

Investment Club Accounting Concepts

Puget Sound Chapter
BetterInvesting

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Jim Thomas

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Basic Concepts

Overview

BetterInvesting recommends that all clubs keep their records using Club Accounting software specifically designed for the job. There are currently three Club Accounting software products available, one desktop product and two web-based products.

BetterInvesting currently endorses all three. Web-based products are offered by bivio (www.bivio.com) and IClubCentral (www.myiclub.com). The Club Accounting 3 desktop product is from IClubCentral (www.iclub.com). .

Since most investment clubs operate as a general partnership, that form of organization will be assumed throughout this document. Other forms of organization are possible (a Limited Liability Company, for example) and may have different registration and tax filing requirements. However, most accounting processes remain generally the same.

An investment club accepts money from its members and invests that money based on group decisions. The purpose of investment club accounting is to maintain a complete and accurate record of all financial transactions involving a club as well as to produce monthly status reports for the members, annual reports for tax purposes, and withdrawal tax reports for members who withdraw some or all of their funds.

Records must be kept for the considerable variety of financial transactions possible in an investment club. Cash accepted from members is deposited with a bank or brokerage firm. The brokerage is directed by a club to buy and sell securities (such as corporate stock). Securities may pay dividends or other distributions which are deposited to the brokerage. Cash on deposit with a bank or broker may produce interest or dividend payments. Club members may withdraw their portion of club assets, either partially or in full. Withdrawals may be paid either in cash or by transferring securities. Securities owned by a club may be subject to a variety of corporate actions, such as splits, mergers, and spinoffs.

Banks and brokers provide monthly account statements. (Brokers also provide confirmation statements every time a security is bought or sold.) These statements are a primary source of the information needed to record a club's financial activities in Club Accounting software. However, such statements reflect club activities as a group. Clubs must also record the date and amount of all money received from individual club members. Further, earnings (realized profits and losses) produced by club investments must be allocated to members for tax purposes.

Club accounting produces two primary monthly status reports, the Valuation Statement and the Member Status Report. Also produced are annual tax reports for each member (on form K-1). A withdrawal report, with additional tax information, is produced every time a member withdraws part or all their funds from a club. These reports are the primary documentation a club member receives about their financial relationship with their club. A monthly transactions report can help all members keep an eye out for errors and omissions.

Taxes and Tax Basis

Perhaps the most important role of club accounting is to keep track of each member's tax basis for their investments in a club. One component of tax basis is the money each member has invested in the club over time (referred to as their "Paid In" amount). The other component of tax basis is each member's proportional share of any club earnings. A member's cumulative Paid In amount plus their cumulative share of club earnings is their tax basis for their club investments. It's also referred to as "Paid-In Plus Earnings" (or sometimes just "PIPE").

Club earnings become a part of each member's tax basis as those earnings are "passed through" to the members every year. Club earnings come from interest and dividends (and other distributions) as well as realized profits or losses from the sale of securities. Club operational expenses are a part of earnings too (expenses, of course, reduce earnings).

A primary reason that most clubs operate as a general partnership is so the club itself does not pay federal taxes (although the club does file a tax return). Instead, all taxable income and expenses produced by the club are "passed through" to the club members. Club members are individually responsible for reporting their share of club earnings on their personal tax return each year. The information club members need to do this is reported to them annually by the club on form K-1. (The K-1 forms are also filed with the IRS as part of the club's form 1065 federal tax return.) For members who withdraw funds from the club, additional tax information is provided on the withdrawal report (information that doesn't appear on form K-1.)

Unit Value

If it were practical for all members of an investment club to always remain exactly equal owners of the club, a unit value system might not be necessary. However, not only is "equal ownership" over time impractical, it's unnecessary and even undesirable. For example, most clubs consider it beneficial to have the flexibility to add new members without requiring that they invest the current market value of an existing member at their first meeting. Also, partial withdrawals always result in unequal ownership and most clubs want their members to have that option.

When members invest money in their club they purchase club "units". The number of units purchased depends on the amount of money invested and the current unit value (i.e., the dollar value of one unit) on the date the money is invested. Conceptually, club units are similar to shares in a mutual fund.

When a new club is started, the unit value is set at some arbitrary value (typically \$10). The specific value chosen for the beginning unit value is completely unimportant. To determine unit value on any particular date after that, the total value of all club assets is divided by the total number of units owned by all club members. See *Valuation Date* for more detail. (Note that traditional investment club accounting holds unit value constant at its initial value until a club has purchased its first security. This is actually a pretty poor

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idea. Only some software does it and, for that software, use of workarounds to prevent it is recommended.)

New units are created only when club members invest new money in a club. All other money added to a club (member fees, interest, dividends, etc.) increases the unit value (without changing the number of units). Unit value also changes along with the fluctuating value of securities held by a club.

Units are removed (without changing the unit value) only when club members withdraw or when expenses are allocated equally among members. Unit value is reduced (without changing the number of units) by expenses allocated among members in proportion to their club ownership and by money leaving a club for some other reason (donations, for example).

As an historical note, it used to be traditional for a club to “distribute” club units at year end as part of the process of allocating its net profit or loss to members. Such distribution of units was never necessary and is no longer a recommended practice. See *Don't: Distribute Units when Allocating Club Earnings.*

References:

www.iclub.com/clubs/unit_value.asp
www.bivio.com/hp/unit-value.html

Valuation Date

When club units (see *Unit Value*) are created or removed, the number of units involved depends on the unit value. (If a member invests \$50 in a club, the number of units purchased depends on the unit value.) It's traditional with investment clubs for unit value to be determined on one specific day each month (as specified in the club's partnership agreement or other organizing documents). Any date on which unit value is determined is referred to as a “valuation date”.

The term “valuation” refers to the process of determining the total value of all club assets on a particular date. For example, the value of each stock holding is determined by multiplying the market closing price per share on a valuation date by the number of shares held on that date. The total value of all club assets is the cash held by the club plus the value of all club stock (or other security) holdings. A club's unit value on a valuation date is the total value of club assets on that date divided by the total number of units owned by club members on that date. The information and calculations involved in determining a club's unit value on a particular date is shown on a Valuation Report.

Typical club procedure is for the valuation date to be several days prior to each monthly club meeting. The reason for this tradition is to allow the treasurer some time to prepare so the valuation report (and, hence, the unit value) presented at a club meeting can be as accurate as possible (even though it will be several days out of date). It's important that a valuation date not be too far before of the monthly meeting date where members typically make their monthly investment in the club. It would be hard, for example, to justify a

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valuation date being more than a week in advance of a monthly meeting.

In general, it isn't possible to always present a completely accurate valuation statement at a club meeting (even when it's dated several days before the meeting). For example, completely accurate information about reinvested dividend payments made in the weeks before a meeting may be unavailable until after the meeting. Or, the treasurer may have overlooked something or recorded something incorrectly. Things of this sort happen and can require adjustments to club accounting records which will change club unit value on prior valuation dates. In other words, the unit value reported at a club meeting is always subject to later change due to correction of clerical errors. Facing this fact head on, some clubs choose to have the valuation date be on the business day prior to the monthly meeting date (or even on the same day as the meeting) with the understanding that the 100% accurate unit value for that month won't be known until sometime later (after the club accounting records have been reconciled against the monthly brokerage statement).

