

REVENUE RULING 70-604: THE LATEST WORD

By: Gary A. Porter, CPA

We continue to receive questions about the proper application of Revenue Ruling 70-604. The Ledger Quarterly has addressed this topic several times in the past, in the Summer 1990, Spring 1991, and Winter 1993 issues. However, in light of the continuing interest in this subject, perhaps it is time for an update. This ruling is still the most powerful tax planning tool that an association has when filing IRS Form 1120. As discussed in previous articles, an association must comply with this, or any other ruling, in order for it to be effective. The questions surrounding Revenue Ruling 70-604 relate to “what does it take to comply?”

Let’s lay a little background first. I have long used the analogy that an association, for tax purposes, is a square peg. IRS income tax return Form 1120-H, designed specifically for homeowners’ associations, is a square hole. The two are a perfect fit, so an association can file Form 1120-H with no tax risk. For most associations, the only other option is to file Form 1120. But when it does so, it is no longer a homeowners’ association. It is now a nonexempt membership organization, and is subject to a different definition and a completely different set of rules. Unfortunately, it appears that few CPA’s, and even fewer associations, are aware of, or understand, this very basic fact. The association filing Form 1120 is now a square peg trying to fit into a round hole. And guess what? It doesn’t fit. Many CPA’s advise their association clients to file Form 1120 to save a little tax money, but they do so with little or no regard for the risk that the association assumes by doing so. Many feel it is a risk worth taking, as less than 2% of corporation tax returns are selected for tax audit nationwide by the IRS each year.

When the association does decide to file form 1120, it must fit into that round hole called Form 1120. In order to make this fit, most CPA’s and associations just interpret the tax Code, Regulations, Rulings, and court cases very liberally, or ignore them completely.

This makes your view of the round hole much bigger, so that the association can fit into it. But if you can visualize that large round hole with the square peg inside of it, you will notice four “half moons” of empty space between the square peg and the inside of the round hole. Let’s call that **tax exposure**. This tax exposure is the risk that an IRS audit will have significant adverse effect on the association, which was created when you filed Form 1120 without complying with all of the hundreds of different technical citations that apply when you file this form.

This is a lesson that is often learned the hard way. Everybody has heard of the infamous IRS audits of some dozen associations in San Diego in 1993, and the large proposed assessments by the IRS based on taxing of reserves. These assessments were based on two

Revenue Ruling 70-604

A condominium management corporation assesses its stockholder-owners for the purposes of managing, operating, maintaining, and replacing the common elements of the condominium property. This is the sole activity of the corporation and its bylaws do not authorize it to engage in any other activity.

A meeting is held each year by the stockholder-owners of the corporation, at which they decide what is to be done with any excess assessments not actually used for the purposes described above, i.e., they decide either to return the excess to themselves or to have the excess applied to the following year’s assessments.

Held, the excess assessments for the taxable year over and above the actual expenses paid or incurred for the purposes described above are not taxable income to the corporation, since the excess, in effect, has been returned to the stockholder-owners.

technical factors; (1) improper segregation of operating and reserve bank accounts, and (2) improper elections under Revenue Ruling 70-604. But, nobody seems to have heard the outcome of these “unjust and outrageous” tax assessments by the IRS. What everybody hasn’t heard is that one of those cases, Mission Heights Homeowners Association, Inc. v. United States of America, US-DIST-CT [96-2 USTC] August 28, 1996, was decided by the U.S. District Court in August 1996. The decision issued by the Court granted summary judgment for the IRS and denied summary judgment for the association on all issues. This means that the association lost on every single issue, and that the Court’s opinion was that the association really did not have a significant legal basis for its various positions. One of those positions was the Revenue Ruling 70-604 election by the association, in which the Court stated “. . . it [the Association] failed to follow the procedures identified in Revenue Ruling 70-604 . . .”



Revenue Ruling 70-604 (continued)

So let's look at this issue a little closer. After all, Revenue Ruling 70-604 is one of the, if not the most, powerful tax planning tools that an Association can use when filing Form 1120 as a non exempt membership organization. This revenue ruling (see box inset) allows an Association to make an election which will remove from taxation or defer tax on the Association's excess membership income (this is a technical definition that, for most associations, approximates "net operating income"). Most associations should make a 70-604 election every year. This election can potentially reduce the Association's tax liability with no downside risk, if done properly. If circumstances dictate that such an election would not apply in a given year, it is simply ignored. If the Association does have excess membership income, then having made a proper election under Revenue Ruling 70-604 can save the Association 15% tax (the tax rate up to the first \$50,000 of taxable income of the association) on the excess membership income. By failing to make the 70-604 election, the excess membership income would be taxed along with the nonmembership income of the association. This is extremely important for those associations who cannot file Form 1120-H because they don't meet the restrictive 60% income and 90% expenditure tests of Internal Revenue Code Section 528 (Form 1120-H).

If an association makes a Revenue Ruling 70-604 election, it must strictly comply with the requirements of the Ruling. These requirements relate to the who, when, how, and where to make the election.

