BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SAN ANTONIO WATER'COMPANY)

Appearances:

For Appellant: Thomas H. McPeters
Attorney at Law

For Respondent: Jack E. Gordon
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of San Antonio Water Company against proposed assessments of additional franchise tax in the amounts of $8,652.56, $838.78 and $1,979.64 for the income years 1963, 1964 and 1965, respectivelyi

Appellant is a mutual water company which was incorporated in California in 1882. Its bylaws provide that the function of the company is to furnish, supply, and distribute water at cost to and for its shareholders for domestic irrigation, and other useful purposes.

In 1963, under the threat of eminent domain, appellant sold a parcel of land to the Southern California Edison Company, a public utility which needed this property for a power transmission-right-of-way. The purchaser owned two of appellant's more than 6,000 shares of stock. San Antonio Water Company realized gain of $291,319 from the -sale.

In its franchise tax'return for each of the years in question, appellant calculated its tax liability

by deducting its total expenses from its total income. This method yielded net losses for the income years 1964 and 1965. The Franchise Tax Board audited the returns and made determinations concerning the deductibility or nondeductibility of the various types of income. That board also allocated the expenses between these two categories of income and disallowed the deduction of, the expenses attributable to the deductible class of income.

The parties have agreed that the initial issue presented by this appeal is whether the gain from the sale of the land to Southern California Edison Company is deductible under section 24405. The second question is whether income which is deductible under section 24405 is a class of income "not included in, the measure of the tax" so that expenses allocable to that income are disallowed as deductions by section 24425. If the second issue is decided affirmatively, we must also decide whether the expenses allocable to the deductible income are allowable as deductions to the extent that these expenses exceed such income. The three issues will be discussed in the order in which they are presented above.

With respect to the deductibility of the gain from the land sale, section 24401 of the Revenue and Taxation Code provides that "... there shall be allowed as deductions in computing taxable income the items specified in this article." Section 24405 specifies one of these items, and provides in part:

> In the case of other associations organized and operated in whole or in part on a co-operative or a mutual basis, all income resulting from or arising out of business activities for or with their members carried on by them or their agents; or when done on a nonprofit basis for or with nonmembers;...

Appellant relies solely on the Appeal of California State Employees Credit Union No. 1, Cal. St. Bd. of Equal., decided December 13, 1961, which allowed the deduction of certain rental income received from members.. Subsequent to that decision, in Woodland Production Credit Ass'n v. Franchise Tax Board, 225 Cal. App. 2d 293, 298 [37 Cal. Rptr. 231], the District Court of Appeal stated with respect to section 24405: "There may be income--and we think the present kind is an

example--which becomes part of the tax base, not because it consists of a profit drawn from nonmembers, but because it is entirely outside the scope of the deduction statute." The Woodland case, supra, 225 Cal. App. 2d 293, 298 [37 Cal. Rptr. 231], was concerned with interest income received from the United States Government. In order to find guidance for interpretation of the scope of the deduction statute in regard to the instant fact situation, it is necessary to refer to the federal income tax area.

Under the federal law, certain favorable tax treatment is provided to cooperatives with respect to income derived from business done with or for patrons (Int. Rev. Code of 1954, §1382(b),§1388(a)), who are defined as persons with whom or for whom the cooperative association does business on a cooperative basis, whether members or nonmembers of the association. (Treas. Reg. §1.1388-1(e).) This limitation appears to be very similar to the deduction limitation of section 24405, quoted above . Appellant is comparable to a so-called nonexempt cooperative under the federal approach, and this type of association is not entitled to special federal tax treatment with: respect to its nonoperating income, such as interest, dividends, rents, and capital gains. (S. Rep. No. 781, 82d Cong., 1st Sess. (1951) [vol. 2, 1951 U.S. Code Cong. & Ad, News, pp. 1969, 1989]; Int. Rev. Code of 1954, §1382(c); Treas. Reg. §1.1382-3(c)(2).) The income at issue here was derived from the sale of land by an association whose cooperative purpose is to furnish water to its members. Under the federal law, such income would be capital gain.

