



# IRS RULING 70-604: CAN AN ASSOCIATION MOVE SURPLUS FUNDS TO RESERVES?

by Don Haney, CPA  
Haney Accountants, Inc.  
Certified Public Accountant

February 2010

[www.haneyinc.com](http://www.haneyinc.com)

Associations that have excess funds at the end of the year face the decision if and how those funds can be moved to Reserves, or if they must be rolled over to the Operating Fund the following year. Since most associations are underfunded in their reserves, it is usually a good idea to apply those excess funds to the reserves. There seem to be several paths to minimize the tax effect of these transfers.

There are no special requirements or actions required for those Associations that file Federal Form 1120H tax returns. They are just required to pay 30% tax on their "Non-Exempt Function (mostly interest) Income". If an Association wants to file Federal Form 1120 as a technique to obtain the 15% tax rate on their "Non Exempt Function" taxable income under \$50,000, then the conventional wisdom is that every year it must comply with Internal Revenue Service (IRS) Revenue Ruling (RR) 70-604 and have their owners vote at the annual meeting to comply with the terms and conditions contained in the ruling. I have no quarrel with that path and respect those professionals who advise their clients to do so. However, let me suggest another path I have followed without an IRS challenge for more than 30 years.

Without going into all the IRS hierarchical rules, the Internal Revenue Code (IRC) trumps IRS Revenue Rulings. The path we suggest Associations consider is to report any year-end "Exempt Function" excess of income over expenses as a "Section 118 Contribution to Capital." In other words, a transfer into the Association's Reserve account. By using this technique we have been able to obtain the desired 15% tax rate result, without requiring owners to vote at the annual election. This is the basic concept. Please note that there are several nuances to this process and it should not be done without professional advice.