A club treasurer works with valuation dates in somewhat different ways, depending on which club accounting software is being used. With IClubCentral software (myclub.com and Club Accounting 3) the treasurer makes a separate entry to identify each valuation date. Any transaction that depends on unit value (e.g., member deposits or withdrawals) uses the unit value from the most recent preceding valuation date entry. With bivio.com software the treasurer enters a valuation date as part of entering any transaction that depends on unit value (and, so, no separate entries are needed to identify which dates are valuation dates).

Cash Accounts

In club accounting software, a "cash account" (or just "account" in bivio.com software) is where cash is held when it's not invested in securities. A club typically has an account for cash held at their brokerage firm and often another account for cash held at a bank or credit union. In addition, a "suspense" account is commonly used to hold cash temporarily as part of more complex transactions. (See *Don't: Petty Cash* for a discussion of why that sort of account is no longer supported in club accounting software.)

Cash, especially at a brokerage firm, is often held in a money market account. In club accounting software such funds are typically recorded in an "account" rather than as a "security". This can be done because the per share value of a money market fund is very likely to remain constant (typically \$1 per share) and, so, there is no expectation for there to be a capital gain or loss when money market shares are sold (when the "cash" can be used for another purpose).

If a club switches to a different brokerage firm or a different bank there is no need to create a new account in the club accounting software for the new financial institution. (Of course, any information in the software related to downloading transactions would need to be updated.) The only time a club would need to have more than one broker (or bank) account in Club Accounting software would be if the club maintained an ongoing relationship with more than one broker (or bank).

Expense Allocation (Proportional vs. Equal)

Investment clubs incur a variety of operating expenses. The cost of purchasing club accounting software is a good example. When accounting for such an expense the question arises of how to allocate the expense among the club members. Club profits are always allocated among members in proportion to member ownership of the club. Expenses are often allocated in the same way, but not always.

Imagine, for example, a six member club where two members each own ten percent of the club and the other four members each own twenty percent of the club. There are two obvious ways in which those club members could share the cost of club accounting software. They could share the cost equally (one sixth each) or they could share the cost in proportion to their percentage ownership of the club (ten percent of the total expense for each for the two ten percent members and twenty percent of the total expense for each for the others). Reasonable people can disagree in good faith about which is the more appropriate method for sharing such expenses. Club accounting software allows either method to be chosen for each expense at the time it's entered.

For a club organized as a partnership, federal tax regulations require that expenses be allocated in proportion to percentage club ownership unless another method is specifically provided for in the club's partnership agreement (and is otherwise in accordance with IRS regulations)¹. If a club chooses to allocate expenses equally, it's important for the club to understand the applicable IRS rules.

When an expense is allocated proportionally, the total club value is reduced by the amount of the expense. This reduces the club's unit value which, in turn, reduces the value of the units owned by each member (in proportion to their ownership share of the club). The total number of club units, however, remains unchanged.

When an expense is allocated equally, the total club value is reduced by the amount of the expense (just as with proportional allocation). In addition, an equal number of units are taken away from each member. The total number of units removed is equivalent in value to the amount of the expense (i.e., the amount of the expense divided by the club's unit value). The combined result of both actions is that the club's unit value remains unchanged. Since an equal number of units are taken from each member, each member's value is reduced by the same dollar amount. The units taken to account for the expense simply go away (they don't end up somewhere else).

With either method, the dollar amount of the expense allocated to each club member is reflected on that member's year-end K-1 form.

References:

biwiki.editme.com/AllocatingExpenses

www.bivio.com/hp/expense-allocation-methods.html

¹ See [IRS Instructions for Form 1065](#) (How Income Is Shared Among Partners). Also U.S. Treasury Regulations section [1.704-1](#).

Startup Methods

When an existing club first starts using club accounting software, two methods are available for making the change. With the first method, the entire history of club transactions is entered into the software all the way back to the very first day of club operation. With the “switchover” method, the status of the club on a specific date (the “switchover date”) is recorded in the software followed by all club transactions occurring after the switchover date.

The switchover method is usually used when a club has already been operating for more than several years. The method is used simply to avoid the additional work of entering the entire history of club transactions. When using the switchover method, it’s important to keep in mind that the software will be unable to calculate investment performance based on dates prior to the switchover date. If calculating investment performance for the entire history of a club is desired, the switchover method cannot be used.

Even with the switchover method, club accounting software needs to be provided with detailed historical purchase information about all club stock (or other securities) owned as of the switchover date. For each security purchased after the switchover date, information needs to be entered about each individual purchase of shares. Also needed are the total of past cash investments and the total of earnings allocated for each person who was a member of the club on the switchover date. The cash balance for each cash account on the switchover date is also needed.

Club Financial Controls

All clubs should have basic financial controls in place. Perhaps the most important of these is to have more than one person reviewing the club’s broker and bank statements on a regular basis. Another good control is having two club members as co-treasurers to split up the work as well as having the co-treasurers double check each other. In fact, having co-treasurers is a good idea for several other reasons (see *Have Co-Treasurers*).

Reconciling accounts in club accounting software with the broker and bank account statements is another very important control. This should be done promptly every month. Every club’s operating procedures should include having an audit committee review the club’s accounting records at least once a year. The audit committee should consist of club members who were not involved in the day-to-day club accounting duties. See *Club Audit*.

New Club Member

Adding a new club member in club accounting software is very simple. Locate the “new member” screen and enter basic information about the member. The only information that’s truly mandatory in the software is the new member’s name. (Note, however, the club will need each member’s name, social security number and mailing address for tax reporting purposes.) Additional information (mailing address, phone number, email address, etc.) can also be entered, depending on your club’s operating procedures and the club accounting software being used. With online club accounting software, there will be a way to “invite” a new member to join your club’s accounting web site (i.e., establish their own personal login name and password). Once a new member has been added, their name will appear on all other club member activity screens in the software.

When a new member starts investing money in a club, there is no need (and no benefit) for that member to “catch up” with either the number of units or the market value of other members. The unit accounting system is designed to make it unnecessary to attempt to maintain equal ownership by all members. It’s perfectly fine, for example, for different members to invest different monthly amounts.

Invest (Member Payments)

Club member traditionally invest money in their club once a month at the monthly club meeting. These investments are traditionally called “member payments”. Don’t let that terminology mislead club members about the nature of the financial relationship between a club and its members. If a club member chooses not to invest every month (or simply forgets), that should not create a debt for the skipped monthly investments. For most clubs it serves no practical purpose to insist that every member invest every single month, or invest the same amount every month, or to charge a “late fee” for missed payments, or to insist that skipped monthly investments be “made up”.

It is certainly within the prerogative of club members to establish club policies such as “invest regularly”. However, in the long run, a better approach to enforcing such policies may be to invite members who routinely fail to follow club policy to withdraw from the club (without imposing any other sort of penalty).

When a member invests money in their club, they buy club units at the most recently established unit value. A member who invests \$50 when the value of one unit is \$10 will end up owning five additional club units. Clubs traditionally establish (in their partnership agreement) a specific date each month as the “valuation date” when unit value is determined for investments made at that month’s meeting. The valuation date is often several days prior to the date of the monthly club meeting. See *Valuation Date* for more information.

Withdrawals

It's common for there to be questions about how withdrawals from an investment club work. Does the withdrawing member get paid in stock or cash? Are there any withdrawal fees? How soon does the withdrawing member get paid? The answer to these and any related questions should be clearly stated in your club's partnership agreement.