The income in question resulted from a business transaction with a member, In Revenue Ruling 66-380, 1966-2 Cum. Bull. 359, the Internal Revenue Service considered a situation where a producer-patron purchased crops which the nonexempt cooperative was marketing for other producer-patrons. The Service stated that the function of the cooperative was to market the crops at the best available price, and a producer-patron who buys such crops places himself in the position of a third party commercial customer. Favorable tax treatment was denied the cooperative with respect to the income from these purchases on the ground that such treatment is only available if the patron deals with the association on a cooperative basis. In the instant situation appellant, under the threat of eminent domain, sold the land in question to a member, Southern California Edison Company. Acting in its cooperative capacity, appellant's

function was to obtain the best possible price for the property. Consequently, the public utility was dealing with appellant as a third party commercial customer, and not on a cooperative basis.

In view of the District Court of Appeal's interpretation of the deduction statute in Woodland Production Credit Ass'n v. Franchise Tax Board, supra, 255 Cal. App. 2d 293, 298 [37 Cal. Rptr. 231] and the relevant federal law, we think that the nonoperating income at issue, which was derived from a transaction with a member that was dealing as a third party commercial customer, is outside the scope of section 24405 and therefore is nondeductible.

The second issue of this appeal involves the Franchise Tax Board's disallowance of the deduction of those expenses allocable to that portion of its member business income which was deductible under section 24405. This disallowance was based upon section 24421 of the Revenue and Taxation Code which provides that "... no deduction shall be allowed for the items specified in this article," and section 24425 which, specifies:

> Any 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, regardless of whether such income was received or accrued during the income year.

Appellant argues that income deductible under section 24405 is included in gross income and therefore is included in the measure of the tax, making section 24425 inapplicable.

However, the California Supreme Court has upheld a similar disallowance of expense deductions with respect to the almost identically worded predecessors of sections 24405 and 24425. (Security-First Nat. Bank v. Franchise Tax Board, 55 Cal. 2d 407 [11 Cal. Rptr. 289; 359 P.2d 625], appeal dismissed, 368 U.S. 3 [7 L. Ed. 2d 16].) Also, the application of section 24425 in this instant type of situation has been repeatedly sustained in prior appeals decided by this board. (Appeal of

Mid-Cities Schools Credit Union, Cal. St. Bd. of Equal., Dec. 15,1966; Appeals of Los Angeles Firemen's Credit Union, Inc., Cal. St. Bd. of Equal., June 28, 1966; Appeal of Southern Calif. Central Credit Union, Cal. St. Bd. of Equal., Feb. 3, 1965; Appeal of Credit Union, Calif. Teachers Ass'n, Southern Section, Cal. St. Bd. of Equal., July 19, 1961.) Therefore, appellant's contention must be rejected.

The final issue of this case is concerned with appellant's contention that the expenses allocable to deductible income should be allowed as deductions to the extent that those expenses exceed such income. Appellant argues that this type of limited disallowance of deductions would be sufficient to prevent a double deduction. Also, appellant argues that section 24405 was intended to benefit cooperatives, but if all the expense deductions in question are disallowed appellant will have a larger tax liability than it would have had if section 24405 had not been enacted.

Appellant has not submitted any authority in support of this limited disallowance interpretation. Sections 24421 and 24425 explicitly disallow as a deduction "[a]ny amount" which is allocable to income not included in the measure of the tax. We must conclude that respondent correctly disallowed all of the expense deductions in question.

O R D E R

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

Appeal of San Antonio Water Company

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 San Antonio Water Company against proposed assessments of additional franchise tax in the amounts of $8,652.56, $838.78 and $1,979.64 for the income years 1963, 1964 and 1965, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of July, 1970, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary