

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
Automobile Club of Southern California) No. 97R-0946
)
)

Representing the Parties:

For Appellant: Frederick A. Richman

For Respondent: Edward J. Kline, Counsel

Counsel for Board of Equalization: Kathleen R. O'Connor, Tax Counsel

OPINION

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code¹ from the action of the Franchise Tax Board on the protest of Automobile Club of Southern California against proposed assessments of additional franchise tax in the amounts of \$168,318.22, \$336,797.42, and \$218,374.39 for the income years ended December 31, 1987, 1988, and 1989, respectively, and pursuant to section 19324, of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the protective claims of Automobile Club of Southern California for refund of franchise tax in the amounts of \$1,489,303.00, \$821,932.00, and \$1,832,669.00 for the same respective income

¹ Unless otherwise specified, all section references in the body of this opinion are to the sections of the Revenue and Taxation Code in effect for the years in issue.

years.² The issue presented on appeal is whether the court decision in California State Automobile Association v. Franchise Tax Board (1987) 191 Cal.App.3d 1253 (review den. July 29, 1987) applies to this taxpayer, i.e., whether the taxpayer must be treated as a cooperative association for the income years at issue.

I. Background:

Appellant is affiliated with the American Automobile Association (AAA). Appellant provides emergency road service, travel information, and other services to its members and generates income primarily by dues from its members along with interest and dividends earned on its investments. Appellant has no power to pay dividends or otherwise make any current distributions out of any surplus funds, except upon dissolution. (Corp. Code, § 7411.) During the income years in question, appellant filed franchise tax returns as a California mutual benefit (nonprofit) corporation.

II. Factual Contentions:

Appellant states that it has filed franchise tax returns in California for more than 50 years. Prior to the years at issue in this appeal, respondent has never treated appellant as a cooperative association, either in whole or in part.³ Respondent reversed its position based upon the court decision in California State Automobile Association v. Franchise Tax Board, *supra* (hereafter CSAA), which held in a case of first impression that it was not essential that an association have the power to make distributions or for the members to have the potential right to receive dividends in order to be considered a cooperative or mutual association.⁴

The California State Automobile Association (CSAA) had originally characterized itself as a tax-exempt “club” for purposes of federal income tax. However the Internal Revenue Service successfully challenged that status in Smyth v. California State Automobile Association (9th Cir. 1949) 175 F.2d 752. Based upon the holding of Smyth, respondent determined in 1950 that CSAA did not qualify as an exempt social club. However, respondent determined that CSAA did qualify as a

² Respondent has listed the claims for refund as \$188,322, \$337,631, and \$227,228, respectively. Respondent has stated that the claim for refund for income year ended December 31, 1989, is \$1,782,806; the source of this amount was not supplied.

³ If appellant is entitled to continue to file as a mutual benefit nonprofit association, then none of the proposed assessments nor the protective claims for refund are valid.

⁴ Respondent opposed this ruling in the CSAA case.

cooperative association for purposes of the California franchise tax. Since that time⁵CSAA filed its tax returns as a cooperative association.

Beginning in 1987 respondent questioned CSAA's right to file as a cooperative association and claim deductions pursuant to section 24405. Respondent argued that CSAA did not qualify as a cooperative association since the CSAA members did not have a right to receive patronage dividends, credits, or rebates in excess of the amounts necessary to cover losses and expenses.⁶ However, the CSAA court ruled that the presence or absence of one single quality or characteristic should not be viewed as the sole criteria for determining whether an organization operates as a cooperative. (CSAA, at 1258.) The CSAA court allowed CSAA to continue to file as a cooperative association and achieve the better tax results which resulted from its doing so. However, in the instant case, appellant achieves a better tax result if allowed to file as a mutual nonprofit corporation.

Subsequent to the CSAA court decision, respondent treated appellant as a cooperative association.⁷ Respondent states that it cannot disregard a published opinion of a California Court of Appeal. Respondent also states that it is not able to distinguish between the CSAA facts and the facts of present appeal.

III. Legal Discussion:

Appellant argues that the CSAA opinion does not apply to appellant, and even if the case does apply, it is factually distinguishable. We agree. In the CSAA opinion, CSAA chose to file as a cooperative as it had done for over 35 years and took deductions relying upon Revenue and Taxation Code section 24405. Thus, the court was correct in considering the pivotal issue to be whether CSAA was a cooperative association, able to avail itself of those deductions. Based upon the narrow issues raised, it was not necessary for the CSAA court to consider statutory authority other than section 24405.

⁵ CSAA has filed as a cooperative association since 1951.

⁶ There are four characteristics to be considered in determining whether a cooperative association exists: (1) Common equitable ownership of the assets by the members; (2) The right of dues paying members to be members to the exclusion of others and to choose the management; (3) A sole business purpose of supplying goods, services or insurance at cost; and (4) The right of the members to a return of the premiums paid in excess of the amounts necessary to cover losses and expenses. The parties agree that appellant in the instant appeal does not meet the fourth criteria.

