenses and report each of these amounts separately. This is partially to allow economic analyses of income, and partially because different types of income are subject to different tax rates.

The year-end "closing of the books" process does all this for us. It provides the necessary allocation of income and expense to each member of the investment club, updates the amount of "already taxed" basis for each member, and provides the detailed information necessary to complete the club's and its members' tax returns. Before we get to the actual process of closing the books, there are two decisions we need to make: how to allocate income and expense, and if we will distribute units as part of the allocation process.



Allocation Methods

In theory, investment clubs can choose almost any method they wish to allocate income and expense to their members, provided that method is clearly stated in the club's Partnership Agreement. The only IRS restriction is that the allocation method must have "substantial economic effect."

In the absence of an explicit allocation method in the Partnership Agreement, "the partner's share [of income, gain, loss, deduction, or credit] is determined according to the partner's interest in the partnership" (2006 Instructions for Form 1065 and IRS Reg. 1.704-1).

For the purposes of this workshop, I will ignore the arguments surrounding equal vs. proportional allocation of specific expenses, other than recommending that your club adopt the language in its Partnership Agreement that documents its choices.

In practice, most investment clubs allocate income and expense according to the ownership percentage of the assets in the club. This is determined by the number of units each member owns, expressed as a percentage of the total number of units outstanding.

This still leaves us a choice. There are two allocation methods provided within the current investment club accounting software. (When I use "club accounting software" in lower case, I am referring to any current software available, regardless of supplier. When I use "Club Accounting 3" or "Club Accounting Online," I am referring to the specific software products of ICLUBcentral.) The two allocation methods are *snapshot* (non-time based) and *time-based*.

Snapshot Allocation

Snapshot (non-time based) Allocation is the older and less-favored allocation method. Its attraction is its simplicity, and it was used when club financial records were kept by hand. **In the Snapshot method, all income and expense are allocated using the end-of-year ownership percentages.** If a member withdraws mid-year, a special allocation is made for that member using the income/expense up to the withdrawal date and her ownership percentage just prior to the withdrawal. One

consequence of Snapshot Allocation is that a member who joins the club mid-year will share in income and expenses for the entire year.

Time-based Allocation

Time-based allocation is the favored allocation method. **All income and expense are allocated using the ownership percentages on the date the income/expense items are realized.** Members only receive allocations for the part of the year that they were members of the club. Computers and club accounting software make the numerous calculations painless.



Distributing Units

The second decision that has to be made before we get down to the nitty-gritty of closing the books is whether or not you want to distribute units as part of the allocation process.

The traditional method -- as recommended by NAIC -- was to distribute units at the end of the year. In essence, the investment club was mimicking a mutual fund. The club would determine its net income and "distribute" it to the members in accordance with the allocation method chosen. The club's current value would be decreased by the amount of income distributed, thereby reducing the unit value. The distributed income would then be used to purchase additional units at the new unit value. The purchase of new units was recorded as a contribution of capital to the member's account. The net result was that the number of units and unit value changed for each member, but their percentage ownership and current value did not.

The problem with this method is that it can lead to some weird situations when a club has a net loss for the year. In this case, the loss is distributed to the members. The club's value is INCREASED by the amount of the loss distributed, thereby increasing the unit value. The distributed loss is then used to SELL units at the new unit value. The sale of new units was recorded as a reduction of capital to the member's account. The net result was that members had fewer units, each worth more, while their percentage ownership and current value remained constant. This was and remains extremely confusing to most club members.

In fact, there was never any need to distribute units. Mutual funds are required to distribute their income to shareholders each year in order to qualify for an exemption on paying taxes at the fund level. The choice of whether to reinvest that distribution in the mutual fund or keep the cash is up to the individual investor. Investment clubs are exempt from taxation at the club level by "definition." They are only required to report the taxable items to their members so that the members can pay the appropriate taxes at the individual level.

At the beginning of this workshop, I stated that one of the objectives of the year-end closing process was to update the "already taxed" basis for each member. Once we've determined the net income/loss allocated to

each member, we simply have to add the income to or subtract the loss from the cost basis for that member.

Therefore, the current recommendation is that clubs do NOT distribute units when they allocate income and expense.

The current club accounting software from ICLUBcentral (Club Accounting 3 [CA3] and Club Accounting Online at myICLUB.com [CAO]) allows you to choose whether to distribute units or not.

To wrap up this section, let's make the two preliminary decisions and make sure our software is set correctly.

CA3:

Club>Settings (in left bar) or **Tools>Settings** (in top bar). Enter a check in **Use Time-Based Earnings Allocation** if you want time-based allocation (recommended). Remove the check to use Snapshot Allocation. If you don't already see an earlier year selected, enter 2007 for the first year to NOT distribute units (recommended).

CAO:

Accounting>Utilities>Allocation Settings. Select **Time-Based Allocation** (recommended) or **Non Time-Based Allocation**. If you don't already see an earlier year selected, enter 2007 for the first year to NOT distribute units (recommended).



Closing the Books - Part 1

The procedures presented below are not the only way to close the club's books, but rather the way that I have done them for the clubs I handle.

Preparation

We need to gather the information necessary to close the books. Collect copies of all of the bank, broker and DRP statements for the year. If you've done your treasurer's tasks correctly throughout the year, you'll only need to refer to the December statements, but it's always useful to have everything close at hand. Since you won't have the December statements until sometime in January, you can't really begin your year-end tasks until then. On the other hand, you might want to wait even longer, perhaps until you receive your tax reporting documents from your bank, broker, DRPs, etc. These should be mailed by January 31, and should arrive in early February.

IMPORTANT NOTE: In recent years, many clubs have received corrected tax reporting documents from their brokers. These corrected documents usually don't arrive until late February or early March, so you may want to wait before filing your taxes.

Reconciliation of Cash Balances and Security Holdings

The first thing to do is generate a valuation statement for December 31. You want to compare each of the cash balances on the report to the cash balances reported by your bank/broker. If there are any discrepancies, you need to identify and reconcile them.

Perhaps there's an outstanding check or a deposit in transit, but if there are errors, now is the time to find them and correct them. Generate a report of all of the club's transactions for the year.

CA3:

Reports>Transaction Summary. Set the dates to 1/1/07 to 12/31/07 and check the box for **Subtotal Tax Allocations.**

CA0:

Reports>Transaction Summary. Set the dates to 1/1/07 to 12/31/07.

I would look for missing dividend or interest entries first. Companies usually pay dividends quarterly, so there should be four entries for each company you've owned for the whole year. Interest is usually paid monthly, so there should be twelve interest entries. If your club uses margin, make sure your margin interest is entered as an expense and not as income.

After you've finished with the cash entries, compare your December 31 valuation statement against your yearend broker and DRP statements to confirm that your records show the same number of shares of each security as your broker/DRP. Don't worry if the closing price per share is different, as that isn't important for our purposes.

If you find a difference, review your transaction report for a missing or doubled entry. If your club reinvests dividends, the most likely source of error is a dividend that was mistakenly recorded as a cash dividend and not a reinvested dividend. You can see this in the transaction summary/history report.

At this point, I would not worry about reconciling the amount of dividends or interest reported on your year-end broker statements with your club records, as brokers often report these amounts one way on the monthly statements and then reclassify them on the tax reporting documents.

Reconciliation of Income and Expense, Gain and Loss

In late January/early February, your tax documents should arrive from your bank, broker, DRPs, etc. There are six types of tax reporting documents your club may receive:

- 1.1099-B - Proceeds from Broker and Barter Exchange Transactions
- 2.1099-DIV - Dividends and Distributions
- 3.1099-INT - Interest Income
- 4.1099-MISC - Miscellaneous Income
- 5.1099-OID - Original Issue Discount
- 6.Schedule K-1 (Form 1065) - Partner's Share of Income, Credits, Deductions, etc.

The first three are common, and most clubs can expect to receive them. The other three are rare. You would receive a 1099-MISC if your broker lent your club's shares to another investor to sell short, and you received

payments from that investor in lieu of the dividends/interest you should have received. You would receive a 1099-OID if you invest in certain types of securitized loans such as REMICs and CMOs. You would receive a Schedule K-1 if your club invested in another partnership and/or certain natural resource royalty trusts. If your club receives one of these three forms, you will have to take additional steps to close your books and prepare your taxes that are beyond the scope of this workshop.