The one rule that trumps all others is that an investment club must follow its partnership agreement. That's true for withdrawals just as it is for all other aspects of club operation. What are discussed here are generally accepted best practices. If the terms of your club's partnership agreement (or bylaws or other organizing documents) are inconsistent with what's stated here (or are unclear), your club should discuss the differences and seriously consider revising its policies.

The purpose of any withdrawal is to convert some or all of a member's club units into securities (e.g., stock shares) registered in the name of the withdrawing member and/or cash. The dollar value of the club units withdrawn is determined on a valuation date. The traditional procedure is for a member's written withdrawal notification to be accepted at one monthly meeting and for the valuation date of that withdrawal to be the valuation date for the next monthly meeting. The idea is that the club will make any decisions about how to fund the withdrawal at the first of these two meetings and for payment to be made as close as possible to the valuation date for the second meeting (typically, within ten business days). This gives the club treasurer an entire month to make any arrangements or take any action necessary to carry out the withdrawal, as authorized at the first meeting.

If any securities will be sold to raise cash to pay a withdrawal, it generally doesn't matter a great deal whether those sales occur before or after the valuation date for the withdrawal. The withdrawing member's gain or loss upon withdrawal will be (nearly²) the same either way. If securities are sold before the withdrawal valuation date, any gain or loss from those sales will be shared by all club members (the departing member as well as the remaining members). If sold after the withdrawal valuation date, only the remaining members will share in any gain or loss from selling those securities. The tax result (amount of realized capital gain or loss) between the two situations can be different for the remaining members (but not the departing member) in the current year but that will even out over the long run³. Before selling securities to raise cash for a withdrawal, however, be sure to read the information about full and partial withdrawals to see why doing so may not be the best choice.

Full withdrawals and partial withdrawals can have very different tax implications for the withdrawing member. The best method of paying a full withdrawal is often not the best method of paying a partial withdrawal. See *Full Withdrawal* and *Partial Withdrawal* for more information.

² Price fluctuation in securities will produce some difference.

³ Gain (loss) realized now adjusts members tax basis in the club up (down), resulting in less (more) realized gain when members eventually withdraw.

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Older club partnership agreements tend to provide for deducting a flat percentage withdrawal fee before paying a departing member (the purpose being to recover the cost of commission charges resulting from selling stock to raise cash). That is now considered poor policy. Generally accepted current best practice is to deduct only actual expenses incurred by a club in processing the withdrawal. There may be no cost at all to a club for processing an all cash withdrawal with sufficient cash on hand, or for a withdrawal paid as fully as possible by transferring stock (the cost to mail a check for any remaining balance perhaps not being worth the trouble to account for). If cash is raised by selling stock (that the club didn't plan to sell soon anyway), deducting a withdrawal fee equal to the brokerage commissions for those sales might be appropriate⁴. If stock is transferred and the withdrawing member is unwilling to open an account with the same broker used by the club, appropriate costs could include the brokerage fees for issuing stock certificates (which can get expensive!). See *Don't: Excessive Withdrawal Fees* for more information.

Club partnership agreements often include a provision that permits (but does not require!) the club to make a partial cash payment soon after the first meeting (where the withdrawal notification is accepted) with the balance being paid according to the normal procedures. Presumably, this would be used for hardship situations, perhaps due to some sort of personal emergency. All members should be encouraged to treat their club assets as long-term investments rather than an emergency fund.

It's typical for a club partnership agreement to state that notice of death or incapacity of a member is treated as notification of full withdrawal. When paying a withdrawal in such circumstances it's generally best to make payment to the executor of the member's estate, or other appropriate legal representative, and to follow the same procedure described in the partnership agreement for any other full withdrawal. It can be a serious mistake, for example, to assume that payment should be made to a surviving spouse or other family member. Note that the valuation date for such a withdrawal should be as specified in the partnership agreement (and generally will not be the date of death or incapacity). While the estate of a deceased member may need to value the member's investment as of the date of death, that should have not effect on the club's withdrawal policy.

After a withdrawal has been paid, changes made to club transactions dated prior to a withdrawal can change the amount of the withdrawal and the contents of the withdrawal report (which the withdrawn member needs to file their personal tax return). Because of this, it's best to: (1) reconcile all club accounts monthly; (2) perform at least a quick club audit before paying a withdrawal; (3) distribute withdrawal reports at year-end (along with form K-1), even if they were distributed at the time of withdrawal.

⁴ It can be argued that imposing a withdrawal fee to recover commissions is inappropriate even when the entire purpose of specific stock sales is to raise cash to fund a withdrawal. If the club happened to have the necessary cash on hand to pay a withdrawal, the withdrawing member would not be charged a withdrawal fee (even though earlier stock sales may have been the source of that cash). This argument is especially valid in the case of a full withdrawal, where selling (rather than transferring) stock to fund the withdrawal is typically a decision made by the remaining club members (not the withdrawing member). Why should an individual withdrawing member bear the entire cost resulting from a club decision? Ultimately this comes down to being a matter of individual club policy.

Full Withdrawal

The intent of a full withdrawal is for a member to completely withdraw all of their assets from a club. In general, the withdrawn member will no longer be a club member in the future. However, there is no particular reason why a withdrawn member can't request to be admitted as a member of the same club again at some future date.

Typical partnership agreements state that decisions about the form of payment for a full withdrawal are made by the remaining members. Will the withdrawal be paid fully in cash? By transferring securities with the balance paid in cash? How many shares of which securities will be transferred? These decisions are generally made by the remaining members, not the withdrawing member. A primary reason for this is because the form of payment for a full withdrawal can have significant current tax consequences for the remaining club members.

From a tax point of view, in a full withdrawal it's generally best for everyone if a club pays as much of the value as possible by transferring the most highly appreciated securities it holds. This allows the remaining members of a club to defer capital gain taxes on their share of the gain in the transferred stock until they eventually leave the club. If the withdrawing member continues to hold the transferred stock, they can defer (until they sell the stock) capital gain taxes on most of their unrealized gain from investing in the club. Even if a club has sufficient cash on hand to pay the withdrawal, it's generally better (tax-wise) to transfer highly appreciated stock instead. Cash can be used to repurchase shares of the transferred stock (at a higher cost basis than before!) if the club wants to continue owning it.

From a practical point of view, especially when the value of a full withdrawal is relatively small, it's certainly less complicated to pay a full withdrawal in cash. If a club decides to sell securities to raise the necessary cash, it's generally best to sell securities held at a loss.

References:

www.bivio.com/trez_talk/mail-msg?t=2984700003&s=1

Partial Withdrawal

The intent of a partial withdrawal is for a member to withdraw a portion of their assets from a club and to remain as a club member. This kind of withdrawal is probably more common among long-time members of successful clubs.

Typical partnership agreements state that decisions about the form of payment for a partial withdrawal are made by the withdrawing member (just the opposite of the situation for full withdrawals). Will the withdrawal be paid fully in cash? By transferring securities with the balance paid in cash? How many shares of which securities will be transferred? For partial withdrawals (and unlike full withdrawals), these decisions are generally made by the withdrawing member, not the remaining members. This is because the form of payment for a partial withdrawal can have significant current tax

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consequences for the withdrawing member.

Looking at a partial withdrawal from a tax point of view, cash withdrawn up to the value of the member's tax basis (PIPE) in the club is a tax free return of capital and is not reported by the member on their personal tax return. Any cash withdrawn in excess of the member's tax basis is a taxable capital gain⁵ and is reported by the member on their personal tax return (Form 1040 Schedule D).

When securities are transferred in a partial withdrawal, the club's tax basis in the transferred securities becomes the member's tax basis in those securities. This tax basis may need adjustment so it doesn't exceed the withdrawing member's tax basis (PIPE) in the club less any cash received in the withdrawal. The tax implications for a partially withdrawing member are more complex to evaluate (vs. a full withdrawal).

From a practical point of view, the longer a member belongs to a club the more likely it becomes that they will want to withdraw some of their money to use for other purposes. The ability for a member to withdraw cash tax free up to the value of their tax basis can be a useful membership retention tool, especially for long term members.

References:

www.bivio.com/trez_talk/mail-msg?t=2981700003

Penalty (Fee)

"Fee" is the traditional term used to describe money a member pays into an investment club which doesn't purchase any units. Generally accepted current best practice is to use a fee only when the intent is to impose a member penalty. Properly used, fees should be very rare events.

A good example of an appropriate fee would be if one of a club member's monthly investment checks "bounced" (was returned unpaid by their bank). When that happens the club is typically charged a bank fee (which the club should record as a deductible expense). When the member reimburses the club for that bank fee (as they should), the reimbursement should be recorded as a "fee" in the club accounting software so the member doesn't receive any additional club units in return.

Inappropriate use of fees happens pretty often. Perhaps the most common example is using fees when club members contribute money to help pay for club operational or administrative expenses. Simply recording an expense ensures that all members share in paying the expense. In most cases there is simply no good reason to collect money that's earmarked to pay expenses. If a club insists on collecting such money anyway (perhaps

⁵ It's impossible to realize a capital loss due to a partial withdrawal. A capital loss means the market value of a member's units is less than their tax basis. However, a partial withdrawal means a member is withdrawing less than the full market value of their units (not enough to reduce their tax basis below zero, since their market value is less than their tax basis). For a member to realize a capital loss either the member must make a full withdrawal or the club must sell securities at a loss.

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because it's short on cash) the money should be recorded as a member payment (exactly like money collected for investment). See *Don't: Confuse Fees with Expenses*.

Another inappropriate use of fees is when a club pays an expense on behalf of a member, the member reimburses the club for that expense, and the reimbursement gets recorded as a "fee". (Club accounting documentation used to recommend doing that!) Perhaps the most common example would be if a club paid annual BetterInvesting membership costs for the club and all members and each member then reimbursed the club for their individual membership costs. Traditionally the reimbursements would have been (inappropriately) recorded as fees.

How should a club handle reimbursement for expenses paid by a club on behalf of its members? There are several methods more appropriate than using fees. Perhaps the best is for a club to not pay expenses on behalf of members in the first place. Instead, have each member write a check for their own expenses (payable to the actual recipient, not to the club). Give all those checks to the club treasurer to forward on to the recipient along with a check from the club for any club expenses. That way, members' personal expenses never appear in a club's records at all. Another method to handle club and member BetterInvesting membership costs is to treat the total cost as a club expense and dispense with having members reimburse the club for any part of it. (Whether such an expense should be allocated among members equally or in proportion to ownership is a club policy decision.)

To understand fees (penalties) it helps to understand what happens when a member pays money that doesn't purchase any club units. Adding money to a club raises the total value of the club (because the club has more cash than it had before). When the additional money purchases additional units (e.g., member investments) the unit value stays the same. When the additional money does not purchase additional units (as is the case with a fee) the unit value goes up, which increases the value of the units held by every club member ... including the member who paid the fee. The effect is that fees are shared among all club members in proportion to their ownership of the club. So, a member who owns a smaller percentage of a club gets hurt more by paying a fee than another member (paying the same fee) who owns a larger percentage of the club.

New Security

Adding a new security in club accounting software is straightforward, but the process is different in different software. With IClubCentral Club Accounting 3 software, locate the “add new security” screen and enter basic information about the security. At minimum you’ll need to enter a ticker symbol, security name and the type of security. With bivio.com or myclub.com software, just enter a transaction using the ticker symbol of the new security (the security type and name are determined automatically in most cases).

Depending on the software being used and the type of security, additional information may need to be provided. With foreign stock, for example, you may need to specify the country where the company is based and whether or not dividends paid are fully eligible to be “qualified”.

Buy A Security

Buying a security exchanges cash for shares of a stock (or other security). Typically the cash comes from a brokerage account.

When entering a purchase transaction, it’s very important that the number of shares bought and the total dollar amount of the transaction agree exactly with what’s shown on the broker trade confirmation. Whether or not the cost per share agrees exactly with what the broker reports is not important. It’s not unusual for the cost per share calculated by the club accounting software to differ slightly from what the broker shows.

Sell A Security

Selling a security exchanges shares of a stock (or other security) for cash. Typically the cash goes to a brokerage account.

As with a purchase transaction, when entering a sale transaction it’s very important that the number of shares sold and the total dollar amount of the transaction agree exactly with what’s shown on the broker trade confirmation. Don’t worry if the cost per share calculated by the club accounting software differs slightly from what the broker shows. On sale transactions it’s not unusual for a broker to collect a small fee in addition to its brokerage commission. Any such fee and commission can be added together and the total entered as the commission.

Security Income (Dividends, etc.)

Securities can produce a variety of different types of income. For most investment clubs the most common type of security income is cash dividends from corporate stock. When income from a stock (or other security) is entered in club accounting software, the entry is made from the “Security” or “Investment” screens in the software.

Investment Activities

Be careful not to confuse income from a security with income from cash held at a bank or broker (perhaps in a money market fund). Income from a security must be entered so it's associated with that security. In bivio software, security income is entered using "Income" under "Investments". In IClubCentral software, it's entered using "Cash Dividends" under "Securities". See [Account Income](#).

When entering a dividend from corporate stock, one of the items of information needed is the so-called "ex-dividend date". It's also needed for certain types of distributions from other securities. The length of time a club holds a security before and after the ex-dividend date is one factor that determines how the income is treated for tax purposes. Income that meets holding period (and other) requirements is "qualified" and taxed at a lower rate than income that doesn't meet the requirements. Club accounting software at bivio.com can look up and fill-in ex-dividend dates. Ex-dividend dates can also be found at www.earnings.com and at www.stockcentral.com (look under "tools" for "research links" and its "View Dividends" link).

Income from non-US corporations generally has foreign taxes withheld by the broker. See [Foreign Tax](#).

If your club has arranged for automatic reinvestment of stock dividends, see [Reinvested Income](#).

Sometimes a corporation pays what's called a "stock dividend". Sometimes this is really a tax-free stock split (common with Tootsie Roll) and sometimes it's taxable income (Cemex 2006). If your club finds itself with such an event, it's best to ask for help.

For information about income from securities other than corporate stock, see [Don't: REIT, ETF and MLP/PTP Distributions vs. Stock Dividends](#).

Reinvested Security Income

A club may have made arrangements for automatic reinvestment of dividends paid by a security. Such arrangements may be made with some brokerage firms, or by using a Dividend Reinvestment Plan (or other similar service). Conceptually, this is just the same as receiving the security income in cash and then immediately using that cash to buy additional shares of the security which paid the dividend. One difference with automatic reinvestment is that it's usually possible to invest every penny of the dividend (which usually means buying fractional shares).

See [Company Paid Charges](#) for information about what happens when a dividend reinvestment plan pays reinvestment purchase commissions on behalf of a club.

Foreign Tax

Cash dividends paid to US stockholders of foreign corporations are generally subject to tax in the company's home country as well as in the US. These foreign taxes are withheld

Investment Activities

from the gross dividend amount. The full gross amount of the dividend is taxable in the US and will be reported at year end by the broker on form 1099. The foreign tax withheld is a tax credit that gets passed along to the club members for use on their personal tax return.

In bivio software, the gross amount of the dividend as well as the foreign tax withheld is entered as a single transaction. The bivio software automatically calculates and records the net amount of the dividend as well as a tax credit for the amount of the foreign tax. In IClubCentral software, the net amount of the dividend is entered as one transaction and the foreign tax is entered as a separate transaction.

Charges Paid by Company

In some situations, a corporation will pay expenses on your behalf. This commonly happens with dividend reinvestment plans (DRPs) where the corporation pays brokerage commissions and other charges incurred to reinvest dividends. Such charges paid on your behalf are considered additional taxable dividend income and will be reported on form 1099 at year end. Such amounts are entered in club accounting software after the 1099 form is received.

Split

The purpose of a stock split is to change the price per share so it's in a more desirable range. In a 2-1 (two for one) stock split, for example, one new share of stock is issued by a corporation for every existing share. Since this doubles the number of shares, the price of each share will be cut in half (so the net change in value is zero). If a club owned 100 shares worth \$50 each, after a 2-1 split the club would own 200 shares each worth \$25. Both before and after the split, the shares would be worth \$5,000. Split ratios of 2-1 (two for one) and 3-2 (three for two) are perhaps the most common, but other ratios are possible. In fact, so called reverse splits sometimes happen, such as 1-2 (one for two) or 2-3 (two for three). In a reverse split, the number of shares goes down and the price per share goes up (just the opposite of a regular split).

In general, fractional shares are not issued for splits. (An exception would be with a DRP account or other dividend reinvestment plan.) Instead, cash is paid "in lieu" of any fractional shares. (See *Cash In Lieu*.) For example, if a club owned 25 shares of stock worth \$30 each, after a 3-2 split each share would be worth \$20 (two thirds of the pre-split price) but the club would not own 37.5 shares. Instead, the club would own 37 shares (the 25 original shares together with 12 new shares) plus about \$10 in cash (the dollar value equivalent to the extra half share of stock).

Splits are not always tax free (July 2006 split of CEMEX is an example).

Merger

In a merger, one corporation "buys" another. Shareholders of the corporation being

Investment Activities

purchased are paid either with shares of the purchasing corporation, or with cash, or with a combination of both. The purchased corporation ceases to exist (as do its stock shares). If a club owns shares of the purchasing corporation, usually (but not always) there is nothing that needs to be recorded in the club accounting software.

If a club owns shares of a corporation being purchased in a merger, the transaction will need to be recorded in club accounting software. Entering a merger can be straightforward (for a merger paid 100% in stock) or more complex (for a merger paid partially in stock and partially in cash). Many corporate mergers are tax free, but some are not. Note that a merger paid 100% in cash is generally entered as a sale, not a merger (and, so, is not tax free).

To determine the correct method for recording a merger in club accounting software, information about a merger that's provided by the merging companies needs to be read and often interpreted. IClubCentral maintains a web site with information about entering specific mergers in club accounting software (see References, below). Mergers can often be properly handled automatically by club accounting at bivio.com via their AccountSync product.

Mergers commonly result in fractional shares. Generally, a club will receive cash in lieu of any fractional shares. See *Cash In Lieu*.

References:

www.iclub.com/support/kb/default.asp?page=transactions

Spinoff

In a spinoff, one corporation becomes two (or even more). Shareholders of the corporation being split generally receive shares in the newly created corporation(s), as well as retaining their shares in the original corporation. Shareholders must allocate their tax basis in the original parent stock among their shares of the original and new stock. The corporation generally gives guidance to stockholders about methods for determining the ratio(s) for this allocation of tax basis.

The percentage of the tax basis in the original stock shares which will remain with those original shares is called "Remaining Basis Percentage" in club accounting software. Whenever possible it's best to specify the remaining basis percentage directly when entering a spinoff transaction. (Club accounting software also provides an alternative to remaining basis percentage that's based on the prices of the original and new stock shares. This alternative method should only be used when the corporation does not provide information regarding the remaining basis percentage.)

In club accounting software, entering a spinoff is generally straightforward. IClubCentral maintains a web site with information about entering specific spinoffs in club accounting software (see References, below). Spinoffs can often be properly handled automatically by club accounting at bivio.com via their AccountSync product.

Investment Activities

Spinoffs commonly result in fractional shares of the newly created corporation(s). Generally, a club will receive cash in lieu of any fractional shares. See *Cash In Lieu*.

References:

www.iclub.com/support/kb/default.asp?page=transactions

Cash In Lieu (of fractional shares)

Stock splits, corporate mergers, and spinoffs can all result in fractional shares. Except with DRPs and other dividend reinvestment plans, stockholders generally receive cash “in lieu” (instead) of fractional shares. For tax purposes, cash received in lieu is treated as a taxable sale of the fractional shares. Cash in lieu is often received somewhat after the effective date of the split, merger or spinoff.

In club accounting software, cash in lieu can be entered as part of the original transaction (split, merger, and spinoff). Another method is to leave the cash in lieu amount blank in the original transaction and enter a separate sale transaction for the fractional shares (the net amount of that sale would be the cash in lieu amount). Pick one method or the other (don't do both)!

Donate Securities

IClubCentral club account software supports the charitable donation of securities by a club. At present, bivio software does not. (Both support donations of cash.)

Tax Implications???

(IraS said ...) The withdrawal and the donation are two separate and completely independent transactions. One (the withdrawal) appears on the club's books. The other (the donation) has nothing to do with the club or its record keeping. Any withdrawal comes first from the cost basis that member has in the club. Whether the withdrawal comes from her cost basis or the taxable portion of her club value has no impact on the deductibility of her donation. And the fact that she donates the money to the foundation has no impact on the tax consequences of the withdrawal.

References:

www.bivio.com/trez_talk/mail-msg?t=13646300003&s=2

Account Income

Do not confuse income from cash held at a bank or broker (perhaps in a money market fund) with income from securities (see *Security Income*). In bivio software, income from cash is entered using “Interest” (or “Dividend”) under “Accounts”. In IClubCentral software, it’s entered using “Interest” (or “Bank/Money market dividend”) under “Cash Accounts”.

Income from cash held in a money market fund is sometimes classified as interest income and sometimes as dividend income. It’s important that the income be recorded in club accounting software using the same classification used on the 1099 form issued at year-end. Regardless of the terminology (interest or dividend), such income is recorded in the software as income from an account (not as income from a security).

Deductible Club Expenses

Most expenses which relate directly to carrying out club investment activities are deductible. Examples of deductible expenses include: BetterInvesting membership dues; fidelity bond or other club insurance; educational materials and subscriptions; office supplies; meeting space rental; club accounting software purchase or subscription costs.

However, most clubs operate as partnerships and do not pay taxes directly. Instead, club tax information is allocated proportionally to individual club members (on form K-1) to be included as part of each member’s personal tax return. Because of this, deductible club expenses end up in club member’s personal tax returns on Schedule A as a miscellaneous deduction subject to a 2% AGI limit. As a club member, this means your share of club expenses are only deductible to the extent that (together with any other such deductible amounts you may have on your personal tax return) they exceed 2% of your adjusted gross income (AGI). For many people, that total will be too small to produce any tax benefit.

Non-Deductible Club Expenses

Non-deductible expenses include: Convention or Seminar registration costs; meals and food; party supplies; flowers or other gifts.

Transfer

A transfer transaction is used to move cash from one account to another. Moving cash from a bank account to a broker account (or vice-versa) is the most typical reason for using a transfer.

Suspense Account

Using an account that does not correspond to an actual account at a financial institution is

Account Activities

sometimes a bookkeeping convenience. That's what the suspense account is for. Ordinary, day-to-day types of transactions don't use the suspense account. It's intended for use with relatively unusual multi-part transactions that involve dollar amounts that cancel each other out. For this reason, the suspense account should never have a non-zero balance for very long. A non-zero balance should always be offset by one or more transactions dated in the very near future.

Here's an example. A club member uses their personal credit card to pay the bivio.com subscription expense on behalf of their club and gets reimbursed with club units equivalent in value to the expense they paid. This is done by recording the expense transaction as usual, but using the suspense account as the source of funds (rather than the bank or broker account). In addition, a member payment transaction is recorded for that member, using the suspense account and the same date and dollar amount as the expense transaction. The dollar amount of these two transactions cancels each other out so the balance in the suspense account doesn't change. Using any other account would work too (since the account balance is unaffected). The reason for using the suspense account is so these two internal bookkeeping transactions don't appear in an account where they didn't actually take place (which would complicate reconciling the account transactions against the account statement from the bank or broker).

Miscellaneous Income

It is very rare for an investment club to receive income that doesn't belong in any other category. Such income would be unrelated to any club investments or cash holdings.

In virtually all cases, if an amount appears on the club's federal tax return classified as "Other Income" that means some amount has been erroneously recorded as miscellaneous income. An amount one might be inclined to classify as miscellaneous income is usually most appropriately recorded as a deductible expense using a negative value for the amount. An example of something that would be appropriately recorded as miscellaneous income is prize money won by a club from entering a chapter portfolio contest.

Different club accounting software uses different terminology for this concept. Club Accounting 3 calls it "Other Income". myiclub.com calls it "Account Income". With bivio.com it's entered in a cash account using the "interest" button and then changing the "distribution type" to "Miscellaneous Income".

Donate Cash

Both IClubCentral and bivio software supports cash donations.

(The 30% vs. 50% distinction in bivio is not commonly needed. Does IClub have something similar?)

Valuation Statement

A valuation statement shows the calculation of a club's unit value on a particular valuation date. (See *Unit Value* and *Valuation Date*.) The statement shows basic information about all club assets as well as the total number of club units. This includes information about all securities held, and the cash balance in all accounts.

Traditionally, a valuation statement also shows the purchase cost of all club securities and the club's capital gain or loss for each security. Depending on the club accounting software being used, compound annualized return for the club's investment in each security may also be shown (although the usefulness of that information is arguable).

Member Status Report

A member status report shows a summary of each club member's ownership on a particular valuation date. For each member the report shows total dollars invested, tax basis, club units owned, and the current value of those units. Also shown are dollars recently invested and the number of units those dollars purchased.

Club Bookkeeping Reports

All club accounting software produces the Valuation Statement and the Member Status Report. These are the two fundamental club account reports and are generally made available to all members each month at the club meeting. All club accounting software produces a variety of other reports too. The additional reports vary depending on which club accounting software is being used.

A recent transactions report is also useful to provide monthly. All club accounting software produces a report that shows all transactions in each account during a specific time period. This report is very useful for reconciling an account in the club accounting software with the monthly financial statement for that account issued by the club's broker or bank (similar to reconciling your personal checking account with its bank statement).

Other reports ... ???

Withdrawal Report

When a club member withdraws some or all of their club investment, the withdrawing member will need to know a variety of tax related information about the withdrawal. The member's year-end K-1 form issued by the club will not contain that information. The purpose of the withdrawal report is to provide a withdrawing member with the tax information they need about their withdrawal. (The purpose of the K-1 form is to show a member their proportionate share of club income and expenses. A member's gain/loss upon withdrawal is not a part of club income or expenses and, so, appears on the withdrawal report rather than the K-1 form.)

Reporting Activities

For a full withdrawal the withdrawal report will show the member's taxable gain or loss on the withdrawal, which must be reported on their personal tax return in addition to any information shown on their K-1 form for that tax year. The report will also show the member's tax basis in any transferred stock (which in the case of a full withdrawal will be different from both the club's tax basis in that stock and the market value of the stock).

For a partial withdrawal the withdrawal report will also show important information necessary to prepare the member's personal income tax return. If the cash component of the withdrawal was greater than the member's PIPE, the excess will appear as a taxable capital gain. The amount of this gain (calculated on the withdrawal valuation date) will be reduced by any subsequent contributions of capital during the tax year, so a revised withdrawal report should be generated at year-end. [Verify with Ira ... do the various software packages do this correctly???] The withdrawal report also provides the adjusted cost basis in any securities transferred as part of the withdrawal.

Year-End Activities

1099 Forms

A 1099 form will generally be issued to a club for every account the club has with a broker or bank. These forms generally become available in late January or early February each year. They will be sent in the mail and are also often available for download from the broker or bank web site.

A club should always wait to receive all 1099 forms before preparing the club tax return and before preparing K-1 forms for club members. It's important to verify that the information on the club's 1099 forms is consistent with the information on the club's tax return and K-1 forms. If the information does not agree, the club may receive a letter from the IRS asking for an explanation. There is the potential for the club and all its members to have to file amended tax returns to correct such discrepancies.

Club Audit

At the very least, every club should perform an audit of its financial records once a year before filing its tax return. Performing at least a quick audit before processing a withdrawal is good policy (to ensure that the withdrawing member is paid the correct amount). Routine quarterly audits are a very good idea. Reconciling all accounts in the software with the corresponding broker or bank statement each month will make auditing much easier.

The purpose of an audit is to detect any errors in the club financial records. Honest mistakes can be made by anyone. Brokers have been known to fail to record a dividend and to make other errors. Intentional fraud is not unheard of, even in clubs where all members know each other well. No matter what the cause, it's best to detect and correct any errors in club financial records as soon as possible.

Procedure ... ???

References:

www.brucereed.com/InvestmentClubs/NAIC/audit-report.html

www.stockcentral.com/community/tabid/143/forumid/296/postid/5991/view/topic/language/en-US/Default.aspx

www.betterinvesting.org/Members/Tools/Articles/Archives/WebFeatures/Authors/BarnettHerb/2004VerifyingTheClubBooks.htm

www.betterinvesting.org/Members/Tools/Articles/Archives/PrintMagazine/Authors/Moo reMartha/200004AuditingYearEndBalances.htm

Federal Tax Reporting

All investment clubs should file a federal tax return every year. Investment clubs operating as anything other than a general partnership will need to research federal tax filing requirements on their own. Most clubs operate as general partnerships and use

Year-End Activities

Form 1065 for their federal taxes. Part of the filing requirement is to provide each club member with a form K-1 (and to send a copy of all K-1 forms to the IRS along with the club's form 1065).

