

TAX AND REGULATORY CONSIDERATIONS FOR SMALL COMMON INTEREST DEVELOPMENTS

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Author's Note: This is an update of an article I wrote back in 2014. There are a number of changes, especially to the website links. This information is also applicable to larger associations, too. Larger associations may have additional requirements such as a review of its financial statements by its CPA.

FINANCIAL STATEMENTS

Associations with revenues greater than \$75,000 per year are required to have a review of their financial statements prepared by a licensee of the Board of Accountancy (CPA). Those statements are comprised of a balance sheet, income statement, cash flow statement, notes and reserve supplementary information. Associations with revenues under \$75,000 are also required to provide financial statements to their members. They can be prepared by management, bookkeepers or a board member. As defined in Corporation Code Section 8321, a balance sheet, income statement and cash flow report are prepared annually and the members are notified of its availability within 120 days after the end of the year.

INCOME TAX FILINGS

FEDERAL

Employer (Tax) Identification Number (EIN) – All associations must file for an EIN with the IRS when created. IRS Form SS-4 is used for this purpose. IRS also has an online process on its website www.irs.gov. This number is used in all Federal and state income tax filings. Banks will also require the number to open bank accounts. If you are a new director or manager for an existing association, you should be able to find the number on a 1099-INT issued by the bank for interest earnings or a prior year tax return. The association's tax preparer will have the number.

Federal Income Tax Return - Form 1120H or 1120 – All associations, no matter what size, must prepare and file a tax return with the IRS at the end of each year. For a calendar year association (December year-end), the return is due April 15. A six month extension of time can be obtained by filing IRS Form 7004. For many small associations, form 1120H (for homeowner associations) is used to report exempt function income (assessments) and exempt function expenses (utilities, insurance, repairs, etc.). Nonmember income such as interest and dividends are taxable. In some instances, it is possible for the association to file form 1120. Consult with a qualified tax preparation professional to see which form is right for you.

Payment of Tax – If tax is owed on a Federal return, the tax must be remitted using the IRS Electronic Funds Tax Payment System (EFTPS). Go to www.eftps.gov to enroll in

the program or make a payment. To enroll, you will need the association's name, mailing address and EIN. You will also need the routing number and bank account number to make the payment. IRS will issue a PIN to access your account information when making a payment. To make a payment, you will need to know the tax form number and year ending period for the payment to be applied to. IRS will not accept checks when filing the return.

CALIFORNIA

Subject to Minimum Tax – All corporations are taxable when formed in California. As such, they are subject to an \$800 per year minimum tax by the California Franchise Tax Board (FTB). To obtain tax-exempt status under Revenue and Taxation Code (R&TC) 23701(t) (no longer subject to the minimum tax), the Association must file Form 3500 with the Franchise Tax Board. Governing documents and income and expense information is submitted to the FTB. If the association has been in existence for several years, they may request some additional information to verify that the Association qualifies as tax-exempt. If the association has tax-exempt status, then it is only subject to tax on its nonmember income such as interest and not on its assessments.

Check to see if exempt status has been revoked – Recently, the FTB contacted many associations and other tax-exempt organizations in its database in an effort to determine if the organizations still existed. Those that did not respond to their inquiries have had their exempt status revoked. If you believe that your association had been exempt at some point, you can check the revoked exempt organization list at:

<https://www.ftb.ca.gov/file/business/types/charities-nonprofits/revoked-entity-list.html>

If your association's exempt status has been revoked, you will need to file for it again using FTB Form 3500 referenced earlier. The FTB is revoking tax-exempt status immediately upon suspending corporate status. See corporate suspension following.

California Income Tax Return – Form 100 – If the association has more than \$100 in nonmember income (e.g., interest), then it is required to file a corporate income tax return with the FTB (even if it is not incorporated). Form 100 is used for this purpose and any taxable income is taxed at a flat rate of 8.84%. Payment can be made by check and quarterly estimates may be required in future years (Form 100-ES). I recommend that even if the association has less than \$100 of nonmember income, the association should file the return anyway to stay in the FTB's system and not have to deal with FTB correspondence later about why you didn't file a return and risk suspension for not filing it.

Small Tax Exempt Organizations – Electronic Return Form 199N – Tax-Exempt Organizations which have \$50,000 or less in total revenues (assessments, interest, laundry income, etc.) must file an information return electronically each year with the FTB. Complete filing instructions and information needed can be found here:

<https://www.ftb.ca.gov/file/business/types/charities-nonprofits/199N.asp>

There is no filing fee with the 199N filing. The return is due 4 ½ months after the end of the fiscal year (May 15 for a calendar year association). A small association can also file a regular form 199. See discussion following

Exempt Organization Annual Information Return – Form 199 – For tax-exempt organizations whose gross revenues are greater than \$50,000, a Form 199 is electronically filed with the FTB. There is no longer a filing fee to remit with this form. The return is due 4 ½ months after year-end but is automatically extended six months, if needed. If the form is filed after the extension period, the fee can increase to \$40 plus interest. An association with revenues less than \$50,000 can elect to file an electronic 199 instead of the 199N. For my clients, I prepare both the form 100 and 199 at the same time since it can be done with the same tax preparation software.

Corporate Filings – California Secretary of State

Articles of Incorporation – Corporation Number - When an association is incorporated, it submits Articles of Incorporation to the California Secretary of State (SOS). SOS assigns a 7-digit corporation number and returns the recorded articles to the association. For many associations, the articles can now be retrieved from the Secretary of State's website. See link following.

Statements of Information and Common Interest Development – Every two years, Associations are required to file these two separate statements with the SOS. The Statement of Information lists corporate officers, agent for service of process (who gets the papers if the Association gets sued) and if the Association is subject to the Davis-Stirling Act (yes). A \$20 fee is required. This form can be filed online. The Statement of Common Interest Development asks for information about the managing agent, President, the number of units/lots and the streets the association is located. There is a \$15 fee to file this form and this form can also now be filed online. These forms are due at the end of the incorporation month of the association. For example, if an association was incorporated on March 6, 1984 (even year), its forms would be due on March 31st of every even year. An association incorporated on August 30, 2003 (odd year) would have its forms due on August 31st of each odd numbered year. To get started on the filing, go to - [Search | California Secretary of State](#)⁺

The SOS usually mails out a postcard to the address it has on file for the Association about 90 days before the forms are due. If there has been a change in officers or management in the past two years, you may not receive the postcard. Forms to file are no longer mailed to the Association. Until recently, the SOS office was severely backlogged in processing these forms. In some cases, it took the SOS 4 months or more to process these filings. As of January 2023, the processing time is down to two weeks. Forms that are incomplete or not completed correctly will be returned to you for correction. Do not set these aside. Refile them as soon as possible. If there has been a change in

the address, officers or agent of service during the two-year period, an amended filing can be done at no charge.

The SOS forms are not tax forms. These forms are not prepared as part of the income tax return preparation process. The incorporation month is not the same as the fiscal year-end in most cases so the due dates will not coincide. Since the SOS forms are due every two years and income tax returns are filed annually, there's no correlation of the due dates at all. These SOS forms can be completed yourself or by your managing agent. Your tax preparer may be able to assist.

Penalty for failure to file – If the association does not file the SOS statements by the due date, the SOS will impose a \$50 per return penalty for failure to file. What can be confusing about the penalty is that the penalty notice comes from the Franchise Tax Board even though it is an SOS penalty. So when the notice is received from the FTB, an association may think it is an income tax penalty or fee and not realize that it is from not filing with SOS. If you receive any notice from the FTB (or the IRS), have your tax preparer review it immediately to understand the nature of the charges. Failure to file the SOS statements can lead to Corporate Suspension. See discussion following.

Third Party Solicitations – Some companies do mass mailings offering to prepare annual meeting minutes for the Association. The solicitation suggests that you are meeting state requirements if you use their “service”. The following is from the SOS website:

“The Secretary of State’s office has been advised that solicitation letters are being sent to California businesses encouraging them to comply with their California Corporations Code filing obligations by submitting fees and documents to a third party rather than by filing directly with the Secretary of State’s office.

Posted February 19, 2009

Misleading Statement of Information Solicitations: Certain private companies have been soliciting business through mass mailings to corporations and limited liability companies with a solicitation similar to a Statement of Information that is required to be filed with the Secretary of State.

