Appendix 10H

98ARD 176-4, FSA 1992-0208-1—Improper Application of Rev. Rul. 70-604

Cross Reference Data

Topical

Election re: excess income
Excess member income
Return of capital

Citation

IRC Sections—118—2C, 277—2F
Committee Reports on IRC Sections—118—3A, 277—3C
Regulations Sections—1.118-1—5C, 1.277-1—5F
Cases—*Portland Golf Club v. Commissioner*—4A
***—Board of Trade of the City of Chicago and Subsidiaries v. Commissioner*—4B**
***—Mission Heights Homeowners Association, Inc., Plaintiff v. United States of America, Defendant*—4P**
***—Maryland Country Club, Inc., Plaintiff v. United States of America, Defendant*—4S**
Revenue Rulings—70-604—6H, 75-370—6P, 75-371—6Q, 77-354—6U
GCM—34613—8B, 35929—8E, 36188—8F, 37466—8G, 37857—8H

Summary

The condominium association had excess membership income, filed Form 1120, made appropriate election under Rev. Rul. 70-604, but did not either refund the excess or carry it over to the subsequent tax year. Instead, the association transferred the excess to reserves. IRS reversed this on audit and treated the excess as taxable income (since excess member income is taxable on Form 1120 unless an election is made and income is either refunded or carried over to the subsequent tax year). The IRS concluded that since the monies had been assessed as operating funds, they could not be subsequently recharacterized as capital contributions.

Improper Application of Rev. Rul. 70-604

Internal Revenue Service Memorandum

CC: TL-N-2114-92
EE: Br8: RBWeinstock

Date: FEB 06 1992

To: District Director *****

Attn: *****

From: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) CC: EE

Subject: **Application of Rev. Rul. 70-604**

This is in response to the inquiry of Revenue Agent *** seeking clarification of the applicability of Rev. Rul. 70-604, 1970-2 C.B. 9.**

ISSUE

Whether a condominium management association properly reduced its taxable income by recharacterizing certain excess membership income as a return of capital.

CONCLUSION

Under the facts, the excess membership income is properly taxable income. [a]

BACKGROUND

Your memorandum states that starting from its ***** tax year a condominium management association has claimed as a return of capital an amount removed from excess membership income. Apparently, **the association has collected excess assessments from its members but has neither refunded these amounts nor applied then to the next year's membership expenses.** The excess amounts are simply retained and carried forward until a year when membership expenses exceed membership income. The association apparently has cited Rev. Rul. 70-604, 1970-2 C.B. 9, and an accounting publication entitled Guide to Homeowners' Associations. This publication cites several rulings involving special assessments: Rev. Rul. 75-370, Rev. Rul. 75-371.

ANALYSIS

The District has under audit a condominium management association which has elected to be taxed as a regular or straight corporation and filed a Form 1120. Accordingly, IRC Sect. 528 and Treas. Reg. Sect.1.528-9 are not applicable. Rev. Rul. 70-604, 1970-2 C.B. 9, held that a condominium management corporation may exclude excess assessments of its stockholder-owners from taxable income where the stockholder-owners hold an annual meeting at which they decide what is to be done with excess assessments, i.e., they decide to return the excess to themselves or have the excess applied against the following year's assessment. The ruling's rationale is that the excess in effect has been returned to the shareholders.

Rev. Rul. 75-370, 1975-2 C.B. 25, held that a condominium management association does not have to include in gross income special assessments collected from the shareholder-owners and accumulated in a separate bank account for specific capital expenditures. The special assessment was made pursuant to a majority vote of the unit shareholders and could be only used to replace the roof and the elevators located in the common elements of the condominium project. The ruling specifically noted that it did not apply to the funds collected by a condominium management corporation to provide the services for which the corporation was formed such as maintenance of the common elements. As an example, funds accumulated to paint the common elements would not qualify under the ruling.

Rev. Rul. 75-371, 1975-2 C.B. 52, involved a condominium management corporation whose shareholder-owners had approved a special assessment to replace outdoor furniture surrounding the swimming pool. The special assessment was placed in a separate bank account. The ruling held that the amounts received pursuant to the special assessment were not included in income under I.R.C. §61, but constituted contributions to capital. The facts you presented our office are readily distinguishable from those in Rev. Rul. 75-370 and Rev. Rul. 75-371, both of which involved special assessments which were kept in a separate bank account from funds used in everyday activities.

