State of California
Franchise Tax Board

Guidelines for Homeowners' Associations

Homeowners' associations provide for the maintenance, care and management of residential real property. These organizations may qualify for state tax exemption if 60 percent or more of their gross income is from membership dues and assessments and 90 percent or more of their expenses are for the acquisition, construction, management maintenance and care of association property.

Homeowners' associations can be condominium management associations, residential real estate management associations or cooperative housing corporations. Mutual water companies providing water to residential members may also qualify for tax purpose as an exempt Homeowners' associations under certain circumstances. Commercial or industrial property does not meet the residential requirements of a Homeowners' association.

Important

The procedures for obtaining exemption from state tax differ from obtaining exemption for federal tax.

A state tax exemption can only be obtained by submitting a completed Form FTB 3500, Exemption Application, to the Franchise Tax Board. Unless an organization applies for and receives a written determination of exemption from the Franchise Tax Board, it remains a taxable non-exempt organization for state purposes. Its federal status, or the fact it may have filed a 1120H Tax Return with the Internal Revenue Service is irrelevant.

The following information answers the most frequently asked questions about becoming tax exempt as a Homeowners' association.

Qualification as a Homeowners' Association

Organizations **organized** and **operated** to provide for the acquisition, construction, management, maintenance, and care of residential association property may qualify as exempt if:

a. At least 60 percent of gross income is from membership dues, fees, and assessments;

b. 90 percent or more of the expenditures for the year are for acquisition, construction, management, maintenance, and care of association property;

c. No part of the net earnings are used to benefit any private individual;

d. Amounts received as membership dues, fees, and assessments not expended for association purposes during the year, are transferred and held in trust to provide for management, maintenance and care of association property; and

e. Substantially all of the square footage of all units are used for residences or substantially all of the lots and holdings are used for residential purposes.

Mutual Water Companies

A tax exemption for mutual water companies is allowed provided:

1. The water is used for residential purposes only; and

2. The members are assessed for the water on an equal basis or based on the size or value of each member's property.

Note

State law has nothing comparable to Section 501(c)(12) of the Internal Revenue Code granting exemption to certain mutual ditch or irrigation companies. Therefore, federal exemption under Section 501(c)(12) does not guarantee that you can qualify for state exemption.

Applying for State Exemption

Apply for state tax exemption on Form FTB 3500.

- FTB 3500 and instructions can be acquired from any of the Franchise Tax Board district offices or by calling the toll free number in your area. Consult your local telephone directory for the location of the local field office or toll free telephone number.
- When submitting Form FTB 3500 to the Franchise Tax Board, be sure that Side 1 is fully completed; all applicable items and information requested on Side 2, Items 7a through j are submitted; all questions on Side 4, Item 19 are answered; and your $25 application fee is included.

  Failure to submit complete information or the fee with the application will result in additional correspondence and delay in issuing a determination.

Incorporation

1. If your organization has already incorporated, or wishes to incorporate immediately, read the instructions for immediate incorporation contained in the Instructions for Form FTB 3500.
2. If your organization wishes to incorporate without payment of the minimum franchise tax, read the instructions ‘‘Delayed Incorporation’’ contained in Form FTB 3500 Instructions.
3. If you are not an incorporated association, read the instructions ‘‘Unincorporated Associations or Trusts’’ contained in the Form FTB 3500 Instructions.

Organization and Operational Test

When applying for exemption under Revenue and Taxation Code Section 23701t, the association must have a creating document that meets the nonprofit requirements of that section.

Corporations

An appropriate specific purpose for the corporation would be to operate a homeowners' association within the meaning of Section 23701t of the Revenue and Taxation Code.

Example of appropriate articles can be found in the Instructions for FTB 3500.

See ''Sample Articles C'' in the Instructions for Form FTB 3500 for sample nonprofit mutual benefit articles that are compatible with exemption as a homeowners' association under Section 23701t.

Unincorporated Associations

Unincorporated associations must have a creating document such as a constitution, articles of association, or bylaws which contains the necessary language to meet the organizational requirement. The following format is acceptable.

1. The name of the organization.
2. The specific and primary purpose of the organization. An appropriate clause would be as follows:

   ''The specific and primary purpose of the association is to operate a homeowners' association within the meaning of Section 23701t of the California Revenue and Taxation Code and Section 528 of the Internal Revenue Code.''
3. A statement indicating that the organization is organized for nonprofit purposes and that the individual members will not derive profit from the organization. An appropriate clause would be as follows:

   ''This organization does not contemplate financial gain or profit to its members and is organized for nonprofit purposes.''

The provisions can be amended into an existing creating document or a new document can be adopted. However, any new instrument or amendments must be signed by an officer.

Operational Test

The organization must operate within the requirements of the statute. An organization that is not active does not meet the operational test to qualify for exemption.

Annual Filing Requirements

Homeowners' associations that receive exempt status under Section 23701t may be required to file Form 199 and/or Form 100 for each accounting period depending on their gross receipts from all activities and whether taxable income exceeds $100. For specific details, you should refer to the forms and instructions for the year in which they are to be filed. However, the following chart can be used as a guide in determining appropriate filings:

For tax years ending 12/31/86-11/30/88;

Gross Receipts $25,000 or Less	Gross Receipts More Than $25,000	Taxable Income $100 or Less	Taxable Income More Than $100
Form 199 Required	Form 199 Required	Form 100 Not Required	Form 100 Required

For tax years ending 12/31/88 and subsequent;

Gross Receipts $25,000 or Less	Gross Receipts More Than $25,000	Taxable Income $100 or Less	Taxable Income More Than $100
Form 199 Not Required	Form 199 Required	Form 100 Not Required	Form 100 Required

If Form 199 is required, the due date is 4½ months following the end of the accounting period.

The requirement to file Form 100 is in addition to the filing of Form 199. The due date for Form 100 is 2½ months following the end of the accounting period.

The tax on Form 100 is computed at the corporate income tax rate with no minimum tax required. Estimated tax may also be due. For details see instructions for Forms 100 and 100ES.

Cooperative Housing Corporations

In contrast to Section 528 of the Internal Revenue Code, state law specifically addresses tenant stockholders, and cooperative housing corporations, and limited-equity housing cooperatives. in Paragraphs 23701t(a)(1),(c)(2), and (d).

A cooperative housing association corporation or a limited-equity housing cooperative as defined in Section 33007.5 of the Health and Safety Code, will qualify for exemption if it meets requirements c, d, and e under ‘‘Qualifications as a Homeowners’ Association’’ (pg. 2) and:

1. The property is held in common by the members of the association through stock ownership;
2. Payments made by stockholder members to pay acquisition indebtedness, and other fees, qualify as exempt function income for purposes of the 60 percent test; and
3. Payments made by the corporation are for either acquisition, construction, or maintenance of ‘‘association property’’ meeting the 90 percent expenditure test.

Exemption as a Civic League or Social Welfare Organization

A homeowners’ association formed to administer and enforce covenants for preserving the architecture and appearance of the development, and to own or maintain common green areas, streets and sidewalks usually does not qualify for exemption under any section other than 23701t. However, it may qualify for exempt status under Section 23701f as a civic league or social welfare organization if it can show that:

1. The community served by the association is a geographic unit reasonably related to a governmental subdivision; and
2. The association does not maintain the exterior of private residences; and
3. The association owns and maintains only areas and facilities of direct governmental concern such as roadways, parklands, sidewalks, and street lights which are available to the general public; or

4. The association owns and maintains recreational areas and facilities for the use and enjoyment of the general public. (The association may not qualify if it owns and maintains parking facilities only for its members.)

Examples of homeowners' associations that may qualify under Section 23701f because their activities are extended to the general public include, but are not limited to, a neighborhood watch, an organization maintaining public facilities, parks or roadways, or an organization representing the concerns of an entire community before elected or appointed public bodies.

Section 23701f organizations are not required to file Form 100, but may be required to file Form 199.

If an association establishes a separate organization to own and maintain recreational facilities and restricts their use to members, and no part of its earnings benefits only the private interest of any member, it may be able to qualify for exempt status under Section 23701g. No more than 15 percent of total income can be from nonmembers, while a combination of nonmember and investment income cannot exceed 35 percent of total income.

Non-Exempt Organizations

An organization is not exempt from state franchise or income tax if:

1. It has not applied for nor received a written determination of exemption under Section 23701 from the Franchise Tax Board; or
2. An application for exemption has been submitted, but denied by the Franchise Tax Board; or
3. State exemption has been revoked for cause, or for failure to comply with exempt organization filing requirements.

Filing Requirements for Non-exempt Organizations

If an organization is not exempt, and incorporates through the Office of the Secretary of State, it is required to file Form 100, Corporation Franchise or Income Tax Return, within 2 months and 15 days after the close of each accounting period and pay at least the minimum franchise tax.

If an unincorporated association is not exempt, it is required to file Form 100 and pay at the normal corporate rate on any taxable income for the year. However, the minimum annual franchise tax imposed upon corporations does not apply to unincorporated associations. **Note:** Corporations and associations that are not exempt are not required to file Form 199. Only Form 100 should be filed.

Taxable Income

In determining taxable income as a non-exempt association or corporation, you may exclude all income from business activities for, or with, members; or income from nonprofit activities with nonmembers. All other income is taxable.

Income which comes from outside the normal scope of the association's activities is considered taxable income.. Some examples of taxable income are interest, dividends, capital gains and even interest from members.

Expenses

You may not deduct expenses which are attributable to nontaxable income to offset taxable income.

It can be difficult to identify expenses attributable to taxable nonmember income. Direct expenses such as bank charges on interest bearing accounts or fees on the sale of property are deductible. Other expenses are not so clear. For instance, a cooperative or mutual association may have expenses for accounting and bookkeeping services, collecting member dues and fees, making deposits and paying bills. Since these expenses are incurred to provide services to members, they are not deductible against taxable income. If interest bearing accounts

are maintained, taxable income is produced, but expenses are unchanged. Yet a certain amount of additional expense does arise from the management of taxable nonmember income. The Franchise Tax Board has determined that this additional expense is only incidental to the expenses incurred from providing member services. Therefore, our policy is to allow an allocation of one percent of taxable nonmember investment income or $100, whichever is greater, to be deducted.

Benefits of Tax Exemption vs Non-exempt Status

Before filing for exemption under Section 23701t as a homeowners' association,you should consider whether the following factors make it beneficial for you to become exempt:

1. Unincorporated associations derive no tax benefits from exemption other than the $100 exclusion from taxable income, since nonmember income can be excluded under Section 24405 if non-exempt. As a taxable association, you are required to file only Form 100, while as an exempt organization you may be required to file both Form 199 and Form 100.

Example: An unincorporated association has $40,000 in gross receipts from all sources for one year. Of that amount, $4000 is taxable income.

As an exempt association you will be required to file Form 199 and pay the $10 filing fee. In addition, Form 100 is required for computing the tax liability as follows:

Taxable Income	$4,000
Specific Deduction under 23701t	100
Net Taxable Income	$3,900
Tax at 9.3%	363

As a non-exempt unincorporated association, only Form 100 would be required with the tax computation as follows:

Taxable Income	$4,000
Tax at 9.3%	372

The $9 saving in taxes for the exempt is offset by the $10 filing fee with Form 199. Therefore, the exempt association would be required to file two returns, instead of one, without any reduced liability.

2. Corporations that are not exempt are subject to the minimum franchise tax for each accounting period. The minimum franchise tax was $200 prior to 1987, $300 for income years beginning on or after January 1, 1987, and $600 for income years beginning on or after January 1, 1988, and is $800 for income years beginning on or after January 1, 1990.

For corporations, the benefits of exemption are the same as unincorporated associations except for the minimum franchise tax that is due if not exempt. Corporations with a tax liability, under Section 23701t, of less than the minimum tax will benefit from exemption. While those with a tax liability as an exempt would exceed the minimum tax and will derive no such benefit. Form 199 and Form 100 may be required if exempt, while only Form 100 is required if non-exempt.

Example: A homeowners' association that incorporated through the Office of the Secretary of State has 1995 gross receipts from all sources totaling $50,000 and, of that amount, $5,000 is taxable income.

As an exempt, the corporation will be required to file Form 199 and pay the $10 filing fee. In addition, Form 100 is required computing the tax liability as follows:

Taxable Income	$5,000
Specific Deduction under 23701t	100
Net Taxable Income	$4,900
Tax at 9.3%	456

$344 ($800 – $456) would result from exemption. However, the $10 filing fee would reduce the savings to $334.

If the facts remain the same, except that taxable income is $10,000, there is no tax savings from exemption, the tax, would be computed as follows:

Taxable Income	$10,000
Specific Deduction under 23701t	100
Net Taxable Income	$9,900
Tax at 9.3%	921

Since the tax liability as an exempt organization exceeds the minimum tax of $800, there are no tax savings from exemption. The $10 fee required with Form 199 will also offset the tax savings from the $100 exclusion.

Definitions for Exemption

The following information and definitions are important in determining whether your organization qualifies for state tax exemption as a homeowners' association.

Association Property

Property held by the organization or held in common by members of the organization is considered association property if it is available for the common benefit of all organizational members and tends to increase the enjoyment of the private residences by their owners.

Examples of such property are swimming pools and tennis courts. However, facilities or areas set aside for nonmembers, or used primarily by nonmembers, are not association property. For example, property owned by an organization for the purpose of leasing is not association property. Property held privately by members of the association qualifies as association property if:

1. It affects the overall appearance or structure of the property;
2. There is a covenant of relating to exterior appearance or maintenance applying the same basis to all property represented by in the project association;
3. There are mandatory annual assessments on all members of the association for maintaining this property; and
4. Membership in the association is a condition of every person's ownership of property within the project.

Dual use of Facilities or Personnel

Where facilities or personnel are used both for exempt functions of the association and production of gross income, the expenses shall be allocated between the two activities. Only that portion of the expenses directly connected to the production of gross income is deductible. The association should be prepared to fully substantiate that the deductions taken against taxable income are not exempt function connected. The position of the Franchise Tax Board as to directly related expenses, is discussed under the heading ''Non-exempt Organizations,'' starting on page 7.

In addition to directly related deductions to taxable income, an association is allowed a specific deduction of $100.

Exempt Function Income

Any amount received as membership dues, fees, or assessments from owners of condominium housing units, within a condominium management association, or owners of residential real property, within a residential real estate management association, is considered exempt function income. However, it must come from members as owners, not as customers of the association's services.

Generally, for membership dues, fees, or assessments on a residential unit to be exempt function income, the unit must be used for, or expected to be used for residential purposes. It should be noted that dues, fees, or assessments paid to an organization by a developer on unfinished or finished units or lots that are unsold, are exempt function income even though the developer does not use the units or lots.

Dues, fees, or assessments will not be considered exempt function income unless each member's liability for payment arises solely from membership in the association. Amounts based on the value or size of property are considered exempt function income. However, amounts based on the extent to which a member makes use of the facility are not exempt function income.

Excess assessments made during a tax year that are rebated to members or applied to their future assessments are not considered exempt function income for such tax year.

However, if the excess assessments are applied to a future year's assessments, they will be considered exempt function income for that specific future year.

Non-exempt Function Income

- Amounts that would be taxable income under Section 23701t except when they are excluded from gross income under general tax law. As an example, interest earned on obligations of the United States is non-exempt function income; however, it is also not subject to the California corporation income tax.

  Amounts received from nonmembers.

- Amounts received from members for special use of the organization's facilities.
- Interest earned on amounts set aside for future repairs or improvements.
- Amounts received for work done on privately-owned property, which is not association property.
- Amounts received from members in return for their transportation to or from shopping areas, work locations, etc.

Exception: Amounts received from member-tenants of residential units owned by members for special use of an association's facilities will be considered as exempt function income if:

1. The amounts paid by members are not paid more than once in any 12-month period; and
2. The privilege obtained from the payment of such amounts lasts for the entire 12-month period or portion of the period in which the facility is commonly in use.

As an example, amounts received from members for a yearly fee for use of tennis courts or swimming pools are considered exempt function income. However, amounts received for the use of a building for an evening, weekend, week, etc. are not considered exempt function income.

Qualifying Expenditures 90 percent test

To meet the 90 percent test, expenditures by an organization must be to acquire, construct, manage, maintain, and care for association property. They include both current operating and capital expenditures. Qualifying

expenditures include expenditures on association property, even if the property may produce income that is non-exempt function income. For example, expenditures on a swimming pool are qualifying expenditures even though guests' fees are not exempt function income. Expenditures used both for association property and other property will be allocated on a reasonable basis.

Some examples of qualifying expenditures are:

- Salaries of an association manager and secretary;
- Security guards;
- Legal and accounting fees;
- Current operating expenses for tennis courts, swimming pools, and recreation halls;
- Replacement of common buildings and facilities; and
- Real estate taxes imposed on association property.

Taxable income is the association's gross income less its exempt function income. This amount is reduced by any deductions directly connected with the production of the gross income. Exempt function income is not taxable.

Caution: Expenses or losses relating to production of exempt function income cannot be used as deductions or offsets against taxable income.

Substantially All Test

''Substantially all,'' for a condominium management association, means that at least 85 percent of the total square footage of the units in the association project is used by individuals for residential purposes. The term ''used for residential purposes'' includes the following:

1. Unit constructed for use as a residence but never occupied;
2. A unit which is not occupied but has been in the past if it was constructed for use as a residence and the individual to occupy it did use it as a residence; or
3. Units that are used for purposes auxiliary to residential use, such as laundry areas, swimming pools, tennis courts, storage rooms, and areas used by maintenance personnel.

Substantially all, for a residential real estate management association, means the lots or buildings (including unimproved lots) will be considered used by individuals for residences if at least 85 percent of the lots are zoned for residential purposes. Lots are considered zoned for residential purposes even if the lots may be used for such purposes as parking spaces, swimming pools, tennis courts, schools, fire stations, libraries, and churches.

Exception: A unit or building is not considered used for residential purposes if for over half of the days in the association's tax year such unit or building is occupied by a person or series of persons, each of whom occupied the unit or building for less than 30 days.