BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
REDWOOD MUTUAL WATER COMPANY)

Appearances:

For Appellant: Robert E. Ferini
Certified Public Accountant

John Flanaaan
Manager

For Respondent: John R. Akin
Counsel

O P I N I O N

This appeal is made pursuant to section 256661' of the Revenue anb Taxation Code from the action of the Franchise Tax Board on the protest of Redwood Mutual Water Company against proposed assessments of additional franchise tax in the amounts of $1,382.43 and $964.08 for the income years ended April 30, 1973, and April 30, 1975, respectively, and of additional franchise tax and a penalty in the total amount of $2,294.10 for the income year ended April 30, 1974.

1/ All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

The primary issue oresented in this appeal is whether appellant, a mutual water company, may calculate its tax liability on the basis of total income and total expenses, the method properly used by most corporations. If not, two additional issues are presented: (1) whether certain adjustments are appropriate which would reduce appellant's taxable qain from sales, and (2) whether appellant may now change to reporting by the installment method with respect to certain sales.

Appellant is a mutual water association created to provide economical water service, and road maintenance and recreational services, to residents of the mountain community of Redwood Estates, a community located near Los Gatos, California. Appellant's principal source of income is derived throuqh assessments levied on members for providing these services. Durinq the period under review, it also sold, at a qain, parcels of real property and items of equipment, previously used in providinq the above services, the sales beinq made both to members and to nonmembers. These sales were made primarily to qenerate income and increase appellant's available capital. Durinq these years, appellant also received interest income in connection with such sales and in connection with deposits in bankinq institutions.

On its franchise tax returns for the years in question, appellant deducted its total expenses from total income. It included in such reported total income the receipts derived from providing the aforementioned services to members, the qains from sales of the real property and eauipment, and the interest income. Havinq sustained substantial total expenses durinq those years, appellant determined for tax purposes that it incurred net losses for the income years 1973 and 1975 ($7,620.98 and $3,377.92, respectively), and a slight net income ($321.95) for the year 1974. Therefore, appellant concluded that its liability for each year was satisfied by payment of the minimum tax orovided for in section 23153.

Appellant is a mutual association within the meaning of section 24405 of the Revenue and Taxation

Code. That section[2/] allows mutual associationsa deduction for all income resulting from or arising out of business activities for or with members, or with nonmembers when done on a nonprofit basis. Respondent concluded that appellant's income from assessinq members for its services constituted deductible income under that provision, but that the income derived from the real property and equipment sales, and from interest received, was not deductible thereunder.

On its books and records, appellant had not seqreqated the expenses attributable to the income determined to be deductible by respondent from the expenses attributable to the income determined taxable by respondent. For each year, respondent allocated expenses in excess of the qreater of one percent of the taxable income or $100.00, to deductible income under section 24405. As a consequence of the provisions set forth in section 24425,[3/] respondent did not allow appellant to deduct the expenses respondent attributed to that deductible income.

2/ Section 24401 states that in addition to the deductions provided in article 1, "there shall be allowed as deductions in computinq taxable income the items specified in this article." Section 24405 provides, in part:

> In the case of other associations orqanized and operated in whole or in part on a cooperative or mutual basis, all income resultinq from or arisina out of business activities for or with their members carried on by them or their aqents; or when done on a nonprofit basis for or with members ....

3/ Section 24421 states that "in computinq 'net income' of taxpayers under this part, no deduction shall be allowed for the items specified in this article." One of such nondeductible items is specifically described in section 24425 as "[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, reqardless of whether such income was received or accrued durinq the income year."

Because the disallowed expense deductions exceeded the amount of income that respondent concluded was deductible, respondent issued the proposed assessments in question. A five percent penalty was also imposed for late filinq'of the return for the year ended April 30, 1974, pursuant to section 25931. A timely protest was filed with respect to the proposed tax assessments. Thereafter, respondent made only minor adjustments.

Appellant contends that in computinq its tax liability, it was entitled to deduct total expenses against total income. It claims this riqht on the ground that, unlike for federal income tax purposes, it does not have an approved nonprofit status under the California law, and therefore it urqes it should be taxed as an ordinary corporation. Appellant also relies on the circumstance that its net worth declined approximately 33 percent in 14 years (three of those years beinq the appeal years) because of consistent net losses. Therefore, it claims that, realistically, it did not receive the net income respondent has calculated.