We believe that Rev. Rul. 70-604 does not support the association's position. It is our view that Rev. Rul. 70-604 is an exercise of administrative authority to provide a convenient tool for condominium management associations to deal with an inadvertent collection of excessive membership payments **for a given year** [b] . In effect, **it is an exception to the general rule of I.R.C. §61** which would otherwise require any excessive assessment to be fully taxable in the year collected. **As such, the revenue ruling should be strictly construed.**

Any amounts collected from the membership in excess of allocable expenses are includible in income of the association unless, by action of the members, the excess is to be applied to the next year's expenses. **If a decision is made to apply the excess to the next year's assessments and that in fact does not occur, the excess is taxable because the amount has not, in effect, been returned to the members, which is the underlying theory of the revenue ruling.We do not read the ruling as providing authority to continually carry over that excess amount beyond the next year.** [b]

The requirement in Rev. Rul. 70-604 that the excess assessments must be applied to next year's expenses is not met if the members' assessments in the subsequent year have not been reduced to reflect the availability of the prior year's excess assessments. The excess amount will be treated as being applied to the next year's expenses only to the extent it is applied to any excess amount of expenses over assessments received in the subsequent year (e.g., for the excess to be fully applied, the subsequent year's shortfall must be at least equal to the amount of the prior year's assessment). If instead of a shortfall occurring, an excess of expenses occurs again in the next year, we see nothing in the revenue ruling to prevent its application to another excess arising in that year; however, in such case, the requirement of Rev. Rul. 70-604 will not have been met with respect to the prior year's assessments.

Your request also contained an inquiry as to what tax effect can be given to an assignment of an overassessment in any given year to a capital account for permanent improvements, or for some other capital purpose. **This issue is being considered within the National Office in conjunction with a reconsideration of Rev. Rul. 70-604.** [c]

At this point, however, assuming there is no legal or tax accounting impediment to a retroactive recharacterization of an assessed amount, it seems to us that the question is largely a factual one to be determined from all the facts and circumstances of each case, as was done in Rev. Rul. 75-371 and Rev. Rul. 74-563, 1974-2 C.B. 38. **Where the amount in question was collected from the members as association dues in the first instance and never earmarked for any specific capital expenditure, an inference is justifiably drawn that the amount was not a nontaxable assessment for a capital expenditure purpose or for placement in a capital surplus account in the absence of any prior understanding that the excess dues would be placed in a capital reserve account.** Note the emphasis placed by the court on a prior understanding as to the use of funds and the need for earmarking of funds in *Lake Petersburg Association v. Commissioner*, T.C. Memo. 1974-55.

We hope these comments will be helpful to your examination of the taxpayer in question. **As noted, Rev. Rul. 70-604 is being reconsidered in light of certain abuses that have come to our attention.** [c] We have coordinated this response with the Office of the Assistant Chief Counsel (Passthroughs and Special Industries) to whom your initial inquiry (Mr. E. O. Muhs) was directed. That office is responsible for Rev. Rul. 70-604.

This document may include confidential information subject to the attorney-client and deliberative process privileges, and may have been prepared in anticipation with litigation. This document should not be disclosed to anyone outside the IRS, including the taxpayer(s) involved, and its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or case discussed

herein.

If you have any further questions, please contact District Counsel in ***** We are sending that office a copy of this response.

MICHAEL A. THRASHER
Assistant Chief Counsel

By:

HENRY G. SALAMY
Chief Branch No. 8
(Employee Benefits
and Exempt Organizations)
cc: District Counsel, *****

Notes:

[a] This clearly shows the impact of an improper election or the failure to follow through in compliance of Rev. Rul. 70-604 (Appendix 6H).

[b] The IRS has long held [beginning with GCM 34613 (Appendix 8B)] that Rev. Rul. 70-604 (Appendix 6H) was intended to be a one year carryover only. It was not intended to be an indefinite carryover.

[c] This was the first known written indication by the IRS that any reconsideration was being given to Rev. Rul. 70-604 (Appendix 6H). The fact that they cited "certain abuses" indicates that they are well aware (through the audit process) of the liberal interpretations being applied to Rev. Rul. 70-604. The authors continue to recommend *strict* compliance with that important ruling.