



## **Bill Analysis**

Author: Quirk-Silva

Sponsor:

Bill Number: AB 2054

Related Bills: See Legislative  
History

Introduced: February 14, 2022  
Amended: March 3, 2022

### **SUBJECT**

Exempt Organizations/Mutual Ditch or Irrigation Companies

### **SUMMARY**

Under the Corporations Code (CC) and Corporation Tax Law, this bill would exempt certain mutual ditch or irrigation companies (mutual water companies) from tax.

### **RECOMMENDATION**

No position.

### **SUMMARY OF AMENDMENTS**

The March 3, 2022, amendment added an additional requirement to the reporting that the Division of Drinking Water (DDW) of the State Water Resources Control Board (SWRCB) would be required to provide to the Franchise Tax Board (FTB).

This is the department's first analysis of the bill and only addresses the provisions that would impact the department.

### **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.

### **ANALYSIS**

For taxable years beginning on or after January 1, 2023, and before January 1, 2028, this bill would generally exempt mutual water companies that operate a public water system from corporate income and franchise taxes, unless the mutual water company does not meet certain requirements as specified in both the CC and the Health and Safety Code, or does not provide required information to a local agency formation commission.

Introduced February 14, 2022, and Amended March 3, 2022

In addition, this bill would create a gross income exclusion, for taxable years beginning on or after January 1, 2023, and before January 1, 2028, for certain funding provided by the SWRCB to a mutual water company operating a water system. Such funding would also have no impact on the company's tax-exempt status.

These provisions would be repealed by their own terms on December 1, 2028.

Under the CC, mutual water companies would be required to adopt policies to comply with open meeting and record accessibility requirements, and submit these adopted policies and a certification of compliance to the DDW by June 30, 2023, and by June 30th of each year annually thereafter. The bill would then require the DDW to submit a list of the mutual water companies that have not complied with the open meeting and record accessibility requirements to the FTB by September 30, 2023, and by September 30th of each year annually thereafter. Furthermore, the DDW would be required to revise the list submitted to the FTB to remove any mutual water company that comes into compliance with the open meeting and record accessibility requirements.

In any year in which a mutual water company is eligible for tax-exempt status, the FTB would be required to notify mutual water companies with a tax exemption that they are on the list received from the DDW, and that it has not complied with the open meeting and record accessibility requirements. The mutual water company would then have 60 days to submit its policies and certification to the DDW. If the mutual water company does not comply, the FTB could revoke the mutual water company's tax exemption.

For purposes of complying with Section 41, this bill provides specific goals, purposes and objectives, including conforming to federal laws and allowing public water systems to utilize grant funds. Annually, this bill would require the FTB to determine the number of corporations that have applied for the exemption and calculate the lost tax revenue due to the exemption.

#### *Effective/Operative Date*

This bill would be effective January 1, 2023, and the exclusion from gross income and tax exemption for mutual water companies would be specifically operative for taxable years beginning on or after January 1, 2023, and before January 1, 2028.

#### *Federal/State Law*

Federal law exempts from federal income tax nonprofit organizations that meet certain criteria. Federal law grants exempt status to mutual water companies if at least 85 percent (85%) 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.

Introduced February 14, 2022, and Amended March 3, 2022

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 (40%) of the total gross income, i.e., at least 60 percent (60%) 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 not satisfy this test. Mutual water companies that do not meet this 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 under 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 (25%) or more of the company's income consists of amounts collected from stockholders for the sole purpose of meeting losses and expenses.

Introduced February 14, 2022, and Amended March 3, 2022

### *Implementation Considerations*

The department has identified the following implementation considerations, and is available to work with the author's office to resolve these and other considerations that may be identified.

The bill requires the FTB to notify a water company that it is in noncompliance with its reporting requirements based on the DDW list. The taxpayer would have 60 days to comply and retain its exempt status. Although the DDW would be required to revise the list for companies that come into compliance, the bill is silent as to how often the DDW would be required to update the FTB. The FTB may not know that a water company complied with its reporting requirement until a revised list is received or the following September. If this is contrary to the author's intent, the author may wish to amend the bill to clarify how often the DDW would be required to revise the list.

The FTB would also be required to annually determine the number of corporations that have "applied" for the exemption and to calculate the lost tax revenue due to the exemption. The department would be able to determine the number of corporations claiming the water company exemption. However, the number of corporations that applied for the exemption and any lost tax revenue is data that would not be readily available to the department. To alleviate this consideration, the author may wish to amend the bill.

This bill provides that this provision will remain in effect until December 1, 2028, and as of that date is repealed. Accordingly, any entity that receives tax exemption by operation of this bill would no longer be exempt after the repeal date. These entities would need to qualify for exemption under a different tax-exempt criteria, or would become a taxable entity. If this does not reflect the author's intent, consider amending the bill.

### *Technical Considerations*

Bill Section 4, in (b)(2)(A), requires the FTB to "determine the number of corporations that have applied for the exemption and shall annually calculate the tax revenue lost..." with no requirement to share that information with SWRCB or the Legislature. The author may wish to amend the bill to clarify if the FTB would provide information to SWRCB to report to the Legislature or would report directly to the Legislature.

If amending the bill, for taxpayer information to be provided to SWRCB, an exception to the disclosure rules would be needed for FTB to share taxpayer information.

Introduced February 14, 2022, and Amended March 3, 2022

If amending the bill, for a report to the Legislature, the FTB would not have full tax year data for the 2023 calendar year returns until after processing returns. For returns filed on extension, the data would be available by approximately March of 2025. If the author would want the FTB to report to the Legislature, sufficient time would be needed for the FTB to provide the information.

*Policy Considerations*

None noted.

**LEGISLATIVE HISTORY**

SB 775 (Rubio, 2019/2020) and AB 3057 (Quirk-Silva, 2017/2018), similar to this bill, would have exempted certain water companies from corporate income and franchise tax. Both SB 775 and AB 3057 did not pass out of the Assembly Appropriations Committee.

**PROGRAM BACKGROUND**

None noted.

**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 2054 as Amended March 3, 2022  
Assumed Enactment after June 30, 2022

<b>Fiscal Year</b>	<b>Revenue</b>
2022-2023	-\$250,000
2023-2024	-\$700,000
2024-2025	-\$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.

Bill Analysis

Bill Number: AB 2054

Introduced February 14, 2022, and Amended March 3, 2022

**LEGAL IMPACT**

None noted.

**APPOINTMENTS**

None noted.

**SUPPORT/OPPOSITION**

To be determined.

**ARGUMENTS**

To be determined.

**LEGISLATIVE CONTACT**

[FTBLegislativeServices@ffb.ca.gov](mailto:FTBLegislativeServices@ffb.ca.gov)