Memorandum

170.0065

To : Mr. Abram F. Goldman

Date: January 17, 1968

From : Thomas L. Hartigan

Subject: Taxation of Mutual Water Stock

Mr. Leon P. Sher, Fresno area supervisor of the Intercounty Equalization Division, addressed a memorandum to you dated July 5, 1967, in which he cited several problems his staff and that of the Kings County Assessor's office had encountered with regard to the taxation of mutual water stock. You forwarded his memorandum to this department July 18, 1967, with a request for our advice.

Classification of Mutual Water Stock

Initially it appears that before an understanding of mutual water stock can be achieved, some understanding of mutual water companies must be had. Mutual water companies began in two ways in California, both following the disintegration of the original Spanish ranchos. The first type came into being when the ranchos were broken up and sold directly to several individual small owners. The rancho water rights were also fragmented amongst the new owners. However, the new small owners were individually unable to properly develop the water rights they owned, so they banded together into cooperative organizations, i.e., mutual water companies. To the latter, the landowners conveyed their water rights in return for water stock.

The second type came into being when a rancho was sold in its entirety to subdividers. The subdividers, in turn, formed two corporations, one a land company, the other a water company. To the former, the promoters conveyed the land they had acquired; to the latter, they conveyed the water rights. When the subdivided lots were sold, accompanying shares in the water company were issued to the purchasers. ("Mutual Water Companies in California" by Theodore W. Russel, Southern California Law Review, Vol. 12.)

A third type developed wherein the companies were formed for the specific purpose of acquiring water rights for the service of agricultural lands, and shares were issued therein to the owners of such lands. ("The California Law of Water Rights," Wells A. Hutchins, p. 169.)

With regard to the nature of mutual water stock there is a conflict of decisions. One series of cases would have the stock be simply a muniment of title to the water right it represents and hence be real property itself. (Lock v. Yorba Irrigation Co. (1950) 35 Cal. 2d 205.) Although these decisions do not report the full facts as to the nature of the companies involved, it appears that this construction of the nature of mutual water stock comes about when companies of the first type are being considered; the rationale being, that the owner of the water right conveys it to the company and gets stock back simply for convenience, and the water right remains the subject of individual ownership after the transaction, as well as before. (Hildreth v. Montecito Creek Water Co 139 Cal. 22.)

Another group of decsions has the nature of the stock, whether realty or intangible personalty, turn on whether the stock is appurtenant to the land it serves. (Kennard v. Binney (1923) 62 Cal. App. 732; Smith v. Hallwood Inc. (1924) 67 Cal. App. 777; and Palo Verde Land and Water Co. v. Edwards (1927) 82 Cal. App. 52.)

I do not believe the fact that a mutual stock is appurtenant should have any bearing on its nature as realty or personalty. With regard to other interests in realty, the fact of appurtenancy does not go to the nature of the interest as realty or personalty.

> "The right to cross over the lands of another is an easement, but no dominant tenement is necessary to support it, and it may be an easement in gross; but if this right is enjoyed with and used for the benefit of certain premises in such a manner as to be an appurtenance thereto, it may be an easement appurtenant; but whether it is an easement in gross or an easement appurtenant it is not personal property." (Balestra v. Button (1942) 54 Cal. App. 2d 192.)

Similarly, that portion of a mutual water stock that represents the right to water, which is an interest in real property (Fall River Irr. Dist. v. Mt. Shasta Power Corp. (1927) 202 Cal. 56; Waterford Irrigation District v. Stanislaus County (1951) 102 Cal. App. 2d 839) should not have its intrinsic nature changed simply because of the happenstance that it is appurtenant or not.

The fact that mutual water stock was appurtenant or not would seem to have significance only in the process of investigating comparable sales and on the value of the stock itself. Both of these matters are discussed more fully below.

Lastly, we find still another categorization of mutual stock in the decisions, namely, that it partakes of both the nature of realty and of personalty.

"The right of a stockholder in a mutual water company to receive water by virtue of his ownership of stock is real property, but the shares themselves are personalty...;" (Wheat v. Thomas (1930) 209 Cal. 306.)