These solicitations are not being made by the California Secretary of State’s office and are not being made by or on behalf of any governmental entity. Although a business entity can use an intermediary to submit filings and fees to our office, no business is required to go through another company in order to file its documents with the Secretary of State’s office.”

Corporate Suspension - What is Corporate Suspension?

A suspended corporation has no corporate powers in the eyes of California law. Why does this matter? Under California Revenue and Taxation Code (R&TC) Section

23304.1(a), "Every contract made in this state by a taxpayer during the time that the taxpayer's corporate powers, rights and privileges are suspended or forfeited pursuant to Section 23301, 23301.5 or 23775 shall, subject to Section 23304.5, be voidable at the instance of any party to the contract other than the taxpayer." Section 23304.5 requires that a lawsuit be brought by the other party in order for the contract to be voided. This could be problematic for a suspended association in the following situations:

a) A dispute arises in a maintenance contract (roofing, painting, landscaping, etc.) and the dispute cannot seem to be worked out other than through the courts. If the association's corporate powers are suspended, the other party could void the contract and/or the association has no ability to enforce the provisions of the contract since the association is suspended.

b) The association is involved in construction defect issues that lead to litigation. Should the corporation be suspended, it cannot pursue the legal remedies permitted until the corporation is "revived".

c) The association is attempting to collect delinquent assessments from a homeowner. Liens could not be enforced or small claims could not be pursued if the association has its corporate powers suspended. The inability to secure the association's assessments during a suspension period could result in lost assessments by the association.

d) If an association is looking to obtain a bank loan to make major repairs, it cannot do so if its corporate status is suspended.

e) Without corporate powers, the association may not be able to enforce any provisions of its governing documents (CC&Rs, etc.)

f) Board members may not have the immunities provided by the Davis-Stirling Act if the corporation is not active.

How does suspension occur? – Corporate powers can be suspended by either the SOS or FTB. Listed below are several scenarios that have occurred in my practice that I believe are not unique but occur regularly:

a) Suspension soon after incorporation – The association was incorporated by the developer's attorney in 1983 and but was suspended in 1985 for failure to file tax returns or pay the California minimum tax. This 5-unit association was built, had a bank account with the manager's tax ID number. Mailing addresses had changed from the attorney to one or more of the owners to the manager over the years. Notices sent by the FTB may not have been received or returned to the FTB due to the change in address. The suspension was discovered when management changed in 1999, fourteen years later.

b) Suspension due to failure to file Statement of Information – As noted in the first scenario, association mailing addresses can change frequently. If the association uses an officer's mailing address or its management company's address as its mailing address,

there is a strong possibility that the postcard from the Secretary of State will not be forwarded to the correct address when officers or managing agents change. Follow-up notices, penalty notices and suspension notices will likewise not be forwarded. This was a problem when the Statement of Information was an annual filing. Now that the statement is filed every two years, nonfiling will probably increase, resulting in more suspensions. Filing forms and requirements can be found at the Secretary of State's website – [Business Entities :: California Secretary of State](#). Missing one filing but making the subsequent filings does not “revive” the corporation.

NOTE: Your first tip that the Association may be headed towards suspension is the receipt of notices from the FTB imposing the \$50 SOS penalties discussed earlier.

c) Suspension for failure to file FTB Tax Form 199 – An association was suspended in 1987 because it had not filed a Franchise Tax Board Form 199 form for 1986. In order to “revive” (meaning restore corporate status), the association had to file a 1986 Form 199 (fifteen years later!).

d) Suspension for failure to file CA FTB Tax Forms 100 and 199 and pay resulting penalties – While this can happen due to the address, officer or management changes noted above, it can also happen due to the negligence of the financial managing agent.

What happens when the tax returns are not filed? Demand notices and penalty notices are sent by the FTB. If no response is received, a series of letters threatening forfeiture of the corporation commence leading to the eventual suspension of the corporation.

Associations with \$50,000 or less in annual gross receipts are not required to file Form 199 with the Franchise Tax Board but can file the 199N noted above. . However, if the association's corporate status becomes suspended, then the FTB will require that all past year's 199s be filed and the resulting, fees and penalties be paid even if revenues are below the normal filing requirements.