We'll need to look at a few other reports to reconcile the tax documents against the club's records: a tax allocation report and a capital gains report. Before you generate these reports, you may need to confirm that each of your club's investments is correctly classified within the accounting software.

CA3:

- 1) **Securities**, Double-click on each security and choose among **Common Stock**, **REIT**, **Other Publicly Traded**, **Mutual Fund**, or **Fixed Income Investment**; or **Tools>Year-End Tasks** and go through the wizard. You will encounter a screen where you can review and change all of the security settings.
- 2) **Tools>Allocate Income and Expenses**. Select **2007**.
- 3) **Reports>Club Capital Gains**. Click the **Prev. Full Year** button.
- 4) **Reports>Allocation of Income and Expenses**. Choose **12/31/2007**.

CAO:

- 1) **Securities>Update Security Settings**. Click on the **edit** link for each security and choose among **Stock (common, REIT or other)**, **Mutual Fund**, or **Other**.
- 2) **Accounting>Utilities>Allocate Income and Expenses**. Select **2007**.
- 3) **Reports>Club Capital Gains**. Set the dates from **1/1/07** to **12/31/07**.
- 4) **Reports>Allocation of Income and Expenses**. Choose **2007**.

Interest

Compare the interest reported on your 1099-DIV (taxable: box 1 and/or box 3; non-taxable: box 8) with the totals reported on either the transaction report or the allocation report.

Dividends

Compare the ordinary dividends reported on your 1099-DIV (box 1a) with the total dividends reported on either the transaction report or the allocation report. Sources of differences could be missing entries (though

we should have caught them in the earlier reconciliation of cash balances and stock holdings), and/or foreign taxes which weren't entered correctly in the software.

Next compare the qualified dividends reported on your 1099-DIV (box 1b) with the qualified dividends reported on the allocation report. If you find differences, make sure that you entered the ex-dividend dates correctly. In CA3/CAO, you can review your entries by preparing a Security Dividends report.

CA3:

Reports>Security Dividends. Set the dates from **1/1/07** to **12/31/07**. Check **Include inactive securities**. Then click on **Select all securities**.

CAO:

Reports>Security Dividends. Set the dates from **1/1/07** to **12/31/07**. Choose both **Active and Inactive securities**.

Another source of errors is REIT and mutual fund distributions that were entered incorrectly. REIT and mutual fund distributions are nonqualified dividends by default, but some distributions may actually be "qualified". In CA3 and CAO, you will have been asked to enter the qualified amount when you generated the Allocation report. Similarly, entries in boxes 2a, 2b, or 3 of your 1099-DIV can point you to other errors associated with REIT/mutual fund distributions. Check your software entries to see that they accurately reflect the nature of the REIT/mutual fund distributions as follows.

Capital gains distributions (Form 1099-DIV, box 2a) should be entered as:

CA3:

Transactions>Enter New>Select Transaction Type: (Reinvested) Dividend or Distribution>Type: Long term capital gain

CAO:

Accounting>Securities>Cash Dividend (or Reinvest)>Type: Long term capital gain

Unrecaptured Section 1250 Gain (Form 1099-DIV, box 2b) is entered in the tax programs in CA3 and CAO.

Non-dividend distributions -- including return of capital, (Form 1099-DIV, box 3) -- should be entered as:

CA3:

Transactions>Enter New>Select Transaction Type: (Reinvested)
Dividend or Distribution>Type: Return of capital

CA0:

Accounting>Securities>Cash Dividend (or Reinvest)>Type: Return of
capital

Capital Gains

Compare the sales proceeds on the capital gains report to the total proceeds reported on Form 1099-B. One possible source of differences is cash-in-lieu received from the sale of fractional shares of stock that were recorded either in your software or by the broker as a dividend. These are correctly reported as sale proceeds. There are also some brokers who don't report cash-in-lieu at all on a 1099 form if the amount is less than \$10. While the total sales proceeds in the capital gains report should match the 1099-B, you only need to worry if the total sales proceeds shown on your report are less than that shown on the 1099-B. The IRS won't care if you over-report your sales.

Other Income

Most clubs should not have any other sources of income. If your transaction summary report shows any other form of income, you should review the specific entries and determine if you have made them correctly. You might want to ask here or on the club-treasurers list for assistance in making this determination.