In our opinion the logic of the last categorization is inescapable. On the one hand, if it is conceded that mutual water stock is stock in a corporation in any sense, it must follow that it has, in some degree, the attributes generally associated with stock in a corporation, e.g., voting rights, the right to a share of the assets upon dissolution, etc. On the other hand, we are told that a mutual water stock carries with it a right peculiar to it and not allowed as an incident to corporate stock generally, namely, the direct right to a quantum of water which can be enforced against the corporation. (Miller v. Imperial Water Co. (1909) 156 Cal. 27; Consolidated Peoples Ditch Co. v. Foothill Ditch Co. (1928) 205 Cal. 54.) Thus, to the extent that it is properly a stock in a corporation a mutual water stock is intangible personal property of a type not subject to ad valorem property taxation (Rev. & Tax. Code, § 111), and to the extent that it represents a water right, it is real property and is subject to such taxation. (Rev. & Tax. Code, § 104.)

Valuation

The above analysis and conclusion seemingly put a most difficult valuation burden on the tax assessment appraiser. He is required to investigate the mutual water stock, find its value as a whole and then apportion that value between taxable and nontaxable aspects.

There is a case that ameliorates that burden to a great extent, however. Tuolumne County v. State Board of Equalization (1962) 206 Cal. App. 2d 352, held that in the case of appropriated water its utility depends on two property interests, namely, diversio structures and the right to appropriate water; although separate property rights, they are integrated and, for practical purposes, inseparable.

Applying the underlying rationale, i.e., that it is impractical to divorce an entitlement to water from the means to realize thereon, it would appear that unless the mutual water company has strayed significantly from its principal corporate purpose of providing water to its shareholders at cost, its entire assets can be viewed as integrated to accomplish that end. Hence they all became a part of the right to water, and hence the water stock, instead of representing two types of interests for all practical purposes represents but one, namely, the right to water, that is, real property; and, hence is taxable to the full extent of its value.

There is another aspect of valuing mutual water stock which is raised inferentially in Mr. Sher's memorandum and which emerged clearly in our later discussion with him and others conversant with the problem. It is the phenomenon that mutual water stock may enjoy a market value higher than the value it contributes to the land with which it is being used at any given time. For example, the land without the mutual water stock (but possibly with other water sources) may sell for $900 an acre, the land with the water stock for $1,000 an acre, but the water stock itself, assuming it is alienable independently of the land, may bring $200. (That this could happen is certainly conceivable, i.e., the water stock could have been the only source of water to a particular acreage initially, whereas, subsequently, the owner obtained other sources such that the value of the water stock might have diminished in relationship to that particular land, but may still retain its initial value or other higher value in relationship to other lands.)

Thus, in review, a mutual water stock can represent the following three values:

1. Its value as an intangible personalty which, unless the company has engaged in other pursuits than delivery of water to its shareholder, can be disregarded.

2. Its value over and above what it contributes to a particular parcel of land.

3. The value it contributes to the land.

The latter two are taxable as land.

Before turning to the specific questions posed by Mr. Sher, it is submitted that a complete answer thereto involves an admixture of both legal and appraisal principles. As to the latter, we have relied where necessary on the following:

a. <u>The principle of substitution.</u> When a property is replaceable its value tends to be set by the cost of acquisition of an equally desirable substitute property. ("Condemnation Appraisal Hankbook" by George L. Schmutz, p. 28 (1949).)

b. <u>The principle of contribution.</u> The principle of contribution is really the principle of increasing and decreasing returns as it applies to some portion of real property. ("The Appraisal of Real Estate" American Institute of Real Estate Appraisers, p. 39 (1960).)

Application of the above tenets of law and appraising to Mr. Sher's questions has produced the following results:

Answers to Questions

1. a. and b. If what is meant by "residual land value" is the value exclusive of any contribution that a water stock may have to its value, then the answer is, yes. The only effect that degree of transferability has would be on the value of the stock, i.e., all other things being equal, the greater the area within it could be used, the higher the value.

1. c. It would seem, as per conventional tax assessment practice, that the entire value of the stock should be assessed to the purchaser.

1. d. This would seem to preclude the possibility of the stock as to its realty aspect having a value independent of its contribution to the value of the land, consequently the evaluation problem would be simplified to that of determining that contribution.

2. Tax Counsel J. J. Delaney in a memorandum to Mr. Abram F. Goldman, dated January 10, 1967, stated that cotton allotments "...constitute intangible personal property not subject to property tax.", with which conclusion I agree.

3. (First question.) The answer depends on what is meant by the term "irrigated land." If it refers to land which is irrigated by sources in addition to that represented by water stock, then the sales must be adjusted to eliminate any contribution to the sales prices from these other sources before the sales can be employed to determine the value of subject property, it having only water stock rights as a water source.

3. (Second question.) The answer to the second question is similar to the answer to the first in that the nature of the data available would dictate whether you capitalize the net to the land irrigated or the net to the land alone.

