BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CALIFORNIA STATE AUTOMOBILE ASSOCIATION)

Appearances:

For Appellant: Valentine Brookes
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

This appeal was originally made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of California State Automobile Association against proposed assessments of additional franchise tax in the amounts of $71,442.50, $165,448.73, $148,841.80 and $187,591.18 for the income years 1968, 1969, 1970 and 1971, respectively. Subsequent to the filing of this appeal, appellant paid the proposed assessments in full. Accordingly, pursuant to section 26078 of the Revenue and Taxation Code, this appeal is treated as an appeal from the denial of claims for refund.

The issues for determination are the following: (i) Was appellant organized and operated on a cooperative or mutual basis so as to be eligible to claim the deduction authorized by sections 24401 and 24405 of the Revenue and Taxation Code: (ii) If so eligible, did appellant improperly claim deductions for income from business done with nonmembers on a profit basis: and (iii) Did appellant file its appeal from respondent's action denying supplemental refund claims within the prescribed statutory period. The supplemental refund claims in the amounts of $157.00 and $6,347.00 for the income years.1970 and 1971, respectively, were based upon the grounds that appellant was entitled to deduct from income, under sections 24401 and 24405 of the Revenue and Taxation Code, loan service fees received from banks in connection with automobile loans made to members.

Appellant was formed under the laws of the State of California in 1907. At the time, California law provided that only financial or agricultural enterprises could be incorporated as mutual or cooperative corporations. Consequently, appellant was formed under California's nonprofit statutory provisions.

A comprehensive revisionof the statutes dealing with cooperative corporations was later adopted by the California Legislature. These new statutes expanded the scope of cooperative organizations to permit the incorporation of consumer cooperatives, (Corp. Code § 12200 et seq.) The Legislature provided that any corporation amending its articles of incorporation to conform to the new statutes would be deemed to be, organized and existing under, entitled to the benefit of, and subject to the provisions of, the new statutes permitting the incorporation of consumer cooperatives, as fully as if they had originally been organized pursuant to them. Appellant opted not to amend its articles of incorporation in order to be governed by the new statutes and continued to operate, as before, under the nonprofit statutory provisions. With few exceptions, appellant still operates under its original charter.

Appellant, having consolidated several automobile clubs operating in northern and central California, initially functioned as a club; however, within a short time it began to offer other services to its members. In 1914, appellant formed an inter-insurance exchange, the Inter-Insurance Bureau, to provide automobile insurance to its members. In 1916, a touring bureau was

added, followed by the publication of California Motorist (Motorland) Magazine a year later, Appellant later established an emergency road service program, a personal accident insurance program, and a worldwide travel service. In 1969 and 1970, respectively, it initiated an automobile financing program and an arrangement to provide replacement tires and batteries. In addition, appellant operates an automotive diagnostic clinic and provides traffic citation and automobile license services. Over the years, appellant has expanded its geographic area of coverage to include not only northern and central California, but also the entire State of Nevada. Membership has grown rapidly, from 10 members in 1910 to 1,185,134 members by 1971, the last of the years in issue in this appeal.

The services provided by appellant have been briefly summarized above. To receive these services, other than travel arrangements, an individual must be a member of appellant. To become a member, one must pay a one-time enrollment fee and an annual membership fee. No portion of the enrollment or membership fees has ever been returned by appellant to its members. Article XV of appellant's by-laws provides that any person ceasing to be a member, forfeits all interest in appellant and its property.

Appellant's status as a tax exempt "club" for purposes of federal income tax was challenged in Smyth v. California State Automobile Ass'n., 175 F.2d 752 (9th Cir. 1949). In that case, the court held that appellant did not operate exclusively for noncommercial or social purposes and, therefore, that it did not qualify as a "club" exempt from federal income taxation.

Based upon the holding of Smyth v. California State Automobile Ass'n., supra, respondent determined in 1950 that appellant did not qualify as an exempt social club, but that it did qualify as a cooperative association for purposes of the California franchise tax. On the basis of respondent's determinations, appellant has, since 1951, filed its tax returns as a cooperative association.

Respondent, in examining appellant's returns for the income years 1968 to 1971, determined that its operations were not organized and conducted on a cooperative or mutual basis. Accordingly, respondent denied the claimed deductions for income derived from business done with members and income from business done with

nonmembers on a nonprofit basis. Respondent further determined that even if appellant operated on a cooperative or mutual basis, some of the business it conducted with nonmembers was on a profit basis and did not qualify for the deduction authorized by sections 24401 and 24405. Respondent's reversal of its 1950 determination that appellant qualified as a cooperative association apparently was not based on changes in the law or the operations of appellant, but rather on the position that appellant was not, and never had been, organized and operated as a mutual or cooperative association.

Respondent issued proposed assessments on September 7, 1973, for the additional taxes it determined were due. After considering appellant's protest of the proposed assessments, respondent issued its notices of action affirming their correctness. Subsequent to filing this appeal, appellant paid the assessments, thereby converting this appeal into an appeal from the denial of claims for refund.

The relevant sections of the Revenue and Taxation Code provide, in pertinent part:

> . . . [T]here shall be allowed as deduct ions in computing taxable income. . . . (Rev. & Tax. Code § 24401.)
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> In the case'of other associations organized and operated in whole or in part on a co-operative or 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; . . . (Rev. & Tax. Code § 24405.)

Respondent argues that appellant is not organized and operated on a cooperative or mutual basis so as to qualify for the special income deduction authorized by sections 24401 and 24405 of the Revenue and Taxation Code, because it has never returned any portion of its enrollment or membership fees to its members. It is respondent's position that a mutual or cooperative association is legally obligated to periodically return savings or profits to its members. While respondent recognizes that appellant is obligated to distribute corporate property to its members-upon dissolution (former Corp. Code § 9801, repealed Jan. 1, 1980), it argues that this obligation is not sufficient alone to

qualify appellant as a true cooperative or mutual association since those members whose interest in appellant terminates before any such possible dissolution would be deprived of their share of accumulated savings, while new members would have an unearned increment conferred upon them.

The courts have repeatedly held that an association is not required to periodically return savings to its members in order to qualify as a mutual or cooperative association. (Peninsula Light Co., Inc. v. United States, 552 F.2d 878 (9th Cir. 1977); Peter Theodore, 38 T.C. 1011 (1962); Estate of Clarence L. Moyer, 32 T.C. 515 (1959); Mutual Fire, Marine and Inland Insurance Co., 8 T.C. 1212 (1947); Order of Railway Employees, 2 T.C. 607 (1943).) Furthermore, the courts have consistently rejected the contention made by respondent here that appellant cannot qualify as a mutual or cooperative association because its members who allow their memberships to lapse may never receive a return of any part of the payments made by them. (Order of Railway Employees, supra; Thompson v. White River Burial Ass'n., 178 F.2d 954 (8th Cir. 1950).) These determinations, however, are not dispositive of the instant appeal.

Neither the Internal Revenue Code, the Revenue and Taxation Code, nor the regulations promulgated pursuant thereto, define a mutual or cooperative association. However, the courts are in general agreement that the characteristics of such an association are: common equitable ownership of assets by members; the right of dues-paying members to be members to the exclusion of others and to choose management; a sole business purpose of supplying goods, services, or insurance at cost: and the current right of members to the return of payments which are in excess of the amount needed to cover losses and expenses. (Modern Life & Accident Insurance Co., 49 T.C. 670 (1968); Estate of Clarence L. Moyer, supra; Holyoke Mutual Fire Insurance Co., 28 T.C. 112 (1957); Mutual Fire, Marine & Inland Insurance Co., supra; Thompson v. White River Burial Ass'n., supra.) While it is clear that appellant meets the first three of these requirements, it is equally clear that appellant's members do not have, under California law, an existing right to the return of payments which are in excess of the amount needed to cover losses and expenses.

As noted above, appellant opted to remain incorporated as a nonprofit corporation even after

California law permitted it to amend its articles of incorporation so as to qualify as a mutual or cooperative association. During the years in question, former Corporations Code section 9200 (repealed Jan. 1, 1980) provided, in pertinent part:

> . . . [N]o corporation formed or existing [as a nonprofit corporation] shall distribute any gains, profits, or dividends to any of its members as such except upon dissolution or winding up.

As we have previously noted, it is not essential that a mutual or cooperative association make periodic returns of excess payments collected. However, it is essential that such an association have the power to make such distributions when there exists a surplus of receipts over the cost of the services provided. (Thompson v. White River Burial Ass'n., supra; Modern Life & Accident Insurance Co., supra; Holyoke Mutual Fire Insurance Co., supra; Mutual Fire, Marine & Inland Insurance Co., supra.)

Since appellant is incorporated as a nonprofit corporation, it was, during the years in question, subject to former Corporations Code section 9200 which expressly prohibited it from making distributions of excess payments except upon dissolution. Consequently, it lacked one of the essential elements of a mutual or cooperative association, namely, the power to make current distributions of surplus payments.

As earlier indicated, the other two issues presented by this appeal are contingent upon a finding that appellant is eligible for the deduction authorized by sections 24401 and 24405 of the Revenue and Taxation Code. Since we have determined that appellant is not eligible for that deduction because it is not organized and operated as a mutual or cooperative association, we need not consider either the propriety of appellant's deductions for income from business done with nonmembers on a profit basis or the timeliness of appellant's appeal from respondent's action denying its refund claims for income years 1970 and 1971 in the amounts of $157.00 and $6,347.00, respectively.

Appeal of California State Automobile Association

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,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of California State Automobile Association for refund of franchise tax in the amounts of **$71,442.50, $165,448.73, $148,841.80** and **$187,591.18** for the income years 1968, 1969, 1970, and **1971**, respectively, be and the same is hereby sustained.

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

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member