Closing the Books - Part 2

In the last section, we analyzed the different income items associated with the club's operations for the year, and how they are reported at year-end via the various reports available in the accounting software. In this analysis, we reconciled the cash accounts and security holdings and began the reconciliation of income and expense.

Let's continue now with the expenses, deductions, and credits. With the exception of taxes withheld (either foreign or backup withholding), none of these will be reported directly to the IRS by a third party, so the club treasurer must confirm that the software entries match the actual use of funds.

Deductible Operating Expenses

Most routine expenses of running an investment club are deductible as ordinary business expenses. These deductible expenses include such items as software (including [StockCentral](#), tax prep, dues, room rental, printing, photocopying, postage, bank charges, etc. Some other deductible expenses (charitable contributions, investment interest expense, taxes, etc.) receive special treatment and need to be reported separately on the club's tax return (see relevant sections below). Finally, certain expenses such as meals and entertainment are not deductible as business expenses for tax purposes, but they reduce your members' ownership value in the club (see [Non-Deductible Expenses](#)).

There is another wrinkle to consider when reviewing your expense entries -- allocation method. When we discussed allocation methods, I stated that my personal preference was proportional allocation for all expenses, but some clubs preferred equal allocation for some or all of their expenses. You can review your expense entries on the transaction summary/history report for the year to confirm that they are assigned correctly.

CA3 provides a report (**Club Expenses**) that make it easy to review your expenses for the year. In CAO, you can use the transaction summary report at myICLUB.com. In both CA3 and CAO, you review each transaction's entry in the database in order to see if it was proportionally or equally allocated.

Charitable Contributions

Charitable contributions should be identified as such in the transaction summary/history report. They are also listed separately on the allocation reports. If your club had any charitable contributions, make sure that you've allocated them in accordance with your club's Partnership Agreement/decision.

Investment Interest Expense (Margin Interest)

Most clubs do not incur margin interest, as the model BI investment club Partnership Agreement includes a prohibition on incurring debt in the club's name. However, for those clubs that do use margin: margin interest should be separately identified because it receives special treatment on your club members' individual tax returns. If necessary, contact the ICLUB Support Team (www.iclub.com/support) for the process to enter and report **Investment Interest Expense**.

Foreign Taxes

Foreign taxes are reported to the club on Form 1099-DIV/1099-INT in box 6. Compare this amount to the amount shown in the **Cash and Reinvested Dividends (Distributions)** section of the transaction report. The total foreign tax paid is also reported separately in the allocation reports.

Backup Withholding

Most clubs will not experience backup withholding. If your club does, it is probably the result of your bank/broker not having the club's correct EIN. Backup withholding is reported on Form 1099-DIV/1099-INT in box 4. Backup withholding can be applied as a direct credit against your club members' personal income tax liability (similar to W-2 withholding). If necessary, contact the ICLUB Support Team (www.iclub.com/support) for the process to enter and report **Backup Withholding**.

Non-Deductible Expenses

Non-deductible expenses are listed separately on the transaction reports. Check to make sure you've correctly identified the non-deductible expenses.

Final Reports

At long last, we've finished reviewing our club's records and are ready to officially close the books. In CA3 and CAO, this means redoing the Allocation process if any changes were made during the review process.

CA3:

Tools>Allocate Income and Expenses. Select 2007.

CAO:

Accounting>Utilities>Allocate Income and Expenses. Select 2007.

Now print the official reports for the club's permanent files and its members. I believe in overkill here, so I print just about everything:

Club Reports

CA3:

Valuation Statement (12/31)

Member Status Report (12/31)

Transactions Summary (1/1 - 12/31)

Club Capital Gains (1/1 - 12/31)

Allocation of Income and Expense Statement (2007)

Individual Valuation Units Ledger (1/1 - 12/31) (all members)

Cash Journal Listing (1/1 - 12/31)

Complete Journal/Ledger (1/1 - 12/31)

Income/Expense and Balance Sheet (12/31)

Member Deposit Report (1/1 - 12/31)

Withdrawal Distribution Reports for all members who took a withdrawal during the year

CAO:

Valuation Statement (12/31)

Complete Journal/Ledger (1/1 - 12/31)

Individual Valuation Units Ledger (1/1 - 12/31) (all members)

