IRS RECONSIDERS REVENUE RULING 70-604

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In early 1999, the Internal Revenue Service was again forced to deal with Revenue Ruling 70-604. The Associate Chief Counsel's office responded by internal memorandum Field Service Advice (FSA) # 99-99999 to a field agent's inquiry regarding proper application of Revenue Ruling 70-604. While this document has little authority, it is probably the clearest expression of the IRS's position regarding 70-604 that exists today. Since it is merely the most recent of multiple statements by the IRS on the same issue regarding this important ruling, every practitioner should be aware of this memorandum (99-ARD-077-4).

Revenue Ruling 70-604 is one of the most powerful tax planning tools that exists for associations that file Form 1120. Much has been written in the last several years regarding the risks associated with filing Form 1120, one of those risks being the clarity of the law itself. The law is not set forth clearly and concisely in a single code section and a single regulation as with the case IRC Section 528 and Form 1120-H. For Form 1120 you are subject to a number of code sections including IRC Section 277 and IRC Section 118 and related regulations, but also to a number of revenue rulings, court cases and private letter rulings that have interpreted these important code sections.

One of the most critical revenue rulings applicable to associations filing form 1120 is ruling 70-604. This revenue ruling is almost thirty years old, but still has the full impact and carries the same weight that in had in 1970. In this ruling, the IRS, in a rare concession, allows a subject association, which meets the qualifications of the revenue ruling, to either refund or carry over to the subsequent tax year the excess of its member income over its member expenses.

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This is the most powerful tax-planning tool that exists for associations that file Form 1120. However it should be used with extreme caution. As we have pointed out in several prior articles, this two-paragraph revenue ruling that seems so simple on its face, is actually extremely complex. It works in concert with other rulings, cases and code sections.

The Internal Revenue Service has continually held that the carryover allowed by the revenue ruling was to be interpreted as a one-year carryover only. That is, you could not indefinitely carry over a series of excess income from year to year to year. As we have pointed out in the past, this is evident in where the apostrophe is placed in the word "year's" in the ruling itself. It is "year's" not "years'," thereby signifying singular rather than plural. The intent here is clearly that it would be a one-year carryover ruling. In addition, General Counsel Memorandum (GCM) 36-188, issued in 1970, represented the Associate Chief Counsel's office comments on Revenue Ruling 70-604 prior to its issuance. That GCM also clearly stated that the revenue ruling was intended to be a one-year

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carryover only. It is also interesting to note that the GCM recommended against issuance of the Ruling. In addition, Technical Advice Memorandum 9539001, in a footnote, further commented on the fact that Revenue Ruling 70-604 was intended to be a one-year carryover. Lastly comes this new internal memorandum document that says more strongly and in plainer language than has ever been stated in the past, that Revenue Ruling 70-604 is a one-year carryover only. It may not be used for multiple year carryovers.

Unfortunately, numerous practitioners have interpreted this Ruling far more liberally than has the IRS. Many tax practitioners and associations have claimed multiple year carryovers of excess income to avoid paying tax on the excess membership income on Form 1120. This is part of the risk of filing Form 1120. This excess income is not taxed on Form 1120-H, but the association must pay a higher tax rate to file the safer form.

In the new memorandum issued by the IRS, they further state that they are aware of certain abuses with respect to application of Revenue Ruling 70-604 and is therefore reconsidering this ruling. This is likely to be very bad news for the association industry. Any reconsideration will restrict associations further to curb the known abuses. A worst case scenario would either eliminate the carryover capability or completely rescind the ruling. Unfortunately, the liberal interpretation and abusive practices of the few will harm the many in this case.

The majority of tax practitioners and associations have adopted a conservative approach and have not been claiming multiple year carryovers under Revenue Ruling 70-604. Many of those who have taken the more liberal approach have never been audited on a tax return and so never have had this issue tested. Some have had this issue tested on audit and have not had a negative adjustment by the IRS. This appears to reflect upon the quality of the IRS auditor more than anything else, because all of the documentary evidence from the Internal Revenue Service indicates clearly the theory that a one- year carryover is the <u>only</u> interpretation of this ruling.

Practitioners are cautioned to be aware of this new IRS memorandum and are urged to practice with extreme caution in this area, lest they become the targets of an IRS audit on this issue. This is particularly important since the Internal Revenue Service is working on a Market Segment Specialization Program (MSSP) manual as a guide for field agents in auditing homeowners associations. Treatment of Revenue Ruling 70-604 as a one-year only carryover is part of that audit manual. The time-share version of this manual already exists in a draft state and will have extremely negative consequences for the industry.

However, the Internal Revenue Service did not stop in dealing with just a single issue with respect to Revenue Ruling 70-604. Another area that they have realized have been severely abused and is also targeted by its memorandum is the treatment of making an election on Revenue Ruling 70-604. The Ruling allows two options, either refunding the excess member income to the members or rolling it forward to the subsequent tax year. However, many tax practitioners and associations have elected a third option, which is to transfer the excess to reserves. The third option is not valid.

The IRS, consistent with all of the rulings that exist on this particular issue, has stated that this is an inappropriate practice that was not intended by Revenue Ruling 70-604 and is not

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acceptable to the IRS. In this memorandum the Associate Chief Counsel's office advised the field agent to readjust the taxpayer's income on this issue. IRC Section 118 and its related Regulations, several court cases, and Revenue Rulings 75-370 and 75-371 all rule consistently on this issue. The reasoning behind the IRS's conclusion is quite simple. The dues were assessed as operating funds and they may not be re-characterized after the fact as capital assessments.

Practitioners and associations are again cautioned to be very careful with this matter. There is a way around this situation, by taking advance action and planning well. If an association recognizes that it is in an excess membership position for a specific tax year it should revise its budget mid year, not at the end of the year. By then, it is too late. While keeping the overall assessments to members the same, reallocate the portion of the budget that goes to reserves upwards and reallocate the portion going to operating assessments downwards thereby eliminating the excess. This means the operating fund will have operated at a profit for the first part of the year and at a loss for the second part of the year breaking even by the end of the year. This accomplishes the same thing as trying to make a reallocation after the end of the year in question. However, having been done properly by revising the budget and getting advance notice to the members that their assessments will now be capital assessments, associations can avoid negative tax implications by acting in a proactive manner.

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