4. Assuming the $200/acre represents the contribution the water stock makes to the value of the land, my answer would be, no, you would not deduct the value of the water stock in arriving at the value of the latter property. It would appear they are both irrigated lands and similar in every respect except as to the nature of their water source. The only effect that the water stock being transferable would have would be that it might enjoy a realty value greater than what it contributes to the land. Again, in evaluating the land as such, deduction of the value of water stock over and above its contribution to the land is necessary; however, to arrive at the total to show in the land column the additiona value if any of the water stock over and above what it

contributes to the land must be added back in because it is an interest in real property as well.

5. If there is a market for the water stock independent of the company where the stock brings higher prices than what the company offers, then the company's prices would obviously not be market value. If the company is the only market, then the company's prices would of necessity be the market value.

6. and 7. Water stock is assessable as part of the land. It is not tax exempt.

8. and 9. A mutual (private) stock company would not have the same assessment basis as an irrigation water district (public). The property of the former would be taxable because it is a private entity, whereas the property of the latter would not be because it is a public entity. There is one qualification of this statement; namely, if a public entity owns lands and improvements thereon outside its boundaries which were subject to taxation at the time of acquisition by that entity, the land and improvements are subject to tax. (Cal. Const., art. XIII, § 1.) If such lands include water stock, such stock should be evaluated in the hands of a public entity in the same manner as it would be in the hands of a private water company.

TLH:smk

Thomas L. Hartigan

cc: Mr. R. G. Hamlin
Mr. R. B. Welch
Mr. L. J. Eastman
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Mr. H. J. Strachan
Mr. J. J. Delaney
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Memorandum

To : Mr. Verne Walton

Date : November 19, 1990

From : Ken McManigal

Subject : Mutual Water Companies - Assessment

This is in response to your August 15 and October 15, 1990, memoranda wherein you referred to San Bernardino County's practice of fully assessing mutual water companies even though shares of ownership are appurtenant to the landowners' properties, you included a copy of your proposed San Bernardino County Assessment Practices Survey Recommendation 12, Revise Assessment Procedures For Mutual Water Companies, and a copy of the Assessor's response, and you asked whether the practice of fully assessing mutual water companies' properties even though shares of ownership are appurtenant to the landowners' properties results in double assessments of the landowners' properties.

The practice of fully assessing mutual water companies properties where shares of ownership are appurtenant to the landowners' properties has been considered double assessing of the landowners' properties for some time by the Assessment Standards Division, at least as early as August, 1969. As then explained is Assessors' Handbook AH 540 C, Valuation of Water Companies, at pages 7 and 8:

"D. VALUE SITUS

It was mentioned earlier that, in some cases, mutual water company shares are appurtenant to the land. In these cases the value of the water company is typically reflected in the value of the land that it serves and to which the shares attach. This is based on the premise that purchasers take into account the matter of water availability--i.e., share ownership--in buying property, and pay more for it than they would pay were water not available. As a result, the appraiser must recognize that the value of the mutual water company is included in the value of the land which it serves and to which the shares attach. If he does not recognize this fact and

appraises the water system separately while appraising the land at the value indicated by sales, a double assessment will result.

A legal opinion expressed within the Board of Equalization points up this problem.[1] This opinion says, in part:

> 'Thus, in review, a mutual water stock can represent the following three values:
>
> '1. Its value as an intangible personalty which, unless the company has engaged in other pursuits than delivery of water to its shareholders, can be disregarded.
>
> '2. Its value over and above what it contributes to a particular parcel of land.
>
> '3. The value it contributes to the land.
>
> 'The latter two are taxable as land.'

Hartigan's item '3' bears on the issue of double assessment."

Apparently, the Hartigan memorandum, a copy of which you also forwarded, was the basis for or was contemporaneous with the conclusion that the separate assessment of mutual water company property when its value is included in the assessment of served properties is a form of double assessment.

In its response to your Recommendation 12, San Bernardino County states that it does not concur, and it claims that "several court cases indicate that the assessment of water rights and water systems owned by a mutual water company and the assessment of land served by the mutual water company is not a double assessment." These cases, however, are distinguishable.

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[1] Thomas L. Hartigan memo to Abram F. Goldman, January 17, 1968.

Initially, San Bernardino County cites Spring Valley Water Company v. Alameda County, 88 Cal. App.157, and San Francisco v. Alameda County, 5 Cal. 2d 243, for the proposition that the situs of a water right is the point of diversion. While such is a correct characterization of the former, neither of those cases involving water rights and water districts is in any way determinative of the question of whether double taxation does or does not occur in instances involving mutual water company properties.

