

ASSESSORS' HANDBOOK
SECTION 542

ASSESSMENT OF WATER COMPANIES
AND WATER RIGHTS

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CALIFORNIA STATE BOARD OF EQUALIZATION

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FOREWORD

Assessors' Handbook Section 542 (AH 542), *Assessment of Water Companies and Water Rights*, is a complete rewrite and compilation of two sections of the Assessors' Handbook: former AH 542, *Assessment of Water Companies* (which is no longer in circulation), and AH 543, *Assessment of Water Rights*. The objective of this handbook section is to provide assessors, assessor's staff, and other interested parties an understanding of issues relevant to water companies and water rights for assessment purposes. However, various other sections of the Assessors' Handbook and other Board publications are cited throughout the text and should be consulted as necessary. If there is an inconsistency resulting from the absence of technical data in this handbook section and a more advanced, specific manual, handbook section, or other authoritative source is available on that topic, parties are advised to consult with qualified experts and those sources regarding the technical aspects of valuing the particular complex property.

The rewrite of this handbook section was undertaken by staff members of the Policy, Planning, and Standards Division (PPSD) in conjunction with the staff of the Property Taxes Section of the Legal Division. As part of the process of producing this handbook section, meetings were held with assessors, industry representatives, and other interested parties. Any issues regarding the final language and content of this handbook section that could not be resolved by consensus among interested parties were voted on and resolved by the Members of the Board of Equalization after hearing relevant testimony from interested parties and Board staff. The Board approved this section of the handbook on December 14, 2000.

Under Government Code sections 15606 et seq., the State Board of Equalization is charged with the duty of administratively enforcing and interpreting the statutes governing the local assessment function. While regulations adopted by the State Board of Equalization are binding as law, Board-adopted manuals are advisory only. Nevertheless, courts have held that they may be properly considered as evidence in the adjudicatory process.¹ The citations and law references in this publication were current as of the writing of the manual.

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December 2000

¹ *Coca-Cola Co. v. State Board of Equalization* (1945) 25 Cal.2d 918; *Prudential Ins. Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142; *Hunt Wesson Foods, Inc. v. County of Alameda* (1974) 41 Cal.App.3d 163.

may also request other information as necessary (i.e., aging schedule of advance contracts and remaining economic life (REL) estimates). Information reported and listed on the CPUC report is very useful to assessors in appraising the property of these companies and the report details changes which occurred during the previous calendar year in balance sheet accounts including plant in service and accrued depreciation. A CPUC report provides historical cost information regarding the company's assets, revenue and expense information, and other financial information. The report also includes annual income statements and/or a description of plant in service.

Mutual and Private Water Companies

The Board prescribes Form 540-S, *Mutual or Private Water Company Statement*, for mutual or private water companies (see Appendix A). The assessor may also use Form 571-L, *Business Property Statement* (see Appendix A), for these types of companies. In either case, the section 463 penalty for the non-filing or late filing of a property statement can be legally enforced by the assessor.

Other Property Statements

Assessors may request owners of water systems and related properties to file an annual property statement other than those statements prescribed by the Board (i.e., county-developed forms) or other questionnaires, designed in a manner that allows the assessor to obtain information necessary to make a proper assessment. However, the assessor cannot legally enforce a section 463 penalty for the non-filing or late filing of a form or property statement that is not prescribed by the Board. If a taxpayer fails to furnish information, other than on a prescribed property statement, the only remedy available to the assessor is to obtain the desired information through an audit.

VALUATION OF WATER SYSTEMS

In general, locally assessed real property (including fixtures) owned by a water company is subject to the provisions of article XIII A of the State Constitution.¹⁹ A base year value for the property is established and the property is assessed yearly at the lesser of its factored base year value or its full cash value on each lien date as defined in section 110(a).²⁰

Personal property owned or used by a water company is not governed by the base year value limitations of article XIII A. This property is assessable at current market value as of the lien date each year. Annually, it must be taxed in proportion to its value as defined in section 110(a):

¹⁹ For information regarding exceptions, see Assessors' Handbook Section 502 (AH 502), *Advanced Appraisal*. See Chapter 2 of this section of the handbook for additional information regarding taxable government-owned "section 11" property.

²⁰ Certain taxable government-owned properties are assessed yearly at the lesser of current market value, factored base year value, or a restricted section 11 "Phillips factor" value (see Chapter 3, p. 46-49).

MUTUAL WATER COMPANIES

DESCRIPTION

A mutual water company is a private (usually non-profit) association created for the purpose of providing water primarily to its stockholders or members. Companies organized for mutual purposes are generally not subject to regulation by the CPUC unless the company delivers water for profit to persons other than stockholders and members.⁴⁴ Section 2705 of the Public Utilities Code allows a mutual water company to make other deliveries of water, as identified in the code section, at cost, without becoming subject to CPUC oversight.⁴⁵ A mutual water company, however, may transfer water for profit to persons other than stockholders and members without becoming subject to regulation by the CPUC.⁴⁶

When incorporated, a mutual association can enter into contracts, incur obligations, own property, and issue stock. If not incorporated, it can do these things in the names of all of its members. A certificate of stock issued by a mutual water company represents ownership of a portion of the assets of the mutual water company. The right to receive water for use on certain lands by virtue of ownership of shares of stock in a mutual company is a right in real property, but the shares are (intangible) personalty that may be conveyed separate and apart from the land. Shares do not automatically pass with a conveyance of the land unless they are appurtenant.