During a year, some club members may have made withdrawals (either full or partial withdrawals). It's important for these members to understand that important tax information about their withdrawal will not appear on their form K-1. To properly prepare their personal tax return, information from the appropriate withdrawal report is needed in addition to the information on form K-1. It's good practice for a club to distribute withdrawal reports at year-end along with form K-1 (even if a withdrawal report was provided at the time of the withdrawal). See *Withdrawals*.

State Tax Reporting

State tax reporting requirements vary from state to state. In some states there are no partnership tax filing requirements at all. In other states there are tax filing requirements at both the state and local (county and/or city) levels. Check with local tax authorities, or with your local BetterInvesting chapter, to learn more about state and local tax filing requirements.

For clubs operating as a general partnership, all club accounting software can prepare state tax forms for some states. Which states are supported by which software varies depending on the software being used and from year to year.

Don't: Equal Ownership

Some clubs feel that it's a good idea to require all club members to maintain equal ownership of the club. However, enforcing equal ownership is a practical impossibility for most clubs.

A club that insists on equal ownership cannot allow partial withdrawals. Successful clubs that have been around for many years generally find it appropriate to allow members to withdraw some of their investment and remain as members (rather than being forced to withdraw fully simply to avoid unequal ownership).

Equal ownership in terms of both dollars invested and club units owned becomes impossible the first time a member misses a monthly investment. If such a member, for example, were to pay double next month they would "catch up" in terms of dollars invested but they would own a different number of units than everyone else. Allowing a member in that situation to buy units retroactively at last month's unit value isn't fair to the members who paid on time.

The primary purpose of the unit accounting system is to make equal ownership unnecessary. It's best for a club to start from day one without all the various complexities clubs try to put in place to encourage and enforce equal ownership and to penalize members who don't follow suit.

Don't: "Buy Out" Withdrawing Members

When a member withdraws (either fully or partially) from a club, some club units cease to exist. If a member withdraws \$1,500 from a club when the unit value is \$15, one hundred club units simply "go away".

Clubs sometimes decide that it might be a good idea to give other members the option to buy those units from the withdrawing member. Technically (from an accounting point of view) this is possible, but none of the club accounting software can properly account for it (including the tax implications). Ordinarily this is completely unnecessary.

What is possible (and much easier) is for other members to invest additional funds into the club and for the club to use those additional funds to pay the withdrawing member in cash. In club accounting software, simply enter the additional member investments as member payments and then enter the withdrawal. With this approach, no different or unusual accounting is necessary; the transactions are just like any other member payment or withdrawal.

Keep in mind, however, that paying a fully withdrawing member in cash virtually never results in the best tax situation for either the club or the departing member. It's generally best to pay a fully withdrawing member by transferring the most highly appreciated securities the clubs owns. If some remaining members want to invest additional cash,

Don't Do It!

simply use that cash to buy whatever stocks the club most wants to invest in. If the club wants to continue investing in the stock(s) transferred to the withdrawing member, it can buy that stock again (at a higher cost basis than before!). See [Withdrawals](#) and [Full Withdrawal](#).

Don't: Excessive Withdrawal Fees

BetterInvesting has long provided a “model” partnership agreement which many clubs have used as the basis for their own partnership agreement. This model agreement contains language that imposes a three percent withdrawal fee on cash withdrawals. The original purpose of this fee was to recover the cost of commissions associated with selling stock to raise the cash needed to pay a withdrawing member. Brokerage commissions are now much lower than they were decades ago. If a club chooses to sell stock to raise cash, commissions should be minimal these days.

Many would consider the actual cost associated with implementing a withdrawal to be an appropriate amount for a withdrawal fee (but see the footnote about this under [Withdrawals](#) for another point of view). A withdrawal fee higher than actual costs really serves no purpose other than to enrich the remaining members at the expense of the withdrawing member. Keep in mind that when a club disbands, the members at that time cannot pay a separate withdrawal at all (because there is no one to pay it to). In effect, the last members to leave a club get the withdrawal fees from all preceding withdrawals.

Some clubs use withdrawal fees to deter withdrawals. Some impose a percentage fee that declines over the first several years of the club. Before imposing withdrawal fees for this purpose, it's worth considering that a club may be better off without members who don't really want to remain in the club. Members who would prefer to withdraw are unlikely to participate effectively in club operations.

Don't: Confuse Fees with Expenses

In club accounting software, fees and expenses are used for two very different purposes. An expense is money a club pays for supplies or services. A fee is money a member pays to a club (almost always as a penalty) which does not purchase any club units.

Don't bother collecting funds to pay expenses separately from funds for investment (there are no “earmarks” in investment club accounting.) All money collected from members should be recorded as payments. (Never use a fee unless the intent is to penalize.) If you ignore this advice for some reason, [never](#) assess a fee to cover club expenses and then record the expense as equally allocated.

References:

biwiki.editme.com/feesforexpenses

Don't: Petty Cash

Current versions of club accounting software do not support use of an “off the books” petty cash account. Older versions of the software did provide a special petty cash account that was intended for tracking cash used for club gifts, meals, parties, or other non-deductible, non-operating expenses. However, that special account was often used inappropriately and was never really necessary anyway.

A club can certainly collect money from members to pay for club social activities. Such money should be recorded just like any other member investment in the club and should buy club units (i.e., do not record such money as a member “fee”). Payments made by the club for club “social” activities should be recorded as non-deductible expenses. See *Deductible Club Expenses* and *Non-Deductible Club Expenses*.

It's perfectly fine for the treasurer to keep a modest amount of club funds in the form of cash to pay for small incidental expenses (for example, stamps or copies). Such cash should be tracked in club accounting software using a separate cash account (i.e., it should be an “on the books” account) and that account should be reconciled monthly with the physical cash. In club accounting software, feel free to name that account “Cash on Hand” or “Petty Cash” or any other descriptive name.

Don't: Delete Members or Securities

Club treasurers sometimes ask how to delete withdrawn members or sold securities from the club accounting software. Doing so is neither necessary nor desirable. All transactions associated with all members and securities should remain a part of the club records forever. There is no reason to delete any kind of old data from club accounting software.

Don't: Opt-out of Federal Tax Reporting

BetterInvesting recommends that all investment clubs file federal tax returns every year. In some states, there may be state and local tax filing requirements as well.

Prior to 1994 BetterInvesting used to point out that investment clubs operating as partnerships could avoid filing federal tax returns by making an election under IRS code section 761(a). The position of the IRS has been that this exemption was never intended for investment clubs (even though, up until 1998, IRS publications used to explain how investment clubs could take advantage of the election!). In any case, while a partnership making that election can avoid filing federal tax returns, by doing so the partnership is imposing additional federal tax reporting requirements on all of its individual partners. Also, making the election does not necessarily allow a partnership to avoid filing a state tax return.

References:

www.bivio.com/trez_talk/mail-msg?t=101500003

Don't: REIT, ETF and MLP/PTP Distributions vs. Stock Dividends

REITs (Real Estate Investment Trusts) and ETFs (Exchange Traded Funds) are two common examples of securities which are traded like stocks but pay income to shareholders as "distributions" rather than "dividends". There are other less common examples too, such as Publicly Traded Partnerships (PTPs), also commonly known as Master Limited Partnerships (MLPs). Investing in any of these securities usually results in more complex tax reporting issues for the club and its members, compared to investing in corporate stock.

Because of the added complexity of tax reporting, many consider such securities more trouble than they are worth for investment clubs. Before investing in such securities the club treasurer should become familiar with the tax issues and be willing to do the extra work. Perhaps most importantly, all the club members need to be willing to put up with the potential for getting their annual club tax information late in the tax season (probably mid-March or later).

MLP/PTP securities cause the most serious problems. None of the investment club accounting software can adequately handle the tax reporting requirements associated with MLP/PTP distributions. Investing in MLP/PTP securities can also subject the club and its members to having to file state tax returns in every state in which the MLP/PTP has operations.

REIT distributions may consist of as many as five components, all separately reportable: qualifying dividends, non-qualifying dividends, return of capital, long-term capital gain, and unrecaptured section 1250 gain. As distributions are paid during the year (generally quarterly), the breakdown of each distribution into these components will be unknown (so club treasurers generally enter them temporarily as a return of capital). The proper breakdown will only become known after the end of the year when form 1099-DIV is received. At that point each distribution entry will need to be deleted and reentered using the appropriate breakdowns. It's not unusual for REITs to issue form 1099-DIV late in the tax season (late in February) and even later to issue a revised form 1099-DIV. It's also not uncommon for REITs to pay a distribution in January (or even February) that's taxable in the prior year.

ETFs holding stocks that pay dividends pass those dividends along to shareholders as distributions. Dividends that would be "qualified" if the stocks were held directly may not be qualified when received as ETF distributions because of the more complex holding period requirements. Not only must the ETF itself meet the usual holding period requirements for the stock dividends, the ETF shareholder must separately meet holding period requirements for the ETF shares. The breakdown between qualified and non-qualified dividends will not be known until a year-end form 1099-DIV is received. At that point, prior distribution entries may need to be modified, and additional entries made to properly reflect the nature of the distributions. If a club does invest in ETFs, those securities should be configured in the club accounting software as a mutual fund (because the tax treatment of EFT distributions and mutual fund distributions is the same).

Don't Do It!

ETF securities should be recorded in club accounting software as “mutual fund” (not as “common stock”).

Don't: Invest in Unregistered Securities

Do not invest in any security or other interest of any kind in any entity, company or business that is not properly registered and regulated by the U.S. Securities and Exchange Commission (or other appropriate government agency) or whose financial statements, affairs and conduct are not subject to independent audit and review. Affinity-group “development bonds” and “private placement offerings” are just two of many examples of such unsuitable investments.

Most U.S. investment clubs limit their activities to investing in securities which are publicly traded on a major U.S. stock exchange (e.g., NYSE, NASDAQ).

References:

www.sec.gov/investor

www.sec.gov/investor/oiepauselist.htm

www.sec.gov/investor/oiepauselistfake.htm

www.finra.org/Investors

www.nasaa.org/Investor_Education/NASAA_Fraud_Center

www.ftc.gov/bcp/consumer.shtm (Investments & Business Opportunities)

www.onguardonline.gov

Don't: Distribute Units when Allocating Club Earning

It used to be traditional for a club to “distribute” club units at year end as part of the process of allocating its net profit or loss to members. The number of units distributed was equivalent to the club's overall profit or loss during the year. (An offsetting adjustment was made to unit value so the net effect on club and member value was zero.) It is recommended that clubs discontinue this practice of distributing units as it never served a useful purpose. It did create confusion among members, especially in newer clubs when units were deducted at year end because of an operating loss (not unusual for newer clubs).

What is important is for the club's overall profit or loss to be allocated to members for tax purposes, in proportion to their club ownership. This allocation is reported on form K-1. Allocating profit/loss for tax purposes is completely separate from the issue of distributing units to represent that profit/loss.

Reports showing tax allocation: in bivio, Member Tax Allocations; in CA3/CAO, Allocation of Income and Expense report.

Don't: Unit Value as a Measure of Performance

It is possible to use club unit value to measure club investment performance if certain rules are followed. However, since it's common to forget about the rules as time goes by, it's better to avoid using unit value for this purpose. It's better to let the club accounting software calculate club performance using reports designed for that purpose.

IClubCentral software can be configured to show performance on the Valuation Statement and Member Status Report. The Club Performance & Benchmark report (myiclub.com only) compares club performance with the performance of equivalent investments in the Vanguard 500 Index Fund and the Vanguard Total Stock Market Index Fund.

With bivio software, performance is shown on the Investment Performance and Member Performance reports. The Performance Benchmark report compares club performance with the performance of equivalent investments in any of a variety of Vanguard index funds.

Tips: Getting Help

There are a number of resources available to club treasurers when they need help. Be aware that accounting for investment clubs may be unfamiliar territory for bookkeepers and CPAs who do not have specific experience with partnership accounting.

The biwiki.editme.com/ClubTreasurers web page lists a variety of resources for club treasurers. The BetterInvesting email discussion list for Club-Treasurers is a great place to ask questions about investment club accounting. Subscribing to this email list at http://lists.betterinvesting.net/read/all_forums/subscribe?name=club-treasurers is highly recommended for any club treasurer.

Help for specific club accounting software products is also available from the software vendors. For bivio software, click the *Club Cafe* icon at www.bivio.com or email support@bivio.com. For IClubCentral software, see www.iclub.com/support (look for the links titled *Contact Support* and *Club Accounting User's Group*).

Tips: Have Co-Treasurers

There are many good reasons to divide up the treasurer's job between two club members. Perhaps the best reason is simply so there is more than one person in the club who understands how to do the job properly. It's also a good idea to have two people involved so they can double check each other. Errors are less likely to slip by when one person makes the bookkeeping entries in the club accounting software and another member reconciles the monthly bank and brokerage statements with the club accounting reports. Ideally, one co-treasurer would write checks and maintain the club accounting records while the other co-treasurer would reconcile the club's accounting records with its monthly bank and broker statements.

Some clubs rotate senior and junior treasurer positions among the club members on a regular basis, along with rotating other club officer positions. Rotating positions every year or two isn't too frequent. When it's time to rotate, the junior treasurer moves into the senior treasurer position while a member other than the senior treasurer moves into the junior treasurer position. The former senior treasurer is available to consult and help train the new junior treasurer.

Tips: Reconcile All Accounts Monthly

Reconciling bank and brokerage statements every month soon after they arrive is a good idea for clubs, just as it is for personal finances. Errors identified sooner are more easily corrected. Auditing all the club financial records at least annually is highly recommended and tends to go much more quickly when monthly statements have already been reconciled.

Tips: Backup Data Frequently

Just as with any computer data, you don't want to risk losing your club accounting data to either a computer failure or human error. Using online club accounting software can eliminate the risk of data loss due to failure of the treasurer's personal computer, but it doesn't necessarily address the risk of human error. A treasurer who inadvertently deletes old accounting entries is someone who will be glad to have made regular data backups.

All club accounting software provides a way to backup and restore club data.

Tips: Get an EIN

All investment clubs need an Employer Identification Number (EIN) because that's how the club identifies itself to the IRS on its annual tax return. The quickest way to get an EIN is to apply online at www.irs.gov (use the search feature there to look for "EIN").

Tips: File Club Tax Returns Every Year

All investment clubs should file a federal tax return, and give each member a K-1 form, every year. See *Federal Tax Reporting*.

Tips: Disbanding a Club

Disbanding an investment club is a task that can take several months to fully complete.

References:

How to Dissolve an Investment Club, BetterInvesting Web Feature, June 2004

How do I dissolve or disband my club?, IClubCentral support topic