

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 359

May 22, 1973

HOLDING PERIOD OF WATER MAIN EXTENSION CONTRACTS

Syllabus:

The holding period of a water main extension contract for any payment constituting a capital gain is the period from the date the contract was purchased to the date the payment is received.

When a developer of a new subdivision requests the local utility company to supply water to the new development, the developer must advance the funds necessary to construct the facilities. The facilities become the property of the water company, and are paid for from the revenue derived from the water sold in the new area. The amount of the advance is refunded by the utility to the developer pursuant to the terms of a refund contract. The contract generally provides for the payment of a specified percentage of the water revenue for a fixed number of years, such as ten or twenty, but terminates if and when the full amount of the advance has been refunded. Payments are made annually or more frequently.

The contract is assignable by the developer, and generally is sold at a substantial discount to an investor. Thereafter, the purchaser of the contract receives the payments from the water company. When the purchaser has recovered in full the cost of the contract, additional amounts received are reportable as capital gains.

It has been held in a federal case construing statutory provisions substantially identical to the relevant provisions of the Personal Income Tax Law that such water main extension contracts are capital assets in the hands of the purchaser and constitute evidences of indebtedness within the meaning of section 18183, and that the periodic payments on the contracts constitute "retirement" within the meaning of that section; therefore, the payments are considered as amounts received in exchange for the evidence of indebtedness. Jamison v. United States, 297 Fed.Supp. 221 (1968), aff'd per curiam 445 Fed.2d 1397 (C.A. 9th, 1971). See, also, Ernest A. Wilson, 51 T.C. 723 (1969).

Inasmuch as each payment received pursuant to the terms of the contract is an "exchange" within the meaning of section 18031, the holding period for determining the percentage of gain taken into account under section 18162.5 is necessarily the time from the date the contract was purchased to the date the respective payment was received.

The result of the federal decisions is to give the courts' approval to the questionable situation which allows for a seemingly single capital asset to be disposed of in parts in a series of exchanges, rather than as a single disposition. However, the possible justification by the court of this questionable result may be contained in the sole comment of the Court of Appeals, 9th Circuit, in the Jamison affirmance, supra, stating:

If our decision means the broadening of loop holes in the tax laws, the remedy is by action by Congress and not by judicial fiat.