Cash Journal Listing (1/1 - 12/31)

Member Status Report (12/31)

Transaction Summary (1/1 - 12/31)

Cash Contributions (1/1/-12/31)

Capital Gains (1/1 - 12/31)

Allocation of Income and Expense Statement (2007)

Income/Expense Statement and Balance Sheet (2007)

Withdrawal Distribution Report for each member who took a withdrawal during the year

Member Reports

Copies of the following reports are given to each member:

CA3:

Valuation Statement (12/31)

Allocation of Income and Expense (2007)

Member Status Report (12/31)

Income/Expense and Balance Sheet (12/31)

Individual Valuation Units Ledger (1/1 - 12/31) for that member

Withdrawal Distribution Report to each member who took a withdrawal during the year

CAO:

Valuation Statement (12/31)

Allocation of Income and Expense (2007)

Member Status Report (12/31)

Income/Expense and Balance Sheet (12/31)

Individual Valuation Units Ledger (1/1 - 12/31) for that member

Withdrawal Distribution Report to each member who took a withdrawal during the year

We're coming down the homestretch. Let's look at how the club's tax return is prepared. We won't go through every item on the return; rather, we'll focus on how the numbers transfer from the reports to Schedules K and K-1. Then we'll review briefly some of the peculiarities associated with the tax modules provided for the accounting software.

From Allocation to 1065

The following table shows how the numbers flow from the allocation report to the tax return on Schedules K and K-1. Club totals are reported on Schedule K. Each member's share of the club totals is shown on the respective K-1.

Item	Schedule K	Schedule K-1
Taxable Interest Income	Line 5	Line 5
Tax-Exempt Interest	Line 18a	Line 18, code A
Ordinary Dividends	Line 6a	Line 6a
Qualified Dividends	Line 6b	Line 6b
Short-term Capital Gain (Loss)*	Line 8	Line 8
Long-term Capital Gain (Loss)*	Line 9a	Line 9a
Unrecaptured Section 1250 Gain (not shown in CA3/CAO reports- get from 1099-DIV, box 2b)	Line 9c	Line 9c
Other Income	Line 11	Line 11, code A
Charitable Contributions	Line 13a	Line 13, code A [Cash contributions (50%)] Line 13, code E [Capital gain property to a 50% organization (30%)]
Investment Interest Expense (need workaround to show in CA3/CAO reports)	Line 13b	Line 13, code G
Other Deductible Expense	Line 13d	Line 13, code J [Deductions - portfolio (2% floor)]
Non-Deductible Expense	Line 18c	Line 18, code C
Backup Withholding (need workaround to show in CA3/CAO reports)	Line 15f	Line 15, code O
Gross Foreign Dividends	Line 16d	Line 16, code D
Foreign Taxes	Line 16l	Line 16, code L
Distributions of Cash (withdrawals)	Line 19a	Line 19, code A
Distributions of Securities (withdrawals)	Line 19b	Line 19, code B
*Entries for Schedule K, Lines 8 and 9a transfer from Schedule D, Lines 5 and 11 respectively		

Tax Preparation Using ICLUBcentral Software

The following section does not walk you through the entire tax return preparation process, but only covers certain items that require additional data input from your year-end reports or tax reporting documents.

CA3/CAO

You begin the tax preparation process by clicking on **Taxes>2007 Tax Printer**. Refer to the available **Help/User Guide** for more specific information.

If your club owns any REITs, mutual funds, or "other" securities and you have correctly identified them in the security profile, you should eventually get to a screen that asks for the amount of qualifying dividends (REIT, mutual fund, "other") from Form 1099-DIV, box 1b and Unrecaptured Section 1250 Gain (REIT) from Form 1099-DIV, box 2b.

(Note: If your club owns any of these in a brokerage account with other securities, you may have to manually calculate the amount of qualifying dividend which is associated with each investment.)

Once you've completed the tax interview for any of the tax software, you should print a full copy of Form 1065, Schedule D (if you had any capital gains/losses), all Schedules K-1, and all supporting statements to file with the IRS. You should print a second complete copy for the club's permanent records. Finally, you should provide each member (current and withdrawn) with a copy of his/her Schedule K-1.

Congratulations! You're done for another year.