

IRS Revenue Ruling 70-604:

Exploring the tax implications of IRS Revenue Ruling 70-604
For Community Associations.



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Note: The information in this flyer is intended for guideline and example purposes only with respect to Revenue Ruling 70-604, and not to be used in lieu of any official legal, CPA, or professional opinion or any Federal or State Statute. This flyer is not legal counsel and should not be used for such purposes.

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Introduction

The purpose Revenue Ruling 70-604 is to allow a Community Association (Homeowner or Condominium) to avoid taxation on its excess membership income by either “refunding” its excess membership income over expenditures to unit owners in a given year, or by carrying the excess to the following year. Whether an Association refunds its excess membership income over expenditures to the unit owners or carries it over to the next year is at the discretion of the Board of Directors.

Background

Community Associations must file a tax return with the IRS on an annual basis. Associations have the option to file taxes with IRS Form 1120 – *U.S. Corporation Income Tax Return* or with IRS Form 1120H – *U.S. Income Tax Return for Homeowners Associations*. An Association elects to file by either method by simply filing the appropriate income tax return form with the IRS.

IRS Form 1120H is specifically designed to be beneficial to Community Associations in mitigating the risk of a tax liability due for a given year; whereas IRS Form 1120 functions as a regular corporate income tax return for an Association and any excess income over expenditures is taxable at the corporate rate of 21%*.

Additionally, filing IRS form 1120 requires an Association to file Florida Department of Revenue (FDOR) Form F1120 Corporate Income Tax Return. The Florida Department of Revenue may further levy income taxes on any excess income over expenditures for a given tax year. Filing IRS Form 1120H results in an Association **not** having to file a tax return with the State of Florida; thereby avoiding taxation on the Association’s excess income over expenditures by the State of Florida for a given tax year.

Electing Revenue Ruling 70-604

Purpose of Filing

Pursuant to Revenue Ruling 70-604, excess membership income is essentially deferred from taxation by either:

1. Returning the excess membership income to the unit owners in the given tax year (not recommended).
2. “Roll” (defer) the excess membership income over to the next year (recommended).

It is not recommended that excess membership income is returned to unit owners because there is often a mismatch between the accrual method of accounting, as required by the State of Florida, and the actual cash flow of an Association. The Association may not have the cash readily available to refund unit owners, and doing so may inhibit the Association’s ability to pay any unexpected major expenditures.

Rolling the excess membership income over to the next year is the default method of accounting utilized by community associations in the State of Florida.

* - If Revenue Ruling 70-604 is not elected and an Association is required to file IRS Form 1120, the first \$50,000 of an Association’s excess income over expenditures is subject to taxation at a reduced rate of 15% and any income over expenditures above the \$50,000 threshold is taxed at the regular corporate rate of 21%. As such, not electing Revenue Ruling 70-604 results in poor tax planning and potentially unnecessary taxes due to the IRS that could have been mitigated by simply electing to enact Revenue Ruling 70-604 for the given tax year.

How to Make the Election for Revenue Ruling 70-604

In general, Revenue Ruling 70-604 *MUST* be made before the tax return is filed, it *SHOULD* be made before the end of the tax year, and it *COULD* be made before the tax year starts. Recent activity by IRS agents has indicated that the IRS expects the membership of an Association, and not the Board of Directors, to make this election. The IRS does not require an Association to make this election at a meeting, in fact, the election could be made via proxy or mail-in vote; however, a majority of the membership should approve the election.

After approved by a majority of the membership, the Board of Directors should adopt a single resolution to ratify the membership’s approval at a Board Meeting and document such approval in the Minutes of the Board’s Meetings.

The recommended wording of the ballot resolution can be found as an addendum to this Memorandum.

Caveats

One-Year Deferral Only

The adoption of Revenue Ruling 70-604 has clearly been indicated by the IRS to be utilized one year at a time. It cannot be used in consecutive years. Revenue Ruling 70-604 is not a permanent deferral of excess income over expenditures.

Understanding Membership and Non-Membership Income

The adoption of Revenue Ruling 70-604 applies to Membership Income only. The IRS also identifies certain “Non-Membership” (or Non-Exempt for purposes of IRS Form 1120H) income for which Revenue Ruling 70-604 does not apply. Such Non-Membership income would be taxable to an Association regardless of whether the Association files IRS Form 1120 or 1120H.

Examples of Membership Income include:

1. Maintenance Assessments
2. Late Fees
3. Fines
4. Any charges against unit owners necessary to maintain and conduct the Association

Examples of Non-Membership Income include:

1. Interest earned, such as from a bank
2. Capital gains
3. Fees for gate keys, decals, clickers, and stickers (access cards)
4. Income from laundry machines
5. Clubhouse rentals
6. Rental income
7. Any fees charged against a unit owner for their exclusive right to utilize the Association’s facilities

Conclusion

The failure to properly elect/adopt Revenue Ruling 70-604 results in poor tax-planning and a greater likelihood of taxes due to both the IRS and the Florida Department of Revenue in a given tax year. There is no downside risk to electing Revenue Ruling 70-604. If circumstances are such that the Association does not have any excess membership income over expenditures in a given tax year, then the election is simply ignored; however, failing to adopt Revenue Ruling 70-604 results in an Association foregoing the opportunity to roll over (defer) any excess membership income over expenditures.

Addendum – Wording for Ballot Resolution

We recommend the following election is made as part of the annual meeting, and then the Board of Directors vote to ratify such election. The Board of Directors will need to further vote on whether to refund the excess income over expenditures to unit owners (not recommended), or roll-over (defer) the excess income over expenditures to the following year (recommended).

The ballot should read:

Vote to approve Tax Election under Revenue Ruling 70-604: YES -or- NO

The Board of Directors recommends a “Yes” vote

Discussion of Ballot Issue – Revenue Ruling 70-604

A “Yes” vote approves the election under Revenue Ruling 70-604 to “roll over” (defer) any excess “membership income” (as defined by the IRS) from the current tax year to the following tax year. This is an important and legal tax planning tool for the Association, as recommended by our CPA, that requires approval by the membership in order to avoid a possible dispute with the IRS in the event of a tax audit. Approval of this election by the membership provides the Association with protection from negative tax results and possibly saves the Association money that would otherwise have to be utilized to pay any taxes due.

At the advice of our CPA, there are no negative consequences to approving this election, but there is the possibility of negative consequences if not approved.

The Board of Directors makes every attempt to budget assessments to cover only necessary Association costs and expenditures. However, due to the timing of transactions and estimates made during the budget process, occasionally there is minor “excess membership income” at year-end. This is a necessary business planning matter, as the Association needs to have sufficient working capital to pay its bills for at least three (3) months ahead. Consequently, it is fairly normal to have excess membership income. The excess is automatically “rolled over” as part of the budget process, and in accordance with State Statute 718 and 720, meaning the Board of Directors considers this amount when calculating next year’s budget.

This tax election under Revenue Ruling 70-604 is the tax equivalent of the normal budget process; however, it does require approval and documentation to comply with the IRS Rules.

The Board of Directors and our Certified Public Accountant (CPA) STRONGLY recommends approving this ballot by voting YES.

The Association should ensure it has the approval of its CPA to use the above wording.