



Analysis of Amended Bill

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Sponsor:

Bill Number: AB 3057

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Amended: March 13, 2018

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Related Bills: See Legislative
History

Subject: Exempt Organizations/Mutual Ditch or Irrigation Companies

Summary

Under the Corporation Tax Law, this bill would exempt certain mutual ditch or irrigation companies from tax.

Recommendation – No position.

Summary of Amendments

The March 13, 2018, amendments removed provisions relating to the confidentiality of settlement agreements in the Civil Code and replaced them with the provisions that are discussed in this analysis.

This is the department's first analysis of the bill.

Reason for the Bill

The reason for the bill is to substantively conform to a portion of federal law that allows certain mutual water companies to qualify for treatment as exempt organizations.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2018.

Federal/State Law

Federal law exempts from the federal income tax nonprofit organizations that meet certain criteria. If an organization fails to meet those criteria, the Internal Revenue Service (IRS) may deny exempt status, or it may revoke the exempt status of an organization which no longer meets the criteria. Federal law grants exempt status to mutual irrigation and ditch companies (mutual water companies) if at least 85 percent of the income collected from members is for the sole purpose of meeting losses and expenses. The same section of federal law also

encompasses local benevolent life insurance associations of a purely local character, mutual or cooperative telephone companies, and mutual or cooperative electric companies. California law does not conform to this provision.

The California Corporations Code governs the formation of corporations in California. A corporation, including a mutual water company, may be incorporated as a “for profit” corporation or a “nonprofit” corporation. A mutual water company is a corporation organized for or engaged in the business of selling, distributing, supplying or delivering water for irrigation or residential use.

Under current state law, nonprofit corporations are not automatically exempt from taxation. A nonprofit corporation must apply for tax-exempt status with the Franchise Tax Board (FTB) and receive a determination exempting the organization from state tax. A tax-exempt corporation may incur a tax liability on its taxable business income unrelated to its exempt purpose.

Under current state law, a mutual water company may qualify for tax exemption as a homeowners’ association if, among other requirements, it provides service exclusively to residential customers and gross income from metered water service does not exceed 40 percent of the total gross income, i.e. at least 60 percent of gross income must be received from membership dues, fees or assessments (flat service rate). If the water company charges fees based on a metered rate, the mutual water company generally will fail this test. Mutual water companies that do not meet the above criteria are taxable as cooperative associations.

Under current state law, cooperative associations are allowed a tax deduction for all income received from members and for income received from nonmembers for business conducted on a nonprofit basis; however, incorporated cooperative associations are required to pay the minimum franchise tax.

Program Background

California does not conform to federal Internal Revenue Code provisions that grant exempt status to mutual water companies. Under state law, a separate determination must be made regarding whether a federally exempt mutual water company qualifies as an exempt homeowners’ association.

However, mutual water companies have difficulty qualifying under the homeowners’ association criteria. A mutual water company must charge a flat service fee or receive 40 percent or less of gross income from metered water service to qualify for California tax-exempt status as a homeowners’ association.

Conversely, a mutual water company does not qualify as a homeowners’ association if it provides metered water service since metered service is based on consumption and is considered fee for service. As a result, incorporated mutual water companies that do not qualify as a homeowners’ association are treated as cooperative associations and thus subject to the minimum franchise tax, even though they have little or no gross income after allowable deductions. The payment of the minimum franchise tax may be a burden for smaller water companies that may serve as few as 10 to 20 residences. Although these entities may be exempt from tax under federal law, state law does not have a similar provision.

This Bill

This bill would generally exempt mutual ditch or irrigation companies from corporate income and franchise taxes.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

Legislative History

AB 2490 (Gatto, 2015/2016) would have exempted from corporate income and franchise taxes, except unrelated business income tax, a mutual fund investment management company wholly owned by one or more regulated investment companies (RICs) and providing management services to the one or more RICs at cost. AB 2490 failed to pass out of the Assembly Appropriations Committee.

SB 1977 (Johannessen, Chapter 1108, Statutes of 2002) exempts from taxation any gain related to the transfer of assets from a mutual water company formed prior to September 26, 1977, to a community services district.

Other States' Information

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. A review of the laws of these states found that all six states require exempt organizations to apply for tax-exempt status.

Fiscal Impact

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 3057 as Amended March 13, 2018
For Taxable Years Beginning On or After January 1, 2018
Assumed Enactment after June 30, 2018

(\$ in Millions)

Fiscal Year	Revenue
2018-2019	- \$3.7
2019-2020	- \$3.3
2020-2021	- \$3.1

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

Based on IRS exempt organizations data, it was estimated that in 2016 mutual ditch and irrigation companies paid \$2.8 million in taxes to California. This estimate was grown to reflect changes in the economy over time resulting in a \$3 million revenue loss in the 2018 taxable year.

The tax-year estimates are converted to fiscal years, then rounded to arrive at the figures in the above table.

Support/Opposition

Support: None provided.

Opposition: None provided.

Arguments

Proponents: Supporters may argue that this provision would allow certain mutual ditch or irrigation companies tax-exempt status at the state level so the company's tax treatment would be substantively similar to federal law.

Opponents: Some may argue that this bill may impact state water policy, which may be viewed as outside the department's role of tax administration.

Policy Concerns

By exempting certain types of mutual water companies, other entities exempted by federal Section 501 (c)(12), such as mutual or cooperative telephone companies, or benevolent life insurance associations, also may seek to be added.

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