Who must make the election? - The IRS makes its own rules, to a certain extent, and doesn't care about state laws or governing documents. That means that you must follow the IRS rules explicitly; you may not reinterpret them for your convenience. Consequently, I recommend that the wording of Revenue Ruling 70-604 be literally interpreted and that the election be in the form of a resolution adopted by the membership. I also recommend that the members' election be ratified by the board of directors to comply with state law and the association's governing documents, which generally state that only the board of directors is empowered to make financial decisions of this nature.

When must the 70-604 election be made? - Revenue Ruling 70-604 simply states "A meeting is held each year . . .". It does not state whether the meeting is to be held before year end or simply before the tax return is filed. There is no authority which addresses this question. In the absence of clarification in this matter I recommend that, to expose itself to the minimum risk of losing the benefit of this election, the Association make the election prior to the end of the fiscal year for which the election is to apply. The election must be made before the tax return is filed, or there is no basis for deferring the income on the return.

Election Under Revenue Ruling 70-604 Excess Income Applied To Following Year Assessments

WHEREAS the Association is a California corporation duly organized and existing under the laws of the State of California; and,

WHEREAS, the members desire that the corporation shall act in full accordance with the rulings and regulations of the Internal Revenue Service;

NOW, THEREFORE, the members hereby adopt the following resolution by and on behalf of the Association

RESOLVED, that any excess of membership income over membership expenses, for the tax year ended December 31, 1997 (Date), shall be applied against the succeeding tax years member assessments, as provided by IRS Revenue Ruling 70-604.

This resolution is adopted and made a part of the minutes of the membership meeting of (Date).

BY: _____
President

ATTESTED: _____
Secretary

How should the election be made? - There are no documentation requirements within the Ruling, but if the election is not documented in writing, you have no evidence of having made the election. My recommendation is that the election is made in writing. The easiest way to accomplish this is to make it a standing agenda item for the association's annual membership meeting, and record the members' vote in the minutes of the annual meeting minutes. Also, see the sample resolution form in the box at right. Likewise, the ratification by the board of directors should be documented in the minutes of the board of directors meeting in which the action is taken.

Where should the election be made? - As stated above, it is easiest to accomplish as part of the annual membership meeting. However, the IRS ruled in 1995, in a footnote to Technical Advice Memorandum (TAM) 9539001, that the election could be made at any vote of the membership that constituted a valid vote in accordance with the association's governing documents or state law.

Other, frequent, technical concerns about the Revenue Ruling 70-604 election are:

1) Should the exact dollar amount being carried over to the subsequent year, or being refunded to members, be indicated



Revenue Ruling 70-604 (continued)

as part of the election itself? - Interpreting the Revenue Ruling literally, an election does not require a specific dollar amount, as the Revenue Ruling states that “any excess assessments . . .” may be carried over or refunded.

2) Should excess membership income carried over from one year to the next be included in the next year's budget? - In essence, it is, simply as part of the function of creating the budget, as any budget will normally consider the opening cash balance as part of the calculation. But the IRS views it differently. If excess income is carried from year one to year two, the dues in year two must show a decrease compared to year one, or other compelling evidence of a “decrease,” or the IRS will contend that there was no true “carryover which benefited year two.”

3) Can you make a carryover election every year, and carry over any excess membership income indefinitely? - No! The IRS answered this question clearly in General Counsel Memorandum (GCM) 34613, issued in 1970. The carryover was specifically intended as a one year carryover. The IRS does not interpret 70-604 to be a perpetual rollover scheme. Indeed, the language of the ruling is “. . . have the excess applied to the following **year's** assessments.” Note that **year's** is singular, not plural. The placement of the apostrophe is critical in applying the Ruling.

Perhaps the most critical issue in applying Revenue Ruling 70-604 is not even part of the Ruling. The big question for an association is “Can we use this Ruling?” Unfortunately for many associations, the answer is no. You have to understand what a revenue ruling is. It is a ruling, issued by the IRS, to explain tax law and establish guidelines in areas that are considered to lack

clarity. These rulings may be cited as a precedent, and have the same approximate authority as Treasury Regulations. Revenue rulings must be followed by the IRS once they are issued, unless overridden by a subsequent higher authority. But the most important issue for associations is that a revenue ruling may be used by a taxpayer only if the taxpayer's facts and circumstances are substantially identical to those stated in the ruling. As this applies to Revenue Ruling 70-604, this means that the association's activities may consist only of maintaining the common areas of the association, since this was the guideline established by the Ruling itself. The IRS used this theory in TAM 9539001 to disallow use of Revenue Ruling 70-604 by a timeshare association whose activities included maid, booking and reservation, recreational, and interior maintenance services. These services were deemed to be far in excess of the common area maintenance services allowed by the Ruling. This presumably means that any association with significant recreational activities (such as a golf course), or any nonresidential association, will probably not qualify to use Revenue Ruling 70-604.

The above information is probably far more detailed than anything you have heard about Revenue Ruling 70-604 in the past. It is also probably far more frightening than anything you have heard about this ruling in the past. Too many people take a very “laid back” approach to compliance with this very important ruling. The goal of this article was to inform readers about the extreme complexity that can exist, even for what seems a very simple, three-paragraph ruling by the IRS. Revenue Ruling 70-604 is an excellent example why association taxation is considerably more complex than most associations appreciate, and why strict compliance is the name of the game.

Note: A modified version of this article was published in CAI's “Ledger Quarterly,” Spring 1998 Issue



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