



## Analysis of Original Bill

Author: Rubio

Sponsor:

Bill Number: SB 775

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Attorney: Shane Hofeling

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.**

### Reason for the Bill

The reason for this bill is to conform to federal law that allows certain mutual water companies to be treated as tax-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, 2019.

### Federal/State Law

Federal law exempts from federal income tax nonprofit organizations that meet certain criteria. Federal law grants exempt status to mutual ditch or irrigation 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. 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.

California law does not conform to this provision. 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 the 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.

In addition, notwithstanding any other provision of law, for taxable years beginning before January 1, 2019, the contribution or other asset transfer from a mutual water company established prior to September 26, 1977, that is tax-exempt under Internal Revenue Code (IRC) section 501(c)(12), but was a taxable entity under California Law, to a community services district formed pursuant to Part 1 (commencing with section 61000) of Division 3 of Title 6 of the Government Code, would not be subject to tax.

Contributions and transfers include the mutual water company's lands, easements, rights, and obligations to act as sole agent of the stockholders in exercising the riparian rights of the stockholders, and rights relating to the ownership, operation, and maintenance of a water system and facilities serving the customers of the company.

The contribution or transfer is not subject to taxes if all of the following requirements were met:

- a) The consideration for the transfer of all or substantially all of the assets is the assumption by the district of the company's liability to provide service to the company's stockholders.
- b) The legal or beneficial title to all or substantially all of the company's assets is vested in the district on or before January 1, 2008.
- c) For the one-year period immediately prior to commencement of the transfer and continuing until the transfer is completed, 25 percent or more of the company's income consists of amounts collected from stockholders for the sole purpose of meeting losses and expenses.

### **This Bill**

For taxable years beginning on or after January 1, 2019, this bill would generally exempt mutual water companies from corporate income and franchise taxes.

### **Implementation Consideration**

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.

### **Technical Consideration**

The department has identified the following technical consideration. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The phrase in section 23701m, page 1, lines 4 and 5, "...subject to the limitations and as described in Section 501(c)(12)..." is unclear and has no limitations. It is recommended that the phrase be amended to read "~~...subject to the limitations and as described in Section 501(c)(12)...~~" for clarity.

### **Legislative History**

AB 3057 (Quirk-Silva, 2017/2018), similar to this bill, would have exempted certain mutual ditch or irrigation companies from corporate income and franchise tax. AB 3057 failed to pass out of the Assembly Appropriations Committee.

### **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, supported by their federal tax exemption. These states generally conform to IRC section 501(c)(12), including tax-exempt mutual ditch or irrigation companies.

### **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 SB 775 as Introduced February 22, 2019  
Assumed Enactment after June 30, 2019

<b>Fiscal Year</b>	<b>Revenue</b>
2019-2020	-\$800,000
2020-2021	-\$700,000
2021-2022	-\$700,000

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 Internal Revenue Service and Franchise Tax Board exempt organization data, it is estimated that in 2019 mutual ditch and irrigation companies would pay \$700,000 in taxes to California. The resulting revenue loss is \$700,000 in the 2019 taxable year.

The tax year estimates are converted to fiscal years and rounded to arrive at the amounts in the above table.

## Policy Concerns

By exempting certain types of mutual water companies, other entities exempted by IRC 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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