San Bernardino County next cites Waterford Irrigation District v. Stanislaus County, 102 Cal. App. 2d 839, copy attached. In that case, an irrigation district owned and had assessed to it appropriative water rights lying outside the district's boundaries. In an attempt to avoid that assessment, the district contended that the tax levied was void as constituting double taxation. The court did not agree, however, and stated at page 848:

> "The right here taxed, that is, the appropriate water right, is alleged to have been purchased by the appellant district from its previous owner and we think that, within the meaning of the constitutional exception, it is owned by that district. Taxes levied upon it therefore are not taxes upon the property of the landowners within the district and consequently the tax fails to meet the test of double taxation, not being a tax upon property owned by the same person."

Thus, taxation of appropriative water rights acquired and owned by an irrigation district outside its boundaries was not taxation of the landowners within the district and did not constitute double taxation.

In this instance, there are at least the following distinctions:

1. Waterford involved an irrigation district, a local governmental entity, whereas a mutual water company is a private association of persons created for the purpose of providing water at cost, to be used primarily by its stockholders or members.

2. The properties assessed/taxed in Waterford were separate and additional appropriative water rights acquired by the district outside its boundaries, whereas the property of a mutual water company is typically property of related landowners acquired at the time the

landowners acquire their properties in order to provide water to their properties.*

3. The value of the properties assessed/taxed in Waterford was the value of separate and additional properties acquired by the district, whereas the value of a mutual water company's property is included in the value of the served properties.*

4. The properties acquired by the district in Waterford were owned by the district and their taxation was not taxation of the landowners within the district, whereas the taxation of typical mutual water company property is taxation of the landowners.*

5. The tax was not a tax upon property owned by the same person, district vis-a-vis landowners, in Waterford, whereas the taxation of typical mutual water company property is taxation of the same landowners who own the properties that the mutual water company serves.*

Thus, the result in Waterford mirrors the result which occurs when the exception to the Assessment Standards Division's mutual water company recommendation/rule occurs, but it does not impact upon the conclusion that the practice of fully assessing mutual water companies where shares of ownership are appurtenant to the landowners' properties results in double assessments of landowners' properties.

Finally, San Bernardino County cites City of Glendale v. Crescenta Mutual Water Company, 135 Cal. App. 2d 784, to point up "the distinction between the right held by a mutual water company and the actual use by the shareholders." In that case, copy also attached, a mutual water company distributed water both within and without the City of Glendale, the City was a member of the Metropolitan Water District of Southern California, the District was authorized to levy annual ad valorem taxes upon all lands within its limits, and the City, as authorized by law, had elected to pay out of municipal funds the amount of the tax that would have otherwise been due in lieu and in avoidance of ad valorem taxes. To require the mutual water company's water users within the city to carry their

*The exception occurs when a mutual water company has excess capacity or when a company owns excess property over and above the facilities necessary to serve its customers.

proportionate share of the burden of the District tax, the City enacted an ordinance imposing an excise tax of $.05 per 100 cubic feet of water upon the use in the city of water purchased from any water distributing agency for use therein. Although the city's water customers were not assessed the $.05 excise, their water rates included an equivalent amount. Nevertheless, the mutual water company sought to have the excise tax declared invalid, in part, because it was discriminatory.

Upon consideration, the court addressed and dismissed the mutual water company's challenge to the ordinance and upheld the imposition of the tax, stating, among other things, as the County has alluded to, at pages 801 and 802:

> "Respondent's counsel assert that the water belongs to the shareholders, that they pay nothing for it when delivered, that the only charge paid is for production and distribution, and hence there is no purchase or sale. Reliance is placed upon Stratton v. Railroad Com., 186 Cal. 119 [198 P. 1051]; Frazee v. Railroad Com., 185 Cal. 690 [201 P. 921]; Hildreth v. Montecito Creek Co., 139 Cal.22 [72 P. 395]. [21] Those decisions hold that in the case of shareholders who own and pool water rights their mutual water company becomes merely their agent in producing and delivering to them their own water. But that is not true of water which is owned by the mutual company and delivered by it to its shareholders even though their stock is appurtenant to their respective lands. (See Consolidated People's Ditch Co. v. Foothill Ditch Co., 205 Cal. 54, 63-64 [269 P. 915].)..." (P. 801)
>
> "...Defendant's amended articles of incorporation provide that it shall deliver water to none except its stockholders and to them only at cost, and immediately add: 'For said purpose or in aid thereof, said corporation shall have power to acquire, develop, maintain and operate a permanent water supply'--e.g., Colorado River water. Also that it rates and charges collected from its stockholders shall be so fixed as 'to preserve the private ownership of the <u>water rights of this corporation</u> and the delivery of <u>its</u> water as a <u>mutual water company</u>.' (Emphasis added.)"...(p. 802)

These portions of the decision relate to the mutual water company's claim that the ordinance did not apply to it or its shareholders because it was a mutual water company and the terms "purchased" and "sold" could not have any application to producing and distributing water at cost to its shareholders

whose shares of stock were appurtenant to the land from which the water was produced. As to the first, the court distinguished between an agency situation and an ownership-delivery situation and concluded that for purposes of the ordinance, water had been sold by the mutual water company to its shareholders. In so doing, it referenced Consolidated People's Ditch Co. v. Foothill Ditch Co., 205 Cal. 54, copy attached, but that case neither pertained to the assessment of mutual water companies' properties nor to mutual water companies:

> "...The several corporations in which the said appellant has thus become a stockholder to the extent above set forth are corporations organized under the laws of the state of California and as such are invested with the powers and duties with respect to both the properties thereof and the stockholders therein as the constitution and statutes of California and the by-laws of such framed in accordance therewith provide. They are not, however, such corporations as are referred to in Section 324 of the Civil Code*, the stock holdings in which have been by the by-laws thereof made appurtenant to certain lands and are to be transferable only with such lands...."(pp. 62-63, emphasis added)

Thus, even if it can be said that it points up "the distinction between the right held by a mutual water company and the actual use by the shareholders," which the Assessment Standards Division recognizes as occurring when a mutual water company has excess property over and above the facilities necessary to serve its customers, City of Glendale is not authority for the practice of fully assessing mutual water companies where shares of ownership are appurtenant to landowners' properties.

As to the second portion of the decision quoted, the reference to the mutual water company's amended articles of incorporation, whatever force and/or effect they might have had in the determination of whether the ordinance in City of Glendale did or did not apply to that mutual water company, such is not relevant in this instance since it has not been claimed, let alone established that the amended articles of incorporation of that mutual water company are the same as or similar to the articles of incorporation of mutual water companies operating in San Bernardino County some 35 years later.

*Now Section 330.24, copy attached.

In this instance then, there are at least the following distinctions:

1. City of Glendale involves the construction and application of an excise tax in lieu of an ad valorem property tax, whereas the practice at issue herein pertains to an ad valorem property tax.

2. City of Glendale was a tax or no tax situation, whereas the practice at issue is a tax or double tax situation.

3. An interpretation of an excise tax under specific circumstances is not relevant to consideration of the application of an ad valorem property tax.

4. Not only does City of Glendale not pertain to the assessment of mutual water companies' properties but also, neither does Consolidated People's Ditch Co., cited therein and referenced by San Bernardino County, pertain to the assessment of mutual water companies' properties or even to mutual water companies.

In sum, the cases cited by San Bernardino County do not establish that the assessment of mutual water companies' properties and the assessment of properties served by such companies are not double assessments.

San Bernardino County's main thrust is that a mutual water company is a person or entity distinct from its shareholders, that any right owned by it is not a right owned by shareholders individually and is taxable to it, and that increased assessment on shareholders' lands through use of water does not result in double taxation of rights owned by a mutual water company. In so contending, however, San Bernardino County is ignoring the premise from which the Assessment Standards Division proceeds, namely, that purchasers take into account water availability/share ownership in buying properties served by mutual water companies and pay more for them than they would pay were water not available, such that the value of the water company is typically reflected in the value of the properties that it serves and to which the shares attach (Valuation of Water Companies, p.7). By so doing San Bernardino County is thus able to transform the exception, where a mutual water company has excess capacity or owns excess property and can be assessed therefor without resulting in double taxation, into the general rule that assessment of a mutual water company's property does not result in double taxation, without having to address the fact that purchasers have taken water

availability/share ownership into account and have paid more for their properties than they would have otherwise paid for them. Accordingly, where purchasers take into account water availability/share ownership in buying properties served by mutual water companies and pay more for them than they would pay were water not available, such that the value of the water company is reflected in the value of their properties, we remain of the opinion that the taxation of the mutual water company's property is taxation of the same landowners who own the properties that the mutual water company serves.

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Attachments

cc: Mr. John Hagerty
Mr. Gene Palmer