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TAXATION OF MUTUAL WATER COMPANIES

This article discusses the federal and state taxation of mutual water companies.

Mutual water companies can obtain federal tax exempt status under IRC §501(c)(12) which grants exempt status to "mutual ditch or irrigation companies." To qualify under §501(c)(12), more than 85% of the company's income must consist of amounts collected from the members for the sole purpose of meeting losses and expenses.

The losses and expenses language was arguably ambiguous leading to questions as to whether amounts added to reserves qualified for the 85% test. The IRS has since clarified that a mutual water company still meets the 85% test if money collected from members is used for purposes funding future expenses and repairs, provided such reserves are not accumulated beyond the reasonable needs of the company (Rev. Rul. 72-36). Thus, amounts collected for reserves qualify for the 85% test, provided the reserve amount is reasonable.

Unfortunately, there is no §501(c)(12) exemption for mutual water companies in California. Thus, even if a mutual water company qualifies as a tax exempt company for federal purposes, it may nevertheless be a taxable entity in California.

The only tax exemption available to mutual water companies is California Revenue & Taxation Code §23701t (patterned after IRC §528), governing *homeowners' associations*. To qualify for this exemption, the mutual water company must receive 60% of its income from non-exempt sources, such as *fixed* assessments on its members. Charges for water usage (i.e. consumption charges) are considered non-exempt and do not count toward the 60% test. Needless to say, this makes it difficult for the mutual water company to devise a rate structure which encourages conservation.

Even if it does not qualify under §23701t, a mutual water company in California can eliminate its taxes – even it does not qualify as a homeowners' association – by using member

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assessments and water charges to fund repairs and other costs of operating the company. Any amounts left over can be transferred to reserves and *deducted* pursuant to §24405(a) of the Revenue and Taxation Code (*see also*, *Woodland Production Credit Ass'n v. FTB* (1964) 225 CA2d 293, 299 [amounts accumulated and added to capital may be deducted under §24405(a)]). Therefore, as a practical matter, since the mutual water company can eliminate any taxable income, the only difference between a taxable mutual water company and a mutual water company which qualifies for the homeowners' association exemption is that the former must pay the annual $800 minimum franchise tax.

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