



## Bill Analysis

Author: Quirk-Silva

Sponsor:

Bill Number: AB 2054

Related Bills: See Legislative  
History

Amended: April 19, 2022

### SUBJECT

Exempt Organizations/Mutual Ditch or Irrigation Companies

### SUMMARY

Under the 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 April 19, 2022, amendments removed the State Water Resources Control Board's (SWRCB) administrative requirements; removed the income exclusion; added certification requirements for the mutual water companies; and modified the Revenue and Taxation Code (RTC) section 41 requirements.

The amendments resolved two of the three implementation considerations and two of the three technical considerations discussed in the department's analysis of the bill as introduced February 14, 2022, and as amended on March 3, 2022; and created an additional implementation consideration and an additional technical consideration.

This analysis only addresses the provisions that would impact the department's programs and operations.

### 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 Corporations Code (CC) and the Health and Safety Code (HSC), or does not provide required information to a local agency formation commission as required under the Government Code (GC).

The mutual water company must provide to the FTB certification, under penalty of perjury, with its initial application for tax-exempt status and with each annual tax filing, that it is exempt for federal tax purposes, has fulfilled all specified reporting requirements with the SWRCB or any local primacy agency, and has complied with certain requirements under the CC, HSC, and GC.

The FTB would be allowed to request any additional information it deems necessary to ensure the accuracy of the certification. In addition, the FTB may prescribe rules, guidelines, or procedures necessary to implement this section. Any rules, guidelines, or procedures prescribed by the FTB would be exempt from the rulemaking procedures of the Administrative Procedure Act.

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. This bill would require the FTB to annually determine the number of corporations that have applied for the exemption, commencing with the 2023 taxable year, by June 1, 2025. In addition, this reporting would not be subject to the prohibition against the disclosure of taxpayer information under Section 19542.

The provisions of this bill would be repealed by their own terms on December 1, 2028.

### *Effective/Operative Date*

This bill would be effective January 1, 2023, and 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.

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 GC, 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.

### *Implementation Considerations*

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

This bill uses terms that are undefined, e.g., “local primacy agency” and “local agency formation commission.” The absence of definitions to clarify these terms could lead to disputes with taxpayers. For clarity, it is recommended that the bill be amended to define these terms.

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.

#### *Technical Considerations*

Bill Section 3 (a)(2) requires the FTB to “determine the number of corporations that have applied for the exemption” with no requirement to provide that information to the Legislature. The author may wish to amend the bill to clarify that the FTB would provide this information to the Legislature.

For consistency of terminology, the following change is recommended:

- In Section 23701m (e), The Franchise Tax Board may prescribe rules, guidelines, or procedures **necessary** to implement this section.

#### *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 April 19, 2022  
Assumed Enactment after June 30, 2022

<b>Fiscal Year</b>	<b>Revenue</b>
2022-2023	-\$300,000
2023-2024	-\$800,000
2024-2025	-\$800,000

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.

**LEGAL IMPACT**

None noted.

**APPOINTMENTS**

None noted.

**SUPPORT/OPPOSITION**

As per the Assembly Revenue and Taxation Committee analysis of AB 2054, dated April 22, 2022, the following support was noted.

*Support*

- Covina Irrigating Company
- Cuerno Largo Mutual Water Company
- Gill Creek Mutual Water Company
- Harbor View Mutual Water Company
- Hartley Mutual Water Company
- Humboldt Woodlands Mutual Water Company
- Jubilee Mutual Water Company
- LA Cumbre Mutual Water Company
- Lakeside Woods Mutual Water Company

Lincoln Ave Water Company  
Los Prietos Water Association  
Maywood Mutual Water Company  
Maywood Mutual Water Company No 3  
Mesa Water District  
Montebello Land and Water Company  
Oak Trail Estates Mutual Water Company  
Palo Alto Park Mutual Water Company  
Rubio Canon Land and Water Association  
South Mesa Water Company  
Sundale Mutual Water Company  
Sunny Slope Water Company  
The Farm Mutual Water Company  
Wendell Lane Mutual Water Company  
Willowside Mutual Water Company  
Covina Irrigating Company  
Cuerno Largo Mutual Water Company  
Gill Creek Mutual Water Company  
Harbor View Mutual Water Company  
Hartley Mutual Water Company

*Opposition*

As per the same analysis, there is no opposition to AB 2054 on file.

**ARGUMENTS**

*Proponents*

As per the same analysis of AB 2054, dated April 22, 2022, this bill is supported by the Palo Alto Park Mutual Water company, which notes, in part:

AB 2054 is a simple bill that conforms the California Revenue and Taxation Code with Section 501(c)(12) of the Internal Revenue Code, which provides federal tax-exempt status for mutual water companies. Without such tax-exempt status under existing California law, mutual water companies serving disadvantaged communities and eligible for funding under Propositions 1 will be taxed for grants they receive. Without correction of the California tax law under AB 2054, mutual water companies are also exposed to tax liabilities for earning interest on reserve accounts meant for water system maintenance; and those desiring consolidations with public agencies may see years in delays due to tax complications.

*Opponents*

In addition, as per the same analysis, no arguments opposing the bill are on file.

**LEGISLATIVE CONTACT**

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