⁷ According to appellant, respondent treated appellant as a cooperative association only partially.

However, in this case, appellant relies heavily upon IRC section 277.⁸ That section was enacted as part of the 1969 Tax Reform Act. It places a limit on the deductions attributable to furnishing services, insurance, goods, or other items of value to members of a social club or other membership organization. Generally, the Internal Revenue Service allows those deductions only to the extent of the income derived during the year from members or transactions with members. However, Congress made a specific exception for organizations such as appellant. Congress noted that IRC section 277(a) was not to be applied to:

“...nonprofit (but taxable) membership organizations (such as the American Automobile Association) which operate in competition with profitmaking organizations which provide the same type of services as a ‘loss-leader.’ Because of this the nonprofit organization must set its dues at the same loss level. The nonprofit organization in such a case offsets the resulting losses with income received from nonmembers. . . . To deal with this problem, the committee’s amendments do not apply if the organization receives prepaid dues income as consideration for services rendered in competition with the charges made by other automobile clubs which are operated as loss leaders for profit organizations.”

(Senate Report 91-522, Tax Reform Act of 1969, reprinted in 1969-3 C.B. 471-472.) IRC section 277 (b) (2) provides that the deduction limit does not apply to any organization which “made an election before October 9, 1969, under [IRC] section 456(c) or which is affiliated with such an organization.” It is undisputed that appellant has made such an election.

Despite the clear language of IRC section 277, respondent takes the position that appellant cannot elect whether it will be treated as a cooperative association. Respondent claims that if a taxpayer fits the criteria of a cooperative, then the taxpayer has no alternative but to file franchise tax returns, reporting as a cooperative. It bases this assertion on the CSAA case and the case of Woodland Production Credit Association v. Franchise Tax Board (1964) 225 Cal.App.2d 293 (hereafter Woodland).

However, neither the CSAA nor Woodland case specifically addresses the issue of whether or not a taxpayer is restricted to either one filing status (cooperative) or the other (mutual benefit nonprofit corporation). We conclude that respondent’s interpretation of those cases is far too

⁸ Revenue and Taxation Code section 24437 adopts IRC section 277 by reference, except as otherwise provided.

restrictive. In CSAA, the taxpayer elected to be treated as a cooperative association for over 35 years. Similarly, in Woodland, the taxpayer did not dispute that it was an agricultural loan cooperative (although it did dispute whether it had to pay California

franchise tax based upon a federal statute).⁹ Thus, the cases are silent on the issue presently before the Board, i.e., whether appellant may elect to file as either a cooperative or a mutual benefit non-profit corporation. Absent legal authority restricting appellant from electing to file as a mutual benefit association, appellant may continue to do so.¹⁰

Accordingly, respondent's action regarding the proposed assessments is reversed and the protective claims for refund are denied.

⁹ In Woodland, the taxpayer, a farm credit association, was incorporated under the federal Farm Credit Act of 1933 (12 U.S.C., §1131d). When it incorporated, it issued two classes of stock. Class A (nonvoting) stock was purchased by the Production Credit Corporation (PCC), which was also a component of the federal farm credit system. Class B stock was purchased by farmer-members. At some time prior to 1952, the Class A (federally held) stock of PCC was retired. However, the taxpayer argued that it did not become subject to state franchise tax on that occurrence. The taxpayer claimed that section 63 of the Farm Credit Act of 1933 exempted it from state taxation. It agreed that when the stock was retired, the statute permitted taxation of the association, its property and income, but it argued that the state could not tax its franchise and funds, and thus, that the California corporation franchise tax did not apply. The court disagreed. While section 63 did not explicitly state that the taxpayer's franchise and funds were taxable, it did state that the exemption did not apply to any Production Credit Association or its property or income after the stock held in it by the PCC had been retired. This, coupled with the fact that the taxpayer was conducting business in California, was sufficient to allow state taxation.

¹⁰ During the hearing we questioned why appellant does not benefit from the cooperative association filing status, as CSAA did. No specific answer was provided to this question. However, it is not necessary that this accounting question be resolved, since our opinion allows appellant to elect continued filing as a mutual benefit non-profit corporation.

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 sections 19047 and 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Automobile Club of Southern California, against proposed assessments of additional franchise tax in the amounts of \$168,318.22, \$336,797.42, and \$218,374.39 for the income years ended December 31, 1987, 1988, and 1989, respectively, be and the same is hereby reversed, and further, that the action of the Franchise Tax Board in denying the claims of Automobile Club of Southern California for refund of franchise tax in the amount of \$1,489,303, \$321,932, and \$1,832,699, for the income years ended December 31, 1987, 1988, and 1989, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of November, 1998, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Klehs, Mr. Dronenburg, Ms. Bornstein* and Mr. Chiang** present.

Dean F. Andal Chairman

_____ Member

Ernest J. Dronenburg, Jr. Member

Julie Bornstein Member

John Chiang Member

* For Kathleen Connell, per Government Code section 7.9.

**Acting Member, 4th District