In view of the provisions of section 24405, it is settled that, for California corporate franchise tax purposes, associations such as appellant, orqanized on a cooperative or mutual basis, whose primary purpose is to provide economical services to members on a cooperative basis, should not include as part of their taxable income, operatinq income derived directly as a consequence of providing such services. (Anaheim Union Water Co. v. Franchise Tax Board, 26 Cal. App. 3d 95, 102 Cal. Rptr. 692 (1972); Appeal of San Antonio Water Company, Cal. St. Rd. of Equal., July 1, 1970; see also Appeal of Unity Credit Union, Cal. St. Rd. of Equal., Jan. 6, 1977.) Therefore, respondent acted correctly in excluding such income. Moreover, because of the lansuage of section 24425, expenses allocable to such income are not deductible and were, therefore, also properly excluded by respondent.[4] (Security-First National Bank v. Franchise Tax Board, 55 Cal. 2d 407 [359 P.2d 625] (1961) app. dism. 368 U.S. 3 [7 L. Ed. 2d 161 (1961).)

4/ Appellant has made no specific objection to respondent's calculation of the amount of expenses attributable to deductible income. On the basis of the record before us, we cannot conclude that respondent's calculation was erroneous.

In an effort to render section 24425 inapplicable where oxpens'es attributable to deductible income exceed that income, cooperative or mutual associations may not elect to trea-t the deductible income as taxable, and then deduct the expenses allocable thereto: they simply are not entitled to obtain a qreater tax benefit by deducting such expenses, and including the lesser income. (Anaheim Union Water Co. v. Franchise Tax Board, supra; see Appeal of San Antonio Water Company, supra.) Consequently, respondent correctly concluded that appellant did not have any such option.

Moreover, notwithstandinq appellant's assertion to the contrary, the consistent economic losses suffered by appellant do not alter the situation. In view of the impact of the aforementioned statutory provisions, a net loss simply did not result, for income tax purposes, durinq the years under consideration. (See Anaheim Union Water Co. v. Franchise Tax Board, supra; Appeal of Unity Credit Union, supra.)

It is also clear that the gains derived from the sales of land and equipment, made to generate more income and increase available capital, are includible in the computation of taxable income. First, with respect to those transactions where the sales were made to nonmembers at a profit, the qain from such sales was clearly not deductible under section 24405. (Woodland Production Credit Association v. Franchise Tax Board, 225 Cal. App. 2d 293 (37 Cal. Rptr. 231] (1964); Appeal of California Pine Box Distributors, Cal. St. Bd. of Equal., Sept. 15, 1949.) Second, where the sales were made to members, the qain from the sales was likewise not deductible. Those latter sales constituted 'business transactions with **members** in the nature of dealings with third party commercial customers, rather than transactions with members on a cooperative basis. Under such circumstances, section 24405 is again inapplicable. (See Appeal of San Antonio Water Company, supra.)

For the same reasons that establish taxability of the gain from the land and equipment sales, the interest income derived from such sales is also taxable. Moreover, **the** interest income received from investments in banking institutions is clearly taxable. (See Appeal of Unity Credit Union, supra.)

Having concluded that appellant's primary contention lacks merit, we must turn to appellant's alternative arguments. Appellant contends that the reported gains on the land were excessively high because appellant expensed property taxes and road maintenance costs rather than capitalizing them. It urges that these costs may be treated as capital expenditures, and thereby added to the basis of the parcels sold, with a consequent reduction of taxable gain. Appellant explains that it would have capitalized, rather than expensed, these costs had it known it was not going to be taxed as an ordinary corporation.

As provided in section 24426, amounts paid for otherwise deductible taxes under regulations prescribed by the Franchise Tax Board may be capitalized if the taxpayer elects, in accordance with such regulations, to so treat such taxes. Pursuant to respondent's regulations, such election is to be exercised, however, by filing with the original return for the year for which the election is made a statement indicating that the taxpayer elects to treat such items as chargeable to the capital account. (Cal. Admin. Code, tit. 18, reg. 24426(a), subd. (3)(c).) Inasmuch as an election was not made in the manner authorized, appellant's present attempt to capitalize the property taxes previously expensed is untimely and thus cannot be given effect. (Appeal of Citizens Development Corporation, Cal. St. Bd. of Equal., July 31, 1973.)

Moreover, we are unable to conclude, as urged by appellant, that the expenditures, which appellant refers to as made for road maintenance, may now be capitalized. Appellant has neither alleged nor proved that the expenditures were other than for incidental repairs and maintenance. Such expenditures are not capital expenditures. (See § 24222: Cal. Admin. Code, tit. 18, reg. 24422(a).)