APPROACHES TO VALUE

The assessable value of property owned by a mutual water company is typically minimal or zero because the value of the property is included in the value of the land which it serves. (See the following section regarding the avoidance of double assessment.) If the property of a company is subject to separate assessment, all approaches to value should be considered when appraising the property of a mutual water company. Generally, the reproduction or replacement cost approach is preferred (over HCLD) because the companies are typically subject to little or no regulation. The income approach (and stock and debt approach) may provide limited information when the business is operated as a non-profit entity, and the comparative sales approach cannot generally be applied due to lack of comparable data.

Appraisers and auditor-appraisers should keep in mind that the value of the owner's equity interests in a mutual water company association may not be equivalent to the fee value of the association's property. This may occur if the association has borrowed money to acquire the property. The value of the owner's equity may have been reduced from the fee value of the property by the amount of the loans. Therefore, the sales price of the served land only includes

⁴⁴ Public Utilities Code section 2705. If a mutual water company delivers water for profit to persons other than stockholders and members, the company becomes a public utility subject to the jurisdiction, control, or regulation of the CPUC.

⁴⁵ See Public Utilities Code section 2705 for more information.

⁴⁶ A water transfer is distinguishable from a water delivery. Public Utilities Code section 2705(c) provides that transfers and exchanges of water or water rights by a mutual water company with another entity, pursuant to state or federal law, are not subject to oversight by the CPUC. See Chapter 1 of the Water Rights section of this Handbook for a discussion on the topic of water transfers.

this reduced value of the equity interest in the mutual water company's tangible property and not the fee value. The assessor must develop assessment techniques for mutual water company property that eliminates the likelihood of escape assessments caused by borrowed funds which reduce the value of the equity in the company, as well as escape assessments due to other causes (such as the value of property with situs in other counties).

An appraiser or auditor-appraiser should review a mutual company's annual property statement and gather as much information as possible to determine the most appropriate method(s) of valuation. Articles of incorporation contain much of the information that must be considered. Articles of incorporation include, for example (1) how the stock is held, (2) whether the mutual company is for profit or non-profit, (3) the area served by the company, (4) land and improvements owned by the company, and (5) a description of water sources, wells, and water rights.

In addition, an appraiser or auditor-appraiser should obtain the following information regarding a mutual water company in order to value the associated property appropriately:

- Articles of incorporation or articles of association, and any amendments
- Bylaws and any amendments
- Lists of land, improvements, and water distribution systems owned by the mutual water company, showing location and identity of each item
- Proof of ownership in the company's name of the land and improvements
- Listing of all assessor's parcels served by the company

SPECIAL ISSUES

Avoidance of Double Assessment

In most cases, mutual water company shares are appurtenant to the land.

...A thing is "appurtenant" to something else when it stands in relation of an incident to a principal and is necessarily connected with the use and enjoyment of the latter. A thing is deemed to be incidental or appurtenant to land when it is by right used with the land for its benefit, as in the case of a way, or water-course, or of a passage of light, air, or heat from or across the land of another⁴⁷

In such 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 value of the share in the mutual water company when buying property, and pay more for land than they would pay if the water was not available. As a result, in these situations, appraisers and auditor-appraisers must recognize that the value of the mutual water company is included in the value of the land that it serves and/or to which the shares attach (e.g., by fee interest or practice of the shareholders). If this fact is not recognized, and the water system is

⁴⁷ *Black's Law Dictionary*, 6th Edition, s.v. "appurtenant."

appraised separately while appraising the land at the value indicated by sales, a duplicate assessment may result.

Even in situations in which shares of a mutual water company are not appurtenant to the land, the value of mutual water company assets may have been assessed with the land. In order to avoid duplicate assessments when mutual water company assets are assessed with the land, minimum values should be assigned to the mutual lands, improvements, and delivery system. Examples of when a mutual water company's land, improvements, and delivery systems may be separately assessed from the service parcels include (1) when stock in the mutual company is not appurtenant to land, and the value of mutual water company assets are not included in land valuations, and (2) when the company's water system (land and improvements) is not in the company's name. The appraiser or auditor-appraiser should consider whether a separate assessment is appropriate under these circumstances. If the value of the mutual water company assets is assessed with the land, then a separate assessment of the mutual water company assets may cause a duplicate assessment.

Sometimes a mixed situation may exist. For example, part of the value of the mutual water company may reside in land to which shares are attached, and part of the value may exist as an independent entity. In addition, a company may have retained some shares and the right to water that they represent instead of distributing all of the shares to the mutual service area. Over the course of time, the company may serve customers outside of the mutual service area. These customers will not acquire shares, but will pay the company the going rate for water. The appraiser or auditor-appraiser should analyze the income received by a mutual water company from non-mutual operations. The net income from such operations should be capitalized into a value that is attributed to the company itself, above and beyond the value of the land which it serves.

Treatment of Income Taxes

When applying the income approach and deriving a capitalization rate, an appraiser or auditor-appraiser may need to estimate an income tax component and/or must determine whether the company is subject to federal corporate and state franchise tax. Some mutual water companies are exempt from federal corporate income taxes and state franchise taxes pursuant to section 501(c)(12) of the Internal Revenue Code.⁴⁸ Other mutual companies operate as proprietorships or partnerships; although the owners or partners are liable for the income received from these entities, the company itself is not liable for either federal corporate income tax or state franchise tax. As a result, the capitalization rate does not require a component for these taxes when the income approach is applied.

⁴⁸ If 85 percent or more of the income of a mutual company consists of amounts collected from members, the company is exempt from federal corporate income and state franchise taxes pursuant to this section. Refer to IRS Publication 557, *Tax-Exempt Status of Your Organization*.