How do you find out if an association is suspended? Some information from the Statement of Information filing is maintained on a database on the Secretary of State's website – [Search | California Secretary of State](#) Enter the corporation's name or a portion of the name (if you are not sure of the exact name) to obtain name matches and corporate information. For example, I entered “Summerland Association” and 8 matches were returned. One of which was a suspended homeowners association, the Summerland Villas Homeowners Association. A “click” on the corporate name generated another report showing the corporation mailing address and the agent for service of process mailing address. Recently, the SOS website will show a history of form filings for your association including the last two Statement of Information filings and Common Interest Development filings. These forms can be helpful if you have questions about how to complete your current filing.

If the association has made all its income tax filings but not the SOS statements, the SOS website will show that it is active under FTB but suspended under SOS. Conversely, if tax returns have not been filed, the FTB will show it suspended but SOS will show it active.

Contact phone numbers are listed on both the SOS and FTB websites. If your corporation is suspended, they can provide information as to what is needed to “revive” the corporation to active status. Further information is available at <https://www.ftb.ca.gov/help/business/my-business-is-suspended.html#Contact-us-about-your-suspension>

Other Tax and Regulatory Issues:

1099s: Association may obtain services from independent contractors such as landscapers, handymen, pool service, janitorial and professional services. If payments are made during the calendar year totaling \$ 600 or more to a noncorporate provider of these services, then Forms 1099-NEC are to be issued in January to the service provider by the association and submitted to the Internal Revenue Service by January 31. You will need the name and address of the service provider, the amount paid to the provider during the calendar year (even if the association is on a fiscal year) and the provider’s EIN or social security number. Management and bookkeeping services should prepare these forms as a part of their services to you. If you do them yourself, forms are available from the IRS website.

Payroll vs. Independent Contractor – If you employ someone on a regular basis to provide services for you, it is possible that IRS and the state might consider them to be employees and subject to tax withholding and reporting (W2s, etc.) This should not occur often in a small association as the amount of services provided would be small or done on a contract basis. See workers compensation following.

New Employee and Independent Contractor Reporting – The California Employment Development Department (EDD) requires employers to report newly hired or rehired employees to the Department using form DE-34 within 20 days of hiring.. For independent contractors, reporting is required for sole proprietors using form DE-542 when payments are expected to exceed \$600 in the calendar year. Form DE-542 is used to report independent contractors. This interim reporting is required to assist the state in collecting delinquent child support obligations.

Workers Compensation – Associations should carry workers compensation insurance in the event that you hire someone who does not have a contractor’s license to provide services for which a license is required (greater than \$500). When contracting for maintenance and repair services you should insist on receiving evidence of liability insurance and workers comp coverage from the contractor prior to paying them. If the contractor does not have coverage and if he or one of his employees gets hurt on the job, the association would be considered the employer and only a workers compensation policy would cover the claim, not the association’s liability policy.

Property Tax/Special Districts – Associations occasionally pay property taxes. Typically, taxes would be assessed only on a unit that the association owns. Property tax on the common area is usually allocated among all the property owners on their own property tax bills. However, the County Tax Collector collects fees and charges for special districts within the County. A common fee is a sanitary district charge. There may be charges for other districts such as vector control (mosquito abatement), library taxes or parcel taxes. Contact phone numbers appear on tax bills if you have any questions about the charges and whether they should apply to the common area parcels.

Pool Inspection – County health departments will inspect pools and spas on an annual basis to determine if current laws and regulations are being met. A permit is issued once any necessary repairs are made. The permit is required to be displayed in the pool/spa area. An annual fee is charged based upon the number of pool/spas the association has.

Backflow Device Testing – If your association has backflow devices in its water system, the devices are subject to periodic testing by a qualified plumbing contractor. A testing form is submitted to the city or water district once the testing successfully concludes. Any deficiencies must be repaired and re-tested before the tests are submitted.

Well Testing – If your association uses potable water from a well, the county health department will require frequent testing to verify the water from the well is safe. County health will also make frequent visits to the well site.

Elevator – If your association has an elevator, it must be inspected periodically by the California Department of Industrial Relations (DIR). Once inspected and passed, a permit is posted inside the elevator showing when the elevator was inspected. Any deficiencies noted in the inspection or periodic testis must be corrected before a permit will be issued.

Fire Inspection - Some cities and fire districts may have an inspection program for public spaces such as a meeting room or clubhouse. They may bill a separate fee for these inspection services.