Next, appellant maintains that it should be allowed to capitalize the amounts previously expensed on its records and returns as depreciation of the equipment subsequently sold. As already indicated, this sold equipment was personal property which appellant had used solely in connection with the furnishing of services resulting in receipt of exempt income. The capitalization now sought, if allowed, would increase the basis of such sold equipment, and thereby reduce taxable gain. According to information furnished by appellant, the equipment sales in question consist only of the sales of two vehicles. One was the sale of a Ford truck for $135.00 in the year ended April 30, 1973, whose cost to appellant of $1,050.00 had been fully depreciated, on appellants records and returns. The other was the sale of a Ford tractor and backhoe for $2,745.00 in the year ended April 30, 1975, whose cost to appellant of $7,650.72 had also been fully depreciated on appellant's returns.

Pursuant to section 24916, proper adjustment to the basis of property is to be made for exhaustion, wear and tear (i.e., depreciation) to the extent allowed (but not less than the amount allowable) under the Bank and Corporation Tax Law. In the instant case, most of the depreciation of the two pieces of equipment was sustained and was deducted by the appellant as an expense for taxable years prior to those on appeal. Since those deductions forprevious years were never challenged by respondent, they were "allowed" within the meaning of section 24916. (See Virqinia Hotel Corporation v. Helvering, 319 U.S. 523 [87 L. Ed. 15611 (1943).) Consequently, that amount of the depreciation was properly treated by respondent as reducing the basis of the. two pieces of equipment sold.

However, as a consequence of the audit for the appeal years, respondent did not allow appellant to deduct the balance of the depreciation of this equipment that was sustained and claimed for the appeal years, since the deduction was attributable to the use of equipment in derivinq exempt income. Thus, this amount of the depreciation was neither allowed nor allowable within the meaninq of section 24916; therefore, appellant is entitled to capitalize this sum. (See United States v. Ludey, 274 U.S. 295 [71 L. Ed. 10541 (1927); Belknap v. United States, 55 F. Supp. 90 (W.D. Ky. 1944).)

Appellant also urqes that the sales price of each parcel of land sold should be revised downward by an amount approximatinq what appellant would have assessed an owner of such parcel for maintaining water, road,and recreational services, had the purchaser, rather than appellant, owned the property durinq the time the services were rendered. Thus, appellant claims it should he allowed to treat such amount as a "back assessment" for services and, consequently, deductible income. This position is untenable. The entire sales price simply was actually received as consideration for the sale.

Finally, appellant contends that it should be permitted to use the installment method of reportinq with respect to the taxable sales. We have held that where a taxpayer elects to report the entire gain on the sale of property in the year of sale, he cannot, thereafter, change his election to the installment method of reporting the gain, after the expiration of the time allowed for filing a return. (Appeal of Glenn R. and Julia A. Stewart, Cal. St. Bd. of Equal., Oct. 18, 1977; Appeal of Carl H. and Ellen G. Bergman, Cal. St. Bd. of Equal., Feb. 19, 1974.) In those appeals, we relied on the decision of the United States Supreme Court in Pacific National Co. v. Welch, 304 U.S. 191 [82 L. Ed. 1282] (1938) which held that where a taxpayer makes an election not to use the installment reporting method, that election is binding and may not be changed after expiration of the time allowed for filing the return. In so holding, the Court stated:

> Change from one method [of reporting income] to [another], as petitioner seeks, would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws. It would operate to enlarge the statutory period for filing returns ... to include the period allowed for recovering overpayments .... There is nothing to suggest that Congress intended to permit a taxpayer, after expiration of the time within which return is to be made, to have his tax liability computed and settled according to [another] method. By reporting income from the sales in question according to [one] method, petitioner made an election that is binding upon it and the commissioner. (304 U.S. at 194-195.) (Footnote omitted.)

In the instant appeal, appellant reported the entire gain from the sales on its tax returns, thereby electing not to use the installment method. In line with Pacific National Co. v. Welch, supra, and the two appeals cited, appellant cannot thereafter change that election and report the gains on the installment basis.

Appeal of Redwood Mutual Water Company

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Redwood Mutual Water Company against proposed assessments of additional franchise tax in the amounts of $1,382.43 and $964.08 for the income years ended April 30, 1973, and April 30, 1975, respectively, and of additional franchise tax and penalty in the total amount of $2,294.10 for the income year ended April 30, 1974, be and the same is hereby modified to reflect the capitalizing of certain of the amounts previously expensed for depreciation of the equipment sold, as directed in the opinion, and thereby, to that extent, increase the basis and reduce the gain from the sales of such property. In all other respects, the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 1st day of August, 1980, by the State Board of Equalization.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

George R. Reilly, Member

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