Revenue Ruling 70-604 and Your Association

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As a “full service” accounting firm providing numerous services to a wide range of clientele, we anticipate having to answer certain commonly recurring questions. While those commonly recurring questions are typically predictable, one trending theme that has sparked a number of interesting conversations this year in particular concerns Internal Revenue Service (IRS) Revenue Ruling 70-604.

70-604 – What is it?

In 1976, the Tax Reform Act gave us Internal Revenue Code (IRC) Section 528 and Form 1120-H. Before that, most homeowners’ associations either filed as a tax exempt organization using Form 990, or as a corporation using Form 1120. The problem with associations filing as corporations using Form 1120, many argued, was that those associations with excess membership income were really drawing the shortest straw. Tax practitioners urged the IRS to lessen the gap separating the tax burdens imposed upon exempt vs. nonexempt associations, and the IRS responded in 1970 by publishing Revenue Ruling 70-604 during the 604th session (hence the 70-604; a real creative bunch, that IRS). Revenue Ruling 70-604 allows homeowners’ associations to avoid taxation on their excess membership income by either rebating the membership, or by carrying it forward and applying it to the following tax year. This can be a definite benefit to an association when completing its tax return, provided that the membership previously elected to apply Revenue Ruling 70-604; it’s not automatic!

Should I Be Doing Something?

If your association files Form 990, the then answer is no. If your association files Form 1120-H, then the answer is “usually no”. If your association files Form 1120, then the answer is “usually yes”. Now, you’re probably wondering what kind of answers “usually yes” and “usually no” are; it’s either “yes” or “no”, right? If your association files Form 1120 and has questions about the applicability of Revenue Ruling 70-604, I would encourage you to consult your tax practitioner, as each association is unique. Conversely, if your association files Form 1120-H and had made the election, the election is simply ignored; no harm, no foul. While your association may have filed Form 1120-H in the past, it needs to meet certain qualifying criteria each year in order to continue to file Form 1120-H. Should the Association not meet those criteria for a given year, having made the 70-604 election could prove extremely beneficial. The 70-604 election is a powerful tax planning tool for an association, but as with any plan, it only works when you’ve prepared it in advance.

So… Now What?

Ok, so you’ve determined that the 70-604 election either definitely applies, or could potentially apply, but either way, you want to cover your bases. Great! So how do you go about doing that? Within Revenue Ruling 70-604, it actually states that “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…” There’s one extremely important piece to key in on within that statement, and that’s the phrase “stockholder-owners”. The overwhelming majority of homeowners’ associations’ governing documents will never reference the phrase “stockholder-owners”. In fact, I have yet to see one that does. But, for the purposes of making the 70-604 election, we need “their” vote. Associations that opt to leave the decision exclusively to the board of directors should be aware that the IRS may challenge their decision, and while that approach may be defensible, information letters provided to other associations by the IRS seem to favor a vote of the annual membership. Interestingly enough, however, is that state statutes in your particular state may establish the authority of the board of directors, but may not establish the authority of a homeowner vote [or its results]. Our recommendation would be to include the 70-604 election on the Association’s annual homeowner ballot, and then to have the board of directors ratify the results during the Association’s next board meeting.

Where Do I Find Example Ballot Wording?

Remember that “full service” accounting firm I talked about in the beginning? Well, we have you covered here too. Please feel free to contact us for a sample ballot that could be put forth to an Association’s membership during its annual meeting that would satisfy the requirements of properly invoking Revenue Ruling 70-604.

If you have any questions on this or any other matter, please contact Tim Nitti at tim.nitti@butlerhansen.com or any other accountant in the firm.